S Corporations — the Good, the Bad and the IRS

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"I once worked as a salesman and was very independent — I took orders from no one."
— Mel Daskal

In 2002 the IRS announced that 59% of all corporations were S Corporations and that the total was over 3,000,000 of such corporations. You can bet those numbers are higher today. The overriding reason for electing to be an S Corporation is *taxes*. These corporations (except in rare instances) are not subject to corporate income taxes, but rather have the tax treatment of a partnership, in that only the "owners" are taxed — and not the entity itself. Thus they avoid the "double taxation" problem of a regular C Corporation in which both the corporation and (later) the shareholders can be taxed on the same profits, *both* annually and in dissolution.

In our practice, almost without exception, the *larger and more profitable* our rep client may be — the more likely they operate as S corporations. Following are the reasons.

S Corporations — Special Advantages

There are unquestionable advantages *if* you fit these *particular* categories or circumstances:

- As just explained, the principal advantage is to avoid the double taxation that can be levied on C Corporations.
- The very first line of expenses on the corporation tax return Form 1120 asks for information on "officers' compensation. Why is that? The IRS is looking for "unreasonable compensation." The S election avoids the "unreasonable compensation of officers" problem that occurs when officers' salaries (plus retirement plan contributions and other perks) are quite high. At that point, there is a risk that the IRS will reclassify a portion as *non*-deductible (by the corporation) dividends. The IRS does *not* define unreasonable compensation except in vague and general terms, but for smaller corporations we have found that somewhere between a salary of $500,000 and $1,000,000 (or more), you may run into this problem.

EXAMPLE: You drew a salary from your C Corporation of $1.2 million and the IRS auditor reduces this to a "reasonable" $700,000. The difference of $500,000 is reclassified as a non-deductible dividend and *your corporation owes additional taxes on $500,000*! (Interestingly, the IRS auditor seldom suggests that you *personally* may now have $500,000 of dividends at a maximum federal tax rate of 15%, instead of all salary at your "normal" federal tax rate of up to 35%. But even in that event, in this example, your corporation would be paying 34%-35%, plus your personal 15%.) And don't forget, even though the audit was first triggered by the apparent unreasonable compensation, chances are the IRS auditor will find other things to disallow as well.

A dangerous piece of advice from some tax advisors has been for the actively participating shareholder/officer of the S Corporation to refuse any salary.

- Losses incurred by the S Corporation (particularly likely in the first few years of a new business) can be passed directly thru to the shareholders, deducted (generally) on their personal tax returns, and thus used to offset their *other* income. (In such cases we usually do elect S Corporation for a few years, but then sometimes switch to a C Corporation.) However, such loss deductions are cumulatively limited to the S Corporation owner's "investment," (see later explanation).

- It escapes the accumulated earnings tax (IRC Section 531) that may be levied on accumulations of more than $250,000 (but since many of our clients have accumulated earnings in the $100 to $500 ranges — this is not a major threat to most of them).

- A qualified personal *service* business such as a sales agency, as an S Corporation, can continue to use the cash method of accounting after average annual gross receipts exceed $10 million, while the same *service* C Corporation (e.g., sales reps) *cannot*. In general, *all service businesses* as S Corporations can also continue to use the cash method — even when their average annual gross receipts exceed $10 million.

- It avoids the flat 20% alternative minimum tax (AMT) for C Corporations, which can be levied (after a $40,000 exemption) on such items as corporate life insurance proceeds, and/or 75% of the excess of "book" income over taxable income — plus municipal bond interest, all dividends received and a number of other "preferences."

TAXTIP: In a C Corporation, if you do have corporate life insurance on an officer or shareholder who is quite ill, you should quickly consider a possible S Corporation election, *or* carefully (with good tax advice), the transfer of the policies out of the corporation.

- By gifting S Corporation shares to other family members, the profits of the S corporation will be divided among a number of individuals, based on their percentage of ownership. This can limit the profits the original owner will be taxed on, but still keeps the money "in the family" — and those profits are frequently taxed in lower brackets as they are spread around the family.

TAXTIP: This income will be "passive" income to the other family members who are *not* active in the business, so only gift it to those dependents age 18 or older (otherwise, it will still be taxed at *your* highest tax bracket). Any cash distributions to children could even be used to pay for their college education! (However, the operator of the business must draw a "reasonable" salary and not just split *all* the corporation income with the other shareholders — see later discussion).

TAXTIP: The fact that passive income can be passed through to certain shareholders provides a tax planning opportunity. If those shareholders have passive *losses* from other investments (i.e., old "tax shelter" partnerships), they can then offset one against the other. In such circumstances, the result can be that all the income from the S Corporation is, in effect, tax-free to that individual.

S Corporations — Lost Fringe Benefits

In general, the IRS severely limits the fringe benefits of S Corporations by placing them in parity with *partnerships* — since any S Corporation shareholder who owns more than 2% of the total stocks outstanding is treated in the same way as a *partner*. Accordingly, certain of the fringe benefits available to C Corporations — in the case of S Corporations — are either limited or completely disappear.

- Group health (medical) insurance premiums paid by the S Corporation receive unfavorable tax treatment for "more than 2%" shareholders. While such premiums are still *deductible* by the S Corporation, that same amount becomes *taxable income* to those shareholders, and must be reported as such on their Form K-1. Then each "more than 2%" shareholder is limited to a *possible* 100% tax deduction of his/her health insurance premiums on their personal tax returns.

- However, to claim this deduction, the individual must have sufficient "self-employment income" (not as an employee) to equal or exceed the premium amounts. This is frequently not true in the case of some more than 2% S Corporation shareholders. In such cases, the premiums then become part of the itemized medical expense deduction and are only deductible in excess of 7.5% of the adjusted gross income (AGI) of the individual.

EXCEPTION: A more than 2% shareholder's *wages* from an S Corporation *are* treated as if they were the shareholder's self-employment income — for purposes of calculating the health insurance premium deduction.

CAUTION: Health insurance should be purchased in the name of the *corporation* and not in the name of an individual shareholder. Otherwise, the shareholder will not be eligible to deduct the cost of the health insurance as an "above-the-line" deduction, but only as an itemized medical expense. Further, there is presently an unsolved problem in some cases, because some states (e.g., California) do not allow a corporation to purchase a group health plan if there is only *one* participant/shareholder.

The following are still other C Corporation fringe benefits — that when paid by an S Corporation — are "passed through" as *taxable income* to shareholders of "more than 2%" of the stock — which negates any tax benefit:

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- Accident and disability insurance premiums.
- Self-insured medical reimbursement plans.
- Group-term life insurance of up to $50,000.

Other S Corporation Negatives

There are some other drawbacks of S Corporations that should be noted:

- There is no possibility of irregular income splitting between the owners *and* the S Corporation, as can be accomplished with the C Corporation — since *all* the income is taxed pro-rata to the shareholders (*whether distributed in cash or not*).

- Further, all such income must be split *exactly* in accordance with the percentage of stock owned. There is no possibility for "special allocations" before that income split (as there is in the case of LLCs, or even partnerships). For example: If you own 22% of the S Corporation, you *must* report 22% of the net income — period.

- There is no 70% deduction for dividends received (on other corporations' stock), as there usually is for C Corporations.

- Most S Corporations usually *must* report on a calendar year and there are complicated and involved rules, plus special "required tax payments" for any S Corporations that elect to report on a fiscal year (IRS Code Sec. 444).

- Certain states do not recognize S Corporation status and continue to tax them as regular corporations — which makes their tax life very complicated (and their accounting fees very high).

- Some states still levy a tax on the net profits of S Corporations (e.g., California — currently 1.5%, but formerly was 2.5%), even though they "recognize" S Corporations.

TAXTIP: In such cases you should compare the payroll tax costs of additional salary vs. the state tax on any net profits (keeping in mind that there is no salary limit on the medicare tax) — and then make your decision.

- The overall law regarding S Corporations is unusually complex, and you will require continuing tax advice and monitoring of the business operations to avoid many special tax pitfalls and to maximize tax benefits. You should expect to pay additional legal and accounting fees — or otherwise, perhaps fall into tax traps you did not even know existed! For example, consider this next point.

- Even that attractive S Corporation feature of passing through and deducting *losses* on the shareholder's tax return has severe limits. Such losses can only be deducted to the *extent* of each shareholder's investment in the stock of the corporation, plus any net loans made from the shareholder to the corporation. Once that "basis" is used up, that individual can deduct no further losses — unless additional loans are first made to the S Corporation (again increasing the "basis"). This involves constant monitoring of each shareholder's stock and loan account, accompanied by the related professional fees and other costs to do so! Also, there are special limitations on losses and credits from passive activities.

- Under certain circumstances, an S Corporation may still be subject to corporate taxes, under quite intricate rules involving: (a) excess net investment income, (b) certain capital gains, (c) "built-in" gains, (d) recomputing a prior year's investment credit, and (e) on LIFO recapture.

Trying to Avoid S Corporation Payroll Taxes

A dangerous piece of advice from some tax advisors has been for the actively participating shareholder/officer of the S Corporation to refuse any salary. The idea is to avoid all social security/medicare taxes by taking the same funds as S Corporation "distributions-dividends." The apparent loophole is that such payments, even to *active* shareholders of S Corporations, are *not* subject to self-employment tax (although the same "guaranteed payments" if made to active partners of a *partnership* are indeed subject to self-employment tax).

Speaking of "active," the IRS has caught on to this ploy and is "actively" auditing many S Corporations that do not claim any officers' salaries. Then they are enforcing an IRS ruling over 15 years old that lets the IRS reclassify shareholders' distributions as wages "when appropriate." Then they collect all the applicable payroll taxes — plus penalties and interest!

TAXTIP: In this situation, if you take a modest salary, you may avoid being picked for an IRS audit. Further, if you *are* audited, the IRS agent is faced with the "judgment call" problem of trying to claim the salary is too small. On the other hand, if you took *no* salary at all, the IRS agent can set up *any* salary that appears "reasonable" and *you* are faced with the problem of trying to overcome that IRS assumption. See the difference?

FROM THE ACTUAL IRS LETTER ACCEPTING THE S CORPORATION ELECTION:

> "When a shareholder-employee of an S Corporation provides services to the S Corporation, reasonable compensation generally needs to be paid… the IRS will re-character-

ize …dividends paid to shareholders as salary when such dividends are paid to shareholders in lieu of reasonable compensation for services…the IRS may also re-characterize other than dividend distributions as salary."

TAX PREDICTION: There are annual discussions in Congress about changing the rules for taxing the S Corporation income of "*active*" shareholders. The usual proposal is to tax 100% of their income as "self-employment income" no matter how much is classified as salary — and *regardless* if the income is actually withdrawn from the corporation. This would put the tax treatment at parity with similar *partnership* income. Our prediction is that this change will be adopted eventually — depending on Congressional priorities, reelection requirements, political scandals and the conjunction of the planets in that particular month. But eventually…

Conclusion

Given all the pros and cons, S Corporations will continue to grow in popularity — particularly among small businesses. After reading this article, you might also consider Limited Liability Companies (LLCs). In many cases the LLC is the alternative consideration to choosing an S Corporation as your entity of choice.

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