

LEITMAN, &
SIEGAL, PAYNE
CAMPBELL, P.C.
ATTORNEYS AT LAW

TO: OUR CLIENTS AND FRIENDS
FROM: JACKSON M. PAYNE
DATE: NOVEMBER 15, 2011
RE: FINANCIAL STRATEGIES FOR YOUR LIVES AND BUSINESSES

PLANNING OPPORTUNITIES WITH S CORPORATIONS

Leverage the Purchase of Additional Shares

Normally, interest paid on debt incurred to purchase investment property (“investment interest”) is deductible by the borrower only to the extent of his or her “net investment income.” This limitation does not apply to interest paid on debt incurred to purchase stock in an S corporation or a partnership. Instead, such interest is deemed to be paid on debt incurred to purchase the pass-through entity’s inside assets. Accordingly, if all of the entity’s assets are used in the conduct of a trade or business, the interest paid on debt incurred to buy stock in the S corporation or partnership will be considered business interest. That’s good news because business interest is not subject to the same limitation applicable to investment interest (in other words, business interest is deductible without regard to the currently taxable income generated by the entity’s business). So if you are thinking about purchasing additional shares (or if you want to help another to purchase your shares in the S corporation), this benefit is worth keeping in mind when running the numbers.

The Employment Tax Loophole for Sole-Shareholder S Corporations

While all of the operating profits of a disregarded single-member LLC or sole proprietorship are subject to employment taxes, only the salary paid to the sole shareholder of an S corporation is considered “wages” subject to employment taxes. Operating income of an S corporation not distributed

in the form of salary is not self-employment income. As a result, sole shareholders of S corporations have an incentive to receive no salary from their S corporations and take all of their incomes in the form of distributions.

Of course, if an S corporation pays no salary to its sole shareholder-employee, the Service may recharacterize some portion of the corporation's distributions as wages for employment tax purposes. Still, it appears the Service is not exercising its recharacterization power as much as it could. So, there remains an advantage to keeping salaries modest and maximizing distributions from an S corporation.

Shift Built-in Gains to Your Low-Bracket Co-Owners

When a shareholder contributes property with a value in excess of its adjusted basis to an S corporation, the corporation generally takes the contributing shareholder's basis in the property. When the S corporation subsequently sells the appreciated property, the gain from the sale, like any gain, is apportioned proportionately among the shareholders. The built-in gain is not allocated automatically to the contributing shareholder, which is not the case for a partnership. This provides contributing partners with an opportunity to shift gain to other, lower-bracket taxpayers without having to worry about the assignment of income doctrine.

Manufacturing Basis to Claim Net Losses

An S corporation shareholder may deduct his or her proportionate share of the corporation's losses to the extent of the shareholder's stock basis and any basis in debt owed by the corporation to the shareholder. Losses in excess of these basis limitations are carried forward to subsequent taxable years, but time value of money considerations suggest we should do what we can to give the shareholder enough basis in the year the loss passes through to the shareholder.

If your share of an S corporation loss exceeds your stock basis and debt basis, you should explore techniques to give you sufficient basis to claim the loss currently. A simple solution is for you to make a loan or capital contribution to the S corporation, but you may not have the dollars immediately available or may want to get basis now but pay later. It is not enough for you to contribute a promise to pay to the corporation; there is no basis credit for your own note until actual payments are made on the note. But if the corporation has another shareholder, you could consider giving a note to the other shareholder in exchange for some or all of the other shareholder's stock. Paying for stock with a note gives you

immediate stock basis that can be used to claim the loss flowing from the S corporation, while deferring the actual out-of-pocket cost to you.

CHARITABLE GIFTS OF S CORPORATION STOCK

Appreciated stock is generally one of the best assets that an individual can donate to a charity. Usually the donor can deduct the full value of the stock yet avoid recognizing taxable gain from the stock's increased value. The tax-exempt charity usually pays no tax on dividend income or on the gain from selling the stock.

However, from the perspective of both the donor and the charity there are three "bad things" that happen when S corporation stock is contributed to a charity: first, the donor's income tax deduction is usually less than the appraised value of the stock; second, the charity must pay the unrelated business income tax (UBIT) on its share of all S corporation income; and third, the charity must pay UBIT on its gain from the sale of the S corporation stock.

This is much harsher tax treatment than if the charity had received and sold an ownership interest in an identical closely-held business enterprise that had been organized as a C corporation, a limited liability company or a partnership.

Accordingly, in most cases, both the donor and the charity will be better off if the S corporation makes a charitable contribution of some of its assets compared to a shareholder making a donation of S corporation stock.

For planning purposes, keep in mind that every charity and every grantor charitable lead trust can own S corporation stock but a charitable remainder trust is prohibited from doing so. And, a private foundation and a donor advised fund must generally dispose of donated S corporation stock within five years of receipt, while most public charities do not have such a time limit.

PLEASE VISIT OUR WEBSITE AT LSPCLAW.COM

The Alabama State Bar requires the following disclosure:
No representation is made that the quality of legal services
to be performed is greater than the quality of
legal services performed by other lawyers.

IRS Circular 230 Disclosure: To the extent this message contains tax advice, the U.S. Treasury Department requires me to inform you that any such advice, whether in the body of the message or in any attachment, is not intended or written by my firm to be used, and cannot be used by any taxpayer, for the purpose of avoiding any penalties that may be imposed under the Internal Revenue Code. Advice from my firm relating to tax matters may not be used in promoting, marketing or recommending any entity, investment plan or arrangement to any taxpayer.