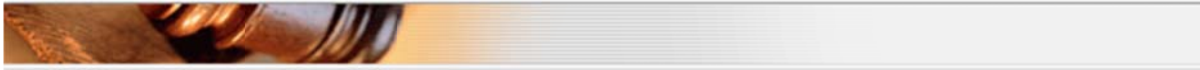
CORPORATE ASSISTANCE
Compliance Management for Business Owners



Keeping Your "S" Corporation Compliant

When you incorporate, you must choose either "C" or "S" status. Depending on which form you choose, there are differences in corporate governance rules. It's important for business owners to understand the requirements for their particular entity type, so they can maintain proper compliance behaviors.

For a number of privately held businesses, an S Corp has features that may make it more attractive than a C Corp. A flurry of 1996 tax law changes increased the income tax appeal of an S corporation. More recently, the American Jobs

Creation Act and private letter rulings from the IRS have eased restrictions that apply to S Corps.

If you currently operate an S Corp, you need to stay abreast of changes in the law so you can remain compliant. Corporate Assistance's compliance management and education services are the best way to do this. We intervene in many instances where business owners risk imperiling their S election due to compliance missteps.

If you are currently a C Corp, you may benefit from a veil review to see if changing to S status would be more advantageous. One benefit could be lower income taxes.

A multitude of factors must be considered when selecting a business entity type. Contact your Governance Specialist for more information.

Two "Flavors" of Corporations

Corporations come in two basic flavors. The default is a "C" Corp. However, you can also make an "S" election. "C" and "S" refer to Internal Revenue Code Subchapters dealing with income tax treatment. C and S Corps differ primarily in how income tax liability is assessed.

C Corps are separate taxable entities with their own tax rates and returns. S Corps pass through corporate income and deductions to owners' individual income tax returns.

S Election Benefits vs. a C Corporation

Depending on your circumstances, an S Corp may be more tax-efficient. You may lower your income taxes and be able to sell the business in a more tax-efficient way.

C Corps pay taxes on corporate earnings. Taxable distributions (dividends) are paid to owners (shareholders) from after-tax earnings. This creates a potentially costly "double tax" situation. Owners of S Corps avoid this trap. They can also potentially reduce their Social Security and Medicare taxes.

When a C Corp is sold, the corporation is taxed on the sale gain. The remaining proceeds become a taxable distribution to owners. This can consume much of the value of the business in taxes. By contrast, S Corps can structure a business sale with a much lower tax burden.

S Corporation Restrictions

Business owners who elect S Corp status accept some restrictions in how they own and operate their corporation:

1. No more than 100 shareholders;
2. Must be a domestic corporation;

3. Limited to one class of stock;
4. Cannot have any nonresident alien shareholders;
5. Must not be a bank, insurance company, or domestic international sales corporation (DISC);
6. Only allowable shareholders are individuals, estates, exempt organizations described in I.R.C. §401(a) or §501(c)(3), or certain trusts described in §1361(c)(2)(A).

Maintaining compliance with S Corp status is important. The IRS can disallow your S election and charge heavy tax penalties if you violate S rules.

Restrictions for Owners of 2%+ of Stock

Certain S Corp restrictions apply only to shareholder-employees with 2%+ ownership. These individuals have tax deductibility limits on treatment of fringe benefits. Violating these limitations can create IRS trouble for business owners. For 2%+ owner/employees, fringe benefits are included as taxable wages. While deductible to the S Corp, they increase the owner's taxable income.

The fringe benefit rules only apply to "statutory fringe benefits", not to stock options, qualified retirement plans, and nonqualified deferred compensation. Fringe benefits reported as wages under the >2%-owner rule include:

- Group term life insurance premiums
- Accident and health benefit plan insurance premiums
- Meals and lodging furnished by the employer

Other fringe benefits, like compensation for injuries, sickness, and dependent care assistance, aren't considered wages. Note also that 2%+ shareholders usually can still deduct statutory fringe benefits using sole proprietorship rules.

Check with your CPA for more information.

NOTE: The most common S Corp pitfall uncovered by our service is when owners try to transfer shares of the S Corp into trusts or partnerships not allowed under S Corp restrictions. We also frequently see violations of tax deductibility rules.

1996 Tax Law Changes

Congress passed a series of tax law changes in 1996. Several of these changes impacted S Corps:

- More trusts may own S Corp stock. Under prior law, only certain trusts could own S Corp stock. Most common were grantor trusts and Qualified Subchapter S Trusts ("QSST"s). After 1996, S Corp stock could be held by an "electing small business trust." Unlike the more rigid QSST, an electing small business trust can have multiple beneficiaries and can accumulate income.
- Lengthening trusts' holding period after death. Under prior law, trusts generally could hold S Corp stock for only 60 days after the death of the original shareholder. The 1996 Tax Act increased these post-death holding periods to two years. The 60-day time frame was often unworkable for estate representatives, who had to scramble to find buyers for the stock, often at a loss.
- S Corps can have subsidiaries. S Corps can now own 80% or more of the stock of a regular C Corp. In addition, an S Corp is now allowed to own a "qualified subchapter S subsidiary." Previously, S Corps could not have subsidiaries.
- Qualified plans and charities can own S Corp stock. Qualified retirement plans or Section 501(c)(3) charitable organizations may now be S Corp shareholders. This provides additional flexibility.

The American Jobs Creation Act

On October 11, 2004, Congress passed the American Jobs Creation Act, with multiple provisions impacting S Corps. The new law relaxes restrictions and improves tax flexibility for S Corps and their owners. Some major changes include:

- Increased number of shareholders – from 75 to 100 (effective for tax years beginning after 2004).
- Increased ability to deduct business losses when
- Qualified Subchapter S Trusts (QSSTs) or divorce is involved. These changes remove some S Corp limitations. As a result, a broader array of businesses may benefit from S status.

Recent IRS Private Letter Rulings

Ordinarily, S Corp stock cannot be owned by a partnership or LLC. But in Private Letter Rulings 200439027 and 200439028, the IRS identified circumstances where an S Corp shareholder could transfer stock to a partnership and trust without losing his/her S election.

In the rulings, an individual transferred S Corp stock to a partnership and to a grantor trust. The partnership was owned by an LLC and by a second grantor trust. Every entity in question (the S Corp, the partnership, the LLC) was owned ultimately by the individual and/or by a grantor trust where the individual was the sole grantor.

The IRS decided to disregard the trusts as entities and treat the S Corp stock as if it was still owned only by the individual, thereby preserving his S status. These private letter rulings represent a small but significant relaxation of IRS rules regarding ownership of S Corp shares.

NOTE: a private letter ruling applies to a specific situation; it is not a general rule. If you have ever considered transferring S Corp stock to a trust, partnership, or other entity, contact Corporate Assistance so we can help you avoid violating any S election rules.

What This Means to You

If you have made an S election for your corporation, you need to follow the rules that accompany this particular business form. You should also benefit from all the distinctive benefits of your S election.

Since a C Corp is the default corporate form, many businesses end up using it without considering whether it is best for their circumstances. If you are operating as a C Corp,

Corporate Assistance can walk you through analysis is to see whether making an S election is right for you.

Regardless of which business form you choose, Corporate Assistant can help you get the greatest benefit from it. Contact your Governance Specialist if you have any questions.

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For additional information visit www.CorporateAssistanceLLC.com on the web or call 877-800-8345 toll free.