US TaxAid Services™

Coaching Program

2010-8

Filing an S Corporation Tax Return

Basics of an S Corporation

An S Corporation is a legal structure. On paper, it looks like a C Corporation. It has Officers, Directors, and Shareholders. It is formed by filing Articles of Incorporation, and uses Bylaws to set out its operating structure, and Share Certificates to indicate the owners. Owners of an S Corporation are provided liability protection from the acts and deeds of the Corporation. In other words, a shareholder may lose his or her investment if the Corporation gets into trouble, but he or she won't be sued personally for Corporation debts. The same liability protection extends to the Officers and Directors, as long as they have acted in good faith, and haven't been using the Corporation to commit illegal acts.

After that, things change. The S Corporation status is a tax classification that is granted by the IRS. In order to receive S Corporation tax status, Corporations have to agree to adopt a few additional rules:

1. The S Corporation may have no more than 100 Shareholders, who must all be natural people, estates (including a bankruptcy

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estates), charities, qualified retirement plans, and certain specific types of trusts (grantor trusts (also known as revocable trusts or living trusts), QSSTs and ESBTs). You can treat a husband and wife (and their estates) as one shareholder for this test. You can also treat all members of a family (as defined in section 1361(c)(1)(B)) and their estates as one shareholder for this test.

2. In three Private Letter Rulings made in 2008 (PLR 200816002, 200816003 and 200816004), the IRS also allowed that a single-member LLC, that is disregarded for income tax purposes, may also own S Corporation stock. This would also apply to an LLC that was owned by a husband and wife, who filed a joint tax return, and who held the S Corporation stock as either community property, or as joint tenants with right of survivorship. (In other words, the couple would need to own 100% of the stock jointly, rather than the husband holding 50% and the wife holding 50%).

3. An S Corporation may own stock in another S Corporation, but only if it holds 100% of the shares, making the controlled S Corporation a 100% subsidiary.

4. All Shareholders must be US residents for tax purposes. That doesn't mean they need to be citizens; it just means all shareholders must file a yearly U.S. tax return.

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5. S Corporations may have only one class of stock. You can have more than one class where voting rights are affected, but to be accepted as an S Corporation all stock must have the same rights as far as profit distributions and stock liquidation are concerned.

The reason for the ownership limitations has to do with the tax classification. An S Corporation does not pay taxes. It passes that responsibility through to its Shareholders. An S Corporation prepares a tax return each year on Form 1120S. The return reports income and expenses for the year, and shows a net profit (or loss) before taxes. That profit or loss is then divided up amongst the shareholders, depending on their individual ownership percentages (i.e., a 50% owner would receive 50% of the S Corporation's profit or loss). Each shareholder receives an IRS Schedule K-1, which shows how their respective profit or loss was calculated. The ownership limitations are because of this flow-through taxation. Otherwise, profits would flow out of the country to non-resident owners with no tax attaching.

Making an S Corporation Election

To become taxed as an S Corporation, a Corporation must prepare and file a Form 2553 within 75 days of the entity's formation, or the date it begins active business operations. In subsequent years (i.e., the Corporation starts of as a C Corporation and wants to change) the Form 2553 should be filed by March 15th of the year in which the Corporation wants to make the change.

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Apart from listing basic corporate information (name, address, Federal Tax ID Number), the Form 2553 also lists the name and address of each shareholder. If you're married, and you live in a Community Property State (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin), then both you and your spouse need to sign the Form 2553, even if only one of you owns S Corporation stock.

The form may be filed by mail or by fax. Upon acceptance, the IRS will issue the S Corporation a letter confirming its S Corporation tax election.

Making a Late S Corporation Election

If you don't get your S Corporation's Form 2553 filed in time, there are several options available to make a late election.

If the election Form 2553 has not been timely filed, the S Corporation must generally request relief for the late election by requesting a private letter ruling and paying a user fee in accordance with Rev. Proc. 2008-1, I.R.B. 2008-1 (or its successor). However, certain relief provisions are available as discussed below.

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Late Filing Within One Year of S Corporation Formation

If your S Corporation is less than one year old, and hasn't yet filed its first tax return, you can follow these steps:

Step 1. You have two options for Step 1, that is, A or B. If you fail to qualify for Step A, use Step B. Only one of the two is required. Note: If you fail to qualify for Step A or B, then the Corporation must generally request relief for the late election by requesting a private letter ruling and paying a user fee in accordance with Rev. Proc. 2008-1, I.R.B. 2008-1 (or its successor).

A. File a copy of the Form 2553 with the **initial** Form 1120S. On the Form 2553, provide a statement establishing reasonable cause for the failure to file the Form 2553 timely. Note that to qualify for this provision, the Form 1120S and attached Form 2553 must be filed within 6 months of the due date of the Form 1120S (excluding extensions). For additional details on eligibility to utilize this relief provision, see Rev. Proc. 2007-62, I.R.B. 2007-41.

OR

B. File a paper copy of the Form 2553 with the appropriate Service Center as directed in the Form 2553 instructions. You may mail or fax this form. Annotate at the top of the form "Filed pursuant to Rev. Proc. 2003-43". Attach to the Form 2553 a statement establishing

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reasonable cause for the failure to file the Form 2553 timely. For additional details on eligibility to utilize this relief provision, see Rev. Proc. 2003-43, I.R.B. 2003-23. Mail this form and the attached reasonable cause statement to the Service Center separate from any other returns or information being submitted. The Form 2553 should be filed prior to the filing of the Form 1120S. The Form 1120S should not be filed until the Corporation is notified of the S election acceptance.

Step 2. File the last C Corporation return (Form 1120) by the due or extended due date. Note: Some taxpayers are required to file electronically.

Year-end of an S Corporation

An S Corporation may choose any of the following year-ends and make the election on the Form 2553:

- A December 31st year end
- A natural business year (that's a 52-53 week period that ends in a business's low point, i.e., after ski season ends, for a ski manufacturer)
- An ownership tax year (this is a year-end that coincides with the tax year used by shareholders holding 50% or more of the S Corporation's stock)
- A tax year selected under IRS Section 444 (Sept 30, Oct 31, Nov 30)

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- A specific 52-53 week tax year; or
- Any other tax year, as long as it can be properly established as necessary by the Corporation under IRS Section 444.

To pick a date other than December 31st, you will need to prove to the IRS that the change is necessary for your S Corporation. That typically will involve providing them with a supporting letter or documents showing your business's natural income cycle, and may also involve the S Corporation pre-paying the taxes that would be due at December 31st.

Why Have an S Corporation?

1. **Ease of Use**. The most common reason to have an S Corporation for a business is because they are easier. The dividends paid from an S Corporation, called distributions, are not subject to another tax. The income from an S Corporation is taxable, whether money is distributed or not. That's because it's a pass through entity.

2. **Losses Taken at Personal Level.** The S Corporation also lets you pass on losses to your personal return. However, make sure you review stockholder basis, included as part of this manual. You must have basis calculations that prove you have sufficient basis to take the loss.

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3. **Deductible Investment Expenses.** It is possible to take investment expenses as a deduction, if the investing is a primary activity of the S Corporation. These will be reported on the tax return as regular business deduction.

4. **Home Office Deductibility.** The home office deduction is taken as a rental expense on the front page of Form 1120S. Calculate your business use ratio by dividing the square footage of space used exclusively and regularly for business by the total square footage of your home.

   The business use ratio is then multiplied by indirect expenses such as rent, mortgage interest, property tax, insurance, homeowner's due, utilities, repairs and the like. Make sure you reduce your Schedule A Itemized deductions by the amounts reported directly on the S Corporation return.

   Direct home office expenses can be included in the rental deduction shown or, if there is a more appropriate line item, elsewhere on the return.

Common Mistakes with an S Corporation

On January 19, 2010, the Government Accountability Office (GAO) released the results of their study into S Corporations and their tax returns.

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The results were staggering.

68% of S Corporation Tax Returns Are WRONG

The study found that of the two years that were reviewed, 68% of the Form 1120S had at least one misreported item. Most of the time, that meant an underpayment of tax.

The most frequent errors caught in this study were:

- Deducting ineligible expenses,
- Inadequate owner compensation, and
- Miscalculating stockholder basis.

The proper method for calculating basis, and the significance, is discussed later in this eBook. The interesting part of the GAO study is their conclusion. They are calling on S Corporations to be responsible for tracking and reporting stockholder basis as part of their tax preparation. This calculation would be reported on the Schedule K-1.

The GAO is recommending that the IRS Commissioner take four actions:

1. **Require licensing of all tax preparers.** I'm for this one. There are just too many hacks out there who get their clients into trouble. That basically will mean that the only people who can prepare tax returns for hire will be CPAs, tax attorneys,

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Enrolled Agents and tax preparers who have taken some IRS training.

2. **Send S Corporation rules and record-keeping requirements to shareholders.** That means more paperwork. The idea is well-intentioned but the paperwork probably won't get read.

3. **Require auditors to analyze Shareholder compensation.** The IRS has been hitting adequate S Corporation compensation for awhile now. It's interesting to see that the GAO wants them to scale it up even more.

4. **Provide specific guidance on compensation to shareholders and tax preparers.** It's obvious that the GAO is targeting in on Shareholder compensation. The difference between distribution and compensation is payroll tax and that is the big issue no one is talking much about. There isn't enough money in the Social Security and Medicare funds to cover the commitments.

Some of the additional issues that I've seen with wrong S Corporation filings are:

- **Improper Treatment of Medical Insurance Premiums.** It's confusing, and doesn't make a lot of sense, but here's how medical insurance deductions work for an S Corporation according to IRS issued Notice 2008-1. (http://www.irs.gov/pub/irs-drop/n-08-01.pdf).

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In short, medical insurance paid under individual medical insurance plans may be deductible “above the line” if the following conditions are met:

1. The Corporation must establish a “plan” for the payment of medical insurance premiums on behalf of the shareholder-employee.

2. The Corporation must either pay the premiums for the plan, or reimburse the employee-shareholder for the premiums paid after being provided proof of premium payment to the S Corporation.

3. Premiums so paid or reimbursed on behalf of the shareholder-employee MUST BE ADDED TO W-2 BOX 1 WAGES. These premiums should be EXCLUDED from Box 3 Social Security Wages and Box 5 Medicare Wages (thus they are exempt from FICA taxes completely).

4. On the 1120S for the S Corporation, the corporate tax return will include a deduction for wages/compensation paid which includes the medical insurance paid on behalf of the shareholder employee.

5. On the shareholder-employee’s 1040 an above the line deduction will be taken for the medical insurance paid by the Corporation which were added to the W-2. In Notice 2008-1 the IRS states that if this treatment is not followed,

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the medical insurance deduction “above the line” will be disallowed and the deduction will be moved to Schedule A. If this happens, the value of the deduction is generally severely limited due to the 7.5% threshold that must be exceeded before medical expenses are allowed.

ACTION ITEMS TO TAKE ADVANTAGE OF THIS DEDUCTION:

1. Document the existence of your Corporation’s “plan” by making note of it in your annual minutes.

2. If you have paid the medical insurance individually, gather up all of your medical insurance payments for 2009 and submit a reimbursement to your Corporation to reimburse yourself for those amounts. Post the reimbursement check to “Officer Wages” or similar gross pay expense account.

3. Contact your payroll company to provide them with the information necessary to include the medical insurance expense (directly paid by the Corporation or reimbursed to the shareholder) in your final paycheck and your W-2 for 2009.

4. If you’ve already issued the W-2s (which you should have) you can create amended ones to correct the medical insurance issue.

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If you’ve got an S Corporation, the IRS has its eye on you. And that means an audit. If the audits are anything like the brutal audit teams that have targeted Real Estate Professionals then we can expect some bad times ahead for S Corporations.

- **Using an S Corporation to Turn Real Estate Losses Into Business Losses.** Real Estate losses need to be shown as real estate losses on the Shareholder’s K-1. Simply running a real estate investment through an S Corporation does not change the character of income.

  I understand why taxpayers try to do this. The real estate loss is suspended if your income is over $150,000 unless you are a real estate professional. And taking the real estate professional deduction is a huge audit red flag these days.

  Somewhere the false idea has been perpetuated that you can change the character of income (turn it into a business loss) simply by putting it in a business structure. That’s patently false. Look for more audits here, I’m afraid.

- **Failing to Properly Report (and Track) a Built-In Gains Issue.** We’ll discuss the Built-In Gains tax (aka the BIG tax) in further detail later on in this eBook. The BIG tax occurs when you move from a C Corporation to an S Corporation and there has been activity in the C Corporation prior. This could lead to problems if there is a sale or distribution of assets.

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Now, let's look at the major issues in greater detail.

Shareholder Compensation vs. Distribution

An S Corporation shareholder will receive cash from his Corporation in two ways: Salary and Distribution. Salary is subject to payroll tax and distributions are not. And that's where all the trouble started.

The S Corporation is required to pay a reasonable salary, but there is no clear guidance as to what exactly is reasonable. As a result of seemingly arbitrary rules and random reinforcement, there is a growing problem that the IRS clearly recognizes.

In fact, in 2005, almost one million S Corporations with one shareholder paid no officers' compensation. Most of these were profitable. Clearly if there had been income and there was someone working (presumably the shareholder) then there should have been some wages paid resulting in some payroll tax. It's estimated that if all profitable S Corporations that reported no officers' compensation had been Schedule C businesses, they would have paid an estimated $4.9 billion in self-employment tax.

S Corporation Preparation Note: Make sure you are paying owner salary and that it is properly segregated on the face of the return as officer's compensation. You may show up on the IRS audit radar simply because you have not properly recorded paying yourself a salary.

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The other big issue is that the calculation of ‘fair and reasonable’ compensation actually has many factors. IRS examiners must consider:

1. The financial condition of the Corporation;
2. The time worked by the shareholder;
3. The company’s compensation package for other workers;
4. The salary structure in companies in similar industries; and
5. The return on investment.

The Financial Condition of the Corporation

If the company is operating at a loss or is in the first year of operation, you will generally get a pass on paying a salary to shareholders. However, don’t make a habit of it. In fact, we recommend that our clients take some kind of salary in the first year even if it is small. The IRS is most likely to win cases where there is no salary at all taken from the S Corporation.

The Time Worked By the Shareholder

The most common calculation is looking at the hours worked by the shareholder and then calculating what you would pay someone else for that time. If you own a shipping facility, a shipping manager might make $50,000 - $75,000. If that’s typical and you’re working the same hour that the manager is making, then you have a salary range. On the other hand, if you are a medical professional and work a lot of hours, a typical salary will be much more.

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The Company's Compensation Package for Other Workers

How does the shareholder's salary compare to other works? If the boss isn't getting paid as much as the people she supervisors, it won't make sense to an auditor

The Salary Structure in Companies in Similar Industries

What is reasonable for the industry? This is probably the most common method used to substantiate salary. What do your competitors pay?

The Return on Investment

Up till now, the salary calculation was based on how much the officer should be paid, tempered by how successful the company was.

Now, let's look at it another way. How much of an investment does the shareholder (you) have in the company? This could mean money invested or the fair market value of the company if sold. Now looking at that amount, how much of a return would you expect? Let's say you would expect a 12% annual return and you have $1,000,000 invested. That means you'd expect $120,000 per year.

If the company makes $150,000, then you might have a good argument for salary of $30,000 and $120,000 in distribution.

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S Corporation Tip: The easiest cases for IRS to win are those where a profitable S Corporation shareholder claims no or negligible salary. This is especially true if the shareholder serves key roles in the business, providing management, sales, or service functions. Bottomline? Pay a salary.

Compensation and Medical Insurance Issues

Health and accident insurance premiums paid on behalf of the greater than two percent S Corporation shareholder-employee are deductible and reportable by the S Corporation as wages. The benefits are not subject to Social Security, Medicare or Unemployment taxes.

A 2 percentage shareholder-employee is eligible for an Adjusted Gross Income deduction for amounts paid during the year for medical care premiums if the medical care coverage is established by the S Corporation and the shareholder.

Initially, the rules said that the insurance had to be in the name of the S Corporation, but insurance laws in some states do not allow a Corporation to purchase group health insurance when the Corporation only has one employee.

So the IRS clarified the rules that said the shareholder would be allowed an above-the-line deduction even if the health insurance policy was purchased in the name of the shareholder. If the shareholder purchases the health insurance in his own name, but the S Corporation

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either directly pays for the health insurance or reimbursed the shareholder for the health insurance and also included the premium payment in the shareholder's W-2, the shareholder would be allowed an above-the-line deduction. The bottom line is that in order for a shareholder to claim an above-the-line deduction, the health insurance premiums had to be paid by the S Corporation and had to be included in the shareholder's W-2.

Passive Activity Losses

S-Corporation shareholders are subject to the passive activity rules. These rules govern to what extent an S-Corporation loss is currently deductible by a shareholder.

If the S-Corporation is engaged in the rental property business, then shareholders must meet the stringent "active participation" tests for real estate professionals in order to deduct rental losses in full. If a shareholder cannot meet the active participation tests for real estate professionals, then S-Corporation rental losses are deductible only to the extent the shareholder has passive activity income.

These are the same rules that you're subject to if you hold real estate in your own name or in an LLC. So, an S Corporation doesn't change the character of the income. If you have passive activity income, it's still passive activity income if it's held in an S Corporation.

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S Corporation Doesn't Mean Simple

The S Corporation tax return is the most commonly filed business entity return and yet it still is one of the most misunderstood.

The rest of this eBook has some advanced issues: Built-in Gains Tax, Basis, Distributions, E & P, and PTI. If you feel like it's more advanced then you want to deal with, make sure that your CPA is up to speed and that you've communicated on these issues.

This is the type of information, especially basis and taxable distributions, that the IRS is going to be auditing heavily. Make sure you have the proper documentation in case of audit.

Bottomline: You don't need to be the expert on the information that follows. But, if you're not, make sure someone on your team is.

Built-in Gains Tax (BIG Tax)

Despite the best tax advice to the contrary, occasionally C Corporations end up accumulating appreciating assets. That means that when the asset sells the profit will get taxed at an ordinary tax rate. And then when the shareholders take out the money, they'll get taxed again for dividends, without an offsetting expense on the C Corporation side. While the BIG tax isn't necessarily a part of your S Corporation filing, it can be such a big issue for S Corporations that the following few pages will go through strategy regarding it.

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And that's why we recommend never holding appreciating property inside a C Corporation. You'll end up paying more than double the tax if you do.

So, what happens if you have a C Corporation with appreciating assets. One suggestion is to elect S Corporate status. That turns the Corporation into a flow through entity so you avoid the double taxation and are able to pick up the lower capital gains tax rate.

Let's go through some numbers on how this would work:

A Corporation holding assets worth $500,000 in market value and having total adjusted bases of $150,000 has $350,000 of "built-in gain" on its balance sheet. Prior to making an S election, the disposal of these assets would generate a $350,000 gain that would be taxed to the C Corporation. When the after-tax proceeds from this sale are distributed, they are subject to tax again at the shareholder level as dividends.

So, what if the C Corporation elects S Corporation treatment? If an S Corporation had an asset like this, it could sell it and the tax would be passed on to the shareholder. In 1986, the IRS came up with something called the built-in gains tax (BIG tax). This says that if you elect S Corporation status after you've acquired appreciated assets, you'll get taxed at the C Corporation rate for the first 10 years after electing S Corporation status.

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The Section 1374 tax, known as the "built-in gains tax" or "BIG tax," is assessed annually on the netted amount of built-in gains and built-in losses realized during the tax year. Net built-in gains are subject to the maximum corporate tax rate, which is currently 35 percent. The total amount of gain subject to the built-in gains tax during the first ten years of an S election is limited to the "net unrealized built-in gains." This is the excess of the fair market value of the Corporation's assets over the aggregate adjusted bases of those assets on the first day of the S election. Any of this gain that is not realized during the ten-year recognition period will not be subject to the built-in gains tax.

Calculation of BIG Tax

Calculation of the unrealized built-in gain begins with the amount that would have been realized if the Corporation had remained a C Corporation and sold all of its assets at fair market value on the date of the S election to an unrelated party who assumed all of its liabilities. (1) This amount is reduced by any liability of the Corporation that would be included in the amount realized on the sale (but only if the Corporation would be allowed a deduction on the payment of that liability) and is also reduced by the aggregate adjusted bases of the Corporation's assets at the time of the sale.

Example of S Corporation Election With Assets

Let’s walk through the accounting for a company that has elected S Corporation status.

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Corporation X, a cash basis Corporation, makes an S election that is effective on January 1, 2011. On December 31, 2010, the Corporation has assets and liabilities as follows:

	FMV	BASIS	
Assets			
Factory	475,000	200,000	
Equipment	100,000	800,000	
Accounts Receivable	300,000	0	
Goodwill	250,000	0	
Total	1,125,000	1,000,000	
Liabilities			
Mortgage			200,000
Accounts Payable			100,000
Total			300,000

If the Corporation had sold all of its assets to a third party who assumed all of its liabilities, the amount realized would be $1,125,000. This is the $825,000 cash received and $300,000 liabilities transferred to the buyer.

It is highly probable that Corporation X will be subject to the built-in gains tax. The unrealized receivables held by a cash basis Corporation will generate built-in gain when collected. To a limited extent, they will be offset by the built-in losses realized by payment of the accounts payable. Since receivables exceed payables by $200,000, at least $85,000 of this potential gain will be subject to the tax if realized during the recognition period.

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Recognition Period

The built-in gains tax applies only to built-in gains recognized during the ten-year recognition period that begins on the day of the S election. This 120-month period applies not only to C Corporations making S elections but to all S Corporations that acquire assets from a C Corporation in a transaction in which the assets' basis is determined by reference to the C Corporation's basis.

In the event of such a transfer, the ten-year recognition period for any built-in gain on the transferred assets begins on the date of the transfer. If the recognition period ends within the S Corporation's taxable year, the amount of net realized built-in gains for the year must be determined as if the Corporation's books were closed on the last day of the recognition period.

Built-in Gains Benefit

If your S Corporation has built-in gains you can offset it with unused net operating loss carryforwards, capital loss carryforwards, unused business tax credits and minimum tax credit carry-forwards from the C Corporation years. These losses and credits are carried over and applied in the same manner as if the Corporation had continued to be a C Corporation.

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Corporations Subject To The Built-In Gains Tax

Code Section 1374 was enacted as part of the Tax Reform Act of 1986 and applies to Corporations making S elections after December 31, 1986. There are two situations that will cause an S Corporation to confront the built-in gains tax. One of these I'm sure you know by now.

1. Any C Corporation with net unrealized built-in gain making an S election after December 31, 1986, is vulnerable. If the Corporation has previously terminated an S election, a new election made after December 31, 1986, will cause it to be subject to the built-in gains tax. It is the most recent election that determines the Corporation's vulnerability to the built-in gains tax.

2. An S Corporation that has always been an S Corporation may still be vulnerable to BIG tax if it acquires assets from a C Corporation through a merger or reorganization.

Strategies For Minimizing the Built-In Gains Tax

Pending S Election Strategies

If you've been operating as a C Corporation and are now considering moving to an S Corporation, here are some strategies to consider first.

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First and foremost, consider built-in gains tax if you're considering moving to an S Corporation. The presence of built-in gains can alter the tax outcome considerably and could cause the tax costs of an S election to outweigh the benefits. If full consideration is given to the impact of built-in gains and an S election is still warranted, do it soon to start the clock ticking on the 10 year period.

If the Corporation is newly organized, the S election should be filed immediately to avoid spending its first year as a C Corporation and creating built-in gains on appreciated assets. The S Corporation election should be made in the first 75 days after beginning the company. But, if you've missed that time deadline not all is lost, there are some procedures for making late elections.

Prior to making the election, it is imperative to obtain a professional and reasonable appraisal to determine if built-in gains exist. The appraisal will provide the information needed to limit the amount of built-in gains to be recognized or to document the absence of any built-in gain. Although there are no reporting requirements relative to built-in gains at the time of the election, the burden of proof will be on you to show that gains from subsequent appreciation of assets did not exist at the time of the election. In other words, if the property later sells for a lot more, can you prove when that gain occurred? Was it before or after the election?

Therefore, it is extremely important that the Corporation retain the appraisal to firmly establish any subsequent increase in value that is not

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subject to the built-in gains tax. The appraisal is equally important as evidence of existing built-in losses.

Certain measures can be taken to lessen the impact of the built-in gains tax when an election is pending. For example, if there are a lot of uncollected (and unrealized) receivables for a cash basis C Corporation, speed up the collection. Otherwise, the income will be subject to the built-in gains tax rate of 35 percent. Conversely, delaying realization of built-in losses to be recognized during the recognition period will be a significant step in reducing the tax.

Be careful about getting carried away with built-in loss property or deductions when an election is contemplated. Anti-stuffing rules will disallow built-in losses acquired immediately prior to the election or during the recognition period if the principal purpose is to avoid the built-in gains tax. This rule can be circumvented if a business purpose can be shown for transferring the loss assets to the Corporation.

Other long-term strategies might be initiated before the S election is made. Preserving allowable C Corporation net operating losses available to offset built-in gains may be especially significant for Corporations that were in the lower corporate income tax bracket of 15 percent of 25 percent but now face a 35 percent built-in gains tax. These carryovers from C Corporation years essentially yield greater tax benefits when used to offset the higher built-in gains tax rate.

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Post S Election Strategies

Once the election is made, there are two strategies to avoid or minimize the tax on built-in gains. One is to control the timing of the recognition of built-in gains and losses and the other is to control the limits that apply to recognized built-in gain.

The first major factor to consider is the expected future activity of the Corporation for the next ten years. If it is possible to defer the sale of built-in gain assets beyond the ten-year recognition period, the tax will be avoided. This is clearly not always possible, particularly if there are net unrealized receivables at the time of the S election. In such cases, realizing built-in losses in the same year that gains are realized may significantly reduce the net built-in gains subject to the tax. Additionally, entering into a Section 1031 like-kind exchange may allow a company to defer recognition beyond the ten-year period, although the built-in gains will be reflected in the new asset.

Another strategy for minimizing the tax is to lower the amount of taxable income (calculated as if the S Corporation were a C Corporation), which limits the amount of built-in gain taxed in the current year. Deferring revenue or accelerating deductions can do this. As examples, a payment of compensation to shareholders or a charitable contribution will have the effect of reducing the taxable income limitation.

The built-in gains tax is also a relevant consideration in business reorganizations or restructuring. The exchange or sale of stock by

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shareholders rather than a direct sale of assets by the Corporation will avoid triggering built-in gain. For example, if there is more than one shareholder and one is likely to withdraw, "retire" or die, the transfer of stock to other shareholders produces no realized built-in gain for the Corporation. If the shareholders dispose of the business, a sale of all stock rather than the sale of assets results in no realized gain for the Corporation.

Pending S Election Strategies:

- Consider cost of built-in gains tax relative to benefits of S election.
- Obtain and retain a professional appraisal to determine existence of built-in gains and to document asset values.
- Make S election immediately for newly organized Corporation to avoid C Corporation status
- Accelerate collection of unrealized receivables.
- Delay realization of built-in losses.
- Preserve any C Corporation net operating losses, capital loss carryovers, and unused business tax credits and minimum tax credits.
- Acquire loss property if business purpose can be shown for acquisition.

Post S Election Strategies:

- Defer recognition of built-in gain beyond recognition period if possible.

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- Use like-kind exchanges for replacement of assets.
- Attempt to realize built-in losses in the same year that gains are realized.
- Minimize taxable income limit through compensation to shareholders, deferment of revenue or other means.
- Opt for shareholders' sale of stock rather than direct sale of assets when reorganizing or selling the Corporation.

Built-In Gain Recognition Period For S Corporations Shortened For 2009 and 2010

The American Recovery and Reinvestment Act (the "Recovery Act") signed by President Obama on February 17, 2009, contains a provision shortening the built-in gain recognition for S Corporations for taxable years 2009 and 2010.

The recognition period for the built-in gains tax is temporarily shortened from 10 years to 7 years.

For S Corporation tax years beginning in 2009 and 2010, no built-in gains tax will be imposed on S Corporations if the seventh year in their recognition period precedes their 2009 and 2010 tax years. Thus, the recognition period for S Corporations that made elections prior to the 2002 tax year (or that received property from a C Corporation in a carryover basis transaction in those years) has ended, and those Corporations would not be subject to the built-in gains tax. For S Corporations that made elections in 2002 or 2003 (or that received property from a C Corporation in a carryover basis transaction in those

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years), the recognition period will end at the beginning of the 2009 or 2010 tax year, respectively. For elections or property transfers made after 2003, the 10 year recognition period will apply.

BIG Tax Tip: If there is a BIG consideration due to a change from C Corporation to S Corporation with assets inside the Corporation, minimize the risk by:

- Limited entity-level taxable income,
- Defer gain recognition through Sec 1031 beyond 10 year BIG period, and
- Lease rather than sell a BIG asset

Calculating Basis

One of the requirements of having an S Corporation is keeping track of basis. Right now, it's the responsibility of the shareholder to track basis, but like we saw from the recent GAO report, it may soon become the requirement of the S Corporation to do so. Here are some of the highlights.

Shareholder Basis, Adjusted Basis, and Loan Basis

A shareholder's capital account needs to reflect the shareholder's investments and current basis in the S-Corporation's equity or liabilities. A shareholder is invested in the S-Corporation to the extent that a

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shareholder has made an equity investment or advanced a loan to the company.

Shareholder's Equity is reflected in the shareholder's capital account. This account should show the dollar amount of cash investments, and value of property donated to the company. A shareholder who contributed cash of $10,000, a computer worth $2,000, and software worth $400 would have a capital account showing a total investment of $12,400.

The capital account is adjusted from time to time to reflect additional equity investments. Additionally, the capital account is adjusted at the end of the year to reflect each shareholder's pro-rata share of income and expenses.

The **adjusted basis** of a shareholder's stock is calculated as follows:

Adjusted basis at the beginning of the year

+ Share of all income items that are separately stated, including tax-exempt income
+ Share of all non-separately stated income items
+ Share of deduction for excess depletion of oil & gas properties

- Distribution of cash or property to the shareholder that was not included in the shareholder's wages
- Share of all loss and deduction items that are separately stated, including Section 179 deductions and capital losses
- Share of all non-separately stated losses

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- Share of non-deductible expenses, such as the non-deductible portion of meals & entertainment expense or non-deductible fines and penalties
- Share of depletion for oil & gas properties not in excess of the property's basis.

= Adjusted basis in S-Corporation stock at the end of the year

Loan Basis

Shareholder may advance money to the S-Corporation as a loan. A common example is a shareholder that pays for company expenses using his personal credit card, and submits an expense report to the company for repayment. Loans to the company may be short-term loans (to be repaid in one year or less) or long-term loans (to be repaid in more than one year). Shareholder's making loans to their S-Corporation may take a tax deduction in the current year for losses in excess of their stock basis, but only to the extent they have loan basis.

Loan basis, and adjusted loan basis, is calculated as follows:

Initial amount loaned to the company

\+ Additional amounts loaned to the company

\+ Deferred interest that is capitalized (added to the loan) instead being repaid

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- Amount of loan principal repaid
- Amount of loan principal forgiven by the shareholder
- Amount of loan principal converted to stock
- Share of net loss in excess of shareholder's adjusted stock basis

= Adjusted basis in S-Corporation debt at the end of the year.

Negative Basis and Suspended Losses

Adjusted basis cannot be below zero. However, using the formula above for calculating adjusted basis will often result in a negative number. Here are the rules for handling "negative basis" of S-Corporation stock:

- Shareholder's stock basis is reduced, but not below zero,

- Then Shareholder's loan basis is reduced, but not below zero.

Any excess "negative basis" is treated as a non-deductible loss. This excess loss is a "suspended loss" and carries over to future years indefinitely. The suspended loss may be deducted in any future tax year during which the shareholder has restored her loan basis or stock basis.

If the shareholder had both an equity investment and advanced a loan to the company, then in following years the shareholder must restore her loan basis before restoring her stock basis.

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Restoring Basis

Shareholders may restore their stock basis or loan basis in several ways. The easiest way to restore basis is to make additional cash investments (to restore stock basis) or to advance additional cash loans (to restore loan basis).

Adjusted stock basis and loan basis should be calculated tentatively just before the end of the year. This will give shareholders sufficient time to make additional loans or equity investments to ensure that any losses are fully tax-deductible.

At-Risk Rules

Each shareholder has an amount at risk. This is the amount of money the shareholder stands to lose from her investments or loans to the company. A shareholder's amount at risk is calculated as follows:

Adjusted Stock Basis
+ Adjusted Loan Basis
= Amount At Risk.

Any loss in excess of the amount at risk is a "suspended loss" and follows the rules for suspended losses outlined above.

Each shareholder's stock basis and loan basis will be adjusted for her pro-rata share of losses even if those losses are suspended because of the

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at-risk rules. It is therefore very important for the S-Corporation and its shareholders to track adjusted stock basis and adjusted loan basis accurately and meticulously.

S Corporation Shareholders are Required to Compute Both Stock and Debt Basis

The amount of a shareholder's stock and debt basis is very important. Unlike a C Corporation, each year the stock and/or debt basis of an S Corporation goes up and/or down based upon the S Corporation's operations. The S Corporation will issue a shareholder a Schedule K-1.

The K-1 reflects the S Corporation's income, loss and deductions which are then allocated to the shareholder for the year. The K-1 does not state the taxable amount of the distribution. The taxable amount of distribution is contingent on the shareholder's stock basis. It is not the Corporation's responsibility to track a shareholder's stock and debt basis, at least right now. It is the shareholder's responsibility.

If a shareholder receives a non-dividend distribution from an S Corporation, the distribution is tax-free to the extent it does not exceed the shareholder's stock basis. The S Corporation income/loss is reported on the Schedule K-1 from the Form 1120S. The distribution doesn't affect the income or loss.

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Losses or Deduction Flow-Through

If a shareholder is allocated an S Corporation loss or deduction flow-through, the shareholder must first have adequate stock and/or debt basis to claim that loss and/or deduction. In addition, it is important to remember, that even when the shareholder has adequate stock and debt basis to claim the S Corporation loss or deduction, the shareholder must also consider at-risk limitations and passive activity limitations and therefore may not be able to claim the loss and/or deduction.

Computing Stock Basis

In computing stock basis, the shareholder starts with the initial capital contribution to the S Corporation or the initial cost of the stock purchased (the same as a C Corporation). That amount is then increased and/or decreased based on the flow-through amounts from the S Corporation. An income item will increase stock basis while a loss, deduction or distribution will decrease stock basis.

The order in which stock basis is increased or decreased is important. Since both the taxability of a distribution and the deductibility of a loss are dependant on stock basis, there is an ordering rule in computing stock basis. Stock basis is adjusted annually, as of the last day of the S Corporation year, in the following order:

1. Increased for income items and excess depletion;
2. Decreased for distributions;

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3. Decreased for non-deductible, non-capital expenses and depletion; and
4. Decreased for items of loss and deduction.

When determining the taxability of a non-dividend distribution the shareholder looks solely to his/her stock basis (debt basis is not considered).

For losses and deductions which exceed a shareholder's stock basis, the shareholder is allowed to deduct the excess up to the shareholder's basis in loans personally made to the S Corporation. Debt basis is computed similarly to stock basis but there are some differences.

If a shareholder has S Corporation losses and deductions in excess of stock basis and those losses and deductions are claimed based on debt basis, the debt basis of the shareholder will be reduced by the claimed losses and deductions.

If an S Corporation repays reduced basis debt to the shareholder, part or all of the repayment is taxable to the shareholder. In other words, if the shareholder has relied

Important Things You Should Know:

- A distribution in excess of stock basis is taxed as a capital gain on the shareholder's personal return, usually a long-term capital gain (LTCG).

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- Non-deductible expenses reduce a shareholder's stock and debt basis before loss and deduction items. If non-deductible expenses exceed basis, they do not get carried forward.

- If the current year has different types of losses and deductions, which exceed stock and debt basis, the allowable losses and deductions must be allocated pro rata based on the size of the particular loss and deduction items.

- A shareholder is not allowed to claim losses and deductions in excess of stock and debt basis. Losses and deductions not allowable in the current year are suspended due to basis limitations.

- Suspended losses and deductions due to basis limitations retain their character in subsequent years. Any suspended losses or deductions in excess of stock and debt basis are carried forward indefinitely until basis is increased in subsequent years or the shareholder disposes of the stock

- In determining current year allowable losses, current year loss and deduction items are combined with the suspended losses and deductions carried over from the prior year, though the current year and suspended items should be separately stated on the Form 1040 Schedule E or other appropriate schedule on the return.

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- A shareholder is only allowed debt basis to the extent he or she has personally lent money to the S Corporation. A loan guarantee is not sufficient to allow the shareholder debt basis. NOTE: Partnership debt basis is calculated differently than shareholder debt basis.

- Part or all of the repayment of a reduced basis debt is taxable to the shareholder.

- If stock is sold, suspended losses due to basis limitations are lost. The sales price does not have an impact on the stock basis. This is an important planning note. Make sure you take advantage of suspended losses FIRST. Otherwise, you'll lose them in a sale.

S Corporation Distributions

If an S Corporation has no earnings and profits (E&P) from when it was a C Corporation, all distributions are considered to be return of basis in the shareholder's stock. Distributions up to the amount of basis are nontaxable. Distributions in excess of basis are capital gain.

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S Corporations With Earnings And Profits (E&P) From C Corporation Days

An S Corporation can have E&P from one of the following sources:

- Liquidations, redemptions, and reorganizations governed by the rules of Subchapter C of the Internal Revenue Code.

- Tax years in which the S Corporation was a C Corporation.

- Corporate acquisition that results in carryover of E&P under IRC §381.

- If an S Corporation has E&P, it must maintain a retained earnings account consisting of three subsidiary accounts: (1) Accumulated Adjustments Account (AAA), (2) Earnings and Profits Account (E&P), and (3) Other Adjustments Account (OAA).

This is where the accounting gets more advanced. It's important to keep track of the E & P (related to C Corporation income) versus the AAA (related to S Corporation income). Otherwise, you can get into some trouble as you make distributions.

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Ordering rules determine the taxation of distributions made by an S Corporation with E&P.

Accumulated Adjustments Account (AAA)	Not Taxable
Earnings and Profits (E&P)	Taxable Dividend
Other Adjustments Account (OAA)	Not Taxable
Stock Basis/Return of Capital	Not Taxable
In Excess of Stock Basis	Capital Gain

These ordering rules, straight from the IRS, show us that while a distribution from an S Corporation isn't taxable, a distribution that hits E & P is taxable. We're back to the double taxation issue with C Corporations, only long after the C Corporation is gone.

Note: Some S Corporations have a retained earnings account called Previously Taxed Income (PTI). The PTI account represents undistributed earnings from pre-1983 S Corporation years. See the instructions for Schedule M-2, Form 1120S for information about treatment of PTI.

Election to Take E&P First: An election is available to take distributions first from E&P [IRC §1368(e)(3)]. The election is made on a year-by-year basis. See Regulation §1.1368-1(f) for information about how to make the election. You may want to take that election if you've got a lower personal income tax year and you know that E & P is an inevitable issue.

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Accumulated Adjustments Account (AAA)

Distributions to shareholders from the AAA are not taxable. The AAA is a cumulative total of undistributed net income items generated by the S Corporation. This account is adjusted in the same fashion as a shareholder's basis. However, unlike stock basis, the AAA can have a negative balance resulting from S Corporation losses (but not from distributions to shareholders). Income in a later year can make the account positive only after the negative balance has been restored. Any decrease in stock basis has no impact on AAA when the AAA balance is negative.

Other Adjustments Account (OAA)

The OAA is used only by an S Corporation that has accumulated E&P. The OAA is increased by tax-exempt income and decreased by related expenses and distributions to shareholders from the account. The account is also increased by federal tax paid which is attributable to a C Corporation tax year. The OAA can have a negative balance resulting from pass-through items, but a negative balance may not result from distributions to shareholders. Distributions from the OAA are not taxable to shareholders.

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Application Of Ordering Rules Distributions by an S Corporation with earnings and profits have the following effects on the shareholders:

1. Distributions come first from the AAA, and are tax free to shareholders. Distributions from the AAA reduce an S Corporation shareholder's adjusted basis.

2. Distributions come second from the E&P account. Distributions from E&P are taxable to shareholders as dividends. Distributions from E&P do not reduce the S Corporation shareholder's basis in stock. An election is available to take distributions first from E&P before AAA.

3. Distributions come third from the OAA, and are tax free to shareholders. Distributions from OAA reduce the S Corporation shareholder's basis in stock.

4. Distributions in excess of the combined amounts in the AAA, E&P and OAA accounts are considered a return of capital, up to the S Corporation shareholder's basis in the stock.

5. Distributions in excess of the S Corporation shareholder's basis in stock are treated as capital gains from the sale of property.

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S Corporation Post Termination Transition Period

When an S Corporation's 'S' status terminates, a "Post Termination Transition Period (PTTP)" begins. During the PTTP, distributions from the AAA and OAA accounts retain their character as nontaxable distributions. The distributions reduce the S Corporation shareholder's basis [IRC §1371(e)(1)]. If the S Corporation fails to distribute all of the AAA and OAA by the end of the PTTP, then any remaining AAA and OAA turns into E&P.

Election: With the consent of all S Corporation shareholders to whom distributions are made during the PTTP, the S Corporation can elect to treat distributions as dividends up to the E&P of the S Corporation. The election is made by attaching a statement to Form 1120 for the year the PTTP ends. The statement should contain a declaration that the S Corporation elects to have Section 1371(e)(1) not apply to any distribution during the period, and should be signed by all S Corporation shareholders required to make the election.

The PTTP ends the later of:

1. One year after the PTTP begins, or
2. Due date for the last S Corporation return (including extensions), or
3. 120 days after a court decision, agreement with the IRS, or audit determination stating that the Corporation did not qualify as an S Corporation.

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Deemed Dividends

If an S Corporation wants to make dividend distributions, but lacks sufficient capital, Reg. §1.1368-1(f)(3) allows the S Corporation to make a "deemed dividend." The dividend is considered to have been made, even though no money is distributed. The amount of the deemed dividend is treated as a capital contribution, and increases the basis of the S Corporation shareholder’s stock.

Property Distributions

When property is distributed, the S Corporation shareholder uses the fair market value of the property to figure the tax effect and the adjustment to basis of his/her stock. If the property is appreciated property, the S Corporation is considered to have sold the property to the shareholder at FMV.

S Corporation Accounting

S Corporations need to maintain accurate and meticulous records of income, expenses, and capital investments. Overall, the S Corporation reports total income and expenses at the company level, and passes-through a share of net profit or loss to individual shareholders. The S Corporation needs to maintain records regarding each shareholder's investment of cash or property. These records are crucial for establishing each shareholder's percentage of ownership in the company.

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Accounting for Income and Expenses

S Corporation accounting is the similar to C Corporation accounting. Income and expenses are reported at the corporate level, and the nature of various types of income and expense are identified at the corporate level as well. S Corporations can choose an accounting method (cash, accounting, hybrid) best suited to report the income and expenses of the company. S Corporations are not required to use the accrual method of accounting; they may choose the cash method or a hybrid method of accounting if those methods of accounting.

Income and expense items retain their character when they are passed-through to S Corporation shareholders. Long-term capital gains, for example, earned by the S Corporation are passed through as long-term capital gains to shareholders. S Corporations therefore need to identify types of income and types of expenses for the benefit of their shareholders.

Accounting for Shareholder Capital

The biggest problem by far is accounting for the capital accounts of each and every single shareholder. The company must maintain meticulous records of each shareholder's equity investments of cash and property, as well as any loans that each shareholder advances to the company.

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Unlike limited partnerships and limited liability companies, shareholders of S Corporations must divide the Corporation's net income in strict proportion to their share of ownership. If a shareholder has contributed exactly one-third of the company's capital, then exactly one-third of the company's net profit or loss must be allocated to that shareholder.

The capital accounts come into play in two crucial parts of an S Corporation's financial and tax reporting. First, the capital accounts are reported on the company's balance sheets as shareholder equity and loans from shareholders. Second, each shareholder's capital account can be summarized on Form 1120S Schedule K-1. Insufficient capital investments can cause shareholders to fail to meet the At-Risk rules for losses and can cause business losses to become non-deductible.

Investing Cash and Property

Shareholders can invest cash or property to an S Corporation. A shareholder might contribute a computer, desk, reference books, and software programs to her newly formed S Corporation in addition to her cash investment. The value of the shareholder's property is the lower of (a) the fair market value of the property, or (b) the shareholder's adjusted basis in the property.

S Corporation Warning

The National Taxpayer Advocates' 2007 Annual Report stated that S

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Corporation tax returns are the most common corporate entity, yet the IRS still hasn't got a fully functioning K-1 matching program. The program has begun and ended and there is talk that there might be some tests going on now. But in general, the K-1 matching program has had too many errors to be reliable.

IRS is now developing a high income taxpayer strategy to test the theory that the highest income Form 1040s (Individual Income Tax Returns) are using a variety of tax products and entities to illegally defer tax liability into future years, turn ordinary income into capital gains income and offset income with sham losses.

Special Tax Issues For Distressed S Corporations

With the economy down, S Corporations might be facing some unusual circumstances. Some of the tax issues to deal with come tax time include:

- Cancellation of Debt
- Reorganizations
- Subordinating shareholder debt
- Issuing stock to creditors
- Soliciting additional capital

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Cancellation of Debt

The general rule is that if a taxpayer has indebtedness forgiven, the amount forgiven is taxable. The same is true for an S Corporation. There is an exclusion, though, for bankruptcy, insolvency or if there is qualified real estate indebtedness. The trade-off from this exclusion is that certain items such as net operating losses (NOL), general business credits, minimum tax credits or capital losses. Alternatively, the taxpayer may elect to reduce basis in depreciable assets.

Reorganizations

This next section is a more advanced portion of tax law and is written more for tax preparers. If you are a taxpayer who wants to learn more about what is possible if you have a distressed S Corporation, read through these, but then definitely seek an experienced practitioner to help you

E Reorg: Raise cash and reduce indebtedness. It is possible to do a reorganization of an S Corporation under a special Code Section 368 (a) (1) (E) which allows a restructuring of liabilities and equities. For example, debt can be converted to junior status as a way to raise cash. Or debt to be converted to equity share as a way to reduce indebtedness.

E Reorg: Convert to S Corporation from C Corporation with multiple classes of stock. If a C Corporation has assets that have fair market value close to depreciated basis, it could make the S election

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with minimal built-in gain exposure. Then once the S election is made, it could bring the type of stock into play. For example it may be necessary to eliminate preferred stock or class B common stock, because an S Corporation is allowed only one class of stock. Neither the shareholder nor the Corporation will incur a recognized gain with an E reorganization. Otherwise, just getting rid of a class of stock is likely to trigger a taxable event.

D Reorg: Create a Parent-QSub group to create basis for losses. It might also make sense to convert brother-sister S Corporations into a parent-Q-sub group and at the same time increase the basis for loss. This can be done, as long as there is a good business purpose, through a D reorganization. Make the profitable company the parent and the Q-sub should be the loss company.

G Reorg: Allow bankrupt S Corporation to transfer assets. You can use a G reorganization to allow a bankrupt S Corporation to transfer assets in satisfaction of its liabilities.

Debt Restructuring

In the current economic climate, debt restructuring and loan modifications are the new buzz words. When there is cancellation of debt (COD), the S Corporation will have to recognize income just like what occurs if an individual taxpayer has COD income.

But there could be an additional issue for the S Corporation – substitution of collateral or guarantors on the debt. As the debt changes,

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there could be changes to the basis of individual shareholders. Don't assume that debt restructuring without COD means nothing taxable has occurred. There actually could be a large tax consequence.

S Corporation Conclusion

Most of the S Corporation complexity comes from duality that occurs when an S Corporation starts its life as a C Corporation. If you've operated for a few years as a C Corporation and then make a change, you'll likely have to track basis separately, watch out for excess distributions and be aware of the BIG tax.

The IRS has issue with S Corporations these days because too many people treat them as a tax dodge to avoid Social Security and Medicare tax, plus ignore issues like basis calculation.

The S Corporation may appear deceptively simple, but it isn't. There are real tax considerations and just like any business structure, must be managed and reported correctly or there could be hassles, penalties and interest down the road.

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