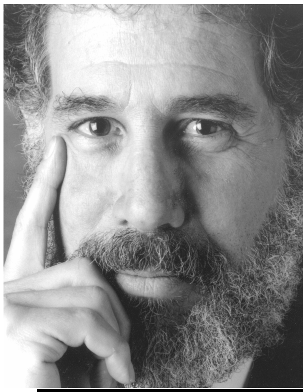

Leimberg's Think About It

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S CORPORATIONS – AN INCREDIBLE PLANNING TOOL

One of the most important of all business entities is the S (a/k/a subchapter S) corporation. This commentary, based on a chapter from my new book, Tools and Techniques of Income Tax Planning (800-543-0874), will explain why this type of entity is so popular and answer some of the more frequently asked questions about S corporations.

S CORPORATION DEFINED

A mental picture of a funnel is a good way to think of an S corporation. At the most basic level, the entity is formed as a corporation but makes a special election that allows income it earns, deductions to which it is entitled, as well as its capital gains, losses, charitable contributions, and credits to be passed through to its shareholders and treated as theirs.

For the most part, S corporations are taxed under partnership rules for federal income tax purposes – but may be treated very differently under state tax law. Apart from the pass-through treatment for federal (and some states) income tax purposes, S corporations receive the same treatment and are entitled to the same creditor protections as any other corporation.

The potential tax-savings aspect of a pass-through entity is a powerful incentive. Assume Larry, Jayne, Jo-Ann, and Steve are four equal shareholders of the Nordhavn Corporation. Suppose in 2004, the business earns a profit of $100,000.

	Earnings	Tax On Earnings at Corporate Level	Amount Remaining for Distribution	Tax at Shareholder Level	Total Tax
C CORP	$100,000	$22,250	$77,750	$11,662.52*	$33,913
S CORP	$100,000	$0	$100,000	$28,000	$28,000

*Assume a 15% tax on dividend distribution.

If taxed as a C corporation, the Nordhavn Corporation and its shareholders will have a total of $33,912.52 in federal corporate and individual tax liabilities. On the other hand, if Nordhavn is an S corporation, the entire $100,000 in profits will be “passed through” to the shareholders and taxed on their individual tax returns. Each of the four shareholders will include $25,000 of the S corporation's income. Assuming a 28% tax bracket, each shareholder potentially will owe about $7,000 in federal income taxes (a total of $28,000 for all four). Formed as a C corporation, the total taxes approximate $34,000; formed as an S corporation, about $28,000. The savings (using these assumptions which may or may not be realistic or appropriate in a given case) is almost $6,000 a year!

WHY MAKE THE S ELECTION?

There are many reasons why tax counsel will suggest a client make and maintain an S election. These include:

BEST OF ALL WORLDS – WELL, ALMOST

There are advantages and disadvantages to every form of entities established for business and/or investment purposes. It is essential that planners explain to clients the costs and downsides of each form, and present the client with sufficient information to make an informed choice. Often, the optimal choice is a form of entity that can, when appropriate, be switched (at minimal cost and aggravation) to another form.

To obtain both corporate limited liability and the ability to pass through income, losses, deductions, and credits, certainly the S corporation will do the job. The appeal of limited liability is obvious (although perhaps sometimes overstated).

The pass-through tax treatment accorded S corporations is appealing for several reasons: Unlike a regular C corporation where the income is taxed twice, first to the corporation when earned and then a second time when paid to shareholders; whereas, at a federal level, income of an S corporation will be taxed only once when paid out or allocated to its shareholders.

By electing an S status, it also allows the owners to deduct any losses that the corporation may incur. This ability to deduct losses at the individual shareholder level is particularly advantageous in the early (and quite often unprofitable) stages of a business. Rather than entirely lose or have the loss deduction delayed, S corporation shareholders can apply business losses immediately against their personal income. Of course, if the business later becomes profitable (or for any other reason a C corporation is preferable) it is always possible to terminate the S election.

A WEALTH SHIFTING AND INCOME SPLITTING TOOL

As presented in **Tools and Techniques of Estate Planning** (800-543-0874), the two most important concepts of estate planning under the current tax environment are: (1) wealth shifting and (2) income splitting. We stress the importance of "dividing and conquering" the income, estate, and gift tax systems by turning the progressive nature of each of these taxes against themselves. S corporation is an excellent tool to do just that, divide wealth and split income among a family unit.

For example, a parent in a 50% combined state and federal tax bracket can both shift wealth and split income – thereby utilize the unified credit equivalent as well as the lower federal income tax brackets of younger family members, perhaps shifting the effective tax on income down to as low as 15 percent or less. (However, the "Kiddie Tax" requires that certain income of individuals younger than age 14 will be taxed at their parent's tax rate.)

A CORPORATE AMT ELIMINATOR

Since S corporations are not (generally) subject to tax at the corporate level, if the alternative minimum tax is an important factor, the avoidance of this tax can be highly advantageous.

AN ACCUMULATED EARNINGS TAX ELIMINATOR

If it is important to avoid an accumulated earnings tax, the use of an S corporation can be highly desirable.

FREQUENTLY ASKED QUESTIONS

Q: What are the requirements which must be met for an entity to attain S status?

A: There are five "tests" which must be met. First, the entity cannot have more than 75 shareholders. For purposes of this requirement, a husband and wife are considered one shareholder. Second, the entity must be a domestic corporation organized under U.S. or applicable state laws. Third, only individuals (citizens or residents of the U.S.), estates, and certain trusts can be shareholders. This means nonresident aliens cannot hold S corporation stock. A trust can hold S stock safely, but only if it is: (1) a grantor trust with a U.S. citizen or resident as grantor, (2) a trust that was a grantor trust prior to the death of the grantor – but only for two years after grantor's death, (3) a voting trust, (4) an ESBT (electing small business trust), and (5) a trust that has S corporation stock transferred to it may be a shareholder for up to two years after the transfer. Fourth, there can only be one class of stock and all shares must have equal liquidation and distribution rights. (But it is permissible for shares to have different voting rights.) Fifth, all shareholders must consent to the S election.

Q: Are there types of entities which cannot make an S election?

A: Yes. The following may not become an S corporation: (1) a financial institution that uses the reserve method of accounting, (2) an insurance company, (3) corporations that elect to have credits for certain income from non-U.S. sources, and (4) a current or former domestic international sales corporation.

Q: What could trigger a loss of an S election?

A: An S election could be lost for numerous reasons. Some are deliberate and others are involuntary. These include:

1. Shareholders holding more than 50% of the S corporation may decide to terminate the S election.

2. An S election will terminate if it no longer meets the requirements to be an S corporation, such as having more than 75 shareholders, or having an ineligible shareholder. For example, if S stock is gifted to a nonresident alien, or sold to a C corporation, the S status will be lost. Such a termination becomes effective on the first day any of the S election requirements has failed.

3. An S election will end if the entity has "excessive" passive income for three years and it has earnings and profits from when it was a C corporation, or due to a corporate acquisition. Excessive passive income is defined as passive income that is more than 25% of the gross receipts of the business for three consecutive years. Should an S election end for this reason, the termination becomes effective the first day of the year following the three consecutive years of excessive passive income.

Q: Can an S corporation whose election is terminated make another S election?

A: Yes. But it generally must wait for some time before making another election and achieving S status. The rule is that the corporation generally cannot elect S status again for five years after a termination – unless it obtains IRS consent. The Service generally will waive inadvertent terminations if the corporation corrects the event that caused the termination and agrees to treat the corporation as an S corporation during the period of time the election was terminated.

Q: Are shareholders in S corporations completely immune from the claims of creditors?

A: No. Although S corporations afford much more protection from creditors than would be available to partners in a partnership and, in fact, the corporate "shield" does limit shareholders' liability to the extent that they are not automatically subject to the debts and obligations of the business, they are not totally exempt from personal liability. First, as a practical matter, the shareholders may have to co-sign for or guarantee loans or other debts of the corporation.

Second, if a shareholder works as an employee of the S corporation, he or she will be liable for actions taken or professional errors and omissions. For instance, suppose Larry Kline, a pulmonary specialist in San Diego, practices in the form of an S corporation. Larry will be personally liable for any medical malpractice he might personally commit (and his S corporation will probably be liable as his employer).

Q: Are owner/employees of an S corporation eligible for the same fringe benefits available to their counterparts of a C corporation?

A: No. This is a potential disadvantage of S status. If a person owns more than two percent of the S corporation, which will often be the case, he or she will be treated as partners for fringe benefit purposes. That will severely limit the tax-advantaged fringe benefits generally available to owner/employees of C corporations. There is, however, one important exception; S corporation owners are eligible for many of the same qualified retirement benefits available to non-shareholder employees.

Q: How does the pass-through of earnings actually work in an S corporation?

A: Unlike a regular C corporation where corporate profits are initially taxed at the corporate level (at corporate tax rate) and again – at the distribution of that income in the form of dividends – to shareholders, in the case of an S corporation, its earnings are taxed only once – at the shareholder level.

As noted above, income of an S corporation is essentially treated as if "passed through" directly to the owners. That pass-through allocation of income (whether or not actually paid out) to S corporation shareholders occurs on a pro-rata basis. In other words, allocation of income is according to the shareholder's ownership percentage (as well as on a per diem basis). For instance, assume an S corporation has two shareholders, one owns 80% of the shares, and the other 20%. If the corporation has a profit of $1,000 in a particular tax year, the 80% owner must report

$800 of gross income and the 20% shareholder will have to report $200 – regardless as to whether or not the income is actually distributed.

Q: If income is not actually paid out to a shareholder, is he or she taxable on it?

A: Yes. Regardless of whether or not the S corporation's profits are actually paid out by the business, S corporation shareholders are taxed on their share of the entity's taxable income. An owner's share of income, loss, deductions, and credit are allocated and treated for tax purposes as distributed – whether or not they actually are – on a per-share, per-day basis. So a 30 percent owner – even a non-working owner – will pay tax on 30 percent of the S corporation's income.

Q: Does income change its character when passed through from the entity to the individual owners?

A: No. When S corporation income is passed through, it retains its character. The shareholder takes it with the same character it had when it was received. The same applies to losses and deductions.

Q: How is a shareholder's basis determined?

A: A shareholder's initial basis is carried over from the basis he/she/it had in the assets contributed.

Basis is then increased by: (1) the owner's share of income (including tax-exempt income), and (2) any excess of deductions for depreciation over the basis of property subject to depreciation.

A shareholder's basis is decreased (but not below zero) by: (1) the appropriate share of any corporate loss, (2) any expense of the corporation that is not deductible and is not a capital expense, and (3) depreciation deductions (but only to the extent the deduction does not exceed the shareholder's share of the basis in the property subject to depreciation).

In a situation where the basis of a shareholder would be reduced to less than zero, excess reductions reduce basis in corporate debt. No deductions are allowed that exceed an owner's basis in the S corporation's stock and debt.

These disallowed deductions are not necessarily lost. Disallowed deductions and losses may be carried forward indefinitely to future tax years. But a shareholder may not currently deduct any more than he has "at risk" with the S corporation. Basis in a shareholder's stock is also reduced by distributions that are not included in the income of a shareholder.

Q: What is the tax implication of receipt of income from an S corporation up to a shareholder's basis?

A: If a shareholder receives a distribution that is not from corporate earnings and does not exceed his basis, that amount will be considered a return of capital and will be recovered income-tax free.

Q: What is the tax implication of receipt of income that (a) is not from corporate earnings, and (b) is in excess of a shareholder's basis in his stock?

A: A distribution that is not from earnings and profits and that exceeds a shareholder's basis in his stock will be treated as a capital gain.

Q: What's AAA and what are its implications?

A: If an S corporation has E&P, distributions to shareholders are treated as a distribution by an S corporation without earnings and profits, to the extent of an account called the accumulated adjustment account (AAA).

AAA is an account that essentially is a record of (a) income already taxed to shareholders minus (b) any amounts already distributed to shareholders. The purpose of AAA is to ensure that shareholders of an S corporation are not taxed twice on S corporation income. Distributions from S corporations that have earnings and profits that are in excess of the AAA will be treated as a distribution under the normal tax rules. If an S corporation was previously a successful C corporation, it will probably have earnings and profits.

The result? S corporation owners will report amounts received as a dividend – up to their share of corporate earnings and profits. Any excess will lower their basis. At the point where a shareholder's basis is recovered, any excess will be taxed as capital gain.

Q: Are there any situations in which tax is levied on an S corporation at the corporate level?

A: Yes. Although typically, income is passed through in a manner similar to partnership income and the entity is ignored for all but informational purposes, there are instances where there may be a taxable event at the corporate level on certain gains.

The most common example is where an S election was made after 1986 and the corporation had previously been a C corporation. If the business sells or otherwise disposes of property within 10 years after an S election has been made, it may have to pay tax on part of the gain. Only gain attributable to pre-election appreciation will be taxed at the corporate level and it will be taxed only to the extent that gain does not exceed the amount of taxable income imposed on the corporation if it were not an S corporation.

Another example of when a taxable event occurs at the entity level is if there is excess "net passive income." If the corporation, at the end of the tax year, has accumulated earnings and profits and if its passive investment income exceeds 25 percent of gross receipts, a 35 percent rate will be imposed (technically, it is the highest corporate rate).

Passive investment income is defined as rents, royalties, dividends, interest, annuities, and proceeds from sales or exchanges of stock or securities.

The definition excludes:

- Rents for the use of corporate property if the corporation also provides substantial services in connection with the property (such as maid service in a hotel),

- Interest derived in the ordinary course of any trade or business,

- Interest on obligations acquired in the ordinary course of business, such as interest earned on accounts receivable,

- Gross receipts derived in the ordinary course of a trade or business of lending or financing, dealing in property; purchasing or discounting accounts receivable, notes, or installment obligations; or servicing mortgages.

- Certain dividends from C corporations where the S corporation owns 80% or more of the C corporation.

Q: What is a qualified subchapter S trust (QSST)?

A: A QSST is, as its name implies, a trust to hold S corporation stock. To qualify as a QSST, the following requirements must be met:

1. A QSST may have no more than one current income beneficiary (and that person must be a U.S. citizen or resident);
2. A QSST must distribute all income in the year it is earned;
3. A QSST's assets may not be distributed to anyone else during the income beneficiary's life.

4. A QSST's income interest must end upon the earlier of (a) the income beneficiary's death, or (b) the termination of the trust, and if the trust terminates during the income beneficiary's lifetime, the entire corpus of the trust must be distributed to that beneficiary.
5. The sole QSST income beneficiary must make an election for the trust to be treated as a QSST.

Q: What is an electing small business trust (ESBT) and how does it differ from a QSST?

A: An ESBT is a trust in which all of the beneficiaries are individuals, estates, or certain charitable organizations. ESBTs are taxed currently at a 35 percent rate (technically, they are taxed at the highest income tax rate). Each potential current beneficiary of an ESBT is treated as a shareholder for purposes of the 75-shareholder limitation.

A potential current beneficiary is generally someone who is entitled to, or in the discretion of any person may, receive a distribution of principal or interest of the trust. An interest in an ESBT may not be obtained by purchase.

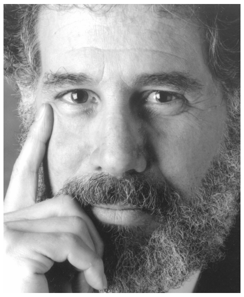
Q: Are there trusts which can not qualify as ESBTs?

A: Yes. The following may not be ESBTs:

1. Trusts that are exempt from income tax,
2. QSSTs,
3. Charitable remainder annuity trusts, and
4. Charitable remainder unitrusts.

REFERENCES

See *Tools and Techniques of Income Tax Planning*, National Underwriter Co., (800-543-0874). For in-depth sources of information about S Corporations, please see: Boris Bittker and James S. Eustice's *Federal Income Taxation of Corporations and Shareholders*, 7th ed., Warren, Gorham & Lamont, (800-950-1216); and Dennis C. Reardon's *Working with S Corporations,* 3rd ed., National Underwriter Co., (800-543-0874).



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