PacificCPE

COURSE
32801A

S Corporation: Electing S Status and Trust Shareholders

Deciding whether to elect S corporation status is one of the most consequential choices a business owner can make. This course walks through the key tax considerations involved in making that election, helping practitioners spot planning opportunities and potential pitfalls early. It also covers the specific types of trusts that qualify as S corporation shareholders—a nuanced area that frequently comes up in estate planning and ownership structuring engagements. Ideal for CPAs and tax advisors working with closely held businesses and high-net-worth clients.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify tax considerations in electing S corporation status.
- Recognize types of trusts that can be a shareholder of an S corporation.

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Chapter 1: TAX CONSIDERATIONS IN ELECTING S CORPORATION STATUS

Chapter Objective

After completing this chapter, you should be able to:

- Identify tax considerations in electing S corporation status.

101 INTRODUCTION

The S corporation entity form has changed significantly since its creation by Congress in 1958. Even its name has changed from the legalese "Subchapter S corporation" to the current "S corporation" after passage of the Subchapter S Revision Act of 1982. It is favored by many because it offers many of the benefits of partnership taxation while giving shareholders limited liability from creditors, bankruptcy, and the like. Law changes continue to fine-tune the S corporation form making it a valuable vehicle for conducting business both in the United States and abroad.

Today, the S corporation, a federal tax hybrid entity, must also be compared with the limited liability company (LLC), a state tax hybrid entity. An S corporation resembles an LLC in operation and concept; however, there are distinct differences. LLCs composed of two or more members work strictly on partnership taxation principles. In many ways, the taxation of an S corporation resembles a partnership; however, partnership tax law does not always apply (e.g., an S corporation cannot allocate income the way a partnership can; distributions of appreciated property are generally taxable).

It may be asked why taxpayers would want to use an S corporation rather than an LLC in view of the similarity of tax principles. Under current tax law, the unique partnership tax principles are only available in an LLC if there are two or more taxpayers. In contrast, S corporations require only one taxpayer to operate. Also, S corporations offer unique planning possibilities not available in LLCs (e.g., the creation of capital gains).

An S corporation's ordinary income and loss is not taxed at the corporate level; rather, it is passed through to the shareholders as in a partnership. Likewise, an S corporation's foreign income and loss, tax-exempt interest, charitable contributions, and passive income are also passed through to the shareholders. Because of this one level of taxation, many individuals elect S corporation status to operate their corporations. In doing so, they avoid the tax technicalities of "regular Form 1120 corporations, commonly known as C corporations (e.g., tax on accumulated surplus, disguised dividends, personal holding company taxation).

The text that follows discusses the primary advantages of using the S corporation form. Additionally, tax pointers offer methods to take advantage of the quirks in the law as well as ways to avoid the pitfalls.

102 ADVANTAGES OF HAVING AN S CORPORATION

Below are 16 income tax reasons why taxpayers elect S corporation status.

.01 Tax-Free Contributions to the S Corporation

When certain requirements are met, taxpayers can contribute assets to an S corporation tax free.

Tax Pointer

Sales tax could arise on a transfer however, if the transfer is not done properly. In Weichbrodt, sales tax was imposed when a shareholder contributed additional property to his S corporation. For a discussion of the imposition of sales tax on a transfer of property and the means to avoid it, see 103.

Contributions of property when debt exceeds basis. When an S corporation shareholder contributes appreciated property encumbered by debt in excess of basis, gain must be recognized. The character of this gain (capital or ordinary) will depend upon the nature of the contributed property.

Example 1-1

Marlene Smith contributes real estate to a newly formed corporation in exchange for 30% of its stock. Her tax basis in the real estate is $150,000; its fair market value is $250,000. The property is encumbered by a $200,000 mortgage. Because the mortgage on the real estate exceeds Smith's basis in the property, she will be required to recognize a $50,000 gain upon transfer of this property to the corporation. The character of this gain will depend upon the nature of the property in Smith's hands prior to the transfer. If it was a capital asset to her, the gain will be capital. See 1117 for further discussion for a means to eliminate this tax.

.02 Protection from Creditors

An S corporation, because it is a corporation, provides its shareholders with protection from corporate debts and against the corporation's creditors throughout the world. The only statutory requirement that the S corporation has to meet for this worldwide creditor protection is to be a domestic corporation. Like any other corporation, certain formalities must be observed, such as an annual meeting of shareholders.

In contrast, LLCs are a relatively new concept in the United States, having started in 1977. While LLCs do have their counterparts in other areas of the world, such as the Satre in France and the GmbH in Germany, there is not a body of law established (as with the S corporation) to detail protection to the owners. Thus, particularly for international operations, until there is an adequate body of law established for LLCs, the better business vehicle is often an S corporation. While an S corporation by definition provides liability protection, shareholders may want additional protection from creditors by creating a chain of entities to own the stock such as having a grantor trust own a single member limited liability company which in turn owns the S corporate stock. Such an ownership situation was approved in IRS Letter Ruling 200339026 (June 23, 2003).

.03 Avoidance of Double Taxation

For individuals starting a business, the S corporation is an ideal business vehicle because, unlike a C corporation, it avoids double federal taxation, having only one level of taxation at the shareholder level. The S corporation's income is taxed to the shareholders. In contrast, a C corporation's income is taxed twice: first at the corporate level and again when the income is distributed to the shareholders.

Tax Pointer 1

A C corporation can convert to an S corporation to avoid double taxation; however, the S corporation may be subject to a built-in gains tax, a passive investment income tax, a LIFO recapture tax, and general business credit recapture.

Tax Pointer 2

Conversion from a C corporation to an S provides interesting tax planning possibilities when the C corporation has suspended passive losses. For a discussion of this planning possibility, see 404.08.

.04 No Recharacterization of Pass-Through Items

S corporations pass through certain items of income, expense, and the like to the shareholder without recharacterization. Consequently, S corporation charitable contributions are not subject to the 10 percent limitation imposed on C corporations. However, S corporations cannot take advantage of two charitable contribution techniques available to C corporations: contributions of inventory and scientific equipment.

.05 Immediate Deduction for Losses

If heavy start-up losses are expected or an operating C corporation anticipates a period of heavy losses, an S election should be considered since S corporation losses are deductible in the year incurred to the extent of a shareholder's basis in S corporation stock and loans to the corporation.

Tax Pointer 1

If the shareholder has more losses than basis in stock and loans, the unusable losses generally may be carried forward indefinitely and taken when the shareholder's basis increases.

Tax Pointer 2

If the loss from an S corporation is passive, the passive loss is only deductible to the extent of passive income.

.06 Code Sec. 199A Available to S Corporations

As discussed at 725, Code Sec. 199A applies to S corporations. In contrast, no such provision is applicable to C corporations. The OBBBA made this permanent.

.07 No Personal Holding Company Tax or Accumulated Earnings Tax

An S corporation, unless it has C corporation earnings and profits, can engage in 100 percent passive investment activities without adverse tax consequences or additional tax liability. In contrast, a C corporation can have a tax imposed on it for its passive investment activities, depending upon the number of its shareholders and the dollar amount of its passive investment income.

Also, a C corporation is subject to penalty taxes if it accumulates its earnings and profits excessively instead of distributing them as dividends to its shareholders. In contrast, an S corporation can accumulate its earnings and profits with impunity, as can an LLC and a partnership. However, the following nontax risk should be noted—creditors have a source of funds for satisfying their claims.

Example 1-2

Bill Ortiz, a pediatrician, incorporates himself as a professional corporation, electing S status on formation. Rather than distributing the earnings and profits of the corporation as they are earned, Ortiz leaves the funds in the corporation for its future growth. The corporation purchases a building, and one day, a brick of the building drops on a patient, Andrea Cruz, and seriously injures her. Cruz sues the corporation, but discovers that the corporation accidentally let the insurance on the building lapse. In the course of the lawsuit, the corporation's profits of $1 million are discovered. Because Cruz learns of the accumulated profits, settlement becomes difficult. If Ortiz had distributed the earnings and profits by salary or as a distribution, only the assets remaining in the corporation would be available to the injured party.

.08 One Level of Taxation in the Sale of a Business

When an S corporation sells its business assets, the shareholders pay tax at one level—the shareholder's level. In contrast, a C corporation will generally pay tax at two levels—once at the corporate level when the assets are sold and again at the shareholder level when the net proceeds are distributed.

Example 1-3

Omega Inc., a calendar-year C corporation, has one shareholder, Bud Taylor, who started the corporation on January 1, 2003. On that date, Taylor contributed $5,000 for 100 shares of stock. On January 2, 2003, Omega Inc. bought as an investment, vacant land, Glenwood, for $5,000 and held the land, its sole asset, until December 31, 2026. Omega Inc. had no other transactions since inception, and on December 31, 2026, Omega Inc. sold Glenwood for $55,000 to an unrelated third party, Sam Peterson, realizing a gain of $50,000 ($55,000 − $5,000 of basis in the land). Omega's tax bracket per Code Sec. 11(b) is 21 percent meaning it paid $10,500 of corporate income tax (21% × 50,000 = 10,500) and it distributed the net proceeds from the sale of Glenwood to Taylor. This would mean Taylor will receive a dividend of $39,500 ($50,000 − (21% × $50,000)). Assume that Taylor's income tax rate is 24 percent; thus he is in the 15 percent dividend rate. The net proceeds to Taylor on the transaction are $33,575 computed as follows: (corporate net income of $50,000 − (21% × $50,000) = $39,500); (15% × $39,500) = $5,925; (50,000 − (10,500 + 5,925) = 33,575). In contrast, if Omega Inc. was an S corporation from inception and the capital gains rate was 15 percent, Taylor would have paid tax of only $7,500 (.15 × $50,000) leaving him a net of $42,500 on the sale ($50,000 − $7,500).

.09 Distribute Earnings Free of FICA, FUTA, and Employment Taxes

Under *Radtke*, S corporations are required to pay reasonable salaries to S corporation shareholders. However, the Radtke court and other courts since that decision have not defined exactly what is a reasonable salary. To the uninitiated, the definition of "reasonable salary" may seem inconsequential and like splitting hairs since the salary is taxed to the shareholder at ordinary income rates, just like distribution of income. However, distributions from an S corporation are free from Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), and other employment taxes such as State Unemployment Insurance (SUI). Since the FICA tax rate is currently over 15 percent, the potential savings can be substantial if a shareholder receives distributions from an S corporation rather than salary. Because there is no "bright line" as to what is a reasonable salary, shareholders have become aggressive in pursuit of such distributions.

Example 1-4

Alice Jenson is the sole shareholder of AJ Inc., a qualified S corporation. This year, Jenson received a salary from the corporation of $75,000 on which she paid FICA taxes of $5,737.50 (7.65%). The corporation paid the employer's share of FICA taxes in a like amount for a total cost of $11,475. If Jenson reduced her salary to $50,000 and took an additional $25,000 as a distribution of profits, she and the corporation would save $3,825 in FICA taxes ($25,000 × .153) because S corporation distributions are not treated as earned income for federal tax purposes.

In contrast, by definition, two-or-more-member LLCs and limited partnerships do provide in certain circumstances that distributions from them can be free of FICA, FUTA, and employment taxes. Specifically, all distributions to limited partners are free of FICA, FUTA, and employment taxes. An individual is treated as a limited partner unless the individual (1) has personal liability for the debts of or claims against the partnership by reason of being a partner, (2) has authority to contract on behalf of the partnership, or (3) participates in the partnership for more than 500 hours during the partnership's tax year. S corporations, however, put no such restrictions on their shareholders; thus, S corporations provide their shareholders with the ability to manage the business and at the same time exempt some of their earnings from FICA, FUTA, and employment taxes. The only requirement is that shareholders who operate the business must take a reasonable salary.