AVOIDING TAX TRAPS
WITH
FLOW-THROUGH
AND
DISREGARDED ENTITIES

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1. Choice of Entity And Operations

1.1. Putting real property in an S corporation

1.1(a) An LLC owned by humans is a much better choice.

1.2. Having S corporation shares held by a grantor trust with more than one grantor when the grantors are not married to each other.[1]

1.3. Using a single-member LLC to hold S corporation shares.

1.3(a) Issuing shares to others will make the LLC a partnership for income tax purposes and blow the S corporation status.

1.3(b) A trust is a better way to veil the true owner of the shares.

1.4. Making disproportionate distributions from an S corporation -- and then equalizing the wrong way.

1.4(a) Risks creating a second class of stock that would blow the S corporation status

[1] See PLR 90-33-044, May 22, 1990.

1.4(b) The regs allow one method. Some private letter rulings permit other methods. A ruling should be obtained if the client wants to use a method not blessed by the regs.

1.5. The S corporation pays state tax for its shareholders.

1.5(a) Risks creating disproportionate distributions

1.5(b) A negative "piercing the corporate veil" factor, because the corporation is paying a personal expense of a shareholder.

1.6. Having the S corporation borrow and then have losses that exceed the share basis.

1.6(a) Better to have the shareholders borrow and loan to the S corporation, which allows them to absorb the tax loss.

1.7. Giving an interest in an LLC to an employee who is not expecting to leave the wage withholding regime and to enter the estimated tax regime.

1.7(a) Possible to pay draws through a payroll service and over-withhold income tax in an amount sufficient to cover the self-employment tax.

1.7(b) Consider the effects on qualified plan coverage tests when these people cease to be employees.

1.8. What if employees of an LLC want ISO treatment for their "stock" options?

1.8(a) A profits interest is possible, but employees who want "stock options" might consider it a poor substitute.

1.9. Using an LLC for a business that might go public.

1.9(a) The transition from LLC to corporation might be difficult if there have been several rounds of financing.

1.9(b) Some investors might not invest until the entity converts to a corporation.

1.10. Unplanned terminations of partnerships under Section 708(b).

1.11. Messing up the inside basis adjustment after a Section 754 election.

1.11(a) Creating new pretend assets per the regs is not very intuitive

1.12. Thinking the Section 754 election applies on a transfer-by-transfer basis.

1.12(a) Once the election is made, it applies to all transfers.

1.12(b) But this is where a planned Section 708 termination of the partnership might be useful.

1.13. Assuming that a "partnership representative" is the same as a "tax matters partner."

1.14. Not having capital calls in an LLC or partnership that will exist after 2016.

1.14(a) The partnership representative might commit the partnership to pay additional taxes, interest or penalty – even after the partnership has dissolved.

1.14(b) The manager needs to have the authority to require the partners to pay up, and the discretion to determine the amounts that the partners must pay.

1.15. Electing to classify an LLC or limited partnership as a corporation.

1.15(a) It can only lead to trouble.

1.15(b) A Nevada corporation offers charging order protection to the shareholders.

1.16. Converting a corporation to an LLC classified as a partnership.

1.16(a) It will be a taxable liquidation of the corporation.

1.17. Not taking a position on the 1374 gain on the Form 1120S.

1.17(a) It gives the IRS an advantage in a later Section 1374 audit.

1.18. Forgetting that cash method receivables will be subject to the BIG tax when they are collected in the first S corporation year.

1.18(a) Avoidable by routine tax planning.

1.19. Assuming the "recognition periods" for built-in gain are the same for federal and California tax purposes (5 years for federal, 10 years for California)

1.20. Not addressing a potential accumulated earnings tax penalty by making an S corporation election

1.21. Addressing personal holding company status by making an S corporation election, but not addressing the excess passive receipts penalties.

1.21(a) *Not* addressing PHC status by making an S corporation election, out of fear of the excess passive receipts penalties.

1.22. Transferring S corporation shares to a charity or a qualified plan.

1.22(a) There is UBTI tax on the sale of the shares, not just on the flow-through income.

1.22(b) Exception – No UBTI tax on flow-through income to an ESOP or on sale of employer stock by an ESOP.

1.23. Having a shareholder sell shares to an ESOP sponsored by an S corporation.

1.23(a) A sale to an ESOP sponsored by a C corporation could be tax-free.

1.24. Letting a non-USA person hold a business in a U.S. LLC or partnership.

1.24(a) The person will have a "permanent establishment" in the U.S.A. for tax treaty purposes and might be required to report his or her worldwide income to U.S. tax authorities.

1.25. Letting a contractor use an LLC in California instead of a corporation.

1.25(a) It's allowed, but the rules for using an LLC are much worse than those for using a corporation.

1.26. Using a series LLC to conduct a business in which one of the series might be pushed into bankruptcy

2. Buy-Sell Agreements

2.1. Using a buy-sell agreement for an S corporation that just says "no transfers to ineligible shareholders."

2.2. A resident alien gets a community property interest in S corporation shares, leaves the USA and becomes a nonresident alien.

2.2(a) Address this in the buy-sell agreement.

2.3. S corporation shares are allocated from a living trust to a QTIP trust and an exemption trust.

2.3(a) A QSST election must be made for the QTIP trust.

2.3(b) An ESBT election must be made for the exemption trust.

2.3(c) The time allowed for the election is two years after the shares are transferred to the trust.

⇒ Consider both a "tax return transfer" (that is, when the shares are treated for tax return purposes as held in the new trust) and a "stock certificate transfer" (that is, when a stock assignment and new stock certificate are signed).

2.3(d) Failing to make a timely election terminates the S corporation status

⇒ An "inadvertent termination" letter ruling might be available. But the cost in 2017 is $28,300 in user fees and probably a similar amount in legal fees.

2.4. Not specifying the damages for improperly terminating the S corporation status

2.5. Not covering the community property interest of a spouse of the named shareholder

2.5(a) Not requiring a new spouse to sign the buy-sell agreement so that the community property interest of the new spouse is covered by the Buy-Sell Agreement

2.6. Not giving the shareholder-employee-ex and the corporation options to buy any shares awarded to the spouse in a divorce.

2.6(a) Especially if the shares are intended to stay in the family.

2.7. Expecting a buy-sell agreement to provide as much protection as trust.

2.7(a) The best protection for shares of a closely-held business held by several generations of a family is a dynasty trust and a buy-sell agreement.

3. Subsidiaries

3.1. Making a QSub election when the subsidiary's debt to the S parent exceeds the value of the subsidiary's assets.

3.1(a) The election will be a "failed" Section 332 liquidation of the subsidiary into the parent (that is, the deemed liquidation of the subsidiary will be a taxable transfer of its assets in partial satisfaction of its debt to the parent).

3.2. An unplanned termination of a QSub.

3.2(a) Could be treated as a taxable sale of all of the assets of the QSub – in a "busted" Section 351 transaction (for example, a sale of more than 20% of the shares of the "QSub").

3.3. Using a QSub when a single-member LLC would work

3.3(a) The conversion of a single-member LLCs to a partnership does not have the downside of a termination of QSub status.

3.4. Treating a QSub as a real corporation in a reorg.

3.4(a) Generally, QSubs are ignored in reorgs, even though they are real corporations for state corporate law purposes.

3.5. Having a charity conducts an "unrelated" business in an LLC instead of a C corporation.

3.5(a) The activity of the LLC will be treated as activity of the parent charity, possibly creating taxable UBTI, and possibly terminating the tax-exempt status.

4. Selling and Buying Businesses

4.1. Agreeing to a sale of S corporation stock without knowing whether the buyer plans to make a Section 338(h)(10) or 336(e) election.

4.1(a) For federal income tax purposes, there will be ordinary income on Section 1245 recapture

4.1(b) The buyer may be willing to make the seller whole for this extra tax

4.2. Not closing the year when S corporation stock is sold.

4.2(a) The buyer can allocate income to the end of the year or defer expenses to the next year, and the seller will share the tax on that income unless they agree to close the year.

4.2(b) Consider closing as of January 1 (for a calendar year S corporation)

4.3. Selling less than all of the outstanding S corporation shares without arranging for the "old" shareholders to receive in cash the profits on which they have paid tax.

4.3(a) Unless arrangements are made, they will share the distributions with the new shareholder(s).

4.3(b) This comes up when one shareholder sells some of his shares, or when the corporation issues shares to employees pursuant to an incentive compensation arrangement.

4.4. In a sale of S corporation shares, not getting an additional payment to pay the tax due on income earned before the closing.

4.4(a) The seller can't receive "dividends" when the seller is no longer a shareholder.

4.5. Having an S corporation buy shares of a target corporation, not making a Section 338 election, and then making a QSub election for the target.

4.5(a) After the QSub election, the basis in the *assets* carries over – but the basis in the *shares* is lost forever.

5. Dissolving

5.1. Selling the assets of an S corporation after the death the sole shareholder, and distributing the sale proceeds in a later year.

5.1(a) Making lifetime gifts of the shares of an S corporation with one shareholder.

5.1(b) The basis step-up in the S corporation shares at the death of a sole shareholder can permit a tax-free dissolution of the corporation, but only if the needle is threaded perfectly.

5.2. Assuming that a 50% member can dissolve an LLC.

5.2(a) True for California corporation, but not for California LLCs.

6. Estate Planning

6.1. Not making a QSST election for a QTIP or an ESBT election for a credit shelter trust.

6.1(a) Two years to make the election after the shares are transferred to the trust.

6.2. Not making a Section 645 election for a trust that (a) holds S corporation shares after the death of a decedent and (b) was a grantor trust before the death.

6.2(a) S corporation shares can be held by estates without any time limit.

6.2(b) The election treats the trust as an estate for income tax purposes for two years (if no estate tax return is filed, until 6 months after the IRS closing letter otherwise), so elections can be deferred until the shares are actually distributed.

[End of outline.]