The S-Corporation Election; Advantages & Disadvantages

Presented by:
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Learning Objectives

At the end of this course, you will be able to:
• Define the advantages of being taxed as an S-Corp
• Recognize the difference of taxation as a S-Corp compared to a C-Corp
• Understand how profit distributions and payroll are taxed in a S-Corp
• Determine if this is a good tax entity choice for your client
• Learn how to make the S-Corp election
What Is The Sub-S Election?

• Chapter 1 Subchapter S of Internal Revenue Code

• Who can make the election?
  – Meet the 5 requirements of IRC §1361 (b)
  – Domestic Corporations
  – Disregarded entity - LLC’s

• Previously an S-Corp, 5 year rule
Is this the right entity for your client?

• Advantages:
  – Liability protection
  – Separate entity
  – Perpetual Life
  – Personal Service Corporation issues
  – Shareholder Agreement
Is this the right entity for your client?

- Disadvantages:
  - Discipline
  - Expense
  - Filing requirements
  - Late filing fees
  - Calendar year restrictions
S Corporation Stock

• Advantages:
  – IRC §1367 requires annual adjustment
  – Raise capital through stock issuance
  – One class of stock
  – Ordinary loss on sale IRC §1244
  – Capital gain treatment on sale
  – Voting vs non-voting
S Corporation Stock

• Disadvantages:
  – Who is keeping track of stock basis?
  – Debt can create second class of stock
  – Stock sale doesn’t qualify for IRC § 1202
  – Basis reduction
  – Disproportionate distributions
Shareholders

• Advantages:
  – 100 limit, family members treated as one shareholder
  – US citizen or resident individual
  – Estates, certain trusts and charities
  – Deductibility of acquisition interest
  – Favorable charitable contribution rules
Shareholders

• Disadvantages:
  – Limitations of shareholders
  – Limitation to raise outside capital
  – No fringe benefits for 2% shareholder
  – K-1 reporting
  – Basis complexity
Pass through Entity

• Advantages:
  – Taxation at individual level
  – Losses flow through
  – No double taxation
  – Capital gains & losses flow through
  – If active participation by shareholder, profits are not subject to NIIT
Pass through Entity

• Disadvantages:
  – Profits are taxed even when not distributed
  – Losses are limited to tax basis
  – Individual tax rates
  – IRC §179 limitations
Reasonable Salary

- Advantages:
  - Retirement funding
  - Minimize risk of excessively high salaries
  - Splitting income with family members
  - Minimize risk of hobby loss
  - Minimize risk of recharacterization
Reasonable Salary

• Disadvantages:
  – For adequate services provided
  – Must actually be paid
  – Payroll taxes
  – IRS scrutiny as to "reasonable"
Distributions

• Advantages:
  – IRC §1368
  – E & P distributions are taxable dividends
  – No E & P, profit distributions are tax free to the extent of basis
  – Not mandatory
Distributions

• Disadvantages:
  – Must be equitable to all shareholders
  – E & P dividend distributions – lower tax rate for individuals
  – No E & P distributions in excess of basis - taxable capital gains
S Corporation taxes

- Excess Net Passive Income (ENPI) Tax IRC §1375
- Built in Gains (BIG) Tax IRC §1374
- Inventory – LIFO vs FIFO IRC §1363
- Investment Credit Recapture
- Avoid Accumulated Earnings Tax
Making the Election

- Form 2553
  - All shareholders must consent
- Form 8832
- Corporation late election
- Combined entity & S election
Other factors to consider

• LLC & sole prop alternative
• Termination – IRC §1362
• Revoking S Status
• Shareholder Agreement
• Inadvertent Termination
• Separately stated items
WHAT?!?

What we learned in the last hour:

• We defined the advantages of the S-Corp
• We can recognize the difference in taxation as a S-Corp compared to a C-Corp
• We now understand how profit and distributions are taxed in a S-Corp
• We know the issues and questions to ask to determine if this is a good tax entity choice for our client
• We learned how to make the S-Corp election
For More Information
National Society of Accountants
More information is available including additional materials at:
Booth in Vendor Hall
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