Woman C.P.A.

Volume 36 | Issue 1 Article 7

1-1974

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Recommended Citation
Rausch, Barbara I. (1974) "Small Business: Subchapter S — Benevolence with Traps," *Woman C.P.A.*: Vol. 36 : Iss. 1 , Article 7.
Available at: https://egrove.olemiss.edu/wcpa/vol36/iss1/7

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Small Business

Subchapter S — Benevolence with Traps

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When Congress enacted legislation to enable small corporations to elect the benefits of taxation similar to a partnership, the intent was clearly benevolent. The extent of this benevolence is probably most strongly underlined by the many attacks the Internal Revenue Service has launched upon electing corporations in an attempt to disallow the single-tax status.

There can be no question about it, if you want to have the benefits of the election, you must cross all your "T's" and dot all your "I's", or you may find out a few years later that the income of the corporation is subject to the usual double taxation of ordinary corporations — retroactively!

Eligibility — The Need for Continuous Review

The whole subject of "Small Business Corporations" is covered by Sections 1371 through 1379 of the Internal Revenue Code of 1954, and space does not permit to go into every technicality. Rather, only the general gist of the regulations and its implications will be discussed. The definition of small business corporations is made by exclusion, except for the first requirement that the entity be a domestic corporation which is not a member of a parent-subsidiary-type affiliated group. The corporation may not have (a) more than 10 shareholders (husband and wife usually counting as one); (b) a shareholder (except for an estate) who is not an individual; (c) a non-resident alien shareholder.

The election must be made within 30 days prior to or 30 days after the beginning of the fiscal year for which it is to be effective. All shareholders must consent to the election — and any new shareholders that acquire stock at any time after the initial election must file their consent within 30 days of the date they become shareholders. This requirement cannot be overemphasized, and tax practitioners who have electing small business corporations among their clients have anxious moments about stock transfers and should keep close touch with the clients to prevent an unintentional revocation of the election.

Several other events cause revocation of the Subchapter S status, such as income from sources outside the United States which make up more than 80% of the corporation's income, or passive investment income (royalties, rents, dividends, interest, annuities, gain from the sale of securities) of more than 20% of the corporation's gross receipts. Passive investment income up to $3,000 will not terminate the election if it is received in either the first or the second year after the corporation starts the active conduct of a trade or business.

These are all unintentional revocations — it goes without saying that the election can be terminated by an intentional act, either a formal revocation which again requires the consent of all shareholders, or by precipitating an event which nullifies eligibility. But, once revoked or lost, Subchapter S status cannot be elected again for five years.

Practical Applications

So, what does it all mean to the shareholders who are faced with the decision to elect or not to elect?

First of all — the electing corporation does not pay Federal income tax (with the exception of certain capital gains). Instead, the shareholders report their pro-rata share of the corporate income on their individual income tax returns and pay the tax as if they had operated the business as a partnership.

If the corporation sustains an operating loss, the shareholders can use their pro-rata share of the loss as a deduction from gross income on their individual income tax returns.

Here there is some controversy among practitioners. None of them argue against the benefits of the loss pass-through, but a lot of them will recommend revocation of the election when the corporation becomes profitable and when the shareholders' tax brackets exceed the corporate rate of tax. An additional ingredient in this formula should be the tax the shareholders have to pay when the earnings of the corporation are distributed in the form of dividends. Let's look at the following example:

Let's assume $150,000 in profits and three equal shareholders, A and B filing jointly and C a single taxpayer. Since it would be virtually impossible to pay a $50,000 dividend per shareholder in any one year out of a regular corporation, the tax is based on a 5-year pay-out at the top

	Corporation	A	B	C	Total
Regular Corporation	$65,500	$26,200	$26,200	$31,000	$149,500
Electing Corporation	-0-	28,120	28,120	32,900	89,140

marginal rate, with $50,000 taxable income before dividends or Subchapter S profits.

In addition to the rather substantial overall tax savings under the Subchapter S set-up, the electing shareholders would never have to worry about the penalty tax on unreasonable accumulations of earnings. And — another big plus — the shareholders would have immediate access to the cash.

Obviously, the intended dividend policy of the corporation is an important consideration. There can be no argument that the election is not for those who plan to use the corporation to build up a large estate and bail out the earnings without paying income taxes, which (at least at the present time) is possible under estate tax regulations.

Also, the cash flow position of the corporation should be taken into account, since the shareholders will be taxed on the income whether or not the corporation is in a position to pay out the earnings. Cash distributions are always considered to be from current earnings, except that payouts made within 75 days of the end of the corporation's year are considered to be out of the undistributed earnings and profits of the preceding year. Previously taxed but undistributed earnings can be paid out tax-free to the shareholders as long as the cash payment exceeds the earnings and profits of the year of distribution.

As previously mentioned, the corporation's operating loss is available to the shareholders. However, the deductibility on the shaeholders' returns is limited to their adjusted basis in the stock and their basis in any loans that they have made to the corporation. Therefore, it is important to maintain that investment basis if losses are likely. Once again, continuous review of an electing corporation's financial situation is an absolute "must". But then, which business can afford to go very long without accurate financial information under today's conditions? Not many!

Tax Planning Tool

There are many situations in which the election is useful, but two situations are particularly advantageous. One is income splitting among family members and the other is retirement.

Ownership of the corporation's stock can be shared with minor children who would be in lower tax brackets. Thus, part of the income is taken out of the major stockholder's high tax bracket. However, caution must be exercised in this situation, since the IRS has authority to reallocate the income among family members if compensation for services is unreasonably low to shift income into profits. The other trap — if the parents want to claim the children as dependents, they may have to meet the support test. But within reason, this approach can save quite a bit of tax.

In a retirement situation, Subchapter S can be a real life saver. An example is a situation where a considerable age difference exists between the shareholders, and one of them is ready to retire. Past services and contributions to the success of the enterprise have been pretty much on a par and there is a very definite moral obligation to keep the outgoing shareholder in spending money. Simple — he or she shares in the profits after salaries to the remaining active shareholders under a Subchapter S election.

What about the situation of a single shareholder? A little more complicated, but still a good possibility with the election. First of all, a really good manager must be found who can take over the business and continue to run profitably. The profits after the manager's salary can be a pretty nice retirement income for the retired shareholder. Naturally, the Social Security Administration is going to be a little cautious about this particular situation and will send out a field representative to ascertain that the shareholder has in fact retired from the operation. Some limited involvement will be permitted, such as 45 hours per month, and of course the shareholder can earn $2,400 per year (starting in 1974) without losing the Social Security benefits. The really important question will be the amount of time devoted to the business after retirement. The profits received from the business as an electing shareholder will be passive income and, therefore, they will not cause loss of Social Security benefits.

Where There's Sun, There's Shade

Two other nice aspects of Subchapter S: compensation paid to officers and shareholders will hardly be questioned as unreasonable unless there is a substantial difference in the number of shares held and services rendered.

Also, the Personal Holding Company income trap for corporations which derive their income from their shareholders' personal services is not an issue with the election — there can't be any avoidance of tax at the shareholder level!

The "shade" is in the area of qualified retirement income programs for shareholder-employees. Contributions to the plan are limited to 10% of compensation (rather than 15% as in a regular corporation) or $2,500 annually. However, the limitations are not quite as severe as they are for Keogh-type plans for self-employed people, since contributions made to the plan in excess of the above limits, even though taxable to the shareholders when paid in, are permitted to accumulate tax-free in the retirement fund. Upon distribution at retirement, the previously taxed contributions are, of course, received tax-free. Also, under proposed tax changes, the same limitations would apply to "owner-managers" of regular tax-paying corporations.

Get All the Facts — Know the Whole Story

This is the inevitable conclusion. The tax advisor of an electing corporation cannot afford to miss any actions taken or any events taking place in the business operation and in the stock ownership.

Taken as a whole, the provisions of Subchapter S are definitely an act of benevolence on the part of Congress, and the "traps" are clearly spelled out, in plain view and avoidable. And they should not scare anybody away from incorporation. There does not have to be a double tax!

Legal Developments
(Continued from page 19)

[4]There were several lower court decisions on this matter and two in the Supreme Court, none of which have been reversed.

[5]*Strauder v. West Virginia*, 100 U.S. 303 (1879). This same case held that it was illegal to exclude black men. See also *Hoyt v. Florida*, U.S., 1961.

[6]*Allred V. Heaton*, 364 U.S. 517 (1960).

[7]*ex. rel. Gaines v. Canada*, 305 U.S. 337 (1938)

[8]Citizens' Advisory Council on the Status of Women, *The Proposed Equal Rights Amendment to the United States Constitution – A Memorandum*, U.S.G.P.O., Washington, D. C. (March, 1970).

[9]Testimony of Martha W. Griffiths before Subcommittee #4 of the House Committee on the Judiciary — The Equal Rights Amendment — H. J. Res. 208, March 24, 1971.

[10]*Yale Law Journal* (Vol. 80, No. 5) p. 945.

[11]Una Rita Quenstedt & Carl E. Winkler, *Monograph No. 1*, Support Committee of the Family Law Section, American Bar Association, quoting a California Judge, 1965. Emphasis added.

[12]See the excellent study by the Citizen's Advisory Council On the Status of Women (Department of Labor Building, Washington, D.C. 20210) *The Equal Rights Amendment and Alimony and Child Support Laws*, January, 1972.

[13]Nagel & Witzman, "Women as Litigants," *Hastings Law Journal*, November, 1971.

[14]Yale Law Journal, *op.cit.*

[15]Martha W. Griffiths, *The Equal Rights Amendment and Social Security*, undated memo.