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INSIGHTS

The Perils Of Electing S Corporation Status

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Some advisers recommend electing S corporation tax status for a limited liability company (LLC) [1] or partnership, or recommend simply organizing a closely held business as a corporation that elects to be taxed as an S corporation. These advisers generally cite the self-employment tax savings that can be achieved as an S corporation relative to an LLC classified as a partnership. More recently, S corporation proponents additionally cite the ability to scale wage payments to shareholders to potentially increase the 20 percent deduction for qualified business income under new Section 199A. [2] As explained below, the asserted tax savings of S corporation status are often illusory or negligible, and the very real and very significant disadvantages of S corporation status are rarely given adequate consideration. For this reason, electing S corporation status for an LLC, or organizing an entity as an S corporation, is rarely advisable. [3]

For businesses that have already elected S corporation status, a subsequent article will offer some options for minimizing the potential disadvantages of S corporation status.

Disadvantages of S Corporations Relative to LLCs

Before discussing the reasons why some advisers recommend S corporations, it helps to have a clear understanding of certain disadvantages of S corporations relative to LLCs.

1. *Restrictions on eligible shareholders*. In general, all of an S corporation's shareholders must be U.S. citizens or resident individuals,

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or certain types of trusts and tax-exempt organizations. The limitation on eligible S corporation shareholders precludes accepting equity investments from partnerships, corporations, many types of trusts, and non-U.S. investors, which can frustrate the S corporation's financing efforts. It also creates fertile grounds for inadvertently invalidating the corporation's S election, sometimes without any knowledge of the S corporation or its shareholders.

2. *One class of stock*. The requirement that an S corporation have only one class of stock precludes issuing preferred stock, profits interests, stock with special allocations or changing profit sharing ratios, and issuing other equity interests other than a single class of common stock. As a result, an S corporation has very limited equity financing flexibility: not only is its class of investors restricted, so too is the class of equity it can issue to those investors.

3. *Potential gain on asset contributions and distributions*. When a person contributes appreciated property to an S corporation in exchange for stock of the corporation, the transaction is non-taxable only if the persons contributing property (including money) to the corporation collectively own more than 80 percent of the corporation after the contribution. In contrast, contributions of property to an LLC generally do not give rise to gain or loss regardless of the ownership percentage of the contributing owner(s). Likewise, a distribution of appreciated property by an S corporation to a shareholder is almost always a taxable transaction, whereas a distribution of appreciated property by an LLC to a member is generally a non-taxable transaction. As a result of these rules, it is much easier to transfer property into and out of an LLC without triggering taxable gain than with an S corporation.

4. *No basis in entity-level liabilities*. A shareholder's tax basis for S corporation stock is limited to the amount the shareholder has invested in the corporation, and does not include any amount that the S corporation has borrowed to finance its operations. In contrast, an LLC owner's tax basis for the LLC owner's ownership interest generally includes the amount the owner has invested in the LLC plus an allocable share of LLC liabilities. Because losses are limited to basis, the S corporation rules potentially limit the amount of losses generated by the business that can flow through to the shareholder (relative to a similarly situated LLC owner). While the "at-risk" rules will generally prevent any advantage to non-corporate LLC owners, this will not always be the case.

5. *Limited deemed asset sale election*. In a sale of an S corporation business, the sale can be structured as either a sale of assets by the S corporation followed by a distribution of the sale proceeds by the S corporation to the shareholders (sale of assets), or as a sale by the S corporation shareholders of their stock (sale of stock). If all of the shareholders sell all of their stock of the S corporation, the shareholders and the buyer can make an election to have the stock sale treated as a deemed sale of assets for tax purposes (a "338(h)(10) election" or "336(e) election"). This election provides flexibility to structure the sale as either a sale of assets or a sale of stock and, in either case, provide the buyer with a stepped up tax basis in the assets purchased. But this flexibility is limited: a 338(h)(10) election or 336(e) election is available only if the buyer is acquiring 80 percent or more of the stock. In addition, the election applies to 100 percent of the stock, even if less than 100 percent is purchased. In contrast, an LLC can make an equivalent election (a "754

election") without regard to the percentage of the LLC's equity acquired, and without triggering tax on the owners who are not selling.

The limits of 338(h)(10) and 336(e) for an S corporation can be partially sidestepped by having the corporation contribute its assets to a LLC or partnership subsidiary (either directly or through an "F reorganization") and then having the S corporation sell a partial interest in the subsidiary using a 754 election. This avoids the 80 percent threshold and the 100 percent gain recognition requirements under 338(h)(10) and 336(e). But this strategy does not work well in the common situation where the S corporation's shareholders are not all selling an equivalent partial interest. More commonly, some shareholders want to sell out, while other shareholders want to continue their investment, or the shareholders want some other non- proportional allocation of consideration. In those cases, the gain from the transaction must be allocated in proportion to stock ownership (consistent with the one class of stock requirement), which creates an inconsistency between the allocation of the taxable sale proceeds and the allocation of the associated taxable gain. This problem can generally be avoided in an LLC using special allocations of gain to the owners who are cashing out or using other structuring strategies not available to an S corporation.

6. *No step up in asset basis at death*. On the death of an S corporation shareholder, the decedent's tax basis in the S corporation stock is stepped up to fair market value, but the S corporation's tax basis in the underlying assets is unaffected. This can lead to a situation in which the persons receiving the decedent's stock recognize ordinary income economically attributable to periods prior to the decedent's death offset by a corresponding capital loss which is recognized only upon a sale of the business or the inherited stock. In contrast, on the death of an LLC owner, the LLC can make a section 754 election to step up the tax basis of the decedent's allocable share of the partnership assets, thereby eliminating the potential phantom income and loss and associated potential character mismatch.

7. *No Direct Section 1202 Conversion*. Section 1202 of the Internal Revenue Code (Code) provides for a limited exclusion from income for gain on the sale of stock of certain small C corporations where certain requirements are satisfied (including a $50 million capitalization limit, a five-year holding period requirement, and a qualified business activities requirement that precludes benefits for certain types of businesses). If a startup business is initially organized as an S corporation (e.g., to facilitate passing through startup losses to the shareholders) and then becomes successful, the shareholders will find that they cannot terminate the entity's S election and thereafter qualify for the benefits of Section 1202. They will generally have to have the S corporation contribute its assets to a newly formed C corporation. This may be difficult if there are transfer restrictions on the company's assets, and in any event will result in a more cumbersome ownership structure going forward, particularly if the C corporation issues additional stock.

In contrast, if the startup business were initially organized as an LLC, the LLC can convert to a corporation (via a simple election and some modifications to its organizational documents) and obtain the benefits of Section 1202 for any post-conversion stock appreciation. This avoids any unwanted two-tier ownership structure and can typically be done without tripping any asset transfer restrictions. With the reduction in corporate tax rates (from 35 percent to 21 percent) under the 2017 Tax Cuts and Jobs Act, Section 1202 is a more attractive option for promising early stage companies, so the added flexibility of an LLC conversion into a Section 1202 corporation can be meaningful for an eligible business.[4]

8. *No charging order protection*. An LLC is sometimes seen as preferable to an S corporation in terms of protection of the business from claims by creditors of an owner. An LLC owner's creditors can typically only obtain a "charging order" against the LLC owner's membership interest, giving the creditor the right to receive any distributions received from the LLC as and when declared by the LLC, but no other ownership rights. In contrast, corporate stock, and all rights associated with it, can be acquired by a creditor through foreclosure. A creditor acquiring corporate stock can call meetings and vote to force the corporation's dissolution. To address this, tax advisers sometimes recommend organizing an LLC under state law, and then electing for tax purposes to classify the LLC as an S corporation. While this seems to be a simple way for an S corporation to enjoy the benefits of charging order protection, it is often poorly implemented and can lead to an unintended invalidation of the entity's S election (resulting in an entity taxed as a C corporation). To minimize this risk, the LLC organizational documents would need to be carefully tailored to satisfy the S corporation requirements in the tax code, and to eliminate a lot of the inherent flexibility of an LLC that is otherwise prohibited in the case of an S corporation. Based on my own observations, the required care is rarely exercised.

9. *No Default Election*. An S corporation must affirmatively and validly elect to be classified as an S corporation. If the entity is organized as a corporation, failure to validly elect S corporation status means the corporation is taxed as a C corporation, which is generally not the desired result. In contrast, an LLC is by default classified as a partnership (if it has more than one owner), and is classified as a corporation only if it affirmatively so elects. This makes it much harder to get the wrong initial tax status for an LLC than for an S corporation.

10. *A mistake waiting to happen*. Clifford Warren, special counsel to the IRS associate chief counsel (passthroughs and special industries), commented on S corporations: "There is no such thing as an S corporation because sooner or later, they invalidate themselves. In fact, we get so many private letter ruling requests in connection with S corporation due diligence that we are developing a revenue procedure to address common S corp foot faults". While many common "foot faults"[5] can often be corrected, that is not always the case, and the propensity of S corporations to fail to validly elect and maintain S corporation status inevitably complicates the process of trying to sell a business organized as an S corporation.

11. *No way out*. If the shareholders of an S corporation decide that the decision to organize as an S corporation was ill-advised and it would have been better to have organized as an LLC, the S corporation cannot simply convert to an LLC without triggering a taxable liquidation. In this respect, an S corporation is like a trap: easy to get into but hard to get out of. In contrast, it is usually a relatively easy, quick and inexpensive (tax-free) undertaking to convert an LLC to a corporation if that is desired after formation of the LLC.

So Why Are There So Many S Corporations?

With all the problems associated with validly electing and maintaining S corporation status under the Code, and all of the disadvantages associated with being an S corporation (relative to an LLC), it's surprising how many businesses are operated as S corporations. For 2017, there were more tax returns filed by S corporations than by entities classified as partnerships.

For some types of businesses, the disadvantages of S corporation status are less significant. For example, a retired executive conducting a consulting business that has few assets and employees (if any), generates little or no goodwill, and does not expect to bring in outside investors could reasonably conclude that an S corporation is a simple and appropriate choice of entity for the consulting business. But for many businesses, the disadvantages of S corporation status are a more important consideration.

In those cases, self-employment tax mitigation is one commonly cited reason for favoring an S corporation over an LLC. An additional reason for 2018 through 2025 might be potential benefits under newly enacted Section 199A (which is scheduled to expire after 2025). As discussed below, these justifications often don't hold up under critical examination.

The Gingrich-Edwards (Self-Employment Tax) Loophole

Sometime prior to 2012, it came to the attention of the public and Congress that former House Speaker Newt Gingrich and former U.S. Senator John Edwards each avoided tens of thousands of dollars of self-employment taxes on income they earned through their respective individually owned S corporations. They accomplished this by having their S corporations pay them a modest salary, which was reported on a Form W-2 and subjected to applicable employment taxes, and then having the remainder of the S corporation income flow through on a Schedule K-1 as a distributive share of profits, which was not subject to any employment or self-employment taxes. This was considered a loophole because the residual profits clearly represented earnings from their personal efforts. If the S corporation business had instead been conducted directly, all of the taxable income of the business would have been subject to self-employment taxes.

Despite the arguably unjustified tax avoidance benefits of the S corporation arrangements used by Gingrich, Edwards, and many other taxpayers, Congress has taken no action to close this alleged "loophole." The planning is as effective today as it was in 2012 (assuming the shareholder materially participates in the business so that the residual income that escapes self-employment tax does not fall prey to net investment income tax, applicable in 2013 and later years).

In contrast, absent careful planning, in most cases the distributive share income of an LLC owner who is active in the business will be subject to self-employment taxes. Therefore, less thoughtful tax advisers often recommend electing S corporation status for an LLC or new entity on the erroneous assumption that an LLC member can never avoid self-employment tax on distributive share income from the LLC.

The Section 199A Advantage

The 2017 Tax Cuts and Jobs Act added Section 199A to the Internal

Revenue Code, which grants a non-corporate taxpayer a deduction generally equal to 20 percent of the taxpayer's qualified business income earned directly or through a partnership or S corporation. For higher-income individuals, the deduction is limited or disallowed if the business pays less than a specified level of W-2 wages. For this purpose, wages that an S corporation pays to its shareholder(s) are taken into account in measuring whether the wages test is satisfied, but compensation that an LLC pays to its owners is not taken into account as wages. Therefore, less thoughtful tax advisers might recommend electing S corporation status for an LLC or new entity as a means of obtaining more flexibility around optimizing the Section 199A deduction for high-income business owners.

Planning Meets Reality

In practice, an S corporation often provides little or no tax benefits relative to an LLC classified as a partnership, primarily for two reasons. First, the business might not generate sufficient residual income (after payment of reasonable shareholder salaries) to produce a meaningful tax benefit. Second, a properly structured manager-managed LLC can produce equivalent tax benefits.

Insufficient Income

To reap the asserted tax benefits of an S corporation, the business has to generate sufficient taxable income to both (a) pay a reasonable salary to the owners and (b) still have a meaningful amount of positive residual taxable income allocable to the owners. There are frequent cases where the business doesn't generate any positive residual taxable income, and in those cases the S corporation produces no tax benefit relative to an LLC taxed as a partnership. This might happen, for example, because the owners set their salary higher than the minimum required level (e.g., to maximize their qualified benefit plan contributions) and the high salaries leave no residual taxable income. In other cases, deductions associated with expansion of the business might fully offset taxable income. Or the business might face unexpected conditions that frustrate its ability to achieve its income forecasts. There may be many other reasons why a business fails to produce a meaningful amount of positive residual taxable income, and for those businesses the promises of tax savings from electing S corporation status are illusory.

Even when the business produces meaningful positive residual taxable income, the self-employment tax benefits only apply if the shareholder materially participates in the S corporation's business. If the shareholder does not meet the relatively high standards for material participation, any self-employment tax savings will often be completely eliminated through imposition of net investment income tax on the residual income.

Finally, even when the business produces meaningful positive residual taxable income and the shareholder materially participates in the business, the self-employment tax savings can be quite modest. Once the shareholder's taxable wages rise above the Social Security contribution and benefit base ($132,900 for 2019), the self-employment tax rate is only 2.9 percent for owners who have taxable wages and self-employment income of less than $200,000 ($250,000 if married filing jointly), and only 3.8 percent for higher income taxpayers. Because half of the tax can be deducted for federal income tax purposes, the effective tax savings is typically less than those rates (generally around 2.5 percent to 3.0 percent). Consequently, even successful businesses may find the asserted self-employment tax savings from electing S corporation status are negligible, particularly when measured in reference to the significant, and often inadequately considered, disadvantages of S corporation status as discussed above.

The potential tax benefits available to an S corporation owner under the new 20 percent deduction provided in Section 199A for qualified business income will often be even more nebulous than the asserted self-employment tax benefits. The potential tax benefits arise only when the shareholder has income in excess of the threshold amount ($315,000 for married individuals filing jointly, and $157,500 for all others), the business is not a specified service business, and the business does not otherwise have sufficient wages to meet the applicable limitations. Even for a business that satisfies all of these conditions, the tax benefits might be very modest, and, under current law, those benefits are temporary, as Section 199A expires after 2025, whereas the detriments of S corporation status will be permanent.

A Properly Structured LLC

In addition to often falling short on promised tax savings, an equally important reason why electing S corporation status for an LLC might be ill-advised is because a properly structured, manager-managed LLC should be able to achieve the same tax savings as promised by an S corporation, without all of the disadvantages of an S corporation as listed above. In particular, if an LLC owner is solely a member of the LLC and has no rights to manage the LLC in the owner's capacity as a member, the owner's distributive share of the LLC's residual taxable income should be exempt from self-employment tax under the "limited partner exception" in Section 1402(a)(13) of the Internal Revenue Code. Management rights can be vested in a management company, in which the owner is an employee, and in that capacity the owner can satisfy the material participation requirements with respect to his passive member interest in the LLC. This structure should also allow the business to take into account the wages paid by the management company to the owner in calculating the owner's Section 199A deduction.

This arrangement is admittedly not as simple or as bulletproof as a single S corporation, but it provides a very strong position for capturing any tax savings promised by an S corporation while also avoiding the significant disadvantages of an S corporation.

Conclusion

Before electing S corporation status for an LLC or organizing as an S corporation, business owners and their advisers should carefully considered the potential disadvantages of electing S corporation status and quantify the realistically forecasted tax savings. If that initial analysis shows that the potential tax savings are likely to be sufficiently significant to outweigh any disadvantages of electing S corporation status (a relatively uncommon result in my experience), then they should also carefully consider whether a properly structured LLC can achieve the desired tax savings (at a slightly higher risk level) without all of the disadvantages of electing to be treated as an S corporation. This two-step analysis will generally lead to the conclusion that an LLC is a better option than an S corporation.

For a discussion of the relative advantages and disadvantages of an LLC as compared to a C corporation, see Legal Insight - Choice Of Entity For A Startup Business After Tax Reform.

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[1] For purposes of this article, assume that all references to an LLC are to an LLC that is classified as a partnership for federal income tax purposes, except where otherwise indicated.

[2] Some advisers recommend organizing as a corporation that elects S corporation status on the theory that the limited liability status of an LLC is less certain than for a corporation. While that concern may have been justified when LLCs were not widely used, it is generally not a concern in current practice.

[3] If an entity was organized as a corporation and has not elected S corporation status (i.e., the corporation is taxed as a C corporation), electing S corporation status (if the corporation is eligible to do so) may be preferable to continuing as a C corporation. That situation is beyond the scope of this article.

[4] If the qualified business and capitalization requirements of Section 1202 can be satisfied when the business is initially formed, it might make sense to organize the business as a C corporation at the outset, rather than initially organizing as either and LLC or an S corporation with the thought of converting later. This will depend on the expected level of startup losses, the owners' ability to obtain a tax benefit for those losses, and the ability to time the conversion to maximize eligible post-conversion gain.

[5] Tax Notes Today, 2018 TNT 85-1 (May 2, 2018).