Navigating the Complexities of S Corporations

A Roadmap to Issues and Recent Guidance

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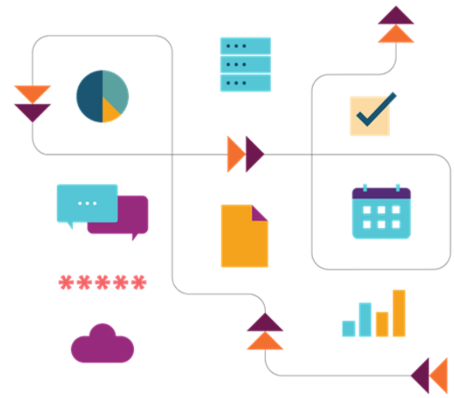

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Agenda

- Recent Guidance
- Distributions/Dividends
- Reasonable Compensation
- TCJA Impact

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Recent Guidance

Rev. Proc 2022-19

- Non-identical governing provisions (i.e., LLC electing to be treated as S Corp).
- Relief from second class of stock.
- Disproportionate distributions.
- Inadvertent errors or omissions on Form 2553.
- Missing S Election or Q Sub letter (new letter can be requested by calling the IRS).
- Federal income tax return inconsistent with election.

Rev. Proc 2013-30

- Simplified relief for late filing of Form 2553 or Form 8869
- Consolidated numerous other revenue procedures into one and extended relief
- Deemed entity classification election - Form 8832 election is not required to be filed first

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General Relief Rules under Rev Proc 2013-30

- Entity intended to be classified as C Corporation, is eligible entity, and failed to qualify solely because election was not timely;
- Entity has reasonable cause for failure to make election timely;
- Entity and all shareholders reporting income consistent with S Corp election in effect for the year the election should have been made and all subsequent years; and
- Less than 3 years and 75 days have passed since effective date of the election.

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Distributions/Dividends

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Distributions

- *Cash Distributions*
  - Cash given to shareholder directly
  - Expenses paid on behalf of the shareholder

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Non-Cash Distributions

- *Property distributions* of appreciated property to shareholder
  - GAIN recognized to extent FMV > adjusted basis of property
  - Shareholder increases basis for amount of gain
- Shareholder's use of corporate property can result in *constructive dividend*
  - Amount is fair market rental value of property

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Tax Treatment of Distributions

- *No accumulated earnings & profit (AE&P)*
  - Non-taxable to shareholder up to tax basis in stock
  - Excess is treated as capital gain from sale/exchange of underlying stock

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Basis Ordering Rules

- Start with BOY basis
- Add current year increases:
  - Non-separately stated income
  - Separately stated income
  - Do NOT increase for tax exempt income
- Reduce by distributions
- Reduce by current year losses:
  - Non-separately stated losses
  - Separately stated losses
  - Do NOT decrease for expenses attributable to tax-exempt income

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Example 1

A owns 100% of stock in S Co (an S Corporation) with a basis of $30,000 and an AAA balance of $10,000. S Co has been an S Corp from inception and has no AE&P. In 2023, S Co had $40,000 in ordinary income, $30,000 in LTCL and distributed $40,000 to A.

BOY Basis	$30,000
Ordinary Income	40,000
Basis before distribution	70,000
Distribution	(40,000)
Basis after distribution	30,000
LT Capital Loss	(30,000)
EOY Basis	$0

AAA balance is irrelevant when there is no AE&P.

Distribution is tax-free.

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Example 2

Same facts as Example 1, except S Co generates only $20,000 of income and distribution increased to $60,000.

BOY Basis	$30,000
Ordinary Income	20,000
Basis before distribution	50,000
Distribution	(50,000)
Basis after distribution	0
LT Capital Loss	0
EOY Basis	$0

$50,000 of distribution is tax-free.

Excess distribution of $10,000 is taxable as capital gains.

LT capital loss is limited by basis and carried forward.

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Tax Treatment of Distributions

- *Entity has accumulated earnings & profit (AE&P)*
  - Generally, when retained earnings are greater than AAA BOY balance
  - Examples:
    - Retained earnings from years treated as C Corp prior to an S Election
    - S Corp merges with C Corp that has AE&P
    - Wholly owned C Corp with A&P liquidates tax-free into S Corp (S Corp makes QSub election for its wholly owned C Corporation)

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Tax Treatment of Distributions

- *Entity has accumulated earnings & profit (AE&P)*
  - Retained earnings from years treated as C Corp prior to S Election
    - Check date entity formed and S Election date on page 1
  - S Corp merges with C Corp that has AE&P
  - Wholly owned C Corp with A&P liquidates tax-free into S Corp
    - S Corp makes QSub election for its wholly owned C Corporation

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Basis Ordering Rules – with AE&P

- Tier 1
  - To extent AAA balance positive distribution is treated same as if no AE&P = non-taxable
- Tier 2
  - Distributions in excess of AAA = dividends to extent of AE&P
- Tier 3
  - Distributions in excess of AE&P = non-taxable

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Example 3

A owns 100% of stock in S Co (an S Corporation) with AAA of $2,500 and prior AE&P of $7,500. The basis at 1/1/2023 is $10,000. In 2023, S Co had $9,000 of ordinary income, $2,000 LTCL and distributed $11,000 to A.

	AAA	AE&P	S Corp	C Corp
BOY Basis	2,500	7,500		
Ordinary Income	7,000			
AAA before distribution	9,500			
Distribution	(9,500)		9,500	
Ending AAA	0			
Distribution from AE&P		(1,500)		1,500
Ending AE&P		6,000		

$9,500 of distribution is tax-free.

$1,500 is treated as a dividend from C Corp earnings.

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Optional Elections

- Elect to distribute AAA after AE&P under Regs. Sec. 1.1368-1(f)(2)
  - *Order of distributions = PTI - AE&P – AAA*
  - Anticipation of rising tax rates on dividends
  - Use of NOL that is expiring
- Elect to distribute AE&P before AAA and PTI under Regs. Sec. 1.1368-1(f)(4)
  - *Order of distributions = AE&P – AAA - PTI*

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Optional Elections

- Deemed Distribution under Regs. Sec. 1.1368-1(f)(2)
  - Allowed if no cash necessary to purge AE&P balance
  - Treated as received by all shareholders,
  - Then immediately recontributed to S Corp
- All elections irrevocable and apply only to the year for which they are made.

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Reasonable Compensation

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Importance of Compensation

- S Corporations are *required* to pay "reasonable salaries" to shareholders before non-wage distributions
- If shareholder wages are reasonable, shareholders may take tax-free distributions
  - Saves payroll taxes on wages
- Upon examination, IRS may reclassify distributions as wages if they deem compensation unreasonable

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Reasonable Compensation

- Generally defined as "at least what other businesses pay for similar services."
- Documentation showing how you arrived at the salary amount is important and should include:
  - Services shareholder performs for S Corp
  - Support for base salary and any bonuses

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Reasonable Compensation Factors (IRS)

- Administrative responsibilities
- Training and experience
- Duties and responsibilities
- Time and effort devoted to the business
- Dividend history
- Payments to non-shareholder employees
- Timing and manner of paying bonuses to key people
- What comparable businesses pay for similar services
- Compensation agreements
- The use of a formula to determine compensation

SOI Tax Stats – S Corporation Statistics

The IRS provides data tables and SOI Bulletin articles concerning 1120S corporations:

S Corporation Statistics | Internal Revenue Service (irs.gov)

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Determining Reasonable Compensation

- Create list of services performed by shareholder
- Start with industry stats for similar positions
- What if shareholder "wears multiple hats"?
  - Adjust salary up or down as needed
  - If you work part-time, consider reducing salary

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Source of Gross Receipts

- Services of shareholder
  - To extent receipts from shareholder personal services, payments should be wages subject to employment taxes
- Services of non-shareholder employees, or
- Capital and equipment
  - To extent receipts from non-shareholder employee's services or from capital and equipment, payments to shareholder should be non-wage distributions

Other Items Treated as Wages

- Health and accident insurance premiums for more than 2% shareholder
  - Added to Box 1 and subject to withholding
  - Not subject to Social Security, Medicare or Unemployment taxes
- Amount treated as SE Health Insurance on Form 1040

Excessive Compensation

- In the C Corp setting, excessive compensation may be a way to avoid double taxation.
- S Corps do not have issue of double taxation so argument may be minimal.
- Situations to watch for:
  - S Corp owned by multiple family members and salary levels do not match the services each shareholder performs for the entity

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Consistency S Corp to 1040

- Have little to no shareholder compensation on S Corp but don't treat shareholder as passive on personal return
- Treat shareholder as passive but show their title as "Executive" for occupation
  - Occupation should be broad enough to cover the shareholder's multiple roles without overstating responsibilities
  - Should be in line with compensation being paid

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Final Thoughts on Reasonable Compensation

- Document employee-shareholder participation in entity
  - Services provided
  - Time spent
  - Calendars, spreadsheets, written narratives, corroborating evidence
  - Be careful of contradictory evidence (titles on business cards, websites and social media)
- Remind clients that paying some payroll taxes is less expensive than being audited

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TCJA Impact

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Sec 163(j) Interest Expense Limitation

- S Corp is subject to the interest expense limitation at the ***S Corp level***, unless they meet the small business gross receipts test.
  - For 2023, average gross receipts must be $29 million or less for prior 3 years.
- Net interest expense limited to 30% of adjusted taxable income.
  - Tax adjusted earnings before interest and taxes
- Excess net interest expense treated as:
  - Tax adjustment for current year, and
  - Carried forward to following taxable year.

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2023 Sec 199A Deduction Thresholds

- If taxable income at the individual level is below certain thresholds, the limitations do not apply. The limits phase out.
- For 2023, the thresholds are listed below:
  - Single - $182,100 - $232,100
  - MFJ - $364,200 = $464,200

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Sec 199A Deduction Limitations

- Allows 20% deduction for qualified business income in qualified trade or business, subject to limitations at ***business level***
  - 50% of W-2 wages, or
  - 25% of W-2 wages, plus 2.5% of unadjusted basis in tangible property subject to depreciation
- Overall limitation at ***individual level***
  - Limited to taxable income less sum of net capital gains
- **Sec 199A deductions are only available through Dec. 31, 2025**

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Example 4

In 2023, A, a married taxpayer, had $100,000 of qualified business income, $100,000 of LTCG, $30,000 of deductions, resulting in taxable income of $170,000.

Section 199A deduction limited to LESSER of:

- $20,000 (20% of $100,000)
- $14,000 (20% of $70,000 net taxable income)
  - $70,000 = $170,000 taxable income LESS $100,000 of capital gain.

Sec 199A deduction is limited to 20% of net taxable income = $14,000

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Wage Limitation

- Managing wage limitation is key to maximizing Sec 199A deduction
- The 2/7 Rule:
  - If QBI is limited for a taxpayer due to low wages.
  - Multiply taxable income by 2/7 to get wages needed to maximize deduction

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Example 5

If wages are increased, higher QBI deduction allowed.

See comparison below.

	Original		Adj Wages	
Taxable Income	1,000,000		1,000,000	
Less: Wages	(50,000)		(285,714)	
Adjusted Taxable Income	950,000		714,286	
QBI (20%)	190,000	A	142,857	A
Wages	50,000		285,714	
50% Wage Limitation	25,000	B	142,857	B
QBI deduction after limitation (Lesser of A or B)	25,000		142,857	
QBI Tax Savings	9,250		52,857	

Results in tax savings of $43,607

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Net Investment Income (NII)

- Gain from sale of S Corp stock not subject to NII tax if:
  - If taxpayer materially participates in the S Corp
  - S Corp has one trade or business activity
  - S Corp does not have any Sec 1411 property (passive)

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Net Investment Income (NII)

- Optional simplified reporting method allowed if EITHER:
  - 5% and $5 million test
    - Net investment income is 5% or less of all income or loss items allocated to shareholder during 1411 holding period, and
    - Gain on disposition is less than $5 million
  - Total gain recognized by the shareholder is $250,000 or less.

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Optional Simplified Method

No portion of the gain/loss is subject to NIIT

- If numerator is positive and there is overall loss
- If numerator is negative and there is overall gain

If the fraction is greater than 1 or less than 0, the fraction is considered to be 1 and all of the gain is subject to NIIT

NIIT Formula

$$\text{Total Gain/Loss} \times \frac{\text{Total of all 1411 items in year of disposition \& 2 prior years}}{\text{Total of all taxable items in the year of disposition \& 2 prior years}}$$

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Thank you

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