Special Reports

S Corporation Shareholder Salaries: A Question Of Source

by William A. Harwood

William A. Harwood, JD, CPA, Shaker Heights, Ohio.

Where there is a lack of guidance, surely a variety of results will follow. To claim general basket foreign tax credits, a corporation's employee shareholder must negotiate a complex interplay of S corporation, partnership, source, and foreign tax credit rules. The calculation requires determination of sources of income and deduction at both the entity and shareholder levels. Gross income, separated by source, will likely be duplicated if tax return preparation follows the scanty guidance available. Additional questions related to source of income with respect to shareholder salaries remain unanswered. This paper argues that the shareholder must make adjustments to gross income for purposes of calculating the credit. It concludes that compensation earned by the shareholder must be sourced consistently with the income source rules used at the entity level, and that compensations paid to each shareholder must not be treated as deductions for purposes of calculating that employee shareholder's foreign tax credit.

S corporations that pass foreign tax credits through to shareholders, and their tax advisers, face inadequate and sometimes misleading reporting guidelines from the U.S. Internal Revenue Service, and a dearth of published, privately produced analysis. A challenging interpretation of tax law affects especially those S corporations that have owners actively participating in the management of the business. Entities taxed as partnerships for U.S. tax purposes present unit holders with some of the same problematic reporting errors as encountered in the S corporation context. Unit holders of all these entities must grapple with issues for which there is little official or privately published guidance, and IRS instructions that can result in materially understated tax benefits to the unit holder returns. This article seeks to set forth a position regarding the proper accounting for foreign taxation; to highlight obvious irregularities that can arise in the preparation of an S corporation return; and to shed light on what some believe to be a correct interpretation of the foreign tax credit calculation rules for unit holders.

Scope of the Problem

Closely held U.S. businesses often operate in the form of a pass-through entity. As is common among closely held companies, the owner or owners of the business have an active roll in the management of the enterprise. In that role, S corporation owners generate a salary, and LLC/partnership owner/managers typically receive preferred returns or guaranteed payments. Those compensatory payments often represent a significant cost to the enterprise relative to overall net profits. Large compensations, while producing some tax inefficiencies compared to pure distributions of profits, often represent the only means of differentiating owner/managers from passive equity investors in allocation of the fruits of the business. Additionally, when financing the enterprise, covenants contained in lending agreements often restrict the amount of profit distribution to equity holders, leaving salaries as a preferred means of moving corporate profits to the owners.

With respect to foreign tax credits passing through from transparent entities, IRS compliance instructions and publications do more to obfuscate the compliance process than to provide elucidation. Few tax practitioners have the combination of international tax skills, significant closely held client companies, and time and inclination to vet and then protest issues that have limited appeal to the broader tax community or the IRS, much less to the courts and Congress. The lack of debate unfortunately has led to a dearth of illuminating commentary or guiding authority.

The problems encountered by S corporations and their owners occur in the systematic process of tax reporting, and begin with preparation of the corporate tax return. The return preparer will follow written instructions that accompany the Form 1120S. Those instructions lead the preparation through Schedule K, line 15, Foreign Taxes, and corresponding entries on line 15 of shareholders' K-1s. Line 15 requests "Total Gross Income from Foreign Sources," broken down by section 904 baskets. It also requests a detailed list of directly allocable expenses for each item of gross income, followed by a "pro rata share of all other deductions not directly allocable" and recharacterized losses. The corporation then reports the foreign taxes paid. Finally, line 15g instructs the preparer to enter "Other Foreign Tax Information." Instructions for the last entry clarify little, providing that one should "Enter in U.S. dollars any items not covered on lines 15c through 15f that shareholders need to complete Form 1116 (e.g., gross income from all sources)."

One might hope that regulations, revenue rulings, and procedures, or other published guidance would assist in the preparation of Schedules K and Form K-1, line 15g. Unfortunately, such guidance is nowhere to be found, and the return will presumably be finished by entering gross income from all sources on that line. Below is a sample preparation of corporate and shareholder returns.

An Example — Facts:

Xco International Inc., is a calendar-year U.S. S corporation that manufactures automotive parts at its base U.S. location and at its branch operation in Canada. Operations and sales divide somewhat evenly between the two manufacturing sites. The Canadian operation like that in the United States is fully integrated both operationally and administratively, although U.S. headquarters provides some executive oversight with respect to the Canadian branch and sets the strategic course for the overall group.

Xco Int'l ownership is equally shared by Susan Jones, president and CEO of the company, and her husband Dan, U.S. operations manager. Susan is the full-time entrepreneurial leader of the company, spending the vast majority of her time at the U.S. headquarters. She conducts executive meetings primarily in the United States and one meeting per quarter at the Canadian office. During 2001, she logged 10 business days in Canada. She also provides strategic guidance to the Canadian branch managers through conference calls and e-mail. Dan spent only four business days in Canada in 2001, during which he reviewed its operational procedures and discussed best practices with the Canadian managers.

In 2001, Xco Int'l generated total worldwide revenues of US $50,000,000. The U.S. operation contributed revenues of US $20,000,000 with the balance generated out of Canada. Both operations produced a 15 percent gross margin. Combined net income for 2001, before income taxes, totaled US $2,100,000. The U.S. calculation of net foreign-source income, all attributable to the Canadian operation, yielded US $1,400,000. Canadian income taxes of US $700,000 were assessed on the branch, inclusive of Canadian withholding tax attached to profits repatriated to headquarters.

Susan received a salary plus bonus of US $700,000 from the corporation, Dan received US $500,000, and together they reported US $150,000 of additional U.S.-source income on their U.S. joint income tax return. The total taxable income shown on their 2001 joint tax return was US $3,200,000. U.S. federal income tax, before foreign tax credits, amounted to US $1,224,000.

Preparation of the Corporate Tax Return — The IRS Way

Results of 2001 operations are summarized in Table 1.

Our example makes the following assumptions about the corporate treatment of shareholder compensation. Allocable expenses include all but that portion of Dan's total compensation that relates to his 236 workdays in the United States, which we treat as directly allocable to U.S.-source income. The Canadian amount, US $8,333,[1] is added to the full amount of Susan's compensation with the total apportioned to U.S.- and foreign-source income based on gross income.

With the preparation of the corporate tax return, Schedule K, line 15 will report US $4,500,000 of general basket foreign-source income, divided between Dan and Susan's personal K-1s according to

[1]Reg. sections 1.861-8(e), 1.861-8(g) Example (21). In this Xco Int'l example, of 240 workdays, 4 are spent out of the United States. (4 / 240 X $500,000 = $8,333).

Table 1

Xco International Inc. (in US$)	Total	Canada	U.S.
Sales	50,000,000	30,000,000	20,000,000
Cost of Goods Sold	(42,500,000)	(25,500,000)	(17,000,000)
Gross Income	7,500,000	4,500,000	3,000,000
Less Allocable Expenses[a]	4,600,000	2,620,000	1,980,000
Less Expenses — Apportioned[b]	800,000	480,000	320,000
Shareholder Compensation Included Above	1,200,000	425,000	775,000
Net Income of S-Corp	2,100,000	1,400,000	700,000
Actual Foreign Taxes Paid/Accrued		700,000	

[a]Reg. section 1.861-8(b).

[b]Reg. sections 1.861-8(g) Example (21), 1-861.8T(b)(3).

their respective percentage of ownership. Similarly, expenses allocable and apportioned to gross income, US $2,620,000 and US $480,000 respectively, are reported on the K-1s. Following the instructions for line 15g, gross income from all sources is reported as US $7,500,000.

Dan and Susan file a joint income tax return and show adjusted gross income of $3,450,000, composed of $2,100,000 of income flowing through from Xco Int'l, $1,200,000 of salaries, and $150,000 of other income. They itemize their deductions, reporting mortgage interest expense of $69,512, state income taxes of $190,000 (paid on income with the same foreign/U.S.-source breakdown as is used for calculation of the foreign tax credit), and other apportionable deductions (other taxes and contributions) totaling $90,000. The AGI-based reduction in itemized deductions totals $99,512.[2] Table 2 illustrates the apportionment of itemized deductions between foreign-source income and U.S.-source income following reduction for limitation of these expenses under section 68.

Table 2

	Total	Foreign	U.S.
Total Gross Income (see Table 3)	8,850,000	4,537,500	4,312,500
Adjusted Gross Income	3,450,000	1,437,500	2,012,500
Home Mortgage Interest[a]	69,512	25,492	24,228
State Income Taxes Allocable[b]	190,000	56,627	79,277
Apportioned Deductions[c]	90,000	33,006	31,369
Total Itemized Deductions	349,512	115,125	134,875
Reduction Under Section 68	99,512		

[a]Reg. section 1.861-9T(d)(iv).

[b]Reg. section 1.861-8(e)(6)(ii). Income taxes, in this hypothetical, have been allocated based on federal AGI as an approximation of state taxable income.

[c]Reg. section 1.861-8(e)(9)(ii) relating to property taxes on a personal residence and section 1.861-8(e)(9)(iv) relating to charitable contributions.

Table 3 is an extract of essential elements from Susan and Dan's Form 1116 "Foreign Tax Credit." The calculations in the table follow all available official information concerning calculation of the credit including IRS-provided instructions for Forms 1116, and 1120S (including Schedules K and K-1), Publication 514, and final, temporary, and proposed regulations. This income consists of the sum of net income passed through from Xco Int'l, plus that portion of salaries that has a foreign source (see Table 3, footnote a).

What Is Wrong With This Approach?

While the $505,808 foreign tax credit produced at Table 3 follows naturally from input of the various tax attributes related to Dan and Susan's 2001 financial year, the IRS calculation process leaves the discomfort of a dissonance in the interplay between tax practice and tax theory. On the individual tax returns, reported gross income from both worldwide and foreign sources includes compensation, other items of income, and all items of gross income reported on the K-1s from Xco Int'l. An S corporation that reports gross income items on Form K-1, line 15, generally includes in those reported numbers the same

[2]Code section 68. IRS instructions for Form 1116 (foreign tax credit) require allocation of the section 68 AGI limitation on itemized deductions. "If you must reduce the total amount of your itemized deductions on Schedule A (Form 1040), line 28, because your adjusted gross income was more than $132,950 ($66,475 if married filing separately), you must reduce each of the itemized deductions that are subject to the reduction by the reduction percentage before you complete lines 2, 3a, and 4a."

Table 3

Form 1116-Per Instructions		
Foreign-Source Gross Income — K-1s[a]	$4,500,000	
Foreign-Source Compensation[b]	37,500	
Total Foreign-Source Gross Income		4,537,500
Deductions From K-1 Line 15	3,100,000	
Apportioned State Income tax	56,627	
Allocable Deductions	3,156,627	
Gross Income — All Sources[c]	8,850,000	
Foreign-Source Percentage	0.5127	
Apportioned Itemized Deductions	33,006	
Apportioned Mortgage Interest	25,492	
Total Deductions		3,215,125
Foreign-Source Taxable Income		1,322,375
Taxable Inc Before Exemptions		3,200,000
Foreign-Source Percentage	0.4132	
Foreign Taxes	700,000	
U.S. Tax Before Credits	1,224,000	
Credit Maximum	505,808	
Foreign Tax Credit		505,808

[a]Foreign-source gross income is comprised of foreign-source income shown on the K-1s of the S corporation, plus compensation for services performed outside of the United States. Reg. section 1-862-1(a)(1)(iii).

[b]Foreign-source compensation is apportioned based on days out of the United States (10/240 of Susan's salary plus 4/240 of Dan's salary).

[c]Salaries, plus gross income from K-1s line 15, plus other U.S.-source income.

income out of which shareholder salaries and wages are paid.[3] Salaries are effectively included twice in the amounts of gross income.

In our example, we assume that the corporation includes no portion of Susan or Dan's salary payments in the calculation of cost of sales. The entire amount of the salaries is included in determining gross income from both foreign and worldwide sources, even though the salaries were deducted to arrive at corporate net income *after* the corporation computed its gross income from each source. Instructions to Form 1116 call for the individual taxpayer, among other things, to add compensation to gross income reported on each Form K-1.

A Better Way

Susan and Dan must make an adjustment to avoid gross income duplications that occur in strictly following IRS instructions. The adjustment will affect the allocation and apportionment of expenses used in calculating the foreign tax credit amount on their personal tax return.[4]

Individual-level adjustments to gross income might be accomplished in one of two ways. First, Susan and Dan might treat the salaries like guaranteed payments under partnership rules. If the salaries are treated as distributions of profits, they effectively generate income sourced in a manner consistent with the sourcing of the net income of the S corporation, determined before the payment of salaries. Second, Susan and Dan can similarly treat the wages as a distribution of profits, akin to guaranteed payments, but with the salaries treated as deductions on the individual return. The deductions have source determined consistently with the code section 861(a)(3) compensation rules. Employing either of the two alternative strategies results in a redetermination of some attributes of partnership income. In both cases, adjusted partnership net income should be the same in total and by source. But a subtle difference between the two approaches can materially change the net tax liability.

Table 4 illustrates the corporate income, by source, before taking the corporate-level deductions for the salaries of Susan and Dan.

Credit Calculation — S Corp. Income Sourced by Reg. Section 1.861-8: Alternative One

Determination of gross income for purposes of allocation and apportionment of expenses results in a straightforward separation by source. As Table 4 illustrates, one simply reduces corporate expenses deducted for both U.S.-source and foreign-source by that portion of the salaries that has been

[3]Shareholder salaries would not be represented in the reported corporate gross income numbers if and to the extent those salaries are included in cost of sales.

[4]To the extent that a portion of shareholder salaries has been allocated to cost of goods sold, that portion will have reduced reported gross income from the S corporation and must remain in reported gross income on the individuals' Form 1116.

Table 4

Xco International Inc.	Total	Canada	U.S.
Sales	50,000,000	30,000,000	20,000,000
Cost of Goods Sold	(42,500,000)	(25,500,000)	(17,000,000)
Gross Income	7,500,000	4,500,000	3,000,000
Less Allocable Expenses[a]	-4,600,000	-2,620,000	-1,980,000
Less Expenses — Apportioned[b]	-800,000	-480,000	-320,000
Shareholder Compensation Included Above	1,200,000	425,000	775,000
Net Income of S-Corp	3,300,000	1,825,000	1,475,000
Actual Foreign Taxes Paid/Accrued		700,000	

[a]Reg. section 1.861-8(b).

[b]Reg. sections 1.861-8(g) Example (21), 1-861.8T(b)(3).

allocated and apportioned to the respective sources of gross income at the corporate level. The reduction will result in an inconsistency between the amounts of deduction reported on Schedule K-1, line 15d and the amount reported as directly related deductions on line 2 of the individuals' Form 1116. There will also be a need to report on the Form 1116 total gross income from both foreign sources (line 1) and from all sources (line 3e), adjusting to amounts that are less than called for by instructions. The reduction in gross income reported will be equal to the amount of salaries.[5]

As can be seen from Table 5 and Table 6, the elimination of duplicated sources of gross income materially affects the calculation of the foreign tax credit. In our example, backing out salaries results in unfavorable changes in the allocation and apportionment of individual-level itemized deductions. Compare the results produced in Table 2 with those of Table 5. Our salary adjustments in Table 5 increase both the relative portion of total gross income that has a foreign source used in apportioning mortgage interest and other itemized deductions, and the relative portion of total adjusted gross income with a foreign source, which we use as the basis for allocating state income taxes.

While the size of both foreign-source gross income and foreign-source adjusted gross income increase significantly relative to the gross income and adjusted gross income amounts from all sources, the most significant effect of backing out shareholder salaries results from the reduction in corporate-level foreign-source expenses that one allocates and apportions to foreign gross income. Deductions apportioned to foreign-source income at the corporate level become deductions directly allocable to an S corporation's gross foreign-source income for purposes of the individual shareholders' calculation of the foreign tax credit.[6] Elimination of shareholders' salaries results in the elimination of the entire amount of shareholder salaries allocated to foreign sources at the corporate level. Consequently, while a larger portion of a shareholder's itemized deductions is allocated and apportioned to gross foreign-source income, the total deductions taken to arrive at net foreign-source income on Form 1116 become lower, and the net foreign-source income increases.

Table 6 presents the first alternative for calculating Susan and Dan's foreign tax credit. This method of calculating the credit seems appropriate and consistent with the overall economics of their financial results.

Table 5

Form 1116	Total	Canada	U.S.
Gross Income From S-Corp	7,500,000	4,500,000	3,000,000
Wage Adjustment	(1,200,000)	(37,500)	(1,162,500)
Other Income	150,000	–	150,000
Total Gross Income	7,650,000	4,500,000	3,150,000
Adjusted Gross Income[a]	3,450,000	1,825,000	1,625,000
Apportioned Mortgage Interest	69,512	29,248	20,473
State Inc Taxes Allocable	190,000	71,891	64,013
Apportioned Deductions	90,000	37,868	26,508
Itemized Before Reduction	349,512	139,007	110,993
Reduction From AGI	99,512		

[a]*See* Table 4.

[5]*See* discussion under "Disclosures" in this article.

[6]Reg. sections 1.861-8(a)(3)(xiii) and 1.861-8(b).

Table 6

Form 1116 — Eliminating Salaries		
Foreign-Source Gross Income		4,500,000
Allocable Deductions[a]	2,746,891	
Gross Income — All Sources	7,650,000	
Foreign-Source Percentage	0.5882	
Apportioned Itemized Deductions	37,868	
Apportioned Mortgage Interest	29,248	
Total Deductions		2,814,007
Foreign-Source Income		1,685,993
Taxable Inc Before Exemptions		3,200,000
Foreign-Source Percentage	0.5269	
Foreign Taxes	700,000	
U.S. Tax Before Credits	1,224,000	
Credit Maximum	644,892	
Foreign Tax Credit		644,892

[a]These directly allocable deductions consist of the Canadian-sourced expenses, determined at the corporate level, net of allocated and apportioned shareholder salaries (*see* Table 4), plus individual income taxes treated as direct expenses (*see* Table 5).

Calculation of the Credit Sourcing Salaries Under Section 861(a)(3): Alternative Two

One might argue that the compensation amount should be treated as an expense of the corporation for purposes of calculating a shareholder's foreign tax credit. Applying that suggestion to the credit calculation would source gross and adjusted gross income as presented in Tables 5 and 6, but treat salary compensations as a deduction for purposes of calculating the shareholders' foreign tax credits. Presumably, the source of the deduction would be determined by allocation under code section 861(a)(3). In our example, $37,000 of compensation would be picked up as a foreign-source deduction under the time rule.[7] With the increase in allocable deductions, net foreign-source income must decrease, resulting in a smaller credit. Table 7 illustrates this effect.

Which Alternative Is Correct?

The tax credit result generated following elimination of duplicated gross income and presented in Tables 4, 5, and 6 seems to run head on into the source rule of code section 861(a)(3),[8] lending support for alternative two. However, as discussed above, the source rule of section 861(a)(3) loses traction when one eliminates from the corporate net income the allocated and apportioned shareholder compensation deductions.

We seem to be faced with an irreconcilable conflict. Resolving this conflict, code section 1373 provides that for purposes of calculating the foreign tax credit, an S corporation should be treated as a partnership,[9] and the shareholders of the corporation should be treated as partners of the partnership.[10] If one adopts the "plain meaning" of the statutory provision, we move directly to subpart K of the code and section 707, which deals with transactions between a partnership and its partners.

Analyzing S corporation shareholder compensations under section 707 introduces the complications of guaranteed payments. Section 707 largely turns on whether a partner acts in the capacity of a partner.[11] Differing

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[7]Reg. section 1-861-4.

[8]Code section 861(a)(3) provides that gross income from sources within the United States should include "compensation for labor or personal services performed in the United States."

[9]Code section 1373(a)(1).

[10]Code section 1373(a)(2).

[11]Code section 707 provides:

(a) **Partner not acting in capacity as partner. —**

(1) **In general.** If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.

(2) **Treatment of payments to partners for property or services.—** Under regulations prescribed by the Secretary—

(A) Treatment of certain services and transfers of property.—If—

(i) a partner performs services for a partnership or transfers property to a partnership,

(ii) there is a related direct or indirect allocation and distribution to such partner, and

(iii) the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, such allocation and distribution shall be treated as a transaction described in paragraph (1).

Table 7

Form 1116 — Eliminating Salaries	Exclude Wage From Gross	
Foreign-Source Income	–	4,500,000
Allocable Deductions	2,784,391	–
Gross Income — All Sources	7,650,000	–
Foreign-Source Percentage	0.5882	–
Apportionable Deductions	37,868	–
Home Interest App'd Foreign	29,248	–
Total Deductions	–	2,851,507
Foreign-Source Income	–	1,648,493
Taxable Inc Before Exemptions	–	3,200,000
Foreign-Source Percentage	0.5152	–
Foreign Taxes	700,000	–
U.S. Tax Before Credits	1,224,000	–
Credit Maximum	630,549	–
Foreign Tax Credit	–	630,549

tax treatments may result based on how the issue is resolved. What constitutes "in the capacity of a partner" is the subject of substantial authoritative interpretation. In 1984, Congress expanded section 707 to provide more definitive rules on when a transaction between a partnership and partner will be treated as not entered into with a partner. The Senate Committee Report stated an intent to preserve "the general rule [where section 707(a) will not apply] . . . in cases in which a partner receives an allocation (or an increased allocation) for an extended period to reflect his contribution of property or services to the partnership provided the facts and circumstances indicate that the partner is receiving the allocation in his capacity as a partner."[12] The report went on to outline six factors to consider in determining whether a partner is compensated in the capacity of a partner.

1. Whether the payment is subject to an appreciable risk as to amount.

2. Whether the partner status of the recipient is transitory

3. Whether distributions are made close in time to the partner's performance of services

4. Whether facts and circumstances indicate that the recipient became a partner primarily to obtain otherwise unavailable tax benefits for himself or the partnership.

5. Whether the value of the recipient's interest in general and continuing partnership profits is small in relation to the allocation in question.

6. Whether the requirement that capital accounts be respected under section 704(b) makes income allocations that are disguised payments for capital economically unfeasible and therefore unlikely to occur.

Regulations issued under section 707 largely echo the stated purpose of the 1984 amendments. Those regulations generally focus on business relationships in a way that each may be classified as either in the nature of consideration for property and/or "outside" services, or as guaranteed payments of cash flow to those partners who spend significant time in the management of a partnership business.

The first five factors identified in the Senate Committee Report strongly support a determination that Susan and Dan received compensation for services provided in their capacity as business owners. Their compensation is certainly subject to the risk of significant decline in corporate profitability. Each is employed long term with compensation paid in predictable, regular intervals without any variation that is based on the execution of individual services. Susan and Dan's legal relationship with the company did not arise from any motivation to capture special tax benefits. Their interest in continuing firm profits is absolute. The salary arrangements evidence a continuing relationship and contemplate that each shareholder renders services essential to the corporate business. The relationship of services provided to management of the fundamental business activities of the corporation indicates that the shareholders are acting in a capacity akin to one compensated for services performed in the capacity of a partner.[13]

Section 707 and the regulations also address the issue of guaranteed payments and the treatment of such payments for purposes of both the partnership and its partners.[14] The statute and regulation both treat any payment for services, the amount of which is determined without regard to the income of the partnership, as a

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[12]Committee Report on P.L. 98-369 (Deficit Reduction Act of 1984).

[13]*E.T. Pratt v. Comm'r*, 64 TC 203, (1975).

[14]Code section 707(c), reg. section 1.707-1(c).

guaranteed payment. Both also state that the guaranteed payments are treated as payments to nonpartners, but only for limited purposes under the code. The nonpartner treatment applies "only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses)." The regulation further states, "Guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b).[15] For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income."[16]

There has been a fair amount of litigation over interpretation of the "only for the purpose of" language in code section 707(c) and its regulations.[17] No court appears to have addressed the specific matter of foreign tax credits and treatment of guaranteed payments as deductions sourced against domestic and foreign income from a passthrough entity. One can conclude that the section 707 "only for" language pours guaranteed payments into the general category of partnership profits. Other regulatory provisions support the inclusion of guaranteed payments in the general characterization of partnership profits.[18] There appears to be no statutory or regulatory provision or compelling interpretation of the provisions that would require the recipients of the guaranteed payments to treat a portion of the payments as deductions for purposes of calculating their foreign tax credit limitations.

Miscellaneous Matters

Several commonly encountered variations demand some elucidation. The above analysis holds water best when the shareholders receive compensations from services typical to an employment environment. Such services will usually be provided in their capacities as owners. Consider, on the other hand, that Dan's compensation derived exclusively from the provision, through his wholly owned law firm, of legal services to the company. In that situation, it can be argued that no adjustment for foreign tax credit calculations would be made with respect to his compensation. It also seems that gross income, for purposes of calculating Susan and Dan's foreign tax credit, would include the entire gross income flowing through from the S corporation plus the entire amount of Dan's compensation for legal work. While it is true that the gross income from legal fees is extracted from the gross income of the S corporation, Dan's legal business constitutes a completely separate line of business and the legal fees paid him by Xco Int'l constitute a completely separate source of gross income.

> Properly accounting for S corporation shareholder salaries in the calculation of their foreign tax credits can produce significantly enhanced benefits.

A second variation from our simple example must also be considered. Usually, a larger S corporation will have a number of shareholders, many of whom do not participate in the day-to-day management of the company and accordingly do not draw salaries. Those inactive shareholders

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[15]None of these three code provisions is relevant to our example. Sections 706 and 708 deal with the need for conforming fiscal reporting years and continuation or termination of a partnership on the occurrence of certain events, respectively. Section 707(b) concerns the treatment of certain property sales between a partnership and one or more of its partners.

[16]Reg. section 1.707-1(c) contains several examples including: "*Example (2).* Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30 percent of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment."

[17]*Carey v. U.S.*, 427 F2d 763 (Ct.Cls. 1970) held that, contrary to the position of the Commissioner, the "only for purposes of" language did not prevent an overseas-stationed partner from claiming a deduction under section 911 for guaranteed payments received from his U.S.-based partnership.

In *Kampel v. Commissioner*, 634 F2d 708 (CA-2, 1980) the Service again invoked the "but only" language to limit the taxpayer's earned income amount, subject to a lower rate of tax, to 30 percent of his total share of partnership income. The court refused to rule for the taxpayers, who argued that the portion of his total partnership profits represented by guaranteed payments should be treated as the equivalent of salary and subject to the 50 percent maximum tax rate of section 1348.

[18]Reg. section 1.904-5(h)(1) provides that "a partner's distributive share of partnership income shall be characterized as income in a separate category to the extent that the distributive share is a share of income earned or accrued by the partnership in such category. Payments to a partner described in section 707 (*e.g.*, payments to a partner not acting in capacity as a partner) shall be characterized as income in a separate category to the extent that the payment is attributable under the principles of section 1.861-8 and this section to income earned or accrued by the partnership in such category, if the payments are interest, rents, or royalties that would be characterized under the look-through rules of this section if the partnership were foreign corporation, and the partner who receives the payment owns 10 percent or more of the value of the partnership."

should not adjust the gross income and deduction numbers provided them on line 15 of their S corporation Form K-1. In keeping with the analysis under the partnership rules, salaries paid to active shareholders, akin to guaranteed payments, produce deductions that reduce the amount of net business income reported to shareholders. Passive shareholders generally do not derive other income from the entity so they have no gross income duplication. If passive shareholders exist, however, the salaried shareholders must be careful to limit the adjustments discussed herein to that same proportion as their ownership bears to overall share ownership.

Disclosure

One additional question remains with respect to the making of gross income and allocable expense adjustments on the shareholder return. Query whether the shareholder must disclose an inconsistent treatment.[19] Since the reporting of income on page one of the individual tax return conforms to all reporting on Forms W-2 and S corporation Schedules K-1, one might conclude that no inconsistency gives rise to the need for such disclosure. However, code section 1366(c) requires the reporting of corporate gross income where "it is necessary to determine the gross income of a shareholder." Since the W-2 salaries of the shareholder are included in gross income under code section 61(a)(1), any reduction in the sum of the pro rata portion of gross income reported on Form K-1 plus W-2 salaries does constitute an inconsistent treatment.[20] While one should disclose changes in the reporting of gross income and deduction amounts on the individuals' Form 1116, care should be taken to clearly explain the adjustments and to provide rationale.

A better approach would seem to be to avoid the disclosures suggested by section 6037 by making adjustments on the corporate return. Such adjustments would appear on detailed schedules related to Form 1120S, Schedule K, and Form K-1 at the respective lines 15g.

Conclusion

Properly accounting for S corporation shareholder salaries in the calculation of their foreign tax credits can produce significantly enhanced benefits. There are fact patterns under which the approach outlined above will reduce available credits compared with calculated credits strictly following official instructions. However, typical scenarios involving managing shareholders who spend the majority of their work time in the United States uniformly produce enhanced benefits using the gross income adjustments. Like many international tax issues, each set of facts and circumstances carries with it distinct arguments concerning allocation and apportionment. The foreign tax credit calculation, notwithstanding concerted IRS efforts to introduce uniformity and predictability, is likely to remain as much an art as a science. ✦

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[19]Code section 6037(c).

[20]To date, the IRS has not promulgated regulations under section 6037(c). Similar provisions at sections 6222 and 6231, relating to consistent treatment on partnership and partner returns, and former sections 6241-6245, related to consistent treatment of S corporation and its shareholders' returns, required disclosure with respect to matters affecting the partner and shareholder returns beyond page one (to adjusted gross income).