NUTS AND BOLTS
OF
S CORPORATIONS

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TABLE OF CONTENTS

Page

1. "C Corporations" and "S Corporations" 1
2. Benefits of Electing S Corporation Status 1
3. Benefits of Retaining C Corporation Status 3
4. S vs. C vs. LLC – Which is best? 4
5. Eligibility to Elect S Corporation Status 7
6. Making the S Corporation Election 13
7. Selecting a Tax Year 14
8. Taxation of the S Corporation and Its Shareholders 15
9. Corporate-Level Taxes 17
10. Shareholder-Level Taxes 22
11. Losses 23
12. Tax Basis in Stock 24
13. Distributions 25
14. FICA and Medicare Taxes 28
15. Actions That Could Terminate S Corporation Status 29
16. California Taxes 32
17. Buy-Sell Agreements 33
18. Non-Tax Considerations 34
19. LLCs as S Corporations 35
20. Key Points 36

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NUTS AND BOLTS
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1. "C Corporations" and "S Corporations"

Generally, all corporations are "C corporations" for tax purposes unless they elect to be treated as "S corporations" (or their parent corporations elect to treat them as Qualified Subchapter S Subsidiaries ("QSubs").[2]

2. Benefits of Electing S Corporation Status

The S corporation election may offer to a C corporation (and to its shareholders) substantial benefits:

- The S corporation election reduces or avoids a second tax on an eventual sale of substantially all of the assets of the corporation, including goodwill.[3]

- If the business grows rapidly and retains a substantial portion of its earnings to finance growth, the S corporation election minimizes the gain on an eventual sale of stock.[4]

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[1] *This outline should be viewed only as a summary of the law and not as a substitute for legal or tax consultation in a particular case. Your comments would be appreciated and are invited.*

[2] I.R.C. § 1361(a)(1).

[3] The sale by an S corporation generally would be subject to a single tax paid by the shareholders, while a sale by a C corporation would be subject to a substantial tax on the corporation's gain and another substantial tax on the receipt by the shareholders of the balance of the sale proceeds. But see the "The Built-In Gains Tax" at page 17 below.

- If the business throws off more cash than (a) necessary to grow or maintain the business and (b) the shareholders can reasonably take as compensation, rent, royalties and other deductible payments, then an S corporation can distribute that cash as tax-free dividends to its shareholders. Those distributions would be taxable to C corporation shareholders. Tax-free distributions from an S corporation are especially helpful for family members who own shares but have a small role in the business.

- An S corporation otherwise eligible to use the cash method of accounting can retain that method, even if the corporation's receipts exceed $5 million for three consecutive years. A C corporation otherwise eligible to use the cash method of accounting cannot use that method if the corporation's average receipts exceed $5 million over a three-year period.[5]

- In years for which the S corporation and QSub elections are in effect, neither the S corporation nor its QSub would be subject to the penalty tax that otherwise might apply to its excess accumulated earnings.[6] If a C corporation has more liquid assets that it can prove that it needs for working capital, this penalty tax is a significant risk.[7]

- There is little reason for tax authorities to question whether the compensation of the shareholder of an S corporation is unreasonably large. In contrast, tax authorities may and sometimes do assert that the compensation of a shareholder of a C corporation is unreasonably large and that the excessive portion should be recharacterized as a

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(footnote continued from preceding page)

4 Earnings that are retained by an S corporation and not distributed to the shareholders will increase their tax basis in their stock of an S corporation, but not a C corporation.

All of these benefits (and a few others) could be achieved by converting a C corporation to a **limited liability company** that is classified as a partnership for tax purposes. 💣 However, the conversion would be treated as a liquidation of the corporation for tax purposes and would trigger both corporate and shareholder taxes.

5 I.R.C. § 448.

6 The S corporation election does not reduce the risk for C corporation years.

7 I.R.C. § 531. The effect of the penalty tax is to enable the IRS on audit to force a dividend that will be subject to the "double tax," described at page 1 below.

dividend, for which no corporate deduction is allowed. If this position prevails, the C corporation would be subject to substantial additional tax.

- If the business generates losses or tax credits, the S corporation rules allow the shareholders to use those losses and credits to reduce their tax on income from other sources, subject to the basis, at risk and passive loss limitations (discussed below).

- An S corporation cannot take advantage of the 15% and 25% tax rates that apply to the first $75,000 of a C corporation's income. However, while the corporation is very profitable, the value of the ability to make tax-free cash distributions as an S corporation can substantially exceed the value of the benefit derived from the lowest C corporation tax rates.

3. Benefits of Retaining C Corporation Status

Retaining C corporation status would allow income from business operations of to be taxed at lower rates and should be used:

- If business operations will generate losses that can be carried back against taxes previously paid; or

- If the business will have zero profit each year *and* the business will not increase substantially in value.

- It would also be necessary to retain C corporation status if the current shareholders or prospective investors in the corporation demand the partial exclusion for gain on the disposition of "qualified small business stock," which is not available for S corporations.[8] For an investor who expects to cash out by selling stock, the tax benefit from the stock basis increases resulting from an S corporation election must be weighed against the benefits of this exclusion, which often will result

8 I.R.C. § 1202.

in tax at an effective 28% AMT rate, not half of the long-term capital gain rate.[9]

4. S vs. C vs. LLC – Which is best?

- An LLC is usually best, if it can be used.

  - ⇨ C corps are subject to a double tax when the business is sold. If an S corp fails the eligibility requirements (discussed below), it becomes a C corp. LLCs will never inadvertently become subject to the double tax.

  - ⇨ LLCs can make a Section 754 election to adjust the inside basis when membership interests change hands. An S corporation shareholder cannot benefit from a high basis in the shares until the corporation dissolves or the shareholder sells the shares.

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[9] I.R.C. § 55. An individual investor excludes from regular taxable income 75% of the capital gains on certain "qualified small business stock" that he or she holds for five years. The anticipated effect is a reduction in the federal long-term capital gain tax rate, but this benefit might be illusory. For alternative minimum tax ("AMT") purposes, 7% of the excluded gain is a preference item. I.R.C. § 57(a)(7). The highest AMT rate is now 28%. Taxpayers with substantial excluded gains probably will be subject to the AMT tax on the gain, not preferential rate long-term capital gain. California taxes, including the tax on the gain from the stock sale, are not deductible for AMT purposes. I.R.C. § 56(b)(1)(A)(i). So for the investor, founder or employee who hits a home run with "qualified small business stock," the AMT preference substantially reduces or eliminates the benefit of the exclusion. The maximum amount of excludable gain is the greater of 10 times investor's tax basis in the shares or $10 million. I.R.C. § 1202.

A "qualified small business" is a C corporation engaged in an active trade or business with capitalization of less than $50 million at all times from January 1, 1993 (or, if later, since its incorporation) through date of stock purchase. I.R.C. § 1202(c), (d). The banking, leasing, real estate, farming, mineral extraction, hospitality and personal service businesses cannot be "qualified small businesses." I.R.C. § 1202(e). (Note that these rules differ from the S corporation eligibility rules.)

To qualify for the exclusion, the stock must be issued after August 10, 1993. I.R.C. §1202(c)(1).

- ⇨ It’s easy to bring members in and out of an LLC (or LLP) and to adjust ownership interests. Section 83 and the one-class-of-stock rule make this difficult for an S corporation.

- ⇨ Distributions and allocations from an LLC can be tailored precisely. There is a one-class-of-stock rule for S corporations but not for LLCs. Also, LLCs can have priority returns and special allocations, but the one-class-of-stock rule prevents S corporations from having anything analogous.

- ⇨ Distributions of appreciated assets from an LLC rarely trigger tax. Distributions of appreciated assets from an S corporation will be taxable to all of the shareholders -- even if only one shareholder receives the appreciated property.

- ⇨ Entity-level borrowings can give members basis in their LLC interest to absorb LLC losses. S corporation shareholders do not get basis to absorb S corporation losses when the S corporation borrows. The shareholder must borrow and loan the money to the S corporation; then the shareholder can use the basis in the loan to absorb loss.

- But …

  - ⇨ LLCs don’t go public, corporations do. The conversion from an LLC to a corporation can be troublesome, so a business that planned to go public would begin as a corporation – and an S corporation if possible, to allow the shareholders to benefit from early losses.

  - ⇨ Owners can do tax-free stock swaps with corporate stock, but not with LLC membership interests.

  - ⇨ Corporations can issue tax-favored incentive stock options, but LLCs can’t.

- ⇨ LLCs cannot conduct in California activities that require a license under the Business and Professions Code.[10] Accountants, architects and attorneys can use LLPs.[11] Otherwise, for an owner who will be active in the business, the S corporation is the best way to minimize the exposure of the owner's personal assets to claims against the business. A limited partnership might be best for a "silent partner" if an LLC won't work.

- Incorporating is all about minimizing liability and maximizing transferability. It has not been about saving taxes since 1986.

- A single-member LLC is the ideal subsidiary.

  - ⇨ No consolidated return rules.[12]

  - ⇨ 💣A QSub of an S corp can trigger tax when it ceases to be 100% owned by the S corp – a trap from which it is not possible to protect your client completely.[13] (The time bomb 💣

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[10] Cal. Corp. Code § 17375 ("Nothing in this title shall be construed to permit a domestic or foreign limited liability company to render professional services, as defined in subdivision (a) of Section 13401 and in Section 13401.3, in this state."); 1996 Cal. Stat. ch 57, § 30 ("Nothing in this act nor Chapter 1010 or Chapter 1200 of the Statutes of 1994 shall be construed to permit a domestic or foreign limited liability company to render professional services, as defined in subdivision (a) of Section 13401 of the Corporations Code, in this state."); 1994 Cal. Stat. ch. 1200, § 93 ("Nothing in this act shall be construed to permit a domestic or foreign limited liability company to render professional services, as defined in subdivision (a) of Section 13401 of the Corporations Code, in this state unless expressly authorized under applicable provisions of the Business and Professions Code or the Chiropractic Act."); Cal. Corp. Code § 13401(a) ("'Professional services' means any type of professional services that may be lawfully rendered only pursuant to a license, certification, or registration authorized by the Business and Professions Code or the Chiropractic Act.").

[11] Cal. Bus. & Prof. Code § 5535 (architects, until 1-1-2012), Cal. Corp. Code §§ 16101(17), 16306(c), State Bar Limited Liability Partnership Rules and Regulations 3.0 and 4.0.

[12] Treas. Reg. §§ 301.7701-2(c)(2) ("disregarded as an entity separate from its owner"); 301.7701-3(a) (the "check-the-box" rules allow a SMLLC to elect to be classified for tax purposes as a corporation – seldom a good idea).

[13] The subsidiary ceases to be disregarded when it ceased to be a QSub. 💣 If buyers purchased more than 20% of the QSub stock, the termination of QSub status would be a

(footnote continued on next page)

symbol indicates a trap for the unwary. Heck, even for the wary.)

5. Eligibility to Elect S Corporation Status

- To be eligible to make an S corporation election and to retain that special status, a corporation must be a "small business corporation."[14]

  ⇨ The eligibility requirements for a "small business corporation" are listed below.

- The corporation must have outstanding only *one class of stock*.[15]

  ⇨ Share which differ only as to voting rights (for example, non-voting stock) but participate equally in distributions are treated as a single class for this purpose.[16]

  ⇨ An S corporation cannot have outstanding a class of stock that gives its holders preferential rights to receive distributions from the corporation (for example, convertible preferred stock, a favorite of venture capital firms and private equity funds).[17]

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"busted" Section 351 transaction – a taxable "exchange" by the S parent. 💣 Even in a good Section 351 transaction, gain can be recognized by the S parent under Section 357(c) if liabilities "assumed" by the subsidiary exceed the basis of the assets "transferred" to the subsidiary in the termination. 💣 And the subsidiary will be a C corporation if the S parent retains any of its stock. *All of these can be tax disasters.*

[14] I.R.C. § 1361(a)(1).

[15] I.R.C. § 1361(b)(1)(b); Treas. Reg. § 1.1361-1(*l*).

[16] I.R.C. § 1361(c)(4).

[17] If the articles of incorporation authorize more than one class but only common is outstanding, it would be good to amend the articles to eliminate the other classes of shares.

- A corporation cannot be a "small business corporation" if it is a DISC or "former DISC", an insurance company or a financial institution that uses the reserve method of accounting for bad debts.[18]

- Generally, only individuals who are U.S. citizens or resident aliens and their estates are eligible to hold shares of an S corporation.[19]

- None of the shares can be owned by a corporation, a partnership of any kind, an LLC, or an IRA.

    - ⇨ Although none of the shares of an S corporation can be held by a corporation, 100% of the shares of a QSub can (and must) be held by an S corporation.[20]

        - ▪ A *QSub* is disregarded for tax purposes.[21]

    - ⇨ These rules mean that if and when a *venture capital company* acquires any shares of the corporation (of any type), its S corporation election will terminate.

- *Bankruptcy estates* and *estates of decedents* can hold S corporation shares, without any limitation as to time.[22]

    - ⇨ If the shares will be distributed from a decedent's estate to an ineligible *testamentary trust*, the ineligible trust has

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18 I.R.C. § 1361(b)(2).

19 I.R.C. § 1361(b)(1)(B).

20 I.R.C. § 1361(b)(3)(B)(i). The S parent must also file an election to create the QSub status.

21 I.R.C. § 1361(b)(3)(B). The QSub is not disregarded for any other purpose. Corporate formalities and separate books and bank accounts should be maintained to minimize the risk of "piercing the corporate veil."

22 I.R.C. § 1361(b)(1)(B).

> *two years* after it *acquires the shares* to dispose of the shares without terminating the S corporation status.[23]

- *Grantor trusts* can hold S corporation shares,[24] so the typical *living trust* qualifies during the lifetime of the trustor and for *two years after death*.[25]

- At the death of the first spouse:

  ⇨ An *administrative trust* can hold S corporation shares for two years after the date of death. [26]

  ⇨ If the *survivor's trust* created after the first death is a grantor trust and the grantor is eligible to hold S corporation shares, the trust qualifies as an S corporation shareholder.[27]

  ⇨ A *QTIP trust* will qualify as a QSST if the beneficiary eligible to hold S corporation shares – 💣 but it must make a timely QSST election.[28]

  ⇨ A *credit shelter trust* will often qualify as an electing small business trust or ESBuT – 💣 but it also must make a timely ESBuT election.[29]

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23 The former 60-day periods in which an ineligible trust must dispose of its S corporation stock was extended to two years, effective for taxable years beginning after December 31, 1996. Small Business Tax Act § 1303, amending I.R.C. § 1361(c)(2)(A)(ii) and (iii). Treas. Reg. § 1.1361-1(h)(1)(iv) (testamentary trusts).

24 I.R.C. § 1361(c)(2)(A)(i). The grantor must be an eligible individual shareholder. I.R.C. § 1361(c)(2)(B)(i).

25 I.R.C. § 1361(c)(2)(A)(ii).

26 Treas. Reg. § 1.1361-1(h)(1)(ii).

27 Assuming the surviving spouse remains a U.S. citizen or resident alien. Treas. Reg. § 1.1361-1(h)(3)(A). Regarding grantor trusts as S corporation shareholders, see Treas. Reg. § 1.1361-1(h)(1).

28 Treas. Reg. § 1.1361-1(j)(4). See page 10 below.

29 I.R.C. § 1361(c)(2)(A)(v), (e). See page 10 below.

- *Separate Trust Shares*

  ⇨ Separate trust shares are treated as separate trusts for S corporation purposes.[30]

- *Qualified Subchapter S Trusts ("QSSTs")*

  ⇨ If it meets the requirements and makes a timely election, a QSST is treated as a grantor trust with respect to its S corporation stock.[31]

  ⇨ It must distribute all of its income annually to a single beneficiary. If it distributes principal, it must be to that beneficiary and to no other.[32] It cannot "sprinkle" or "spray."

- *Electing Small Business Trusts ("ESBuTs")*

  ⇨ Since 1996 S corporation shares have been permitted to be held by ESBuTs, which can be sprinkling trusts and can have contingent charitable beneficiaries.[33]

  ⇨ The ESBuT is treated as a separate trust for trust tax accounting.[34]

- *Grantor Retained Annuity Trusts ("GRATs")*

  ⇨ As a grantor trust, the GRAT is eligible to hold S corporation shares.[35]

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30 I.R.C. §§ 663(c), 1361(d)(3) (flush language); Treas. Reg. § 1.1361-1(j)(3).

31 I.R.C. § 1361(d)(1).

32 I.R.C. § 1361(d)(3)(A). 💣 The regulations say that the trust instrument must contain this provision; operating this way is not sufficient. Treas. Reg. § 1.1361-1(j)(1)(ii).

33 I.R.C. § 1361(a)(1), (b)(1)(B), (c)(2)(A)(v), (e).

34 I.R.C. § 641(d).

- *Defective Grantor Trusts*

    - ⇨ As grantor trusts, defective grantor trusts are entitled to hold S corporation shares. The defective grantor trust holding stock of a very profitable S corporation is a powerful estate planning technique.

- *Crummey Trusts*

    - ⇨ In theory part of a Crummey trust is a grantor trust with respect to the beneficiaries, and the S corporation stock could be allocated to that part of the trust.

    - ⇨ 💣 The better approach is to *be very conservative with the S corporation status*, and to avoid S corporation stock in Crummey trusts.

- *Voting Trust*

    - ⇨ Ignored for S corporation purposes.[36]

- *Bypass or Credit Shelter Trust*

    - ⇨ Usually does not qualify as a QSST because it does not require current distributions to a single beneficiary.

    - ⇨ So must qualify as an ESBuT, if at all.

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[35] *See* PLR 94-15-012, January 13, 1994. A GRAT is an ideal way to capture a third discount (a time value of money discount added to those for lack of control and lack of marketability) when S corporation shares are gifted.

[36] I.R.C. § 1361(c)(2)(A)(iv); Treas. Reg. § 1.1361-1(h)(1)(v).

- *Foreign Trust*

  - ⇨ 💣 Does not qualify as an S corporation shareholder -- even if the beneficiaries are eligible or the trust would otherwise be a QSST, voting trust or ESBuT.[37]

- *Custodian for the benefit of a minor*

  - ⇨ A custodian for the benefit of a minor is not treated as the shareholder for the purpose of counting S corporation shareholders and the other eligibility rules. [38]

  - ⇨ The minor must be an eligible shareholder, but the custodian need not be eligible.

  - ⇨ 💣 When the S corporation election is made, the minor's parent or guardian must consent to the S election, and the consent of a custodian who is not the parent or legal guardian is not sufficient.[39]

- No more than 100 families can hold shares of an S corporation.[40] Avoiding exceeding the *100-family limit* is now less important as S corporation shares move through the second and third generations.

  - ⇨ Holding the shares in ESBuTs is the best way to avoid exceeding this limit.

    - ▪ The necessity of getting shareholder and spousal consents to changes to the buy-sell agreements makes them inferior to trusts.

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[37] Treas. Reg. 1.1361-1(h)(2).

[38] Treas. Reg. §1.1361-1(e)(1).

[39] Rev. Rul. 68-227, 1968-1 C.B. 381; Rev. Rul. 66-116, 1966-1 C.B. 198. *See, e.g.,* PLR 94-47-022, August 23, 1994 (inadvertent termination relief), 91-21-027, May 24, 1991 (same).

[40] I.R.C. § 1361(b)(a)(A), (c)(1).

⇨ The trust instrument can specifically address the 100-family limit.

▪ The trust needs a mechanism (such as a trust protector) to change as the S corporation rules change over time.

• Note that *none* of these eligibility rules apply to LLCs.[41] This is a major advantage of the LLC over the S corporation.

6. Making the S Corporation Election

- To become an S corporation, a corporation must be a "small business corporation" and must make a proper and timely S corporation election.[42] The S corporation election is made on Form 2553.[43]

- The S corporation election can be made at any time before the first day of the taxable year for which it will be effective.[44] If made by the 15th of the third month of the taxable year, and the other eligibility requirements are satisfied, the election would be effective as of the first day of the tax year.[45]

- The election must be signed by each shareholder (and by each spouse of a shareholder if the spouse has a community property or other interest in the shares).[46]

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41 Treas. Reg. §§ 301.7701-2(c)(1) (defining a "partnership" for tax purposes); 301.7701-3(a) (the "check-the-box" rules allow an LLC to elect to be classified for tax purposes as a corporation – seldom a good idea; see "LLCs as S Corporations" at page 35 below).

42 I.R.C. § 1361(a)(1).

43 Treas. Reg. § 1.1363-6(a)(2)(i).

44 I.R.C. § 1362(b)(1)(A).

45 I.R.C. § 1362(b)(1)(B).

46 Treas. Reg. § 1.1362-6(a)(2)(i), -6(b)(2)(i). There is a procedure for filing spousal consents late. Rev. Roc. 2004-35, 2004-1 C.B. 1029.

- The election must be filed on time with the Internal Revenue Service.[47] It is not effective unless it is sent to the IRS. Attaching it to the corporate tax return in not sufficient.

- 💣 Eligibility requirements must be satisfied by the corporation and each shareholder.[48]

  - ⇨ 💣 These requirements must be satisfied at all times while the election is in effect.

  - ⇨ 💣 If the requirements fail to be satisfied at any time, the S election will terminate.[49]

    - 💣 If the S election for an S parent terminates, each QSub will become a C corporation (a tax disaster).

    - If a valid S corporation election is made, new shareholders need not consent to the election.[50] Nor can they terminate the election by failing to consent to it.

- *Late Elections*

  - ⇨ The IRS has published procedures to permit various late elections.[51]

7. Selecting a Tax Year

S corporations have a limited range of permissible tax years.

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[47] The fully-signed election form should be mailed to the Internal Revenue Service on or before the last day to make the election. It is a good idea to send it as certified mail, return receipt requested.

[48] See “Actions That Could Terminate S Corporation Status” below.

[49] See “Actions That Could Terminate S Corporation Status” below.

[50] Treas. Reg. § 1.1362-6(a(2)(i).

[51] Rev. Proc. 97-48, 1997-2 C.B. 521; Rev Proc. 2003-43, 2003-1 C.B. 998; Rev. Proc. 2007-62, 2007-41 I.R.B. 786.

- Generally an S corporation can use the calendar year or, by paying a corporate-level federal tax for the privilege, it may use a year ending in September, October, or November.[52]

    - ⇨ To adopt a tax year other than a calendar year, the corporation should file Form 8716 with its S corporation election.[53]

- Using a September year can minimize the "income bunching" problem when a fiscal-year C corporation makes an S corporation election.[54] Bunching is an important issue in a C2S conversion.

8. Taxation of the S Corporation and Its Shareholders

Subject to the tax for using a fiscal year and the two taxes described below, S corporations generally are not subject to federal income tax.[55] Instead, each shareholder is taxed directly on his or her share of the corporation's taxable income.[56]

- As noted above, an S corporation cannot use the 15% and 25% federal income tax rates that apply to the first $75,000 of a C corporation's income.[57]

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52 I.R.C. §§ 444, 1378; Treas. Reg. §§ 1.441-1(c), 1.444-1T, 1.1378-1.

53 Treas. Reg. § 1.444-3T. Although the corporation could file Form 8716 after the S corporation election, it is a good idea to file Form 8716 it with the S corporation election.

54 For example, a C corp with a January year might pay bonuses to its shareholders in January 2010. If the S corporation election is effective on February 1, 2010 and the corporation changes to a calendar year, the shareholders will take into income for 2010 the January bonuses and 11 months of income from the S corporation. In contrast, if with the S corporation election the corporation changed to a September year, the shareholders would take into income for 2010 the January bonus and only 8 months of S corporation income. There is bunching either way, but less bunching if the corporation changes to a September year rather than a calendar year.

55 I.R.C. § 1363(a).

56 I.R.C. § 1366(a), (b), (c).

57 I.R.C. § 11(b)(1). The savings for a C corporation can exceed $11,000 annually. However, as the C corporation's taxable income increases from $100,000 to $335,000, the corporation gives back the benefit of the lower rates by paying a federal 39% tax rate. So the tax savings of C corporation status over S corporation status taper off as taxable income ap-

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⇨ As a result of the S corporation election and QSub elections, the taxable income of the business will be taxed at the federal and California tax rates for individuals.[58]

⇨ The maximum average federal income tax rates for individuals (33% and 35%) are *currently* approximately equal to the maximum average federal income tax rates for C corporations (34% and 35%).

⇨ The maximum California personal income tax rate (9.55%) is somewhat higher than the California franchise tax rate (8.84%) for C corporations.[59]

(footnote continued from preceding page)

proaches $335,000. The 35% federal tax rate for C corporations kicks in at $10M of taxable income.

[58] See "Shareholder-Level Taxes" at page 22 below.

[59] The California taxes are deductible for federal tax purposes. I.R.C. § 164(a)(3). The federal and California itemized deduction cut-backs based on adjusted gross income increase the effective federal income tax rate for individuals by almost two percentage points over the nominal rates mentioned in this paragraph. I.R.C. § 68, Cal. Rev. & Tax. Code § 17077. The California personal income tax rate is 10.55% for income over $1 million. Cal. Rev. & Tax. Code § 17043.

A corporation that is an S corporation for federal purposes is also an S corporation for California tax purposes. When the federal election terminates, the California election terminates also. It does not matter whether the corporation is incorporated in California or qualified to do business in California. There is longer the possibility of being an S corporation for federal tax purposes and a C corporation for California tax purposes, or vice versa. Cal. Rev. & Tax. Code § 23801(a), (b), (e).

This is important!

- The S corporation election *avoids a "double tax"* when the corporation sells or distributes cash or other assets to its shareholders (ignoring, for the moment, the built-in gains tax on sales or distributions of appreciated assets, discussed below).

  - ⇨ 💣 The effective combined California and federal double tax rate can be 54%.

    - ▪ This is the effective tax rate if tax authorities recharacterize some C corporation compensation as a dividend, or force a C corporation to make a substantial dividend to avoid the penalty tax on excess accumulated earnings.

  - ⇨ In contrast, the effective tax rates on income of an S corporation distributed to the shareholders would be 43% for ordinary income and 27% for long-term capital gain.

  - ⇨ These effective rates would increase to 57%, 47% and 32% under the President's 2010 Budget Proposals.

  - ⇨ *Avoiding or minimizing the double tax on C corporations is an important benefit of the S corporation election.*

9. Corporate-Level Taxes

9.1. The Built-In Gains Tax

If the S corporation or its QSub sells or distributes appreciated property during the first seven or ten tax years that the S corporation election is in effect, a federal corporate tax probably will apply to a portion of the actual or "deemed" gain on the sale.[60]

- Only the portion of the gain attributable to the appreciation in the property's value *before* the effective date of the S corporation election (the "**built-in gain**") is subject to the corporate-level tax. Assets with an actual value greater than their depreciated or amortized value for tax purposes (that is, more than their adjusted tax basis) on the election date would also have "built-in gains."[61]

    ⇨ In concept, the built-in gains tax "freezes" the double tax that would be recognized if the C corporation sold all of its assets on its last day as a C corporation and distributed the assets to the shareholders.[62]

- 💣 A cash method corporation' accounts receivable (which have value but no tax basis) are subject to the built-in gains tax when collected.[63]

- The built-in gains recognized during "the recognition period" is taxed to the S corporation at the highest income tax rate applicable to C corporations (currently 35% for the federal income tax and 8.84% for California franchise tax).[64]

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60 I.R.C. § 1374. For a discussion of distributions that are treated as "deemed" sales, see "Distributions" at page 25 below.

61 💣 Assets that the S corporation acquires in carry-over-basis transactions can also be subject to the built-in gains tax if those assets (a) were acquired from C corporations or (b) had built-in gain in the hands of the S corporation transferor. Built-in loss is also measured, and the maximum amount of built-in gains that can be taxed is the "net" built-in gain (built-in gain minus built-in loss) on the day the S election becomes effective. So if all the built-in gains are recognized before any built-in loss, the S corporation will pay built-in gains tax sooner than if the losses were also recognized, but the S corporation will not pay more built-in gains tax than if all the built-in loss assets were sold at the same time.

62 It's actually worse than that. See footnote 114 at page 33 below.

63 Treas. Reg. § 1.1374-3(c) Example 1.

64 I.R.C. § 1374(b)(1). Note that the built-in gains tax would apply to a sale of an S corporation's assets, but not to a sale of its stock. 💣 The built-in gains tax would apply to

(footnote continued on next page)

⇨ The recognition period is generally the *ten-year* period following the S corporation election.

⇨ For dispositions in tax years beginning in 2009 or 2010, the recognition period is *seven years*.[65]

- The burden of proof is on the S corporation to prove that (a) it did not own the asset when the S election was made, (b) that the asset was not tainted (with built-in gain) when acquired after the election or (c) that some or all of the gain is attributable to appreciation after the S corporation election.

- To minimize the risk of a costly dispute with the Internal Revenue Service or the Franchise Tax Board over the value of assets on the effective date of its S corporation election, it is helpful to have an appraisal of the total value of the operating businesses as of that date.[66]

  ⇨ The appraisal report should be kept with the S corporation's permanent tax records.

  ⇨ The officers should prepare a list of the built-in gain assets that the S parent or its disregarded subsidiaries might sell or exchange in its first three years after the S corporation election. It might make sense to sell these before the S corporation election is effective.

(footnote continued from preceding page)

a sale by an S parent of its QSub stock. Special rules apply to partnership interests held or acquired by S corporations during the "recognition period" and the deferred gain on installment sales made during the "recognition period." Treas. Reg. § 1.1374-4(h), (i).

This discussion omits several important limitations on the built-in gains tax, such as the reduction in pass-through income by the amount of the built-in gains tax.

65 I.R.C. § 1374(d)(7)(B).

66 More protection would be afforded by obtaining an appraisal of each of the assets, including goodwill and other intangibles. The overall value of the corporation sets the maximum amount of built-in gains tax and will be very helpful if the entire business is sold, but it will not be very helpful in a dispute with a tax authority over the amount of built-in gain for a particular asset.

- Consider strategies to minimize problems resulting from this tax.[67]

- Some C corporations with loss carry forwards should consider deferring the S corporation election until the corporation has profits sufficient to absorb the loss carry forwards.[68]

- *The built-in gains issue merits careful attention before making the S corporation election.*

9.2. The Excess Passive Receipts Tax

💣 If in any year as an S corporation (a) more than 25% of the gross receipts of the S Parent and its QSub(s) are from passive sources (defined as rents, royalties, interest, dividends, annuities, or sales of stock or securities), and (b) at the end of the year the S parent and its QSub(s) have undistributed earnings and profits earned in C corporation years, then the S parent would be subject to a federal corporate tax on a portion of its passive income.[69]

- 💣 If the S corporation met both tests for three consecutive years (even if the tax did not apply in one or more of those years because the S corporation had no taxable income), its S election would terminate.[70]

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[67] For example, for a cash method business, one or more shareholders might buy from the corporation its accounts receivable at the end of its last C corporation year. The buyer would pay when the AR was collected. The corporation would elect out of the installment method of accounting for the sales proceeds. The effect is to accelerate the income into the last C corporation year, but to avoid recognizing built-in gain in the first S corporation year, when the AR is collected.

[68] 💣 If the corporation is increasing in value as it becomes profitable, deferring the S corporation election also means there will be more built-in gain when the S corporation election is made. Recall also that the recognition period does not start until the S corporation election is made. Also, that loss carry forwards can be used to reduce built-in gain.

[69] I.R.C. § 1375.

[70] I.R.C. § 1362(d)(3). An S corporation would not be subject to this tax or to termination of its S corporation status for this reason if, before the end of its first year in which it has excess passive receipts, it distributes to its shareholders all of its undistributed earnings and profits accumulated during C corporation years and makes a special tax election. I.R.C. §

(footnote continued on next page)

⇨ It is unlikely that this tax would apply to an S corporation while it continued to operate a going business.

- Investments in businesses with low profit margins directly or through partnerships can generate active receipts that the S corporation can use to reduce the percentage of passive receipts below 25%.[71] This makes the excess passive receipts problem manageable.

9.3. Other Corporate-Level Tax Issues

- 💣 Items of *expense paid to a shareholder* by an *accrual-method* S corporation are not deductible by the corporation until paid.[72] A similar rule applies to C corporations, but only for shareholders who own *more than* 50% of the corporation's stock. This rule would delay the S corporation's deduction for salaries, bonuses, royalties and rents that are owed to shareholders at year end.

- Net operating losses ("NOLs") incurred in S corporation years cannot be carried back to generate tax refunds for C corporation years.[73]

- 💣 If the C corporation or its subsidiaries have carry forwards of passive *activity losses* or of regular or alternative minimum *tax credits*, consider the possible effects of the S election.

- A C corporation can deduct the costs of *fringe benefits* it provides for its employees, including employees who are also its

(footnote continued from preceding page)

1362(d)(3)(A)(1)(1). Because such a distribution would be taxable to the shareholders, it should be avoided except in extraordinary circumstances.

[71] Rev. Rul. 71-455, 1971-2 C.B. 318; see. e.g., PLR 2005-39-009, June 21, 2005.

[72] I.R.C. § 267(e)(1).

[73] I.R.C. § 1371(b) (2). However, the NOLs can be used to offset corporate-level built-in gain. I.R.C. § 1374(b)(2). The "clock" keeps ticking on the NOLs while the S corporation election is effective. I.R.C. § 1371(b)(3); Treas. Reg. § 1.1374-5.

shareholders, and for income tax purposes the employees *do not include in their income* the value of most of these fringe benefits.[74] If a corporation elects S status, employees who are also shareholders must include in their income the value of *group life insurance premiums*, *accident or health plan premiums* and *death benefits* that the corporation pays on their behalf and meals and lodging furnished by the employer; the corporation deducts those amounts.

- C corporations are allowed a deduction for *dividends received* from other U.S. corporations.[75] This deduction is not available for S corporations.[76]

- If the business uses the tax credit for *research and development*,[77] uses the *LIFO* (last-in-first-out) [78] or *completed contract*[79] *method* of accounting for tax purposes, the possible effects of the S election should be considered.

- S corporations are not subject to the penalty tax on *personal holding companies*.[80]

10. Shareholder-Level Taxes

Generally, the income, gain, loss and credits of the S corporation after the effective date of the S corporation election would flow through to its shareholders

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[74] I.R.C. § 1372; Rev. Rul. 91-26, 1991-1 C.B. 184, J. Eustice & J. Kuntz, FEDERAL INCOME TAXATION OF S CORPORATIONS, ¶ 7.05[2].

[75] I.R.C. § 243.

[76] I.R.C. § 1363(b).

[77] I.R.C. § 41(e)(7)(i) (S corporations not eligible).

[78] I.R.C. § 1363(d).

[79] Treas. Reg. § 1.1374-4(g)

[80] I.R.C. § 1363(a). The S corporation might be subject to the excess passive receipts tax, but that is manageable. See page 20 above.

in proportion to their share ownership and would be included on their individual tax returns.[81]

11. Losses

For S corporation years in which the S corporation has tax losses (for the combined operations of it and its QSubs or single-member LLCs subsidiaries), the losses would flow through to the shareholders' individual income tax returns -- but the losses could offset other income only for those shareholders who have sufficient tax basis in their S corporation stock and any loans from them to the S corporation to absorb the losses.[82]

- Accordingly, before each tax year ends, the officers of the S corporation and the S corporation's accountant should review its tax position. If losses are likely, they should determine whether any action should

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[81] I.R.C. § 1366. If any S corporation shares change hands during a year, 1/365th of the corporation's taxable income would be allocated among the shareholders for each day of the year in proportion to their share ownership on that day. I.R.C. § 1377(a)(1). The shareholder generally must treat the tax items consistently with the S corporation. I.R.C. § 6037(c).

As a consequence of the interaction of this tax rule with the corporate law rules regarding distributions, the Board of Directors of the S corporation should consider declaring distributions immediately before each stock issuance or transfer that occurs while the S election is effective. See "Distributions" below. The issuee or transferee should acknowledge such distributions in writing to avoid misunderstandings as to the motives for the distribution.

[82] I.R.C. § 1366(d). See "Tax Basis in Stock" at page 24 below. Borrowing by the S corporation or its subsidiaries does *not* increase the shareholders' stock basis for this purpose (in contrast to the partnership rule). A shareholder's guarantee of a debt of the S corporation or one of its subsidiaries will *not* give the shareholder basis in the guaranteed debt or increase his or her basis in his or her stock or his or her loans to the S corporation. See J. Eustice & J. Kuntz, Federal Income Taxation of S Corporations, ¶ 7.07[3][c].

A shareholder is not entitled to deduct the pass-through loss unless he or she is "at risk" for tax purposes. I.R.C. § 465.

The "passive activity loss" limitations could also prevent shareholders from using the corporation's tax losses immediately to offset their income from other sources. I.R.C. § 469. These limitations might apply if the corporations have tax losses from rentals, royalties, or other inherently passive activities or if a shareholder is not involved in the business on a day-to-day basis. Losses that a shareholder could not use immediately because he or she lacks sufficient basis, at-risk amounts or passive income can be carried forward indefinitely while he or she holds the shares. I.R.C. § 1366(f)(2). If the shareholder dies, the carry forwards might not be able to be used by any other person. Treas. Reg. § 1.1366-2(a)(5).

be taken to enable the shareholders to derive the maximum benefit from the losses.

12. Tax Basis in Stock

After the S corporation election, each shareholder's adjusted tax basis in his or her S corporation stock will equal the sum of his or her capital contributions to the corporation *increased by* his or her share of the income of the S corporation (both taxable and tax-free, such as life insurance proceeds), and *decreased by* the distributions from the S corporation to him or her and his or her shares of the losses, deductions and nondeductible expenses (such as life insurance premium payments) of the S corporation.[83]

- Generally, the stock basis is adjusted at the year end of the S corporation or when a shareholder disposes of shares.[84]

- As a result of these rules, each year in which the S corporation is profitable but distributes only enough cash to enable its shareholders to pay their taxes on its income, *their tax basis in their stock will increase*.

  ⇨ These basis increases will reduce the gain on an eventual sale of the stock.

  ⇨ While the business is growing rapidly, this can be an important benefit of S corporation status.[85]

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83 I.R.C. §§ 351 (tax-free contribution to corporation), 358 (basis in stock after tax-free contribution to corporation), 1367(a) (S corp adjustments), 1012 (cost), 1014 (inherited stock). In contrast, the income, loss or distributions of a C corporation will not affect a shareholder's basis in the shares.

84 Treas. Reg. § 1.1367-1(d). Upon a partner's transfer of his partnership interest, a partnership may make a "Section 754" election to adjust the tax basis of a portion of its assets. An S corporation cannot make this election (which is often advantageous).

85 When a shareholder dies, each heir's basis in the decedent's shares is adjusted to the value on the date of death. I.R.C. § 1014. Consequently, for shares held until death, the benefit of the pre-death basis increase is lost, but the heirs may benefit from post-death basis increases resulting from the S corporation status. This law is scheduled to change at the end of

(footnote continued on next page)

13. Distributions

- The S corporation election permits the shareholders to receive distributions from the S corporation which, with adequate planning, will not be considered income to them for tax purposes.[86]

- Special tax rules will apply to distributions by the S corporation to its shareholders after the effective date of the S corporation election.

  ⇨ If the corporation has undistributed C corporation earnings and profits, the S corporation will maintain a fictitious tax account (the "*accumulated adjustments account*" or – somewhat redundantly – the "AAA" account).

  ⇨ The AAA account is *increased by* the S corporation's taxable income at the end of each S corporation year.

  ⇨ The AAA account is *decreased by* the S corporation's tax losses and any distributions to shareholders during an S corporation year.[87]

  ⇨ To the extent that a cash distribution does not exceed the balance of this tax account, *the distribution is tax-free to the shareholders.*[88]

  ▪ This rule is very important because it will allow the S corporation to make tax-free distributions.

(footnote continued from preceding page)

2009, but most observers believe that new legislation will prevent it from changing. I.R.C. §1014(f).

86 I.R.C. § 1368(b)(1), (c)(1).

87 I.R.C. § 1368(e). For purposes of determining the tax effect of a distribution by an S corporation, all distributions are deemed to be made on the last day of the corporation's tax year. I.R.C. § 1368(c) (flush language).

88 I.R.C. § 1368(c)(1). 💣 Before the corporation makes any distribution, its credit agreements and other arrangements should be reviewed to determine whether the distribution would be an event of breach or default or would have other adverse consequences.

> ⇨ As long as the S corporation generates more cash flow than it needs to grow the business, this will be a substantial benefit of the S corporation status.

- If in any year as an S corporation the distributions from the corporation *exceed the balance of the AAA account* (generally determined at year end), the shareholders will be subject to tax on the excess distributions as follows:

  1. 💣 If the S corporation and/or QSub has undistributed earnings and profits generated in C corporation years, such excess distributions from the S corporation will be taxed to the shareholders as dividends from a C corporation to the extent of those earnings and profits;[89]

  2. Distributions that exceed those earning and profits will be received tax-free to the extent of the shareholder's basis in his or her S corporation stock, and will reduce that basis;[90] and

  3. When those earnings and profits are exhausted and his or her basis in the shares is reduced to zero, any additional distributions will be taxable to him or her as capital gain.[91]

- After the S corporation election, each shareholder will be required to pay the income tax on his or her share of the corporation's taxable income (the "S corporation tax").[92]

  ⇨ Accordingly, the shareholders probably will expect the S corporation to distribute regularly at least enough cash to enable them to pay their S corporation taxes.

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89 I.R.C. § 1368(c)(2). 💣 If the S corporation or a subsidiary acquires assets from another corporation in a transaction that is partly or fully tax-free, the S corporation may also acquire C corporation "earnings and profits" that, if distributed, would be taxable to the shareholders. I.R.C. § 1371(c)(2).

90 If the corporation does not have any undistributed C corporation earnings and profits, this is where the analysis starts. I.R.C. § 1368(b)(1).

91 I.R.C. § 1368(b)(2), (c)(3). See "Tax Basis in Stock" at page 24 above.

92 I.R.C. § 1366(a).

- ⇨ If the S corporation does not make such distributions, the shareholders will be required to obtain from other sources enough cash to pay their S corporation taxes.

- ⇨ 💣 Without an agreement requiring the corp to make such minimum distributions, neither tax nor corporate law requires an S corporation to make any distributions.

- ⇨ Whether, when and in what amounts distributions are made, and whether distributions are made in cash or other property, are all decided by the Board of Directors, subject to applicable agreements, if any, and certain legal limitations designed to protect creditors of the corporation.

  - ▪ The agreement could require the S corporation to make minimum distributions to enable shareholders to pay their S corporation taxes.[93]

  - ▪ 💣 Shareholders who do not control the Board of Directors might want the Company to agree to make a minimum level of distributions before they sign the S corporation election.

- All distributions to the shareholders should be made from the S parent, and not directly from a subsidiary to the shareholders of the parent.

  - ⇨ A subsidiary should make distributions only to its parent.[94]

- If a corporation *distributes* to its shareholders *property* with a fair market value greater than the tax basis of the corporation in the prop-

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93 See “Buy-Sell Agreements” at page 33 below.

94 This is to adhere to corporate formalities and to minimize the risk of “piercing the corporate veil.”

erty, the corporation will be deemed for tax purposes to have sold the property to the shareholders at its fair market value.[95]

⇨ 💣 The S corporation will recognize *gain* on the deemed sale, that gain will pass through to the individual tax returns of the shareholders and they will pay tax on that gain.[96]

⇨ Each shareholder would have a tax basis in the property equal to his or her share of the property's fair market value on the distribution date.[97]

⇨ 💣 If the adjusted basis of the S corporation in the distributed property is less than the property's value, *no loss would be recognized* (by the shareholders or the S corporation) when the property is distributed, but the property's fair market value on the distribution date would become the shareholders' initial basis in the property.[98]

14. FICA and Medicare Taxes

- All wages are subject to FICA tax (6.2% paid by the employee and 6.2% paid by the employer) and Medicare tax (1.45% paid by the

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95 I.R.C. §§ 311(b). This C corporation rule also applies to S corporation. I.R.C. § 1371(a).

96 I.R.C. § 1366. The "deemed gain" may also be subject to the "built-in gains" tax discussed at page 17 above.

In contrast, appreciated property distributed by a partnership to its partners in proportion to their partnership interests generally does not result in tax to the partners. 💣 For this reason and several others, *appreciating property should not be acquired by a corporation (whether an S corporation or a C corporation) absent compelling reasons to do so*. Instead, assets such as land, buildings, collectibles and fine art should be acquired by the business owners individually or in a separate partnership or LLC. The corporation can then *lease* the property from them or their partnership.

97 I.R.C. §301(d); Treas. Reg. § 1.301-1(h).

98 I.R.C. § 311(a)(2). Thus, the shareholders suffer a basis reduction without the benefit of a tax loss. Accordingly, it is often preferable to have the corporation sell the property, recognize the loss, and then distribute the sale proceeds to the shareholders. (Here too, the partnership rule is generally more favorable, allowing partners to take the property tax-free and at the partnership's basis in many cases, but not in liquidating distributions.)

employee and 1.45% paid by the employer).[99] This includes wages paid to shareholder-employees of S corporations.

⇨ However, amounts distributed to shareholders from a corp (assuming, in the case of an S corporation, that the corporation pays a reasonable amount of wages for any services actually rendered by the shareholders to the corporation) are not subject to the FICA, Medicare or self-employment taxes.[100]

15. Actions That Could Terminate S Corporation Status

The holders of a majority of the outstanding shares of an S corporation can terminate that election by notifying the IRS.[101] The S corporation election will also terminate if the corporation ceases to be a "small business corporation."[102]

💣 Generally, if an S corporation election is terminated, even unintentionally, the corporation cannot re-elect S corporation status for five taxable years.[103]

- 💣 The S corporation status will terminate if any shares are acquired by a person or entity that is not eligible to hold shares of S corporation stock, or if the number of families holding the S corporation's stock exceeds 100.

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99 I.R.C. §§ 3101(a) (tax on employees), 3111(b)(6) (tax on employers).

100 I.R.C. §§ 1402(a)(2) (dividends), 3121(a) (defining "wages"), Rev. Rul. 74-44, 1974-1 C.B. 287, Rev. Rul. 59-221, 1959-1 C.B. 225; see J. Eustice & J. Kuntz, FEDERAL INCOME TAXATION OF S CORPORATIONS, ¶ 11.02. The profits that generate the funds to make the distribution would be subject to the 1.5% California franchise tax, discussed at page 32 below, which is deductible by the shareholders for federal tax purposes.

101 I.R.C. § 1362(d)(1). This includes both voting and non-voting shares.

102 I.R.C. § 1362(d)(2).

103 I.R.C. § 1362(g). 💣 While it is a C corporation it may generate earnings and profits that will be troublesome for excess passive receipts tax purposes if it re-elects S corporation status. 💣 At the re-election a new recognition period will begin for built-in gains tax purposes and the built-in gain will be measured at the effective date of the re-election. See "Corporate-Level Taxes" at page 17 above. 💣 If the corporation ceases to be an S corporation, then each of its QSubs will become a C corporation. *These are terrible tax consequences.*

- Generally, only individuals who are U.S. citizens are eligible to hold shares of an S corporation.

  - Non-citizens who are U.S. residents for tax purposes, bankruptcy estates, estates of decedents, most living trusts[104] and certain other trusts are also eligible to hold shares of S corporations, but strict limitations apply.

  - *Ineligible shareholders include all corporations, partnerships, limited liability companies, certain banks, individual retirement accounts ("IRAs") and nonresident aliens, as well as certain trusts and nonprofit organizations and most venture capital companies.*

- An S corporation can hold any amount of the stock of another corporation or any percentage interest in a partnership or LLC.[105]

- Organizations that are exempt from income tax under Section 501(c)(3) of the Internal Revenue Code can hold S corporation shares, but other nonprofit organizations cannot.[106]

- Certain qualified retirement plans may hold S corporation shares.[107]

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[104] Shares are often held in a living trust to avoid probate. A typical living trust is a grantor trust for tax purposes. A grantor trust is permitted to hold shares of an S corporation. If the individuals who created the trust (the "trustors" or "settlors") can withdraw the property from the trust or amend the trust at any time, it is a grantor trust. Usually all or part of the trust ceases to be a grantor trust when a trustor dies. At that point, the trust must qualify as a "qualified subchapter S trust" (a "QSST") or an "electing small business trust" (an "ESBuT") and the beneficiary must promptly make an election to preserve the S corporation election.

[105] A subsidiary corporation cannot be or remain a QSub unless it is owned 100% by the S corporation parent. Consequently, if an S corporation owns less than all of the shares of another corporation, the other corporation generally must be a C corporation (or a DISC).

[106] All of the S corporation income is treated as unrelated business taxable income ("UBTI"). So is the gain on the disposition of the S corporation stock. I.R.C. § 512(e). A harsh rule.

[107] The same UBTI rules apply as for section 501(c)(3) organizations, except for ESOPs. ESOP participants are taxed like other S corporation shareholders, and the S corporation income is not UBTI for the ESOP. I.R.C. § 512(e)(3).

- 💣 If (1) an S corporation or its QSub has undistributed C corporation earnings and profits and (2) the combined receipts of the S corporation and its disregarded subsidiaries from passive sources account for more than 25% of all of their receipts for three consecutive years, the S corporation election would be terminated.[108]

- 💣 Examples of other actions by a S corporation that (under current law) could terminate its S corporation status are:

  ⇨ Issuing a second class of stock (or issuing debt or options or entering into another arrangement that could be *treated for tax purposes as a second class of stock) unless the classes differ only as to voting rights; or*

  ⇨ *Issuing stock to an ineligible shareholder* or causing the number of families holding S corporation shares to exceed 100.

- 💣 Examples of actions by shareholders that (under current law) could terminate the S corporation status are:

  (a) Transferring shares (during life or at death) to an ineligible shareholder or to a number of shareholders that would cause the total number of families holding S corporation shares to exceed 100;

  (b) Transferring shares to themselves or others as trustees of ineligible trusts;

  (c) Amending or reforming a qualified subchapter S trust (a "QSST") so that it would no longer qualify as a QSST;

  (d) Amending or reforming an electing small business trust (an "ESBuT") so that it would no longer qualify as an ESBuT;

  (e) For a beneficiary of a QSST, refusing to consent to, or obtaining the consent of the Service to revoke the tax election to have the trust treated as a QSST;

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[108] See "The Excess Passive Receipts Tax" at page 20 above.

(f) For a shareholder who is a resident alien for tax purposes, moving out of the U.S. (and becoming a nonresident alien);[109]

(g) For a U.S. citizen, moving abroad and renouncing U.S. citizenship (and thus becoming a nonresident alien); or

(h) For a qualified retirement plan, losing its tax qualification; or

(i) For a nonprofit organization exempt from income tax under Section 501(c)(3), losing that exemption.

- Note that the special federal income tax status of an S corporation can be lost by seemingly harmless events, including gifts, transfers or issuance of stock, a resident alien's change of personal residence or a change in tax status.

16. California Taxes

The federal S corporation election is effective for California tax purposes. as is the termination of the federal S corporation election.[110]

- S corporations are subject to California franchise tax at a rate of 1.5% (rather than the 8.84% rate that applies to most C corporations).[111]

  ⇨ A QSub is disregarded for California tax purposes.[112]

- The top California tax personal income rates is 9.55%, which is higher than the franchise tax rates for C corporations.[113]

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[109] If a shareholder is also an employee, his spouse can acquire a community property interest in his shares under California law. If that spouse is a nonresident alien (or is not a U.S. citizen and then moves out of the U.S. -- thus becoming a nonresident alien), the corporation's S corporation status probably would terminate because a nonresident alien would own a community property interest in its shares.

[110] Cal. Rev. & Tax. Code § 23801.

[111] Cal. Rev. & Tax. Code § 23802(b)(1). California has special rules for an S corporation that is also a "financial corporation," but this outline does not cover them.

[112] Cal. Rev. & Tax. Code § 23801.5(a).

- A minimum annual franchise tax applies to C corporations, S corporations and QSubs, even if the corporation has a tax loss for the year, and is payable with the first estimated tax payment each year. The annual minimum tax is currently $800.

- The California corporate alternative minimum tax does not apply to S corporations.

- California also imposes a built-in gains tax and an excess passive receipts tax, with rules similar to the federal rules.[114]

- As under federal law, the shareholders of a California S corporation are taxed on the corporation's taxable income.[115]

  ⇨ The 1.5% California franchise tax is deductible by the shareholders for federal -- but not for California -- tax purposes.[116]

- Credits apply at both the corporate and shareholder levels, subject to a reduction at the corporate level.[117]

17. Buy-Sell Agreements

Because the special federal and California tax status of an S corporation can be destroyed by a seemingly harmless gift or transfer of stock or a change of personal residence (as discussed above), and because an inadvertent termination of

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(footnote continued from preceding page)

113 Cal. Rev. & Tax. Code § 17041(a)(2) (including the extra 0.25% for 2009 and 2010). The California personal income tax rate is 10.55% for income over $1 million. Cal. Rev. & Tax. Code § 17043.

114 Cal. Rev. & Tax. Code §§ 23809 (built-in gain), 23811 (excess passive receipts). However, the California version of the built-in gain tax results in a surprisingly high tax. This is because the California rules reduce the pass-through gain by the amount of the California corporate-level tax, but not the federal corporate-level tax. As a result, the effective California and federal tax rate on built-in gain is 60%, higher than the effective 54% double tax rate on income of a C corporation that is distributed to the shareholders.

115 Cal. Rev. & Tax. Code § 17087.5.

116 I.R.C. § 164(a)(3).

117 Cal. Rev. & Tax. Code § 23803.

that status could result in significant additional federal and California tax, an S corporation with more than one shareholder should consider adopting a buy-sell agreement to prohibit such transfers.

- 💣 No stock should be issued to new shareholders until they sign an appropriate buy-sell agreement.

- 💣 The S corporation is not required to make any distributions to its shareholders to enable them to pay their additional income tax flowing through to them from the S corporation.[118]

    - ⇨ For the benefit of the shareholders, provisions concerning distributions, damages, and other subjects could also be included in the buy-sell agreement.

18. Non-Tax Considerations

- The S corporation election does not affect the limited liability of shareholders that is achieved by doing business as a corporation.

    - ⇨ The Board of Directors should formally authorize each distribution to the shareholders.

    - ⇨ 💣 Failing to adhere to these formalities could influence a court to disregard the corporation and to hold the shareholders liable for claims successfully asserted against the S corporation or its subsidiaries.

- Shareholders should ask their accountants about the effects that the S corporation election would have on the financial statements of the S corporation and its subsidiaries.

- Each shareholder might also want to consider the effect, if any, that the election might have on his or her personal financial statements.

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118 See “Distributions” at page 25 above.

19. LLCs as S Corporations

- Why – charging order protection

  - ⇨ To get that protection, the LLC probably needs to have members who are not all close family members and who either bought their interests or made capital contributions to acquire them.

  - ⇨ 💣 Might not be available to a single-member LLC or to a "family limited partnership" organized as an LLC.[119]

- How

  - ⇨ Forms 8832 and 2553[120]

  - ⇨ 💣 The operating agreement must not have any special allocations or any distributions based on capital accounts

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[119] Although a judgment creditor of an LLC member is generally limited to a charging order or becoming a holder of an economic interest – not a voting membership interest -- in the LLC, many doubt that a judgment creditor of a single-member LLC would be prevented from obtaining the LLC's assets. Cal. Corp. Code § 17302 (charging order rules, with no statutory exception for single-member LLCs); *but see* In re A-Z Electronics, 350 B.R. 886 (Bankr. D. Idaho, 2006) (bankruptcy trustee of sole member and not member-manager entitled to file bankruptcy petition on behalf of the LLC); In re Albright, 291 B.R. 538 (Bankr. D. Colo. 2003) (allowing a Chapter 7 bankruptcy trustee to reach the assets in the debtor's single-member LLC). *See also* J. Stein, Building Stumbling Blocks, BUSINESS ENTITIES (September/October 2006) 28, 34-36, and J. Stein, Advanced Asset Protection and Tax Planning with LLCs, 29 Los Angeles Lawyer 17 at nn. 20-21 (June 2006) (arguments in favor of respecting charging order protection for the single-member LLC.)

[120] Treas. Reg. § 301.7701-3(c)(1)(v)(C) ("An eligible entity that timely elects to be an S corporation … is treated as having made [a check-the-box-] election under this section [7701] to be classified as an association, provided that (as of the effective date of the [S corporation] election … the entity meets all other requirements to qualify as a small business corporation....").

- Why not?[121]

  ⇨ 💣 One class of stock rule – risk of becoming a C corporation

  ⇨ 💣 Expectations of advisors (who expect a single-member LLC to be disregarded for tax purposes and a multi-member LLC to be classified as a partnership for tax purposes.) – and trap for unwary advisor – or for members who rely on "cocktail party" advice.

  ⇨ 💣 Transaction costs – getting every advisor up to speed

20. Key Points

- If the LLC is available, use an LLC and not a corporation.

- If a business in a C corporation has a "grow it and sell it" plan, it should make an S corporation election if it can. Making the election sooner rather than later minimizes the built-in gains problem.

- Before the S corporation election is made by a C corporation, the advisers and owners need to work through:

  ⇨ The built-in gains problem (page 17 above)

  ⇨ The excess passive receipts problem (page 20above)

  ⇨ The bunching problem (page 14 above

  ⇨ A buy-sell agreement (page 33 above)

[End of outline.]

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121 Is a single-member LLC taxed as an S corporation the perfect entity because it provides pass-through tax treatment, reduces FICA and Medicare taxes for the member, and the member's creditors are limited to charging orders, as opposed to getting the stock of a real S corporation? 💣 Probably not, because the S corporation can default to a C corporation, the full SSI should be paid anyway in most active businesses, and the structure will cause confusion forever.