Do Not Fall into S Corporation Tax Traps

The combination of a single layer of taxation, no self-employment tax on earnings and a familiar corporate structure continue to make S corporations a popular entity choice for closely-held businesses. Despite the benefits of S corporations, taxpayers utilizing them should be alert to avoid certain tax traps for the unwary.

1. If an S corporation distributes appreciated property to its shareholders, the corporation will recognize gain on the distribution as if it had sold the property to the shareholders for its fair market value. If the appreciated property is distributed to a shareholder who owns more than 50% of the corporation and who will depreciate or amortize the distributed property, the net gain will be treated as ordinary income. This is a harsh result, especially if the shareholders do not intend to sell the property.

   Consider putting the appreciated property in a partnership or LLC and distributing the partnership or LLC interest to the shareholders rather than the appreciated property directly. Since the partnership or LLC interest will not be depreciable by the shareholders, the S corporation's gain on the distributed partnership interests may be taxed as a long-term capital gain. Make sure there is a valid business purpose for forming the partnership or LLC other than avoiding the gain recharacterization. Also, this strategy generally will not work if there is only one S corporation shareholder. A single member LLC is disregarded for Federal income tax purposes and the transaction would be deemed a distribution of the underlying assets, *i.e.* the same result as if the assets were distributed directly.

2. If some or all of an S corporation's stock is owned by a grantor trust, the trust will cease to be a grantor trust at the grantor's death. In that event, the S corporation's subchapter S election will be terminated if no action is taken by the trust within two years of the date of death.

   Consider having the former grantor trust distribute the S corporation stock within two years of the date of death to its individual beneficiaries. The trust could alternatively sell the stock to them or to other parties who are eligible to be S corporation shareholders within two years of the date of death.

   Alternatively, the trust could elect to become a Qualified Subchapter S Trust ("QSST") or an Electing S Corporation Business Trust ("ESBT"), either of which is an eligible S corporation shareholder. These trusts are highly complex, and you should review the tax rules carefully before pursuing them. The tax election for either of these trusts must be filed within two years from the decedent's date of death in order to preserve the S election.

3. S corporation shareholders are able to deduct pass-through losses against the basis of any debt that they have loaned directly to the corporation. Unless the debt basis is restored to the debt's face value by subsequent income, any repayment of that debt by the corporation will result in

some income recognition to the shareholder. For example, assume a shareholder loaned $500,000 to his S corporation and that he has deducted $300,000 of pass-through losses against that debt basis, leaving $200,000 of debt basis (a 60% basis reduction). If that debt basis is not restored by subsequent income and the S corporation pays back $200,000 of the debt, 60% of that repayment, or $120,000, will be capital gain income to the shareholder.

A shareholder facing this situation should consider contributing the debt to the capital of the corporation. Neither the S corporation nor the shareholder recognizes income on the contribution to capital and the shareholder receives additional stock basis equal to his remaining basis in the contributed debt. In the future, the shareholder will be able to take distributions or losses against that additional stock basis. This is a complex transaction that must be carefully planned and executed, especially if there are multiple shareholders.

4. S corporations are frequently utilized in an effort to minimize payroll taxes. Typically, this is accomplished by a shareholder taking minimal or no salaries, while funding personal cash needs through tax-free distributions of AAA. The net result is a reduction in payroll taxes. Be aware that the IRS is aggressively pursuing this issue and is often winning the battle in the courts. Generally, an employee-shareholder needs to earn a reasonable salary to steer clear of IRS scrutiny.

S corporations are still a viable and popular entity choice for closely-held businesses, but shareholders need to carefully navigate around the potential landmines to avoid unintended tax consequences. Contact your CBIZ Tofias advisor with questions, or you may reach us at TheBottomLine@cbiztofias.com and 888.761.8835.

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