

Getting Money out of an S Corporation

American Society of Woman Accountants

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S corporation is a corporation/partnership hybrid. § 1363(a). . .an S corporation shall not be subject to the taxes imposed by this chapter [i.e., income taxes]”

§1363(b). An S corporation’s income items shall be separately stated, just like a partnership, and these items will pass through to shareholders §1366(a)(1)—just as a partnership’s items pass through to the partners.

Ways to get money out of an S corporation:

1. Have corporation pay shareholder’s personal expense.
2. Have corporation loan money to shareholder whenever shareholder needs *it*.
3. Make corporate distributions
4. Pay salary
5. Pay fringe benefits.

Pluses and minuses for each method:

1. *Corporation pays shareholder ‘s personal expense*

Taxpayer treats this as a deduction to *t* the corporation; shareholder reports no income.

The IRS has, for decades, treated a third party’s payment of taxpayer’s expense as payment by third party to T, and then T paying the expense. Applying this principal, the IRS will treat this situation as a corporate distribution to the shareholder, and the shareholder paying the personal expense. A corporate distribution to a shareholder is not deductible by the corporation, so the corporation loses the deduction (a personal expense is not deductible by the shareholder, so he/she has no deduction). Since the corporation loses the deduction, its income increases. As an S corporation, the income passes through to shareholders, so the shareholder pays more tax. In *U.S. v. Leona Helmsley*, the government was able to prove that this technique is a type of felony tax evasion.

There’s another type of transaction that the tax-ignorant sometimes confuse with the Helmsley technique.

Getting money out of an S corporation

Suppose the shareholder, in the course of corporate employment, pays a business expense.

- *Example:* Ralph Krandem has to take a subway from the repair depot to the dispatcher's office. Ralph buys his own token for the trip. Assume Ralph is a 10% shareholder of the bus company.
 - (a) Bus company gives check to Ralph for \$1.25 the following week.
 - (b) Bus company does not give a check to Ralph.

In choice (a), Ralph is deemed to have advanced money to the corporation when he bought the token. It's a loan by Ralph to the corporation, and the expense of the token is a deduction to the corporation.

In choice (b), corporation can treat it three ways— Loan by Ralph to corporation. Corporation has transportation expense.

Capital contribution by Ralph to corporation. Corporation has transportation expense.

Ralph has employee travel expense, which is a miscellaneous itemized deduction to Ralph, Schedule A.

Choice (3) is least advantageous to Ralph, due to 2% AGI floor on miscellaneous itemized deductions. If corporation got deduction, it passes through to Ralph as does income— 1 2.5 cents less, since Ralph is a 10% shareholder. Since Ralph could lose entire deduction due to 2% AGI floor, having the corporation deduction may benefit Ralph—and would definitely benefit other shareholders.

Choice (2) compared to choice (1): if Ralph makes corporate contribution, his basis in stock increases. If Ralph makes loan to corporation, corporation can repay the loan at a later date— corporation can't repay capital contribution, because that would be unequal distribution with respect to the stock, which violates one class of stock rule.

2. Corporate loan to shareholder whenever needed

Taxpayer treats all money withdrawn as a loan from the corporation to the shareholder. Since corporation pays no salary to taxpayer, corporation pays no payroll taxes, such as FICA, Medicare, FUTA, SUTA, Worker's compensation, Disability. Since corporation makes no distribution to shareholder, shareholder basis in corporate stock isn't reduced by amount of distribution, Sec. 1 367(a)(2). Therefore, basis available for loss deduction is higher. **Sec.** 1366(d). Distribution in excess of shareholder basis = capital gain. **Sec.** 1368(b)(2). Distribution of appreciated property = gain recognized as if property sold at fair market value. **Sec.** 311(b)(1).

IRS doesn't like corporation avoiding the payroll taxes, or avoiding basis reduction and gain recognition on certain distributions. Therefore, the IRS takes the position that if a shareholder renders significant services for the corporation and if the corporation has adequate income to pay a salary, shareholder must receive fair market value salary. If corporation fails to do so, penalties for underpayment of payroll taxes may apply. If corporation never filed payroll tax forms because all employees are shareholders and they purportedly receive no salary, IRS takes the position that since no returns were filed, statute of limitations never started to run and thus all years are open to audit.

Regarding distribution in excess of reasonable salary, IRS won't treat it as loan unless loan is bona fide. Bona fide loan means in writing, with definite due dates, at a fair market value interest, and pattern of timely repayments by shareholder to prove intent that loan is bona fide.

3. Make corporate distributions.

Getting money out of an S corporation

We still have problem of no payroll taxes paid. IRS requires reasonable salary, or else it's a sham to avoid payroll taxes.

4. Pay salary.

Corporation must pay payroll taxes. If corporation has only two officers, corporation may elect exclusion for the officers from Worker's compensation and Disability (I personally have found that dealing with the carriers to get this exclusion is like beating my head against a concrete wall, but it can save some bucks).

5. Fringe benefits.

Sec. 1372 says for fringe benefit purposes, S corporation is treated as a partnership and any 2% shareholder is treated as partner. 2% shareholder is direct or indirect (through family members, for example).

Partnership rule: partnership pays fringe benefit is same a partnership payment of partner's expense. Recall third party payee rule: treated as distribution from partnership to partner, and payment by partner of the expense. Any deduction, if permitted, therefore becomes that of partner.

IRS was mandated by Code **Sec.** 1372 to treat S corporation fringe benefits (for 2% shareholder) as third party payment—like a distribution.

But suppose corporation has plan that says medical insurance is paid for all employees.

Example: Buffalo Bob and Howdy Doody are equal shareholders in an S corporation that has a plan that specifies that the corporation will pay medical insurance for each employee. BB lives in Manhattan and HD lives in Westchester. BB's health insurance costs \$390 per quarter and HD's insurance costs \$370 per quarter. Under the partnership fringe benefit rules, each payment would be treated as a distribution to the respective shareholder, and the shareholder paying the medical insurance. Note that BB gets \$80 more per year than HD. This violates the one-class of stock rule, since distributions for each share must be equal.

Faced with a rock—the §1372 mandate—and a hard place—the one class of stock rule—IRS looked to intent *behind* the rule. The intent is to treat fringe benefit as not deduction from partner's GI, but deduction as Schedule A expense if warranted.

IRS solution: treat fringe benefits as additional W-2 income to shareholder, *i.e.* salary. Salary doesn't have to be pro rata with shareholdings. Note that this is subject to payroll tax.

- *Example:* Captain Kangaroo is the 100% shareholder of an S corporation. Mr. Greenjeans is his son. Both are employees of the corporation. Mr. Greenjeans has use of a company car for company business and for commuting. If Mr. Greenjeans were not related to the Captain, then Mr. Greenjeans would have includible income to the amount of the commuting use of the car. However, since Mr. Greenjeans is considered as the indirect owner of 100% of the stock, his fringe benefit use of the car must be treated as if he were a partner. Mr. Greenjeans' includible income is equal to the fair market rental value of the care, which is more than just the commuting use of the car. Mr. Greenjeans may of course, be entitled to a mileage deduction for actual business mileage, as a miscellaneous itemized deduction.

Getting money out of an S corporation

Continued viability of S corporation in age of Limited Liability Co.: IMPORTANT: THE FOLLOWING WAS WRITTEN BEFORE THE IRS ISSUED THE CURRENT "CHECK THE BOX REGULATIONS," AND IS NO LONGER VALID. UNDER CURRENT LAW, A SINGLE MEMBER LLC IS TREATED AS A DISREGARDED ENTITY. DLS 12/2001

Rev. Proc. 95-10, 1995-3 I.R.B. (1/17/95) states that LLC will be taxed as partnership rather than as corporation (provided drafter is careful in choosing options under LLC statute). However, IRS has not yet extended partnership—or other passthrough entity—treatment to one person LLCs. Therefore, if you want limited liability for your client with a one-person business, best to use S corporation until the issues are settled.