Chapter 21

S Corporations

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Subchapter S Issues
(slide 1 of 6)

- S Corporation status is elective
  - Failure to make the election in the manner prescribed results in the entity being taxed as a C Corporation
    - However, the IRS has authority to waive the effect of an invalid election caused by inadvertent failure to qualify or to obtain required shareholder consents
    - IRS can also treat a late election as timely where there was reasonable cause

Subchapter S Issues
(slide 2 of 6)

- S Corporations are still corporations for legal purposes
  - Owners receive the benefits of limited liability, ability to raise capital (within limits), etc...

Subchapter S Issues
(slide 3 of 6)

- Taxation resembles partnership taxation
  - Certain items (primarily business income and certain expenses) are accumulated and passed through to shareholders
  - Other items are "separately stated" and each item is passed through to shareholders

Subchapter S Issues
(slide 4 of 6)

- An S corporation is a reporting (rather than tax-paying) entity
- Tax liability may still arise at the entity level for:
  - Built-in gains tax, or
  - Passive investment income penalty tax

Subchapter S Issues
(slide 5 of 6)

- An S Corporation is not subject to the following taxes:
  - Corporate income tax
  - Accumulated earnings tax
  - Personal holding company tax
  - Corporate alternative minimum tax

Subchapter S Issues
(slide 6 of 6)

- Entity is subject to Subchapter C rules for a transaction unless Subchapter S provides alternate rules

When To Elect S Corp Status

- Following factors should be considered:
  - If shareholders have high marginal tax rates vs Corp rates
  - If NOLs are anticipated
  - If currently C corp, any NOL carryovers from prior years can't be used during S corp years
    - Still reduces 20 year carryover period
  - Character of anticipated flow-through items

S Corp Qualification Requirements (slide 1 of 3)

- To elect under Subchapter S, a corporation must meet the following requirements:
  - Must be a domestic corporation
  - Must not otherwise be "ineligible"
    - Ineligible corporations include certain banks, insurance companies and foreign corporations
    - S corps can own up to 100% of a C corp
    - After 1996, S corps can also have wholly owned S corporation subsidiaries

S Corp Qualification Requirements (slide 2 of 3)

- Corporation may have only one class of stock
  - Can have stock with differences in voting rights but not in distribution or liquidation rights
  - It is possible for debt to be reclassified as stock
    - Results in unexpected loss of S corp status
    - Safe harbor provisions mitigate concern over reclassification of debt

S Corp Qualification Requirements (slide 3 of 3)

- Must have 75 or less shareholders (35 before 1997)
  - Shareholders can only include individuals, estates and certain trusts
    - Partnerships,corps, LLCs, LLPs and IRAs cannot own S corp stock, but S Corps can be partners in a partnership or shareholders in a corp
  - Shareholders cannot include any nonresident aliens

Making The Election (slide 1 of 3)

- To become an S corp, must make a valid election that is:
  - Filed timely
  - All shareholders must consent to the election

Making The Election (slide 2 of 3)

- To be effective for current year
  - Make election by 15th day of third month of current tax year, or
  - File in previous year

Making The Election (slide 3 of 3)

- Shareholder Consent
  - Each shareholder owning stock during election year must sign consent for election (even if stock is no longer owned at election date)
  - May be able to obtain extension of time for filing consent from IRS if most shareholders sign by due date of election
    - Election is not effective if entity does not meet S corporation requirements at time election is filed

Termination of Election

(slide 1 of 4)

The S election is lost in any of the following ways:

1. Shareholders owning a majority of shares revoke the election
   - Revocation must be filed by 15th day of third month to be effective for entire year
   - Otherwise, it is effective for first day of following year, or any other specified future date

Termination of Election
(slide 2 of 4)

2. New shareholder owning > 50% of entity refuses to consent to election
3. Entity no longer qualifies as S Corp
   – (e.g., the entity has > 75 shareholders or a nonresident alien shareholder, a second class of stock exists, etc.)
   – Election is terminated on date disqualification occurs

Termination of Election

(slide 3 of 4)

4. The corporation has excess "passive investment income" (PII) for three consecutive years
   - The entity has excess PII if passive investment income (net of passive investment expenses) > 25% of Gross Receipts
   - This test only applies if the entity has E & P from a prior year in which the entity was a Subchapter C corporation
   - Election is terminated as of beginning of fourth year

Termination of Election
(slide 4 of 4)

- A new election normally cannot be made within five years after termination of a prior election
  - Five year waiting period is waived if:
    - There is a > 50% change in ownership after first year termination is applicable, or
    - Event causing termination was not reasonably within control of the S corp or its majority shareholders

Computation Of Taxable Income

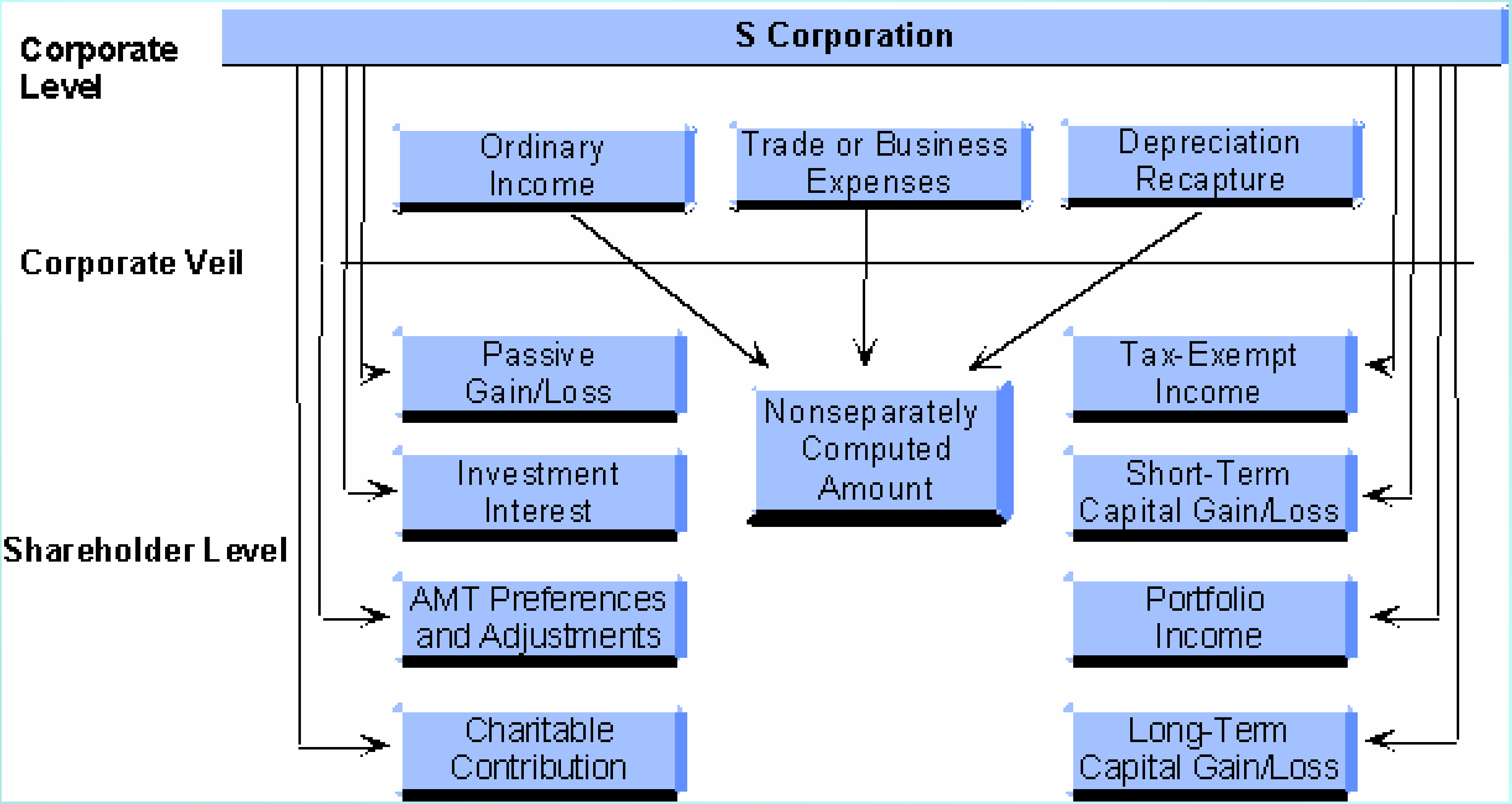
(slide 1 of 2)

- Determined in a manner similar to partnerships except:
  - S corp can amortize organizational costs
  - S corp must recognize gain (but not losses) on distribution of appreciated property to shareholders

Computation Of Taxable Income
(slide 2 of 2)

- S corp items are divided into:
  - Nonseparately stated income or loss
    - Essentially, constitutes Subchapter S taxable income or loss
  - Separately stated income, losses, deductions and credits that could uniquely affect tax liability of shareholders
    - Identical to separately stated items for partnerships

Flow-Through of S Corporation Items



Separately Stated Items

- Examples include:
  - Tax-exempt income
  - Gains/losses from disposal of business property and capital assets
  - Charitable contributions
  - Income/loss from rental of real estate
  - Interest, dividend, or royalty income
  - Tax preference items

Allocation Of Income And Loss
(slide 1 of 2)

- Each shareholder is allocated a pro rata portion of nonseparately stated income (loss) and all separately stated items
  - If stock holdings change during year, shareholder is allocated a pro rata share of each item for each day

Allocation Of Income And Loss
(slide 2 of 2)

- Short-year election is available if a shareholder's interest is completely terminated (through disposition or death)
  - Allows tax year to be treated as two tax years
    - Results in interim closing of books on date of termination
    - Shareholders report their shares of S corp items as they occurred during year

S Corporation Distributions
(slide 1 of 7)

- Amount of distribution to shareholder = cash + FMV of any other property distributed
- Taxation of distribution depends on whether the S corp has accumulated E&P from C corp years

S Corporation Distributions
(slide 2 of 7)

- Where no Earnings and Profits exist

1. Nontaxable to the extent of adjusted basis in stock
2. Excess treated as gain from the sale or exchange of property (capital gain in most cases)

S Corporation Distributions

(slide 3 of 7)

- Where Earnings and Profits exist
  1. Tax-free to the extent of accumulated adjustments account*
  2. Any PTI from pre-1983 tax years can be distributed tax-free
  3. Remaining distribution is ordinary dividend from AEP**
  4. Tax-free to extent of Other Adjustments Account
  5. Tax-free reductions in basis of stock
  6. Excess treated as gain from the sale or exchange of stock (capital gain in most cases)

  – * Once stock basis reaches zero, any distribution from AAA is treated as a gain from sale or exchange of stock. "Basis" is the maximum tax-free distribution a shareholder can receive.
  – ** AAA bypass election is available

S Corporation Distributions
(slide 4 of 7)

- Accumulated Adjustments Account (AAA)
  - Represents cumulative total undistributed nonseparately and separately stated items
  - Mechanism to ensure that earnings of an S corp are taxed to shareholders only once

S Corporation Distributions

(slide 5 of 7)

- Accumulated Adjustments Account (AAA) is adjusted as follows:
  - Increased by:
    - Nonseparately computed income and Schedule K items other than tax-exempt income
    - Depletion in excess of basis in property
  - Decreased by:
    - Adjustments other than distributions
    - Portion of distribution treated as tax-free from AAA (but not below zero)

S Corporation Distributions
(slide 6 of 7)

- Other issues regarding distributions:
  - Distributions of *cash* during a one-year period following S election termination receives special treatment
    - Treated as a tax-free recovery of stock basis to the extent it does not exceed AAA account
    - Since only cash distributions receive this special treatment, the corp should not distribute property during this postelection termination period

S Corporation Distributions

(slide 7 of 7)

- Other issues regarding distributions:
  - If E & P exists, the entity may elect to first distribute E & P before reducing AAA

Distributions Of Property

- If the entity distributes appreciated property
  - Gain must be recognized
    - Treated as if property sold to shareholder for FMV
    - Gain is allocated to shareholders and increases shareholders' basis in stock, before considering the effect of the distribution
    - Basis of asset distributed = FMV
  - Losses are not recognized
    - Since loss property receives a step-down in basis without any loss recognition by S corp, distributions of loss property should be avoided

Shareholder's Basis (slide 1 of 4)

- Determination of initial basis is similar to that of basis of stock in C corp
  - Depends on manner stock was acquired
    - e.g., gift, inheritance, purchase, exchange
  - Basis is increased by:
    - Stock purchases
    - Capital contributions
    - Nonseparately computed income
    - Separately stated income items
    - Depletion in excess of basis

Shareholder's Basis (slide 2 of 4)

- Basis is decreased by:
  - Distributions not reported as income by shareholders (e.g., from AAA or PTI)
  - Nondeductible expenses (e.g., fines, penalties)
  - Nonseparately computed loss
  - Separately stated loss and deduction items
- Similar to partnership basis rules
  - First increase basis by income items
  - Then decrease it by distributions and finally losses

Shareholder’s Basis (slide 3 of 4)

- Shareholder’s basis cannot be negative
  - Once basis is reduced to zero, any additional reductions (losses or deductions, but not distributions) decrease (but not below zero) basis in loans made to S corp
  - Any excess losses or deductions are suspended
  - Once basis of debt is reduced, it is increased by subsequent net increases from all positive and negative adjustments
  - Debt basis is adjusted back to original amount before any increase in stock basis

Shareholder's Basis (slide 4 of 4)

- Basis rules are similar to partnership rules except:
  - Partner's basis in partnership interest includes direct investment plus a ratable share of partnership liabilities
  - Except for loans from a shareholder to the S Corp, corporate borrowing does not affect shareholder's basis

Treatment of Losses
(slide 1 of 2)

Step 1. Allocate total loss to the shareholder on a daily basis, based upon stock ownership

Step 2. If shareholder’s loss exceeds stock basis, apply any excess to adjusted basis of indebtedness to the shareholder. Distributions do not reduce debt basis.

Step 3. Where loss > debt basis, excess is suspended and carried over to future tax years.

Step 4. In future tax years, any net increase in basis adjustment restores debt basis first, up to its original amount.

Treatment of Losses

(slide 2 of 2)

Step 5. Once debt basis is restored, remaining net increase is used to increase stock basis.

Step 6. Suspended loss from a previous year now reduces stock basis first and debt basis second.

Step 7. If S election terminates, any suspended loss carryover may be deducted during post-termination transition period to the extent of the stock basis at the end of this period. Any loss remaining at the end of the period is lost forever.

Passive Losses And Credits

- An S corp is not directly subject to the passive loss rules
  - If the corporation is involved in rental activities or shareholders do not materially participate
    - Passive losses and credits flow through to shareholders
    - Shareholder's stock basis is reduced even if passive losses are not currently deductible

At-Risk Rules

- Generally apply to S corp shareholders
  - At-risk amounts include:
    - Cash and adjusted basis of property contributed to corp
    - Any amount borrowed for use in the activity for which the shareholder is personally liable
    - Net FMV of personal assets that secure nonrecourse borrowing
  - Losses suspended under at-risk rules are carried forward and are available during post-termination transition period

Built-in Gains Tax
(slide 1 of 4)

- Generally applies to C corporations converting to S Corp status after 1986
  - Corporate-level tax on built-in gain recognized in a taxable disposition within 10 calendar years after the effective date of the S corp election

Built-in Gains Tax

(slide 2 of 4)

- Tax base includes unrealized gain on assets held on date of S corp election
  - Highest corporate tax rates apply (currently 35%)
  - This gain passes through to shareholders as taxable gain

Built-in Gains Tax

(slide 3 of 4)

- Amount of built-in gain recognized in any year is further limited to an “as if” taxable income, computed as if the corp were a C corp
- Any gain that escapes taxation under this limit is carried forward and recognized in future years
- S corp can offset built-in gains with unexpired NOLs or capital losses from C corp years

Built-in Gains Tax
(slide 4 of 4)

- LIFO recapture tax
  - Any LIFO recapture amount at time of S corp election is subject to a corporate-level tax
  - Taxable LIFO recapture amount = excess of inventory's value under FIFO over the LIFO value
  - Resulting tax is payable in four annual installments
    - First payment is due on or before due date of last C corp tax return

Computation of Built-in Gains Tax (slide 1 of 2)

Step 1. Select the smaller of built-in gains or taxable income.*

Step 2. Deduct unexpired NOLs and capital losses from C corporation tax years.

Step 3. Multiply the tax base from step 2 by the top corporate tax rate.

*Any net recognized built-in gain > taxable income is carried forward to the next year, as long as the next year is within the 10-year recognition period.

Computation Of Built-in Gains Tax (slide 2 of 2)

Step 4. Deduct business credit carryforwards and AMT credit carryovers from a C corporation tax year from the amount obtained in step 3.

Step 5. The corporation pays any tax resulting in step 4.

Passive Investment Income Penalty Tax (slide 1 of 3)

- If an S corp has accumulated E&P (AEP) from C corp years
  - A tax is imposed on excess net passive income (ENPI) calculated as follows:

$$\text{ENPI} = \frac{\text{Passive investment income} > 25\% \text{ of gross receipts}}{\text{Passive investment income for the year}} \times \text{Net passive investment income for the year}$$

Passive Investment Income Penalty Tax (slide 2 of 3)

- Passive investment income includes royalties, rents, dividends, interest, annuities, and sales and exchanges of stocks and securities
- Only net gain from disposition of capital assets (not stocks and securities) is included
- Net passive income is passive income less directly related deductions

Passive Investment Income Penalty Tax (slide 3 of 3)

- Excess net passive income cannot exceed corp taxable income before considering any NOL or other special deductions
- Tax rate applied is the highest corporate tax rate for the year

If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

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