Messed-up S Corps

For many businesses, electing or maintaining S corporation status is critical. A business that (1) can be built up and sold (or is a "cash cow"), (2) is held in a corporation (3) the shares of which are owned by humans, trusts or estates (and not other business entities) is the perfect candidate for the S corporation election. Why? Because a buyer will want to buy the business assets, not the stock. The gain on the assets (including goodwill) will be taxed at a 23% tax rate when sold by an S corp and a 54% rate if sold by a C corporation (with the proceeds taxed at two levels: first to the corporation, on the sale, and then to the shareholders, when the after-tax sale proceeds are distributed to them) – a 31% spread. The spread will be similar if in 2013 federal tax rates increase as presently scheduled.

The valuable S corporation status is fragile. C corporation status (and a double tax on the sale of the business) is the default. The corporation and its shareholders must make a valid S corporation election and satisfy eligibility rules at all times that the election is in effect. This is not always easy. For example, if the shares are held as community property, both spouses must consent to the S election. My office has fixed many S corporations that otherwise might have defaulted to C corporations. We've had the IRS bless a late consent by a spouse of a shareholder (which delayed the closing of the sale of the business). We've even had the IRS bless a late consent when the spouse consented after the shareholder died. We've had the IRS accept very late S corporation elections.

An S corporation can have only one class of stock. A less-than-obvious corollary: when an S corporation makes distributions to its shareholders, it must distribute the exact same number of dollars per share to each shareholder. Distributions that violate this rule plus an agreement to make them create the dreaded "second class of stock" that can terminate the S corporation election. We've made laborious calculations to determine the distributions that an S corporation musk make to "equalize" past distributions.

It's not possible to make good distributions unless there is certainty about how many shares each shareholder owns. The stock records must be consistent with the percentage interests shown on the S corporation's tax return (Form 1120S, Schedule K-1). We have "rebuilt" stock records to make them consistent with the tax records and to avoid the risk of a "second class of stock."

An S corporation that has undistributed C corporation profits must pay a penalty if more than 25% of its gross income is from passive sources. One possible remedy is to distribute to the shareholders all of the C corporation profits and pay tax on them. Less drastic: have the S corporation buy pass-through interests in entities with low gross margins, so a dollar buys lots of pass-through active receipts.

It is often good estate planning to put S corporation shares in a trust. The typical living trust can hold S corporation shares with no problem. The tax issue arises when the person who made the trust (or one of them) dies. The trust typically splits into new trusts, some of which are not able to hold S corporation shares unless a special tax election is made by the trustee or the beneficiaries (depending on the type of trust). The election generally must be made within two years after the shares are transferred into the trust. Sometimes the shares are not really transferred, but the tax returns are prepared as if the shares had been transferred. This can make it difficult to tell when the two-year period started. We have sorted out the stock records in these cases, working closely with the estate attorney and/or the accountant. We can ask the IRS to permit late trust elections, using procedures that the IRS has published.

It is also helpful if the trust document instructs the trustee to act to preserve the S corporation status. The document should address what the trustee should do if the trustee is instructed to distribute S corporation shares to a person or trust that cannot hold S corporation shares. We have reviewed and commented on several trusts to help preserve the valuable S corporation status.

But what we do most often is to include in buy-sell agreements among shareholders provisions that protect the valuable S corporation election. Sometimes the agreement also requires the corporation to make distributions in amounts sufficient to allow the shareholders to pay their taxes on their shares of the S corporation's income. We have reviewed many buy-sell agreements prepared by others and commented on how well they protected the S corporation election – or whether they caused other tax problems.

I would be happy to talk with you about making the S corporation election or protecting the valuable S corporation status for your clients.

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