S Corporation Update

By some accounts, the advent of S corporations in the late 1950s was the most notable revolution in American tax policy since the Revolution. And it's easy to see why: S corporation owners can protect themselves against personal liability and have their income and gains taxed only once, as opposed to the double exposure of C corporations and their owners at the corporate level and again on individual returns. In 1997, S corporations became the most common type of entity filing a corporate return with the IRS. Since then, their numbers have continued to grow, reaching about 3.6 million and making the S corporation the most popular corporate entity in America. "The cornerstone of America's small business community," the S corporation Association of America calls it.

Although the structured resting on that cornerstone has been relatively stable, CPAs must reckon with several legal and regulatory developments in recent years that affect such areas as electing and maintaining S corporation status, limits on follow-through of losses, basis issues, payroll taxes, built-in gains, annual returns and international issues. CPAs advising businesses must keep informed about these changes, which affect many aspects of governance and operation. Here's and overview of how the S corporation landscape has evolved, with some new landmarks and few extra bends in the road to business success.

REQUIREMENTS FOR ELECTING AND MAINTAINING STATUS

Shareholder limit. In 2004, Congress increased the maximum number of shareholders in an S corporation to 100 and modified the law to allow certain family members with a common ancestor to be treated as a single shareholder. As the IRS advised in notice 2005-91, any family member can make the election by notifying the corporation and identifying himself or herself as well as the common ancestor and designating the tax year in which the election takes effect. The common ancestor cannot be more than sic generations removed from the youngest descendant shareholder. The spouses and former spouse of the common ancestor or any lineal descendant may also be counted as family members. Also, estates of deceased family members and family members who own stock through certain trusts will not be counted as separate shareholders.

LLCs and multipurpose Form 2533. A domestic LLC with two or more owners is classified as a partnership under the default rules but may choose to be treated as a corporation by filing Form 8832. When corporate status is chosen, the entity may elect S status. In the past, an LLC was required to file Form 8832 to elect corporate status and then file Form 2553 to elect S status. New regulations simplify the paperwork requirements. An eligible entity that makes a timely and valid election to be classified as an S corporation will be deemed to have elected to be classified as an association taxable as a corporation. When Form 2553 is filed by the 15th day of the third month of a taxable year, both the deemed election to be classified as a corporation and the S election are effective as of the first day of that year . The election to be treated as a corporation is effective until the entity files a different election. These regulations are effective for elections to be an S corporation filed on or after July 20, 2004, but can be relied on for timely elections filed before that date.

In Letter Ruling 200528021, the IRS considered whether an existing S corporation may convert to an LLC and elect to be treated as a corporation without losing its S status. The new entity would be considered under state law to be the same as the old entity. The new entity would conduct the same business as in the past, and there was not plan to redeem ownership interests. The IRS ruled the conversion to an LLC followed by an election to be taxed as a corporation for federal tax purposes would be a tax-free reorganization under section 368(a)(1)(F). The S election would not be terminated as a result of this reorganization, and the usual basis carryover rules would apply. In addition, the new entity would keep the old employer identification number.

IMPACT OF DEBT ON BASIS AND LOSS FLOW-THROUGH

The cases last year show a wrong and a right way to increase shareholder's basis for business debts so that they may deduct an S corporation loss.

No pass-through. William Maloof owned several S corporations that collectively borrowed $4 million from a bank. Maloof was jointly and severally liable on the dent and gave a security interest in a $1 million insurance policy on his life. The Sixth Circuit Court of Appeals found that Maloof's role in the loan did not cause the corporation to be liable to him, which would be necessary to create basis for Maloof in debt of the corporation and permit pass-through of the losses. Likewise, Maloof's guarantee of the debt did not result in an additional capital contribution that would raise his basis in his stock. Basis would have increased if the bank had sought recourse on his guaranteed.

Pass-through allowed. In contrast, Timothy Miller successfully deducted corporate losses because he personally had borrowed $750,000 from a bank and loaned the funds to his corporation. The corporation paid the funds to the bank in full satisfaction of an existing corporate debt. The Tax Court concluded that the series of transactions qualified as an economic outlay by Miller that left him economically poorer.

The flow-through deduction is available for a stockholder loan only if there is clear evidence that the corporation is liable to the stockholder.

Another thorny problem for S corporations has been how to account for charitable contributions of appreciated property. The Pension Protection Act of 2006 brought some clarity. If an S corporation makes a charitable contribution of a capital asset having a basis of $100 and a fair marker values of %500, the shareholders will be treated as having made a $500 charitable contribution (or each shareholder a pro rata share of it), unless a lesser amount is required by special rules of Section 170(e) of the Internal Revenue Code of 1986, as amended (the "Code"). The amount of the shareholder's basis reduction in the stock of an S corporation will be equal to his or her pro rata share of the adjusted basis of the contributed property. If the S corporation has only one shareholder, the basis of its stock will be reduced by $100,or the amount of the shareholder's pre-contribution stock basis if it is less. This provision applies to contributions made in taxable years beginning after Dec. 31, 2005, and before Jan.1, 2008.

Regulations proposed in 2005 [provide that a qualified subchapter S subsidiary (QSub) would no longer be treated as a disregarded entity for purposes of employment taxes and certain other tax law requirements. A QSub (or other disregarded entity) would be liable for employment taxes on wages paid to employees and for other employment tax obligations such as paying backup withholdings under Code Section 3406, making timely deposits of employment taxes, filing returns and providing wage statements to employees on Form W-2. The owner of a disregarded entity would no longer have such responsibilities.

But these proposed regulations won't be effective until 2008 at the earliest, because they are applicable to wages paid on or after the first day of the year following their publication in final form in the Federal Register, which hadn't happened by early 2007. For that reason Emiel Kandi, the sole owner of an LLC in Washington state, was unsuccessful in district court last year in his attempt to extend the proposed regulations' provisions retroactively to payroll taxes owed for 2001. The LLC was a disregarded entity because a check-the-box election of corporate treatment had not been made, the court said.

Owners contemplating an election to switch from a C to an S corporation should be aware of the so-called "built-in gain" (BIG) tax that could result.

With the Tax Reform Act of 1986, Congress repealed the General Utilities Doctrine by reinstating double taxation of distributed gains by C corporations. Previously, under the 12-month liquidation provision, a corporation could sell its assets without recognizing gain at the corporate level and distribute the proceeds to its shareholders. The act also required a C corporation that distributed appreciated property to shareholders to be treated as having sold the property to them at an amount equal to fair market value. Both type of distributions continued to be subject to tax at the shareholder level.

Congress acted to prevent c corporations from avoiding these new rules by simply electing S status. It did so, also in 1986, with a new Code Section 1374, which imposes a tax on the appreciation component of assets held by a C corporation on the first day that it makes an election under subchapter S. This built-in gains tax applies if the S corporation disposes of the appreciated asset within 10 years after electing S status. The

BIG tax does not apply to a corporation that has always been as S corporation. Under Code Section 1374, a corporation that elected S status while owning appreciated property must hold the assets for 10 years after election to avoid the BIG tax upon sale or distribution to its shareholders.

One court had held the 10-year holing period started on the date of the initial election of S status for a corporation that later lost or revoked its status and then elected S status again. Final regulations now provide that the 10-year period begins on the date of the most recent election.

A corporation using the cash method elects to become an S corporation effective Jananuary 1, 2007, when it has accounts receivable of $100,000 for services rendered before that date. On that date, the accounts receivable have a fair market value of $95,000 and an adjusted basis of zero. During 2007, the company collects $100,000 on the accounts receivable and includes that amount in gross income. The company recognizes the entire $100,000 as built-in gain, which is subject to income tax of $35,000 at the corporate level (using the highest corporate rate of 35%). The shareholders will have a flow-through of $65,000 of income (the total income of $100,000 less the corporate tax paid).

As a general rule, the amount of built-in gain recognized when an asset is sold is limited to the excess of its value over its basis on the date of the S election. If the company above sold the receivable, the built-in gain is limited to $95,000. Other factors may reduce the amount of recognized built-in gain for a current year, such as low taxable income for the year, or an NOL carryover from a year before the S election. A built-in gain that is realized in the current year but not recognized carries forward to future years.

Many S corporations must file a new tax schedule beginning this year. For tax years ending on or after Dec. 31, 2006, S corporations that report assets of $10 million or more on schedule L of form 112S must file Schedule M-3. Part I of Schedule M-3 reconciles worldwide consolidated net income or loss with net income or loss reported on the taxpayer’s income statement or books and records. The adjustments on part I remove income or loss from non-includible foreign and domestic entities. They also remove certain consolidating adjustments for intercompany transactions and reconcile income for the statement period to the corporation’s tax . Parts II and III of Schedule M-3 reconcile the company’s net income on part I with total income or loss shown on page three, Schedule K, line 18 of form 1120S. The IRS says M-3 will enable it to focus more quickly on high-risk issues and taxpayers requiring attention and reduce time spent with compliant taxpayers.

Even with these added nuances, S corporations are likely to remain a favored entity, especially for smaller businesses. As long as business owners are poised to take advantage of pass-through treatment of income, gains and losses and need a greater level of formality than partnerships and LLCs, they will choose an S corporation structure. They’re also likely to find clearer and simpler tax rules as its governance continues to be refined. Whatever the reasons business adopt the form, advisers must be well-furnished with knowledge of the latest developments.