

HAS THE S CORPORATION OUTLIVED ITS USEFULNESS?

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ABSTRACT

Although the S corporation is the most popular form of business organization aside from a sole proprietorship, it is an extremely complex organizational type. Many S corporation owners do not adhere to IRS regulations resulting in erroneous returns, non-filing, and a tax gap of an estimated \$22 billion per year. The emergence of LLC's over the past few decades presents a simpler form of organization with many of the benefits of an S corporation. It may be time to reconsider the place of the S corporation in our tax code.

INTRODUCTION

Since the inception of the S corporation in 1958, it has become the dominant form of corporation for income tax purposes, outpacing C corporations by a two-to-one margin in recent years. [8] However, sole proprietorships are still the most common form of business organization, followed by partnerships. [6] A recent addition to the menu of entity choices is the Limited Liability Company, or LLC. In 2007, the number of new domestic LLC's formed exceeded the number of corporate formations by almost two-to-one. [2]

These numbers can be somewhat misleading for tax purposes, however. S corporations are not a separate form of business organization, but an election made for tax purposes. Similarly, an LLC may file as a sole proprietorship, partnership, S corporation, or C corporation depending on the choices made by its members. For our purposes, the actual number of the types of organizations is not important. The relevant factor the number of tax returns filed under the various entity banners. In 2010, according to IRS statistics, the number of returns filed by the various entities is as follows: [6]

C Corporations	2,355,803
S Corporations	4,808,078
Partnerships	3,508,856
Proprietorships	>23,000,000

Of course, these numbers do not reveal the actual legal form of the above businesses. Since the LLC is a disregarded entity for tax purposes, their numbers do not appear in the IRS statistics. Chrisman indicates, however, that since 2004, the LLC has been the number one choice for new business owners. [2] This statement must be tempered by the fact that sole proprietorships do not register, so their numbers cannot be accurately determined. There is no dispute, however, that both the S corporation and the LLC are popular tax choices for business entities.

The popularity of the S corporation belies the complexity of that form of organization. In a study released by the Government Accountability Office, it was found that 68 percent of S corporation returns filed in 2003 and 2004 incorrectly reported at least one item affecting net income. The GAO estimates this misreporting resulted in lost tax revenues of \$8.5 billion for these two years. Additionally, there are an unknown number of S corporations that do not even file bringing the estimated S corporation tax gap to \$22 billion per year. [14]

Given the complexity of tax reporting for S corporations, and a viable alternative in the form of limited liability companies, perhaps it is time to take a closer look at the S corporation and see if it has outlived its usefulness.

HISTORY OF THE S CORPORATION

The S corporation is strictly a creature of the tax code. When a corporation receives its charter from the state, it is simply chartered as a corporation. The choice to become recognized as an S corporation is made when the owners file Form 2553 with the IRS. This election requires unanimous consent of the shareholders.

Prior to the creation of the S corporation, business owners had two choices beyond the sole proprietorship. A corporation provided limited liability protection, but confronted the owners with double taxation on earnings. A partnership avoided the double taxation, but did not provide liability protection. In 1946, the Department of Treasury suggested the concept known today as the S corporation. [8]

It was not until 1958, when President Eisenhower recommended creation of the small business corporation to Congress that the S corporation came into being. Led by Senate Finance Chairman Harry Byrd, Congress acted on this recommendation and subchapter S of the U. S. Tax Code became law. Four major limitations on S corporations were made a part of this legislation:

- They were required to be domestic corporations.
- They were limited in the number of shareholders.
- They were restricted in who could be a shareholder.
- They could have only one class of stock. [8]

This was a highly significant step in the history of taxation in the United States and provided considerable tax relief. At the time, corporate rates topped out at 52 percent and the top individual bracket was 91 percent. Upon passage, a substantial number of businesses immediately incorporated and elected S corporation status. Creation of the S corporation is credited with encouraging small business creation in the United States. Their popularity has increased over the years and is now the most widely-used corporate form of organization in the United States. [8]

However, the S corporation faced some early challenges. At the time, the tax code included two maximum levels of taxation. Earned income was taxed at a rate not to exceed 50%. Unearned income, such as dividends, interest, rent, royalties, and capital gains were subject to a maximum 70% rate. [3] The IRS issued Rev. Rul. 59-221 which ruled that income passing from the corporation to its shareholders is not earnings from self-employment, and therefore not subject to self-employment tax. [1]

This ruling had the immediate effect of subjecting S-corporation earnings to the higher unearned income rate so many newly formed corporations reverted back to their former status. [3] Due to the higher income tax rate, the other implication of this ruling was apparently relegated to insignificant status. When the IRS ruled that S corporation income was not subject to self-employment taxes, it opened the door for owners of S corporations to avoid paying these taxes. However, this was not a big issue at the time, as the difference in the income tax rates exceeded the self-employment tax rate.

In 1981, President Reagan proposed a maximum rate of 50% on all income and Congress approved the legislation. Upon passage, a substantial number of new S corporations were formed. With the new tax rates, and a surge in the number of S corporations, Congress soon realized that the law of unintended consequences was now coming into play as there were numerous loopholes allowing for abuse of the tax code. Since distributions from S corporations were not subject to self-employment taxes, employee-owners of these organizations simply did not pay themselves a salary. This enabled them to avoid all payroll taxes on their earnings. This goes beyond the self-employment tax issue and includes state and federal unemployment compensation taxes as well as local payroll taxes. [3]

A second issue was that there were no restrictions on the choice of a fiscal year for S corporations. Consequently, an S corporation could elect a year-end of January 31. This would make the tax on the shareholders' 1040's due April 15 of the following year, resulting in a deferment to file and pay the tax. [3]

It did not take Congress long to act on these issues and the 1982 Sub Chapter "S" Revenue Act was passed to eliminate these abuses. S corporations generally were required to utilize a calendar year for tax purposes. Additionally, the act enabled the IRS to allocate "reasonable compensation" to employee-owners of S corporations. The law specified that, in rendering services to the corporation, the shareholder was entitled to compensation and the corporation would be required to compensate the owner for these services. [3]

In recent years, the popularity of S corporations has increased due to a relaxation of some of the S corporation rules. Currently, there are three shareholder-related requirements:

- The corporation can have no more than 100 shareholders.
- Shareholders must be individuals, estates, certain tax-exempt organizations, or certain kinds of trusts.
- A shareholder cannot be a nonresident alien.

In addition, there are three corporation-related requirements:

- It must be a domestic corporation or an unincorporated entity that elects to be treated as a corporation for tax purposes.
- It must not be an ineligible corporation.
- It can only have one class of stock. [7]

S CORPORATION COMPLEXITY

At first blush, the S corporation would appear to be a simple form of organization. After all, it does not pay income taxes, and just passes the profits or losses to the shareholders. Many S corporations appear to be started by someone who wants to avoid paying self-employment taxes and forms the corporation for that purpose only. Unfortunately, there is often a lack of knowledge about the requirements to maintain the corporate form of organization. The Government Accountability Office has identified three reasons for the \$22 billion tax gap related to S corporations – misreporting, basis issues, and owner-employee compensation. [14] While some of this may relate to a fraudulent attempt to avoid taxation, much of it is likely due to a lack of knowledge or no desire to maintain corporate formalities.

Although not directly related to the tax gap issues, a significant factor contributing to the complexity of the S corporation deal with an understanding of the basic nature of a corporation. It is an entity, separate and distinct from the owner(s). Failure to recognize this distinction can result in a failure to keep personal and corporate transactions and assets separate. In addition to the risk that the courts could pierce the corporate veil and strip the owner of the limited liability protection, the tax issue is that personal expenditures could be recorded on the corporate books. [9]

The GAO found that of the non-compliant corporations, 80 percent understated income while over 91 percent overstated deductions. Additionally, a sample of S corporations found that 41 percent of deducted personal expenses while 31 percent could not document the expenses. [14]

One area of deductions not noted in the GAO study is the home office issue. As a sole proprietorship, the owner is accustomed to deducting expenses for a home office on Schedule C. Since there is no longer a Schedule C, and the corporation and the owners are separate entities, this can create another level of complexity. There are three approaches available to the S corporation owner.

First, the owner-employee of an S corporation can take an employee business expense home office deduction on Schedule A. Although the simplest approach, this is the least attractive as the tax deduction is reduced due to the two percent limitation on miscellaneous itemized deductions and the requirement to itemize to obtain any tax benefit. A second approach is for the shareholder to rent the home office to the S corporation. This creates a deduction for the corporation and can result in zero income reported on the shareholder's Schedule E. One caution here is that the rental may be subject to sales taxes in some states. A third approach is to have the corporation pay the shareholder for any out-of-pocket expenses of a home office under an accountable plan. This can include a portion of mortgage interest, property taxes, insurance, and other expenses. The last two options do require rigorous record-keeping. Failure to keep adequate records will result in a loss of the deduction, along with penalties and interest on the amount due. [12]

A related issue that arises here is the failure to keep minutes of board and stockholder meetings. Certain actions must be approved by the board or shareholders for them to be valid for the corporation. A commonly encountered item is shareholder loans due to or due from the shareholder. These are frequently used as balancing items on the balance sheet. However, these loans must be approved by the board and not netted. There should be a promissory note with interest (when above \$20,000) and repayment terms. Failure to document these "loans" may result in them being treated as distributions or as additional capital investments. Both of these are changes in the percentage of ownership. [9]

The failure to maintain a distinction between the owners and the corporation frequently manifests itself in disproportionate distributions to shareholders. By law, distributions of profits to shareholders are required to be in proportion to ownership. Undocumented loans to shareholders, distribution of non-cash property, and sale of corporate property at less than fair market value can be disproportionate distributions. The main tax issue with these distributions is that they run afoul of the "one class of stock" rule for S corporations. The IRS views disproportionate distributions as evidence of a second class of stock. Having a second class of stock can invalidate the S corporation election. [11]

Maintaining the stockholder's basis can be complex. This is especially true with regard to maintaining both inside and outside basis. Since inside basis is (supposedly) maintained by the corporation it is usually the easiest to determine and maintain. When a shareholder deducts S-corporation losses, outside basis is important. Since outside basis is not maintained at the corporate level, determining the shareholder's proper outside basis can be an elusive goal. [10]

In many cases basis is misreported simply because the owner does not know what constitutes basis, much less the dollar level of that basis. A shareholder may not take deductible losses in excess of basis. If shareholder basis is not maintained, the owners do not know when a loss cannot be deducted. If an IRS audit occurs, the shareholder may be hit with a large tax deficiency due lack of basis or to an inability to show basis. [10]

GAO RECOMMENDATIONS

Complexity and compliance seem to be related factors in dealing with S corporations. The GAO makes four recommendations to help address the compliance challenges:

The first is to identify and evaluate options for improving the performance of paid preparers through licensure and assessing "appropriate penalties." [14] While this may have some positive effect, it seems to place the responsibility on the preparers to assure that returns are properly prepared. The bulk of the problem is not preparer inadequacy, it is tax code complexity and lack of taxpayer awareness. The preparer can only work with the information available from the taxpayer and is not an auditor for the IRS.

Second, the GAO recommends sending additional guidance on S corporation rules and recordkeeping requirements to new corporations for distributions to shareholders. This assumes that the shareholders would read the material and understand those rules and recordkeeping requirements. Regardless of how much information is provided to the shareholders, if they don't understand the rules, they are not likely to be followed given the current lack of recordkeeping.

The third recommendation is to require IRS examiners to document their analysis by using comparable salary data when determining a reasonable salary level. It seems that this is what should have been done all along. Related to this recommendation is the fourth, which calls for more specific guidance to shareholders and taxpayers in the process of determining how to arrive at a reasonable salary. Done properly, this could be of great benefit. However, all the guidance in the world is not likely to change the actions of shareholders who do not pay themselves any salary.

A LOOK AT LLC HISTORY

Limited liability companies (LLC) are a relative newcomer to the scene of business organization structures in the United States. The first U. S. LLC legislation was enacted by Wyoming in 1977. Five years later, in 1982 Florida followed suit. Today, all states have enacted such legislation. [13] However, LLC's have a long history internationally. In 1892, Germany law authorized the *Gesellschaft mit beschrnkter Haftung*, an organization type similar to today's LLC. This law became the focal point for other countries that subsequently enacted similar legislation. The concept was quickly adopted in a number of countries worldwide. [5]

The initial growth of the LLC in the United States was hampered by the IRS, which placed strict rules on LLC's and how they could be taxed. Initially, the IRS proposed regulations taxing them as corporations based upon the limited liability feature. This came about despite a

private letter ruling issued in 1980 confirming that the Wyoming LLC would be taxed as a partnership. The IRS was widely criticized for this perceived hostility toward LLC's and withdrew the proposed regulations three years later. Meanwhile, LLC's were not even a blip on the radar screen of business organization structures. For a decade after the initial legislation, Wyoming had less than 100 LLC's. Florida was the only other state with similar legislation. [4]

Eleven years after the first LLC legislation was passed in the United States, the IRS issued Rev Rul 88-76, stating that LLC's would be taxed as partnerships despite having the limited liability feature. This opened the door for other states to enact enabling legislation for LLCs. But states reacted slowly and with great caution. It was not until 1990, when Colorado and Kansas passed LLC statutes that additional states stepped forward. By 1996 all fifty states had jumped on the bandwagon and LLC's became available nationwide. Corresponding to this rise in the number of states recognizing LLC's was the number of businesses taking advantage of this new form of organization. [4]

A second IRS ruling, coming in 1997, gave LLC's the tax flexibility they now enjoy. This ruling created the well-known "check the box" rules that allow an unincorporated business to elect tax treatment as a corporation, partnership, or sole proprietorship (in the case of a single member LLC). While maintaining its IRS status as a disregarded entity, an LLC was now allowed to choose to be taxed as a corporation (including an S corporation). This ruling also made LLC's attractive to sole proprietorships, as single member LLCs were previously treated as corporations by the IRS [4]

THE NEXT STEP

The current tax situation in regard to S corporations cannot continue. This form of organization is not yet broken, but it does have some severe problems. These problems are manifesting themselves through the complexity required to maintain the organizational structure and through filing of erroneous returns. It should be emphasized that often the erroneous returns are not done intentionally, but due to a lack of proper recordkeeping. A third factor is simply a failure to file. As a result the annual \$22 billion tax gap continues.

There is a definite place for the S corporation. It is the best choice for some businesses. However, in looking at the overall picture, one must ask if the place for the S corporation remains large enough for it to remain as a choice for tax purposes. LLC's have achieved great popularity in recent years. During this time, S corporations have maintained their popularity as more S corporation returns are being filed.

There are five factors that would recommend an LLC over an S corporation. First, formation of an LLC is not as complex as formation of an S corporation. In most states, one merely files short Organization Statement with the state and pays a fee. Related to this is the second factor, that an LLC lacks the complexity and formalities of the S corporation. Minutes, directors, and annual meetings are not a required component of most LLC statutes.

A third factor is that the home office deduction can be more straightforward. The home office expenses for a single member LLC are simply deducted on the 1040 using Form 8829. For a multi-member LLC reporting as a partnership, the deduction can be shown as an additional item on the member's Schedule E section for reporting K-1's. This avoids the rent or reimbursement issue previously discussed.

Fourth, basis issues will not go away, but they become more manageable under the LLC form of organization as requirements for tracking basis are not as rigorous as with an S corporation.

The final advantage of an LLC is in the area of profit and loss distribution. LLC members can decide how to distribute profits and losses among themselves. They are not required to follow the proportional distribution rules mandated for corporations. Therefore, the issue of disproportionate distributions to the owners is not an issue that confronts members of an LLC.

Based on these advantages, it would be easy to make a case for the abandonment of the S corporation as a form of organization in our tax code. One issue, however, is likely to provide the largest hurdle to eliminating the S corporation. That issue is the ability of an S corporation owner to avoid self-employment taxes on S corporation earnings. However, that ability may be quickly eroding. H. R. 4213 was presented in Congress in 2010 and would have subjected owners of certain small businesses (S corporations) to self-employment taxes on the earnings of the company. The targeted businesses were designated “professional service businesses” – doctors, lawyers, accountants, and so on. [15]

This was positioned as a loophole closer but it is a tax increase to the tune of \$11 billion over the next ten years. One reason such legislation has even been proposed is that the privilege has been abused by S corporation owners who pay themselves little or no salary and minimal self-employment taxes.

It is unfair to subject all S corporation earnings to self-employment taxes. The earnings of an S corporation are due in part to the efforts of the owners and they should be compensated for those efforts through the receipt of a reasonable salary. However, there is the profit aspect of an S corporation. The owners have invested money in these businesses and deserve compensation for their investment – compensation for the risk taken in starting the business. These profits from investment activities should not be subject to self-employment taxation.

This ability to shield S corporation earnings from self-employment taxes is not available to owners of LLC’s. One suggestion is that Congress should enact legislation covering both S corporations and LLC’s, allowing them to exclude a certain portion of earnings from self-employment taxes. This could be an amount based on a percentage return on the owner’s basis in the organization. Unfortunately, this again raises issues relating to basis. A second approach would exclude a set dollar amount from self-employment taxes. This fails to take into account the value of services being rendered by the owner of the business and the amount of investment in the business.

A third approach would allow a set percentage of earnings to be excluded from self-employment taxes. Allowing a business owner to exclude 25% of earnings from self-employment taxes would assure that some self-employment taxes would be paid, while recognizing that the owner should be compensated for risk. This is a simple approach that does not require maintaining of (or allow for manipulation of) basis.

CONCLUSION

While the S corporation as a form of business organization remains highly popular, it is a complex form of organization that is often misunderstood by corporate owners. As a result, S corporation owners may frequently find themselves having difficulty with the IRS as they have

failed to meet some of the rigorous S corporation requirements. Additionally, the S corporation tax gap is cited by the IRS as \$22 billion per year. However that number balloons when the incidence of non-filers is taken into consideration.

The LLC is a viable alternative to S corporations and it is a much simpler form of organization. Its main drawback is that the earnings of an LLC are subject to self-employment taxes. That drawback may diminish over time as Congress withdraws the exemption S corporation owners now enjoy.

It is time to consider abolishing the S corporation as a form of organization. It can be phased out or given a definite sunset date. The most reasonable approach for tax purposes would be to merge S corporations into the LLC form of organization, along with some changes in the tax code to minimize the impact of the change. The approach will help solve the complexity issue, will be less stressful for business owners, and will help reduce the tax gap currently attributed to the S corporation.

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