



S Corporation Update

Charles E. Marston, CPA, MST
Tax Principal, S.R. Snodgrass, P.C.
cmarston@srsnodgrass.com

S Corporation Update



Agenda

- I. S Corp basics – overview
- II. What's new?
 - Late election relief
 - NII tax
 - Reasonable comp/SH loans
 - Self employment tax proposals
 - S Corporation Permanent Tax Relief Act of 2014
- III. Other items
 - Comparison to other entities
 - Former C Corp issues
 - Termination issues

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Basics – What is an S Corporation?

- Sub-chapter S of Tax Code
- Federal election/states differ
- Operates same as a “C Corp”
- Income/(loss) flows through to owners

Requirements

- Number of shareholders (limited to 100)
- One class of stock (can have different voting rights)
- Types of shareholders are limited
- Domestic corps only

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Basics – Double Taxation Concept

	C Corp	S Corp
Income	Tax – Corp	Tax – Individual
Distribution*	Tax – Dividend	No tax

*Assuming basis exist

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Basics – S Corp Advantages

Avoid double taxation

Losses deducted at individual level

No AMT (at corporate level)

C Corp legal protection

Possible employment tax savings

Tax rates may be advantage

Basics – S Corp Disadvantages

One class of stock/number of shareholder limitation

Limitation of losses – basis/active vs. passive

Certain fringe benefits taxed

Tax year-end limitations

Taxed on all income – distributed or not

Only proportionate distributions

Possible multiple state tax returns/issues

Tax rates may be disadvantage

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Basics – How Is Income Taxed?

1. Passed through via 1120S/SchK1
2. Non-separately stated items – shareholders' rate
3. Losses – can be limited
4. Separately stated items – treat individually
 - Interest/dividends
 - Capital gains/(losses)
 - Rents and royalties
 - Section 179 expense
 - Charitable contributions
 - Misc. credits

Basics – Basis/Distributions

- Basis – amount “invested”
- +’s – original cost, profits, additional contributions
- -’s – distributions, losses taken
- Loans can be used for basis – *Be Careful*
- Unused losses carried forward
- Distributions – generally tax-free up to basis

Late Election Relief

- Form 2553 election
 - Due no later than 2 months and 15 days after beginning of year
- Late election relief – Rev. Proc. 2013-30
- Extends time period for relief
 - 3 years and 75 days after intended effective date
 - Can be more
- “Filed pursuant to Rev. Proc. 2013-30”

Late Election Relief

General Requirements:

- Late filing is only defect
- Qualified as an S Corp
- Intended to be an S Corp/“Acted” like one
- “Reasonable cause”
- All shareholders reported as if S Corp
 - Signed statement required
- Request within 3 years and 75 days after intended date

Late Election Relief

Exception to 3 years and 75 days rule:

- Meet all requirements in “general” except time period
- Corporation (not an LLC)
- At least 6 months have passed since first tax return filed
- No IRS notification of problems within 6 months of first filing

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NII Tax

Net investment income tax

- Effective years beginning after December 31, 2012
- 3.8% on net investment income over certain MAGI amounts
- Individuals MAGI \$250,000 MFJ/\$200,000 S

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NII Tax – What Is NII?

Category 1 – interest, dividends, annuities, royalties, rents, and other passive income, unless they constitute business income other than Category 2

Category 2 – gross income from trade on business that is: (a) trading in financial instruments or commodities or (b) earned in a passive activity (Sec. 469 & Regs)

- “Materially participate” – Reg 1.469-5T/7 tests

Category 3 – net gain from disposition of property, other than assets used in a trade on business not described in Category 2

NII Tax

1. Operations

- Not NII as long as it's derived in ordinary course of a non-passive business activity
- Trading in financial instruments or commodities business is NII

2. Separately stated items

- Nature of item
- Interest and dividends – NII

NII Tax

3. Sale of S Corp assets

- Category 3
- NII unless assets sold used in an active trade on business (not Category 2)
- Information needs disclosed on SchK-1

NII Tax

4. Sale of S Corp stock

- Would be capital – Category 3/without additional rules
- Section 1411 provides rules
- NII if attributable to investment assets, passive activity assets or trading business assets
- Must be engaged in at least one active business (not trading) or all NII
- Two methods:
 1. Simplified short-cut method
 2. Regular method

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NII Tax

Simplified short-cut method

Can use if either or both met:

1. Gain or loss is \$250,000 or less
2. Total of NII pass through items is 5% or less of all pass through items during Section 1411 holding period and total gain or loss is \$5 million or less
 - 1411 holding period – generally current year plus past two years
 - Losses and deductions are positive amounts

NII Tax

Simplified short-cut method can't be used if:

1. Holding period is less than 12 months
2. Certain transfers of NII property during Section 1411 holding period
3. 25% or more change of NII property during Section 1411 holding period for certain reasons
4. C-to-S conversion during Section 1411 holding period

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NII Tax

Simplified method

$$\text{Regular tax gain/loss} \times \frac{\text{NII pass thru items during Sec. 1411 H.P.}}{\text{Total pass thru items during Sec. 1411 H.P.}}$$

- Losses and deductions are treated as negative items netted with positive
- If fraction is greater than 1 or less than 0, fraction = 1
- If regular tax gain and numerator is negative, fraction = 0
- If regular tax loss and numerator is positive, fraction = 0

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Example – Simplified Method, Gain

Gain/(Loss)	\$200,000
NII during 1411 H.P.	\$25,000
Bus. Inc. during 1411 H.P.	\$475,000
Mat. Participate/Active Bus.	Yes

$$\text{NII} = \$200,000 \times \frac{\$25,000}{\$500,000} = \underline{\underline{\$10,000}}$$

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Example – Simplified Method, Loss

Gain/(Loss)	\$(100,000)
NII during 1411 H.P.	\$25,000
Bus. Inc. during 1411 H.P.	\$475,000
Mat. Participate/Active Bus.	Yes

$$\text{NII} = \$ (100,000) \times \frac{\$25,000}{\$500,000}$$

- Numerator is positive and tax loss – fraction = 0
- NII = 0

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Example – NII Is Loss

Gain/(Loss)	\$200,000
NII during 1411 H.P.	\$(10,000)
Bus. Inc. during 1411 H.P.	\$475,000
Mat. Participate/Active Bus.	Yes

$$\text{NII} = \$200,000 \times \frac{\$(10,000)}{\$465,000}$$

- Numerator is negative and tax gain – fraction = 0
- NII = \$0

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Example – Loss on Sale, NII Is Loss

Gain/(Loss)	\$(100,000)
NII during 1411 H.P.	\$(10,000)
Bus. Inc. during 1411 H.P.	\$475,000
Mat. Participate/Active Bus.	Yes

$$\text{NII} = \$ (100,000) \times \frac{\$ (10,000)}{\$ 465,000}$$

- Fraction is negative, (-0.022) – fraction = 1
- NII = \$(100,000)

NII Tax

Regular method

- As if actual assets of S Corp were sold for FMV
- Gains and losses separated by types of assets
- NII treatment based on each type of asset
- S Corp must report this information on K-1 if it is known that the SH doesn't qualify for simplified method

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Reasonable Comp

Issues – S Corp

No payroll tax/SE tax on income
Most pay “reasonable comp”
Sch C vs. S Corp tax savings plan

What Is “Reasonable”?

Not defined by Code or Reg
Facts and circumstances
FS-2008-25 – listing of considerations

Reasonable Comp

Glass Blocks Unlimited v. Commissioner, T.C. Memo 2013-180

- No compensation reported
- IRS said all income should be compensation
- “Loan repayments” —→ no documentation
- Court determined “reasonable salary” exceeded total income
 - Disputed taxpayer’s “unreasonable compensation” claim

Reasonable Comp

Sean McAlary, Ltd. Inc. v. Commissioner, T.C. Summary Opinion 2013-62

- No wages reported, \$235,000 net income
- IRS determined \$100,755 was “reasonable comp”
- S Corp, in Tax Court, said \$24,000 was “reasonable comp”
 - Written compensation “agreement”
- Tax Court adjusted IRS’s amount to \$83,200

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Reasonable Comp

What can an S Corp/SH do?

- Consistent, written compensation policy
- Document, using IRS's factors, how amount is arrived at
- Document all in minutes
- Loans – document and follow

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Self Employment Tax Proposals

Proposed Tax Reduction and Reform Act of 2007
Proposed American Jobs and Closing Tax Loopholes Act of 2010
Narrowing Exceptions for Withholding Taxes Act of 2012
Stop the Student Loan Interest Rate Hike Act of 2012
Narrowing Exceptions for Withholding Taxes Act of 2013
Job Preservation and Sequester Replacement Act of 2013
2015 budget
Draft of Tax Reform Act of 2014

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S Corporation Permanent Tax Relief Act of 2014

- Makes permanent 5-year BIG period
- Makes permanent the basis (not fmv) treatment of charitable contribution of property
- Passed House in mid-2014

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Comparison to Other Entities

S Corp versus C Corp

- Double taxation
- Limits on class of stock/shareholders
- Fringe benefits
- Same legal protection
- Distributions versus dividends
- Accounting methods
- Tax year-end

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Comparison to Other Entities

S Corp versus Partnerships

- Same flow through status
- Different legal protection
- Distributions vs. guaranteed payments
- Proportionate vs. disproportionate distribution
- Flexibility
- Organizing documents

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Comparison to Other Entities

S Corp versus Schedule C

- Legal protection
- IRS scrutiny?
- Basis limitations
- SE tax
- Other taxes – PA capital stock

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Former C Corp Issues

- Accumulated earnings and profits
- Distributions – possibly taxable
- BIG tax
 - Unrealized gains at conversion
 - Limited period (10 years?)
 - Triggered by recognizing gains
 - Highest corp tax rate
 - Valuation

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S Corp Terminations

- By majority
- Shareholder limit
- Ineligible shareholder enters
- Class of stock violated
- Termination can cause split tax year
- Generally, can't re-elect for 5 years

Questions?

Charles E. Marston, CPA, MST

cmarston@srsnodgrass.com

(724) 934-0344



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