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Year-End 2009: S Corporations and Partnerships

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Unlike the other year-end tax newsletters and flyers you've been receiving from your accountants and other tax advisors (all of which you should be reading and heeding), this newsletter is addressed to those of you who are wondering what effect your business or partnership interests have on your 2009 tax bottom line.

Any sort of year-end tax planning typically includes whether to rush or delay income and deductions; the reasons are usually clear, and I discuss those in greater detail in [last year's year-end newsletter](#).

Shareholders in S Corporations

As an individual, you have some control over whether to rush/delay. As a shareholder in an S Corporation ("S" stands for "small", by the way), the same decisions generally apply, since items of income, profit, deduction, and loss are passed through to you. However, those items are also passed through to your fellow shareholders, who may have a different view of how to treat these items at the corporate level. Additionally, you and the other shareholders may also be filing joint returns with spouses, in which case that person's income, income characterization, and tax liability should also be considered.

If you expect that the S Corporation may pass through a loss to you, you also need to consider whether that loss is a loss that you can write off against your other income. Passive losses (e.g., losses from rental activity) can not be written off against ordinary income (e.g., wages, earned income). Ordinary losses from the S Corp can not be used to reduce portfolio income (e.g., interest, dividends, royalties, and gains or losses from investments).

What does this mean? It means that if you have an S Corporation that's going to give you an ordinary loss, you won't be able to use that loss against

your passive activity income or your portfolio income activity. Practically speaking, this means that those of you who have an S Corporation business (that passes through a loss) and also own rental property (that passes through a profit) will not be able to use that loss to write off against that income. In deciding whether to accelerate or delay, this becomes a very important consideration, and one which many people fail to address before December 31. (It is, after all, the holiday season.)

In addition, even if your S Corporation has an ordinary loss, you will not be able to use that loss even to reduce your ordinary income (or your spouse's ordinary income - ah yes, the spouse that actually had a job this year while you tried to get your business off the ground) unless you have basis in your stock in the S Corporation. Basis is, generally, the amount you paid for the stock; frequently in a corporation it's the money you put in to start the business - for many people this is \$0 or minimal, especially if you started the business with an outside loan/source. Basis can also increase by your loan(s) to the corporation. (A full discussion of the concept of "basis" is beyond the scope of this newsletter, and is frequently the subject of tax controversy.)

So what happens when you have a loss and zero basis? Your loss, the loss that passed through to you (whether characterized as ordinary or passive) will carry over for you to use the next year (if you can). These determinations are all made as of December 31 (for calendar year corporations), and thus a loan, for example, if in place by that date, would act to increase your basis.

Partnerships

The rules for partnerships, and the losses from them, are similar to S Corporations. The basis rules apply, and the limitations on the types of losses that can be used to offset income are generally the same. The carryover rules also apply. Losses passed through to limited partners, absent certain safe harbor exceptions, are, by default, passive losses.

In Summary

Plan now. It's a pain, but talk to your tax preparer or advisor before the end of the year. It will force you to get your taxes in order, and there's a chance it could provide you with significant savings, or even a better understanding of what April 15 is going to look like.

This article is intended as a general guideline. The rules are complex, and changing continually. Please consult your tax advisor.

If you have any questions or suggestions for article topics, please feel free to email David

at dherzog@pinnaclelawgroup.com.

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