

The Pros and Cons of Using an S Corp

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Today's Presenter

- Lawrence Pon
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 - Mr. Pon has been in practice since 1986 and speaks regularly to tax professionals on the latest tax planning and preparation topics.
 - Mr. Pon teaches Income Tax at the College of San Mateo
 - Mr. Pon received his BS in Business Administration from UC Berkeley and MS in Taxation from Golden Gate University in San Francisco

The Pros and Cons of Using an S Corp

- How S corporations compare to other structures
- The factors to consider in deciding whether to form an S corporation
- The steps in forming an S corporation
- Maintenance and compliance obligations

S-Corp Basics

- Domestic corporation
- Have only allowable shareholders
 - Individuals
 - Certain trusts and estates
 - No partnerships, corporations or non-resident alien shareholders
- Have no more than 100 shareholders
- Have only **ONE** class of stock
- Not be an ineligible corporation
 - Certain financial institutions
 - Insurance companies
 - Domestic international sales corporations (DISCs)

S Corporations

- Advantages of S Corporations
 - Eligible for Qualified Business Income Deduction
 - §199A 20% deduction
 - Avoids double taxation like in a C Corporation
 - Distributions of income are not subject to SE tax
 - Distributions of income are not subject to NIIT
 - Shares can be sold to investors
 - Watch out for second class of stock
 - Watch out for limits on shareholders

S Corporations

- Disadvantages of S Corporations
 - High late fees
 - Types of shareholders are limited
 - Must maintain business formality
 - Annual meetings and minutes
 - No step up in basis for assets held in the corporation on death (inside basis)
 - Step up in basis occurs on the stock inherited by the heirs (outside basis)
 - Property distributed to shareholders is a taxable event at the time of distribution

Great Candidates

- New business anticipating initial start-up losses
 - Assumes sufficient basis
 - Losses passed onto shareholders on their personal tax returns
 - S corporation stock is eligible for IRC §1244 treatment
- Cash-rich closely held corporation
 - Profitable cash-rich closely held corporation
 - Make cash distributions to shareholders
- Established business in a mature industry
 - Avoid double taxation of C corporation
 - Earnings growth slows and reinvestment in plant and equipment falls
 - Accumulate earnings, even if substantial dividends paid
 - Avoid exposure to corporate-level accumulated earnings tax

Not the Best Candidates

- Qualified small business stock (IRC §1202)
 - Only for C corporations
- Rapidly growing corporation in an expanding market
 - Profits passed through to shareholders
 - Individual tax rates higher than corporate rates
 - May need to retain cash to reinvest in plant and equipment or R&D
- Limitations on fringe benefits
- Limitations on ability to raise outside capital
- Sole proprietorship with little or no profit

Taxes Paid by S Corporation

- Built-in Gains Tax
- Tax on Excess Net Passive Income

Built-in Gains Tax

- Built-in gains (BIG) tax applies to S corporations that were formerly C corporations
 - At the time of the conversion from C to S status held assets with a FMV greater than their tax basis
 - Built-in gain assets
 - If such corporations sell (or make liquidating distributions of) built-in gain assets within the applicable recognition period (currently five years of the date of conversion to S status) a tax applies at the highest corporate rate
 - Currently = 21%
 - Built-in gains tax is treated as a loss sustained by the S corporation during the tax year
 - The character of the loss (ordinary income, recapture, capital, 1231, etc.) is determined by allocating the loss proportionately among the built-in gains that gave rise to the tax

Built-in Gains Tax

- Example: BIG, Inc. elected S status three years ago
- It had unrealized built-in gain because the FMV was greater than the basis of some of their assets
 - Let's say = \$3,500,000
 - $\$3,500,000 \times 21\% = \$735,000$ BIG tax
 - Shareholders deduct tax paid by the S corp
- Accordingly, BIG is subject to the BIG tax because it used to be a C corporation and is disposing assets within the recognition period.
 - Tax paid by the corporation

Built-in Gains Tax

- Appreciation after conversion
 - Not subject to BIG tax
 - FMV has to be determined at time of conversion
- FMV at time of conversion
 - Subject to BIG tax if realized within five years of conversion date

Built-in Gains Tax

- Does not apply if S corporation is a new entity
 - It was never a C corporation
 - Schedule C, Schedule E, Schedule F
- Recommend getting appraisals for all assets
 - Real estate and equipment
 - Otherwise IRS will use sales price
- Accounts receivable has zero basis, but full FMV
- BIG applies to LLC that elected to be taxed as a C corporation then converts to S corporation

Built-in Gains Tax

- Installment sales cannot be used to avoid the BIG tax
 - Defer collection of gains beyond the recognition period
 - Not allowed for dispositions before or during the recognition period
 - Reg. 1.1374-4(h), Notice 90-27
 - Time limit extended for any installments sale before or during recognition period

Tax on Excess Passive Income

- Taxed at the highest corporate rate
- Applies only if previous C corp with C Corp E&P still on the books
 - S corp not subject to personal holding company tax
- S corp sells assets and invests money without distribution
- C corp converts to S corp with investments

Tax on Excess Passive Income

- Passive investment income can cause termination of S status
 - Even if S corp not subject to the tax on excess passive income
 - S election can terminate if
 - Corporation as AE&P, and
 - It's gross passive investment income exceeds 25% gross receipts in each of three consecutive years
 - Corporation can request an IRS waiver of termination

Tax on Excess Passive Income

- Four conditions for tax to apply
 - Previously taxed as C corporation
 - Still have C corp earnings and profits on books
 - Interest, dividends, & rents > 25% of gross receipts
 - Current year taxable income

Tax on Excess Passive Income

- Taxed at highest corporate rate on lesser of:
 - Excess net passive income, or
 - Taxable income
 - Credits (other than fuel tax) do not offset

Tax on Excess Passive Income

- Passive income includes:
 - Rent
 - Interest & dividends
 - Royalties
 - Stock sales
- Not subject
 - Capital gains from non-securities assets

Tax on Excess Passive Income

- If S Corp has E&P from C Corp years and excess passive income for 3 straight years
 - Loss of S status effective 1/1 of 4th year
- Tax is paid at 21% current highest corporate rate
 - Deducted by individual shareholders

Tax on Excess Passive Income

- How to avoid
 - Do not convert to S corp
 - Pay out all current earnings
 - Pay out old C corp E&P
 - Consider deemed dividend election
 - Minimize passive income
 - Close corporation

How To Become an S corporation

- A corporation elects to be taxed as an S corporation by filing Form 2553 – Election by a Small Business Corporation
- Existing C corporation
 - At any time during the year preceding the first tax year the S election is to be effective, or
 - On or before the 15th day of the 3rd month of the initial S corporation tax year
 - An election not made by the 15th day of the 3rd month will be effective on the first day of the following tax year
- S election can be retroactive to the first day of the tax year if the election is filed within 2 ½ months after the beginning of the tax year

How To Become an S corporation

- Determining when the election becomes effective when C corporation elects S status
 - C corp decides to elect S status effective for its tax year beginning 1/1/24.
 - Election must be made during 2023, or
 - On or before March 15, 2024
 - For example, if filed on March 20, 2024
 - Cannot be effective retroactively
 - Would be effective for the year beginning on January 1, 2025

How To Become an S corporation

- Newly formed corporation
 - Must file on or before the 15th day of the 3rd month of the first tax year
 - S corporation's initial year does not begin until the earliest of one of the following 3 events:
 - Corporation has shareholders
 - Corporation has assets, or
 - Begins doing business

How To Become an S corporation

- Limited liability company
 - Checking the box to be classified as a corporation
 - LLC that is eligible to elect S status and timely files Form 2553 is considered to have made the election to be treated as a corporation
 - Not required to file Form 8832 (Entity Classification Election)
- LLC converting to S status must conform to S corporation rules
 - Members are treated as shareholders
 - Member/shareholders who provide services to the corporation are employees of corporation
 - Watch out for one class of stock issues

How To Become an S corporation

- File Form 2553
 - Must include name of each shareholder, number of shares owned, and dates acquired, and social security numbers
 - Each shareholder must sign
- Filed in following ways
 - Mail
 - Private delivery service
 - Fax

Rev Proc 2022-19

- IRS provides relief procedures for S elections
 - Taxpayer assistance procedures to resolve certain issues involving S corporations and their shareholders without requiring the issuance of a PLR
 - Agreements and arrangements with no principal purpose to circumvent one class of stock requirement
 - Governing provisions that provide for identical distribution and liquidation rights
 - Procedures for addressing missing shareholder consents, errors with regard to a permitted year, missing officer's signature, and other inadvertent errors and omissions
 - Procedures for verifying S elections or QSUB elections
 - Procedures for addressing a federal income tax return filing inconsistent with an S election or a QSUB election
 - Procedures for retroactively correcting one or more non-identical governing provision

Rev Proc 2022-19

- First five are ones that the IRS has historically identified as not affecting the validity or continuation of the S election
 - Events do not terminate the S election
 - No-rule list
- Final area covered in the new guidance deals with an S election that was invalidated or terminated by one or more non-identical governing provisions
 - These provisions that result in having more than one class of stock
 - Rev Proc 2022-19 provides procedures to retroactively preserve the S status without the need of a PLR

Letter Ruling 202110010

- Second class of stock created by LLC operating agreement
 - LLC electing S corporation status
 - Provisions of the LLC's operating agreement create a second class of stock
 - In the event the LLC might be liquidated, then the liquidating distributions shall be made to the member who have positive capital accounts in compliance with the §704(b) regulations
 - Mere existence of the partnership provisions caused the LLC to have a second class of stock
- If second class of stock issue exists, then can obtain §1362(f) relief through a private letter ruling process for inadvertently invalid S election or an inadvertent termination of an initially valid election
 - Relief must be sought at the time the issue is discovered

Letter Ruling 202205018

- Spouse's failure to consent to an S election
 - Each person who owns stock on the date the corporation files the S election must consent to the election
 - If there are joint owners, all the owners must consent
 - IRS has permitted late consents if there is reasonable cause for the delinquency
 - If community property, Rev Proc 2004-35 allows the couple to file a statement with the Service Center
 - There is no time limit on the consent for a community interest holder
 - Service center provides relief
 - No private letter ruling or pay a user fee
- In this PLR, no joint ownership
 - Stock issued to one spouse, but the other spouse consented to the S election
 - IRS treated the election as inadvertently invalid and granted the corporation's election

Deckard v Comm (155 TC No 8)

- Not-for-profit corporation was not allowed to make S election
- Nonstock, not-for-profit corporation failed to develop and suffered losses during the first two years in existence
- Dissolved twice under state law for failure to file its annual reports
- Tax Court held Deckard had no beneficial ownership rights as a shareholder
 - Deckard was prohibited from making an S election and was not permitted to claim any losses of the corporation on his individual return

Terminating S corp Election

- File a revocation
 - Requires consent of shareholders holding $> \frac{1}{2}$ of shares
 - Statement to IRS Service Center
- Inadvertent termination of S election
 - Disqualifying events
 - > 100 shareholders
 - Ineligible shareholders
 - > 1 class of stock
 - Become an ineligible corporation such as an insurance company or DISC
 - Transferring place of incorporation to foreign country

Fleischer v. Commissioner

- Financial consultant fails to avoid self-employment tax with S corporation structure
 - Licensed financial consultant set up S corporation
 - Entered into an employment agreement with the S corporation
 - Paid salary as a financial advisor
 - Reported on W2
 - Paid FICA and Medicare taxes
 - Salary = \$35,000
 - Individually, had contracts with Mass Mutual and LPL
 - Income reported on 1099
 - S-corp income = \$150,000

Fleischer v. Commissioner

- Fleischer testified that he individually entered into the contracts because it would have been too costly and perhaps impermissible for his S corporation to become licensed and registered under federal securities laws
- IRS disregarded the S corporation
 - Treated Fleischer as individually earning the commission income
 - Generating sizable SE tax liability
- Tax Court agreed with IRS
 - Lack of contracts between Mass Mutual and LPL with S corp
- TC Memo 2016-238

Watson v. Commissioner

- Watson, CPA and sole shareholder/employee of S corporation
 - W2 = \$24,000 for 2002 and 2003
 - K1 = \$375,000
 - Court upheld district court's determination that annual reasonable compensation was \$93,000
 - IRS turned to MAP survey by the AICPA specific to the Iowa Society of CPAs
 - 20 years of experience
 - Advanced degree
 - Number of hours per week
- Watson, 107 AFTR 2d 2011-305 (DC LA 12/12/10)

Sean McAlary Ltd, Inc.

- Taxpayer single-handedly ran his S corporation's real estate business
 - Pay \$24,000 base salary plus bonuses for agents recruited by him
 - IRS says compensation should be \$100,755 based upon an hourly rate of \$48.44/hr.
 - Based upon the median wage for real estate brokers in southern California
 - Tax Court did not agree with either amount
 - Ignored base pay agreement because it was not arms length
 - Added general market conditions and taxpayer's limited experience, settled on \$83,200 based upon a \$40/hr rate
- TC Summary Opinion 2013-62

S Corp Dividends vs. Compensation

- Spicer Account Inc. v US (1990, CA9) 66 AFTR 2d 90-5806
 - Payments made to S corp shareholders were salary and not dividends
 - Shareholders generated all income
 - Corp had no reasonable basis for not treating shareholders as employees
- Dunn & Clark, PA v Comm (1994, DC ID) 73 AFTR 2d 94-1860
 - Home construction company's payments to President and Vice President were wages
 - Performed substantial services and management functions

Reasonable Compensation

- IRS empowered to reallocate S corporation's income
 - Rendering services
 - Furnishing capital
 - Inadequate salary can result in reallocation by IRS
- Documentation in corporate minutes
 - Business reasons for payments
 - No definition of "reasonable" in Tax Code

Reasonable Compensation

- The character and financial condition of the corporation
- The role the shareholder plays in the corporation
 - Including employee's position, hours worked, and duties performed
- Corporation's compensation policy for all employees
 - Shareholder's individual salary history
- How compensation compares with similarly situated employees of similar companies
- Conflicts of interest in setting compensation levels
- Hypothetical independent investor's adequate return

Non-wage Income from S Corp

- Renting portion of shareholder's home to S corporation
 - Office space
 - Storage
 - Valid lease with FMV rental payment
 - Rental income reported on shareholder's 1040, Schedule E
 - Claim rental expenses
 - Mortgage
 - Property taxes
 - Insurance
 - Maintenance, repairs, supplies, etc.
- Fringe Benefits
- Retirement Plans

Pass-through Entity Tax

- Before 2018, individual taxpayers could claim a deduction for certain state and local taxes (SALT) paid in a tax year
 - Deduction applies to those who itemize deductions
- TCJA limits SALT deduction to \$10,000
 - Beginning 2018 with a sunset of 2025
- Workarounds for passthroughs
 - Connecticut first state to enact an option for PTEs to be taxed at the entity level in 2018

Pass-through Entity Tax

- IRS Notice 2020-75
 - IRS “stamp of approval” to these type of passthrough entity taxes
 - IRS to issue proposed implementing regulations
 - Clarify tax treatment for entity and owner’s tax returns
 - Passthrough entity would deduct tax in the year tax is paid and that the tax payment would reduce the passthrough entity’s distributable net income reported on the owner’s K-1 for the year the tax is paid
 - If the taxpayment paid in 2023 for the 2022 tax year
 - Deduction would be on the 2023 tax return and passed through on the 2023 K-1

Pass-through Entity Tax

- The federal deduction is not affected if individual members receive a benefit
 - Such as a tax credit to apply against the member's state personal income tax liability
- The state PTE tax must be a direct imposition on the PTE
 - Composite or withholding taxes paid by the PTE on behalf of members are not covered by Notice 2020-75
 - Not deductible by the PTE under IRC §164
 - PTE tax must be a tax imposed on the entity, not the individual owners

Pass-through Entity Tax

- 32 states have enacted a PTE tax effective for the tax year 2023
- Single shareholder S-corporation (CA example)
 - Net income = \$350,000
 - CA S-Corp tax = \$5,250 (1.5% of \$350,000)
 - PTE = 9.3% X \$350,000 = \$32,550
 - Payment due to FTB = \$32,550 + \$5,250 = \$37,800
 - PTEC to shareholder = \$32,550
 - Federal K1 = \$317,450
 - CA K1 = \$350,000

IRS Audits

- **S corporation basis campaign**
 - Issue-based examinations
 - Soft letters encouraging voluntary self-correction
 - Conducting stakeholder outreach
 - Create a new form for shareholders to assist in properly computing their basis
 - Form 7203 - S Corporation Shareholder Stock and Debt Basis Limitations
- **Unreasonable compensation audits**
 - Use the correct business activity code
 - No officers identified
 - Confirm percentage of time devoted to business
 - Be consistent with individual return
 - Keep written logs
 - Minimize loans with company

Documents for Your Files

- Copy of Secretary of State approval for corporation
 - Check Secretary of State website to check status of corporation
- IRS FEIN letter
- IRS S Corporation approval letter
- Copy of stock certificates
- Copy of corporate or LLC charter organization documents

Audit Avoidance

- Input the correct industry code
- Report officer wages
- Review reasonable compensation
- Watch out for inadvertent S election terminations
- Keep track of shareholder basis

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