



# S Corporations: Tax Considerations & Qualifying Trusts

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Course #3251A

Taxes

2 Credit Hours

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# S CORPORATIONS: TAX CONSIDERATIONS & QUALIFYING TRUSTS

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S corporations are currently the largest tax filer in the United States of America. This course covers the tax considerations in electing S corporation status and trusts that qualify as S corporation shareholders.

## LEARNING ASSIGNMENTS AND OBJECTIVES

*As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.*

### SUBJECTS

Tax Considerations in Electing S Corporation Status  
Trusts That Qualify as S Corporation Shareholders

Study the course materials from pages 1 to 38

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

### Objectives:

- Identify tax considerations in electing S corporation status
- Recognize types of trusts that can be a shareholder of an S corporation.

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Program publication date 9/6/2019

## EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.
- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.
- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.
- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.
- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

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# CHAPTER 1: TAX CONSIDERATIONS IN ELECTING S CORPORATION STATUS

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## Chapter Objective

### After completing this chapter, you should be able to:

- Identify tax considerations in electing S corporation status.

## INTRODUCTION

The S corporation entity form has changed significantly since its creation by Congress in 1958. Even its name has changed from the legalese “Subchapter S corporation” to the current “S corporation” after passage of the Subchapter S Revision Act of 1982. It is favored by many because it offers many of the benefits of partnership taxation while giving shareholders limited liability from creditors, bankruptcy, and the like. Law changes continue to fine-tune the S corporation form making it a valuable vehicle for conducting business both in the United States and abroad.

Today, the S corporation, a federal tax hybrid entity, must also be compared with the limited liability company (LLC), a state tax hybrid entity. An S corporation resembles an LLC in operation and concept; however, there are distinct differences. LLCs composed of two or more members work strictly on partnership taxation principles. In many ways, the taxation of an S corporation resembles a partnership; however, partnership tax law does not always apply (e.g., an S corporation cannot allocate income the way a partnership can; distributions of appreciated property are generally taxable).

It may be asked why taxpayers would want to use an S corporation rather than an LLC in view of the similarity of tax principles. Under current tax law, the unique partnership tax principles are only available in an LLC if there are two or more taxpayers. In contrast, S corporations require only one taxpayer to operate. Also, S corporations offer unique planning possibilities not available in LLCs (e.g., the creation of capital gains).

An S corporation’s ordinary income and loss is not taxed at the corporate level; rather, it is passed through to the shareholders as in a partnership. Likewise, an S corporation’s foreign income and loss, tax-exempt interest, charitable contributions, and passive income are also passed through to the shareholders. Because of this one level of taxation, many individuals elect S corporation status to operate their corporations. In doing so, they avoid the tax technicalities of “regular Form 1120 corporations, commonly known as C corporations (e.g., tax on accumulated surplus, disguised dividends, personal holding company taxation).

The text that follows discusses the primary advantages of using the S corporation form. Additionally, tax pointers offer methods to take advantage of the quirks in the law as well as ways to avoid the pitfalls.

## ADVANTAGES OF HAVING AN S CORPORATION

Below are 16 income tax reasons why taxpayers elect S corporation status.

### Tax-Free Contributions to the S Corporation

When certain requirements are met, taxpayers can contribute assets to an S corporation tax free.

#### Tax Pointer



Sales tax could arise on a transfer however, if the transfer is not done properly. In *Weichbrodt*, sales tax was imposed when a shareholder contributed additional property to his S corporation. For a discussion of the imposition of sales tax on a transfer of property and the means to avoid it, see ¶103.

**Contributions of property when debt exceeds basis.** When an S corporation shareholder contributes appreciated property encumbered by debt in excess of basis, gain must be recognized. The character of this gain (capital or ordinary) will depend upon the nature of the contributed property.

#### Example 1-1



Marlene Smith contributes real estate to a newly formed corporation in exchange for 30% of its stock. Her tax basis in the real estate is \$150,000; its fair market value is \$250,000. The property is encumbered by a \$200,000 mortgage. Because the mortgage on the real estate exceeds Smith's basis in the property, she will be required to recognize a \$50,000 gain upon transfer of this property to the corporation. The character of this gain will depend upon the nature of the property in Smith's hands prior to the transfer. If it was a capital asset to her, the gain will be capital. See ¶ 1117 for further discussion for a means to eliminate this tax.

### Protection from Creditors

An S corporation, because it is a corporation, provides its shareholders with protection from corporate debts and against the corporation's creditors throughout the world. The only statutory requirement that the S corporation has to meet for this worldwide creditor protection is to be a domestic corporation. Like any other corporation, certain formalities must be observed, such as an annual meeting of shareholders.

In contrast, LLCs are a relatively new concept in the United States, having started in 1977. While LLCs do have their counterparts in other areas of the world, such as the *Satre* in France and the *GmbH* in Germany, there is not a body of law established (as with the S corporation) to detail protection to the owners. Thus, particularly for international operations, until there is an adequate body of law established for LLCs, the better business vehicle is often an S corporation. While an S corporation by definition provides liability protection, shareholders may want additional protection from creditors by creating a chain of entities to own the stock such as having a grantor trust own a single member limited liability company which in turn owns the S corporate stock. Such an ownership situation was approved in IRS Letter Ruling 200339026 (June 23, 2003).

## Avoidance of Double Taxation

For individuals starting a business, the S corporation is an ideal business vehicle because, unlike a C corporation, it avoids double federal taxation, having only one level of taxation at the shareholder level. The S corporation's income is taxed to the shareholders. In contrast, a C corporation's income is taxed twice: first at the corporate level and again when the income is distributed to the shareholders.

### Tax Pointer 1



A C corporation can convert to an S corporation to avoid double taxation; however, the S corporation may be subject to a built-in gains tax, a passive investment income tax, a LIFO recapture tax, and general business credit recapture.

### Tax Pointer 2



Conversion from a C corporation to an S provides interesting tax planning possibilities when the C corporation has suspended passive losses. For a discussion of this planning possibility, see ¶ 404.08.

## No Recharacterization of Pass-Through Items

S corporations pass through certain items of income, expense, and the like to the shareholder without recharacterization. Consequently, S corporation charitable contributions are not subject to the 10 percent limitation imposed on C corporations. However, S corporations cannot take advantage of two charitable contribution techniques available to C corporations: contributions of inventory and scientific equipment.