Session Description

S Corporations continue to be a viable alternative to LLCs.

It may even make sense for an LLC to make an S Corporation election.

This session will cover those topics and other S Corporation updates.

Agenda

• S Corporation Election by an LLC
• S Corporation “Conversion” to an LLC
• S Corporation Capital Structure
• S Corporation Operating Structure
• S Corporation Distributions
• S Corporation Sale
S Corporation Election by an LLC

• Business and Tax Considerations
• Eligible Corporation Requirement
• Eligible Shareholder Requirement
• One Class of Stock Requirement
• Mechanics of Making the Election

S Corporation Election by LLC

Business and Tax Considerations

Indiana Code 23-18-3-3

*Personal liability of members, managers, agents, or employees*

Sec. 3. (a) A member, a manager, an agent, or an employee of a limited liability company is not personally liable for the debts, obligations, or liabilities of the limited liability company, whether arising in contract, tort, or otherwise, or for the acts or omissions of any other member, manager, agent, or employee of the limited liability company.

S Corporation Election by LLC

Business and Tax Considerations

Indiana Code 23-18-3-3

*Personal liability of members, managers, agents, or employees*

A member, a manager, an agent, or an employee of a limited liability company may be personally liable for the person's own acts or omissions.
Sec. 7. (a) On application to a court with jurisdiction by a judgment creditor of a member, the court may charge the interest of the member in the limited liability company with the payment of the unsatisfied amount of the judgment with interest.

(b) To the extent the court charges under subsection (a), the judgment creditor has only the rights of an assignee of the member's interest in the limited liability company.

(c) This article does not deprive a member of the benefit of any exemption laws applicable to the member's interest in the limited liability company.
Bona fide members of a partnership are not employees of the partnership within the meaning of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the collection of income tax at source on wages.

Such a partner who devotes his time and energies in the conduct of the trade or business of the partnership, or in providing services to the partnership as an independent contractor, is, in either event, a self-employed individual rather than an individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.
A radiologist's and wife's refund claim that they were not liable for self-employment tax on a portion of distributions from their diagnostic imaging limited liability company was rejected on summary judgment.

The taxpayers, who had reported part of the distributions as taxable wages but the remainder as nontaxable distributions, were off base since any earnings from a partnership were self-employment income to general partners.

S corporations must pay reasonable compensation to a shareholder-employee in return for services that the employee provides to the corporation before non-wage distributions may be made to the shareholder-employee.
S Corporation Election by LLC

Eligible Corporation Requirement

Small Business Corporation

- domestic corporation
- not more than 100 shareholders
- individual shareholders and certain trusts and estates
- no nonresident alien shareholders
- only one class of stock

Eligible Shareholder Requirement

- Individuals
- Estates
- Certain Trusts
- Charitable Organizations under Section 501(c)(3)

Nonresident aliens, corporations, partnerships, multi-member LLCs, LLPs, and IRAs are not qualified shareholders

Estates and trusts are subject to the 3.8% Medicare contribution tax if they have undistributed net investment income and also have adjusted gross income over the dollar amount at which the highest tax bracket for an estate or trust begins, $11,950 for 2013.
S Corporation Election by LLC
Eligible Shareholder Requirement

- Voting Trusts
- Certain Grantor Trusts
- Qualified Subchapter S Trusts
- Electing Small Business Trusts
- Trusts under Terms of a Will (two-year limit)
- Certain Tax-Exempt Qualified Retirement Plan Trusts

S Corporation Election by LLC
Eligible Shareholder Requirement

Qualified Subchapter S Trusts
- sole beneficiary is an eligible shareholder
- beneficiary is taxed on the S Corporation income
- trust may continue two years after grantor’s death
- trust’s income beneficiary signs election
- late election relief in Rev. Proc. 2013-30

S Corporation Election by LLC
Eligible Shareholder Requirement

If the Qualified Subchapter S Trust sells some or all of its S corporation stock, any gain or loss recognized on the sale will be that of the trust, not the income beneficiary for purposes of the 3.8% Medicare contribution tax, under Prop. Reg. §1.1411.
S Corporation Election by LLC

Eligible Shareholder Requirement

- Electing Small Business Trusts
  - trust is taxed on the S Corporation income
  - 3.8% Medicare contribution tax applies
  - beneficiaries must be eligible shareholders
  - trustee makes ESBT election
  - late election relief in Rev. Proc. 2013-30

S Corporation Election by LLC

One Class of Stock Requirement

- Identical Rights to Distribution and Liquidation Proceeds
- Voting and Nonvoting Shares Permissible
- Safe Harbor for Straight Debt
- Buy-Sell Agreement Permissible
- No Section 704(b) Special Allocations Permitted

S Corporation Election by LLC

Mechanics of Making the Election

Form 8832 Entity Classification Election
E lecting to be Classified as an S Corporation.

An eligible entity that timely files Form 2553 to elect classification as an S corporation and meets all other requirements to qualify as an S corporation is deemed to have made an election under Regulations Section 301.7701-3(c)(v) to be classified as an association taxable as a corporation.
S Corporation Election by LLC
Mechanics of Making the Election

Form 2553 Election by a Small Business Corporation
• All current LLC members must consent
• Later LLC members/shareholders need not consent

S Corporation “Conversion” to an LLC

Indiana Code 23-1-38.5-10
Conversion of domestic and foreign corporations and other entities

Sec. 10. (a) A domestic corporation may become a domestic other entity under a plan of entity conversion.

A client wants to convert an S Corporation into a limited liability company.

What are the federal income tax consequences of this transaction?
S Corporation Capital Structure

Worthless Stock

Worthless stock creates a capital loss unless Section 1244 applies.

Abandonment of stock is a capital loss under Reg. §1.165-5(c).

S Corporation Capital Structure

Bad Debt

The IRS treats a bad debt on a loan to an S Corporation as nonbusiness bad debt, a capital loss under Section 166(d).

S Corporation Operating Structure

Qualified S Corporation Subsidiary

Section 1361(b)(3) Treatment of Certain Wholly Owned Subsidiaries

Form 8869 Qualified Subchapter S Subsidiary Election

The IRS may grant S corporations an extension to elect to treat a subsidiary as a Q Sub under Rev. Proc. 2013-30.
What are the federal tax consequences if S corporation buys 100% of the stock of another corporation for $500,000 and makes a QSub election?

What is the impact on suspended losses if the group is restructured to allow for QSub elections?
S Corporation Operating Structure
Consolidating Brother-Sister Operations


S Corporation Distributions
Distribution of Real Estate

An S corporation shareholder wishes to distribute real estate out of the S Corporation.

The S Corporation formerly was a C Corporation in the prior five years, and has C Corporation accumulated earnings and profits.

What tax issues are involved in the proposed distribution?

S Corporation Sale
Application of 3.8% Medicare Contribution Tax

Section 1411 *Imposition of Tax*
(c)(4) Exception for certain active interests in partnerships and S Corporations

In the case of a disposition of an interest in a partnership or S Corporation -
S Corporation Sale
Application of 3.8% Medicare Contribution Tax

(A) gain from such disposition shall be taken into account under clause (iii) of paragraph (1)(A) only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S Corporation were sold for fair market value immediately before the disposition of such interest, …

S Corporation Sale
Section 338(h)(10) Election

ABC, an S corporation, has negotiated to buy the assets of XYZ, an S corporation.

The shareholders of XYZ then realized that the XYZ customer contracts are not transferable in an asset sale, so they proposed a stock sale with a Section 338(h)(10) election.

S Corporation Sale
Section 338(h)(10) Election

Shareholders→ Stock→ S Corporation

Step 1
Sale of XYZ stock to ABC for cash, with per share price negotiated with ABC by individual XYZ shareholders

Step 2
Joint election on Form 8023 by all XYZ shareholders and ABC to treat the stock sale as an asset sale: Purchase price allocation jointly reported on Form 8883
**S Corporation Sale**

**Section 338(h)(10) Election**

Shareholders | S Corporation
---|---
XYZ | ABC

Buyer | Assets
---|---
XYZ | XYZ

**Step 3**

XYZ reports deemed asset sale on Form 4797, reports gain to shareholders on Schedules K-1, and files final Form 1120S.

**Step 4**

XYZ becomes a subsidiary of ABC, with XYZ assets revalued to reflect the stock purchase price.

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**S Corporation Sale**

**Section 338(h)(10) Election**

ABC | Parent
---|---
S Corporation | 

XYZ | QSub

**Step 5**

ABC makes a QSub election for XYZ so that XYZ operations are reported on the ABC Form 1120S.

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**S Corporation Sale**

**Section 338(h)(10) Election**

**Reasonable Cause for the Failure to File the Election**

On August 23, 2012 officers of ABC met with their CPA, their attorney, and their tax adviser regarding the acquisition of XYZ. Although they had agreed to an asset acquisition, the XYZ shareholders notified ABC that business considerations would require a stock sale.

To facilitate the transaction, the XYZ shareholders suggested a stock sale in conjunction with a Section 338(h)(10) deemed asset sale election.
S Corporation Sale
Section 338(h)(10) Election

At the August 23, 2012 meeting, the tax adviser reviewed the requirements of Section 338(h)(10) and the desired deemed asset sale treatment.

Election procedures for Section 338(h)(10) on Form 8023 were discussed, and it was agreed that Form 8023 and related Form 8883 Asset Allocation Statement would be prepared by the attorney and included in the Stock Purchase Agreement.

S Corporation Sale
Section 338(h)(10) Election

While the advisability of a QSub election for the acquired subsidiary XYZ was discussed and approved by ABC, specific responsibility for the preparation and filing of the QSub election on Form 8869 was not assigned to the CPA, the attorney, or the tax adviser.

The failure to timely file was inadvertent.

S Corporation Sale
Section 338(h)(10) Election

Form 8869 was due two months and 15 days after the requested December 7, 2012 effective date.

The failure to file Form 8869 was first discovered as the March 15, 2013 due date for ABC’s 2012 return approached, and this Request for Late QSub Election Under Revenue Procedure 2013-30 was promptly prepared and filed.
S Corporation Sale
Section 338(h)(10) Election

IRS
May 13, 2013
Acceptance of Form 8869
Qualified Subchapter S Subsidiary Election

We’ve accepted your election to be treated as a Parent S corporation, with an accounting period of December.

Your election is effective December 7, 2012.

Disclaimer

The information included and discussed in this presentation is general in nature and should not be relied upon in providing tax and accounting advice without independent research and analysis.

A lawyer should be consulted regarding any legal advice.

Specific client advice should be provided only after independent tax research and analysis.