S Corporation Tax Compliance Challenges

William C. Staley, Attorney

Strafford
CPE/CLE Webinar and Teleconference

April 1, 2010

William C. Staley,

Business and Tax Attorney

Law Office of William C. Staley

818 936-3490

www.staleylaw.com

This presentation should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome.

Date prepared: March 24, 2010

Advantages Of S Corps

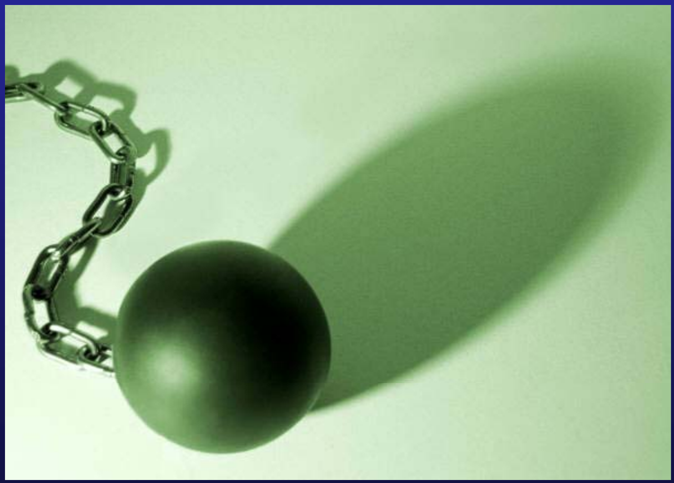
Advantages Of S Corps

- Vs. C corp
  - No federal tax on income
  - Low or no state tax
  - No tax on cash distributions of S corp income
  - No accumulated earnings or personal holding company penalty taxes

Advantages Of S Corps (Cont.)

- Vs. C corp (Cont.)
  - Can reduce employment taxes – but not to zero
- Vs. LLC
  - Can issue incentive stock options
  - Can do tax-free stock swaps

Disadvantages Of S Corps



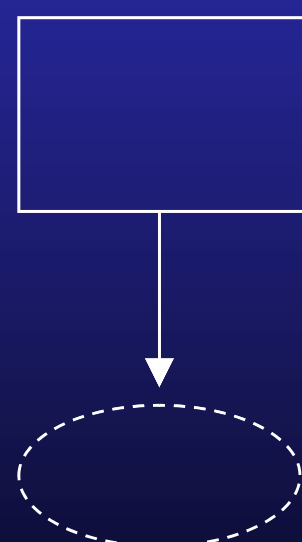
Disadvantages Of S Corps

- Vs. C corp
  - Can't use lowest tax rates
  - Income taxed to shareholders, whether they get distributions or not
  - Eligibility limits
  - Fringe benefits

Disadvantages Of S Corps (Cont.)

- Vs. LLC
  - ➢ Eligibility limits
    - o Can become a C corp
  - ➢ Built-in gain tax
  - ➢ Excess passive receipts tax
    - o Although this problem can be managed with sufficient cash

Organizing A Subsidiary



Organizing A Subsidiary

- **Brother-sister structure** – Eliminates need for a subsidiary, but complicates ownership arrangements (buy-sell agreements, etc.) and might trigger taxes to move an asset out of an existing corporation.

- **Parent-subsidiary** – Sub stock is available to creditors of the operating parent.

- **Holding company owning operating companies**
  - SMLLCs vs. QSubs

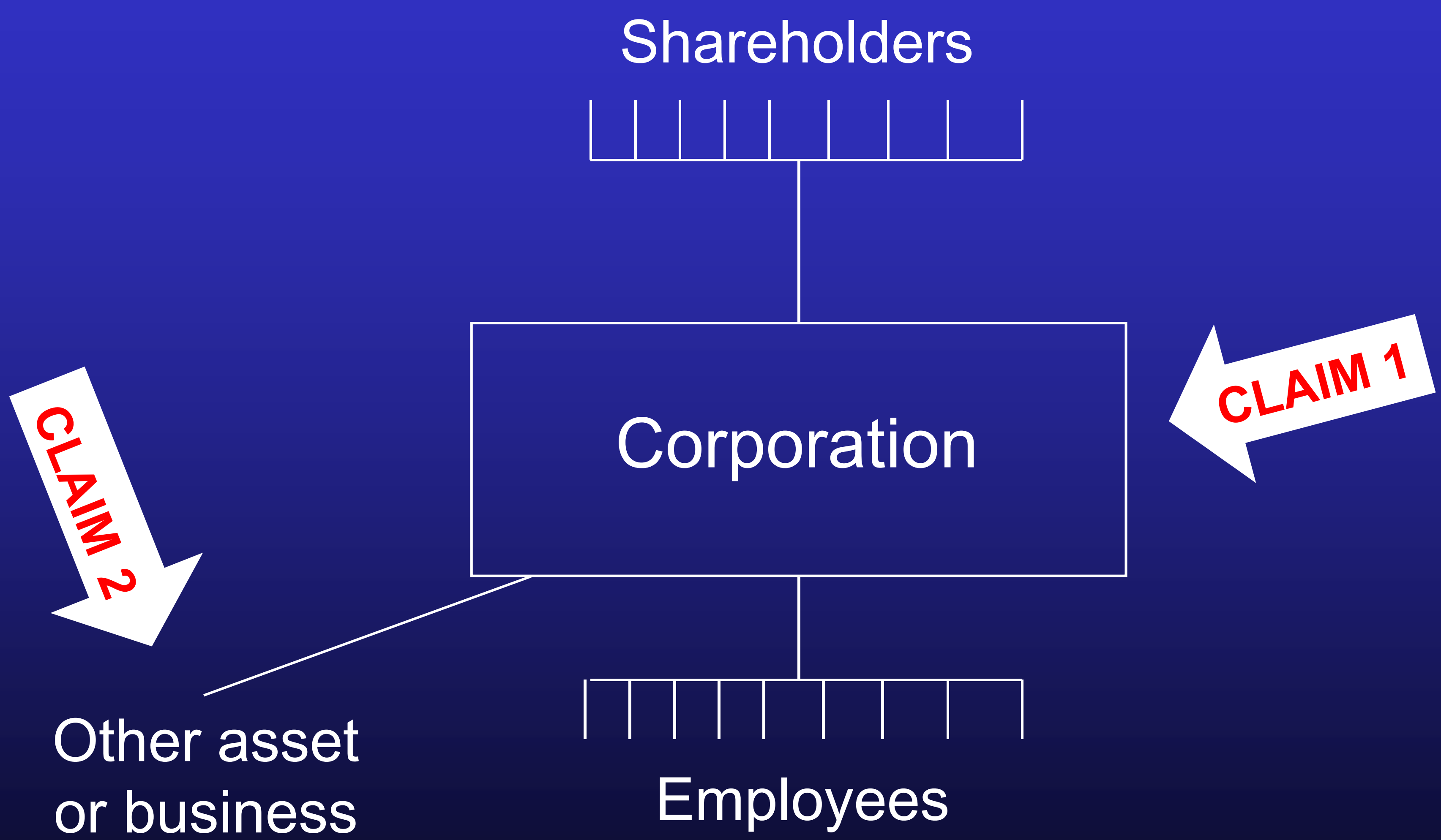
Organizing A Subsidiary (Cont.)

Situation: Existing corp (C or S) has operating business and other appreciated assets (maybe real estate, art, a second or third business) in the corporation.

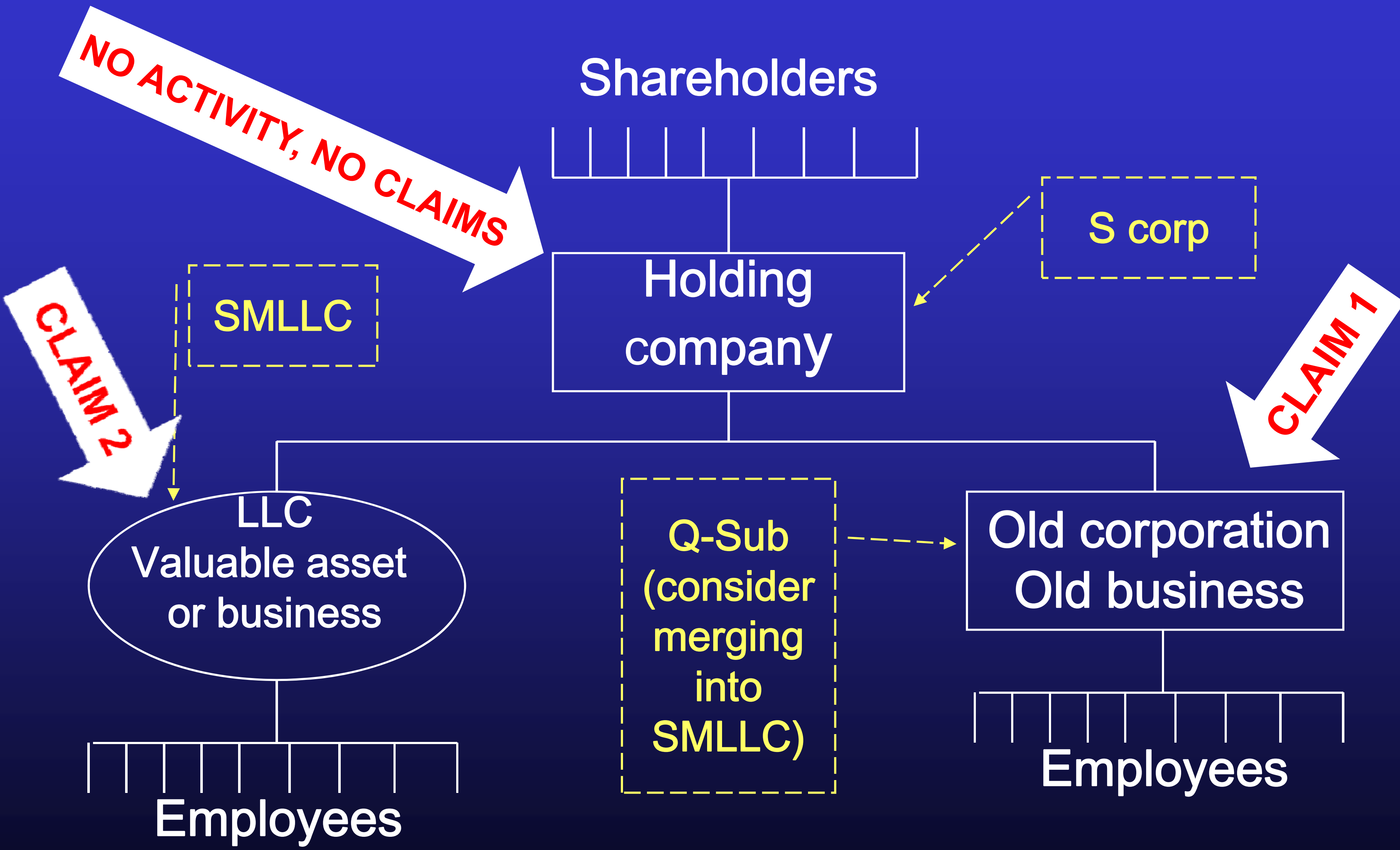
Concern: A claim against the operating business can be satisfied with the other valuable assets.

Tip: Create a holding company structure to isolate the operating business from the valuable assets.

Old Structure



New Structure

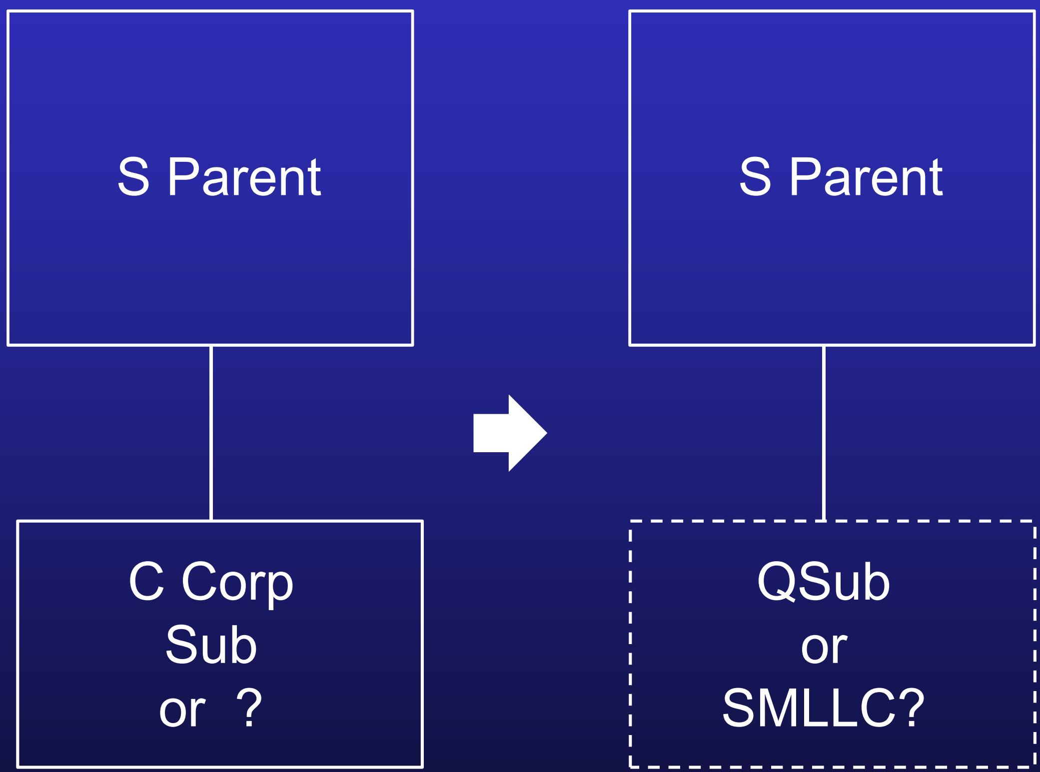


SMLLC

Single-Member LLC

- Disregarded for all federal and most state tax purposes
- Great to upgrade a sole proprietorship in an estate plan
- Great for a liability-prone activity of a well-funded non-profit organization
- Perfect subsidiary

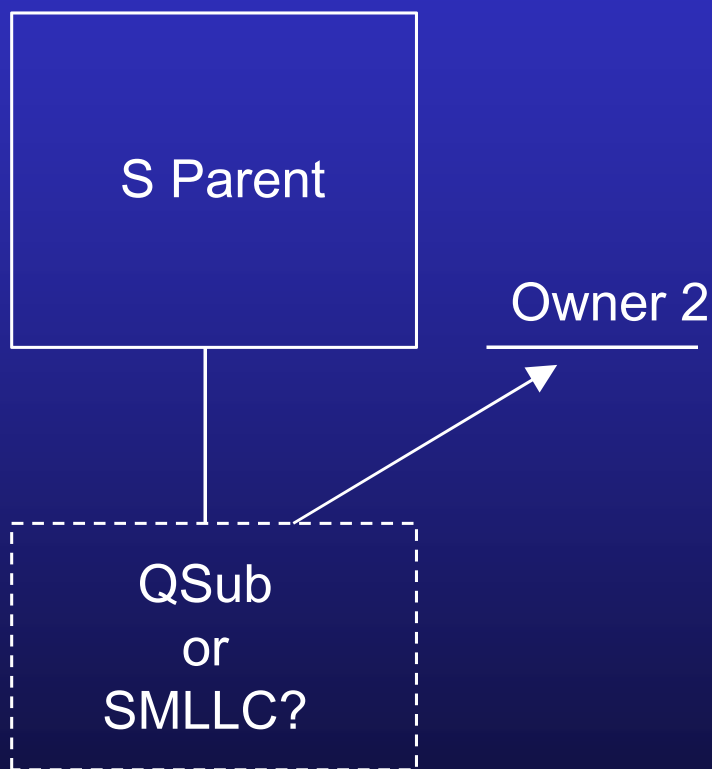
Creating “Disregarded” Status



Creating "Disregarded" Status

- For a corporate subsidiary, the Qsub election is treated as a Section 332 liquidation of a subsidiary into a parent.
  - ➢ The parent's basis in the subsidiary stock disappears. This can be unfortunate.
  - ➢ The S parent takes the QSub's basis in its assets.
  - ➢ For a corporation, there is no "Section 754 election" to increase the "inside" basis when stock is transferred.

Terminating "Disregarded" Status



Terminating “Disregarded” Status

- Adding a second owner to an SMLLC or Q-Sub terminates the “disregarded” status
- SMLLC ⟶ Partnership
  - No problem
- Qsub ⟶ C corporation
  - Big problems!

Terminating “Disregarded” Status (Cont.)

- The transaction is treated as a good Sect. 351 exchange by S parent
  - But … gain can be recognized by the S parent under Sect. 357(c) if the liabilities “assumed” by the subsidiary (its “real” liabilities) exceed the basis of the assets “transferred” to the subsidiary (its “real” assets) in the termination.

Terminating "Disregarded" Status (Cont.)

- And, the subsidiary will be a C corporation if the S parent retains any of its stock.

- *These results can be tax disasters.*
- To eliminate these risks, a Q-Sub should be merged into a SMLLC (a disregarded transaction).
  - Or, to reduce the risks, consider authorizing only one share of Q-Sub stock, and adding a legend to the Q-Sub stock certificate about getting tax advice before issuing or transferring any shares.

Effects Of Proposed Tax Rate Increases

Effects Of Proposed Tax Rate Increases

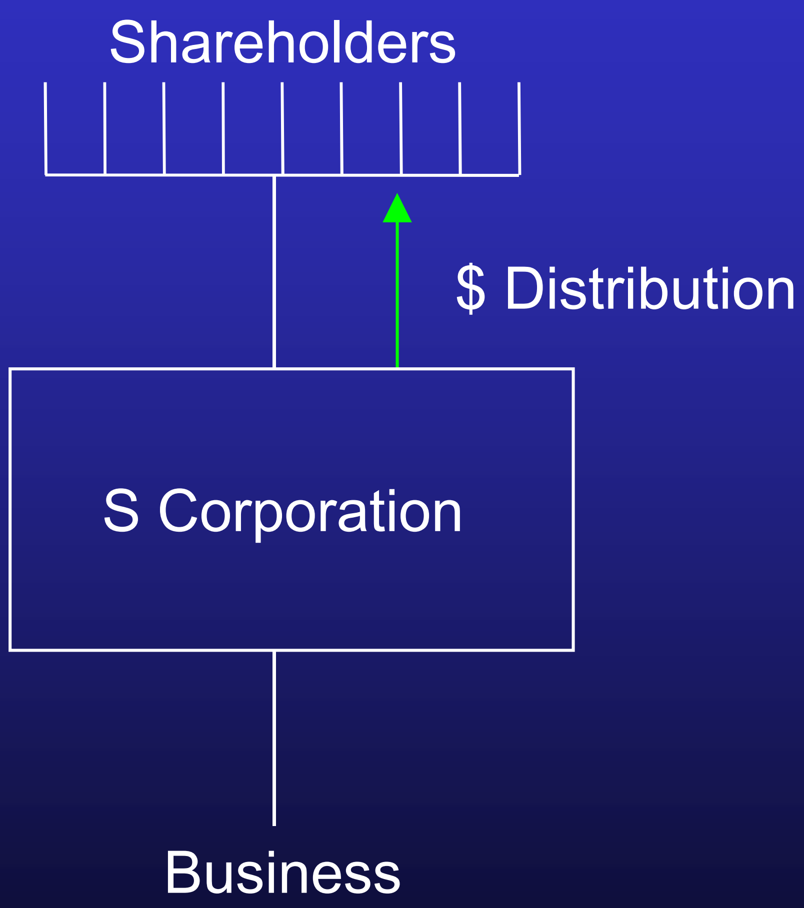
- C corporations earnings will continue to be subject to a double federal tax when distributed as dividends or when the business is sold and the proceeds are distributed.

- Even at proposed higher individual federal income tax rates and less favorable long-term capital gain rates, flow-through entities will result in substantially less tax:

  - On dividends, and

  - When the business is sold.

S Corporations Distributions



Corporate Law Issues

Corporate Law Limits On Distributions

- Distributions reduce cash and retained earnings.
- Balance sheet tests
- Creditors can recover excess distributions from:
  - ⇒ Shareholders
  - ⇒ Directors (possibly)
- Risky transaction: Share buy-back

Distributions And Salary

Distributions And Salary

- Zero salary from an S corporation is too little for a shareholder who is a full-time employee.
  - ⇒ Must take a reasonable salary
- Don’t reduce from C corporation salary too fast
- Don’t make distributions every payday
  - ⇒ Not more often than quarterly
  - ⇒ Pay salary on paydays

One Class Of Stock

S Corporation Distributions

- One level of tax on income earned while S corporation election in effect
- Vs. double-tax on C corp “earning & profits”
- So, must keep the valuable S corporation status

One Class Of Stock

- To be eligible to make and keep an S corporation election, the corporation must have only one class of stock.
  - ⇒ This means *the same number of dollars per share must be distributed at the same time to each shareholder.*
  - ⇒ Different voting rights are okay.
- The IRS cares.
- It is important to know exactly how many shares are outstanding and who owns them.

Distributions To Pay Estimated Taxes

Distributions To Pay Estimated Taxes

- The corporation should transfer $ *to its shareholders.*
  - ⇒ Not to IRS or state or local tax authorities
  - ⇒ Distribute the exact same number of dollars per share to each shareholder, even if tax needs differ.
- Unequal distributions can = more than one class of stock = blown S corporation election.

Distributions To Pay Estimated Taxes

- Special case: Required state payments or withholding of income tax
  - ⇒ Will not create a second class of stock – if:
    - o *All of the shareholders get the same number of dollars per share when these payments are treated as distributions*
  - ⇒ Timing differences are OK for these "distributions."
    - o But, best to minimize any timing differences

Distributions To Pay Estimated Taxes

- No law requires the S corporation to pay dividends to enable shareholders to pay their estimated taxes.
  - ⇒ The board of directors decides.
  - ⇒ There is a risk for minority shareholders – they might be pressured to sell at a low price if dividends are turned off.

  - ⇒ Best to have a written agreement on this

Fixing Bad Distributions

Fixing Bad Distributions

- Equalize ASAP
  - ⇒ One year later in example in IRS regs
- Treat higher distributions as loans?
  - ⇒ From the corporation? No, they were not booked that way.

  - ⇒ From one shareholder to another? There is no documentation that they were loans, and the evidence of the fix is not in the corporation's records.

Fixing Bad Distributions (Cont.)

- The IRS regs approve only one method – equalize *up* to the highest distribution per share
  1. For each distribution, find each shareholder's actual distribution per share.
  2. Who got the highest $/share?
  3. How much would each other shareholder have received at that $/share?

Fixing Bad Distributions (Cont.)

- Equalize up (Cont.)
  4. How much does each other shareholder need to get that amount?
  5. Repeat for each distribution
  6. What is the total amount each shareholder needs to be equalized?
  7. Can the S corporation make that distribution now, tax-free and legally? Does it have the cash?

Fixing Bad Distributions (Cont.)

- Equalize up (Cont.)
  8. Have the board of directors adopt resolutions authorizing the equalizing distribution -- and explaining why $/share differs for this distribution.
  9. Have the corporation write the checks and have the shareholders deposit them.
     ⇒ OK to loan cash back to the corporation
       - Document it with a promissory note.

Fixing Bad Distributions (Cont.)

- Equalize <u>up</u> (Cont.)
  - ⇒ Okay to show "declared but unpaid" distribution on the balance sheet as a liability
  - ⇒ But, better to pay it

Distributions After Share Transfers

Distributions After Share Transfers

- Don’t transfer shares before getting the cash distribution to pay the taxes.
  - ⇒ Corporation can only make distributions to shareholders of record on record date.
  - ⇒ This arises with gifts, exercise of stock options, sales of shares.
    - ▪ Stock option plan for S corp: Issue stock 30 or 60 days after exercise, to allow time for a distribution
    - ▪ Sale of shares – Increase price by available tax-free dividend?

Distributions After Share Transfers (Cont.)

- Note that a distribution reduces tax basis in shares, so not getting a distribution results in a higher tax basis.
  - But, it won't make your client very happy that he lost a dollar but saved a quarter in taxes.
  - Unless the client sold the shares, it might be a long time before the higher tax basis produces any tax benefit.

Advisors

The Advisor’s Duties

- Accountants
  - ⇨ File Form 1120 or 1120S? Are you opining on the S corporation status?
  - ⇨ Tell the client if there is a one-class-of-stock risk.
  - ⇨ Don’t condone distributions as payroll or distributions paid to IRS or SALT authorities to pay estimated taxes.

The Advisor's Duties (Cont.)

- Attorneys
  - ⇨ Preparing minutes – document all distributions
  - ⇨ Be alert to sloppy corporate formalities
  - ⇨ Caveat your assumption about S corporation status

[End of slides.]