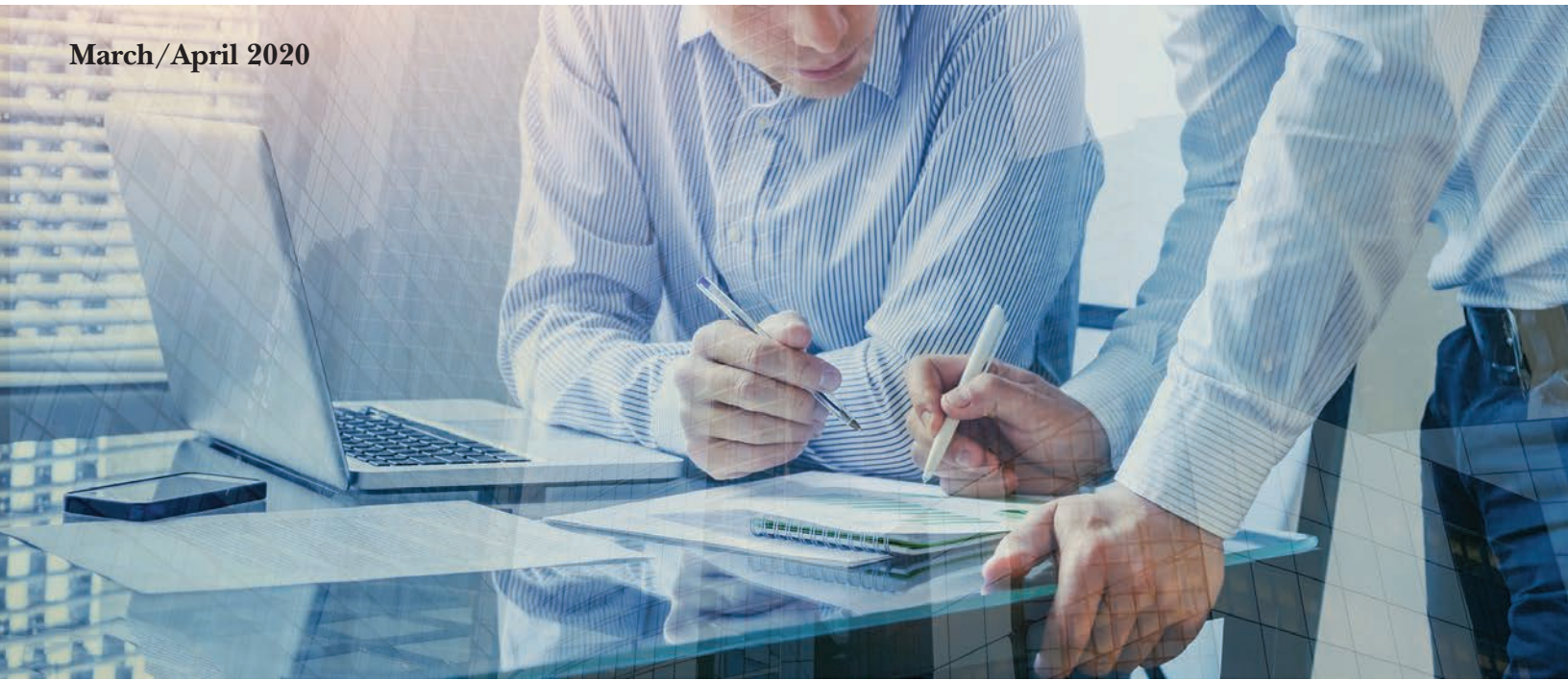


TAX IMPACT

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The proper care and feeding of your S corporation

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Tax Tips

The proper care and feeding of your S corporation

Diligence required to avoid inadvertent termination and loss of tax benefits

The S corporation continues to be a popular entity choice, combining the liability protection of a corporation with many of the tax benefits of a partnership. But these benefits come at a price: S corporations must comply with strict requirements that limit the number and type of shareholders, prohibit complex capital structures, and impose other restrictions.

Advantages of S corporation status

Like a traditional corporation, an S corporation shields its shareholders from personal liability for the corporation's debts. At the same time, it provides many (though not all) of the tax benefits associated with partnerships. Most important, an S corporation, like a partnership, is a "pass-through" entity, which means that all of its profits and losses are passed through to the owners, who report their allocable shares on their personal income tax returns. This allows S corporations to avoid the double taxation that plagues traditional C corporations, whose income is taxed at the corporate level and again when distributed to shareholders.

S corporations, unlike partnerships, lack the flexibility to allocate profits and losses among their shareholders without regard to their relative capital contributions. But S corporations have one important advantage over partnerships: Shareholders need not pay self-employment taxes on their shares of the profits, provided they receive "reasonable" compensation.

S corporation requirements

To qualify as an S corporation, all of a corporation's shareholders must sign and file an election by filing Form 2553 — *Election*

by a Small Business Corporation — with the IRS. In addition, the corporation must:

- Be a domestic (U.S.) corporation,
- Have no more than 100 shareholders (certain family members are treated as a single shareholder for these purposes),
- Have only "allowable" shareholders (see below),
- Have only one class of stock (generally, that means that all stock confers identical rights to distributions and liquidation proceeds; differences in voting rights are permissible), and
- Not be an "ineligible" corporation, such as an insurance company, a domestic international sales corporation (DISC) or a certain type of financial institution.

Allowable shareholders include individuals, estates and certain trusts. Partnerships, corporations and nonresident aliens are ineligible. A trust is



an allowable shareholder if it's domestic and qualifies as one of the following:

- A grantor trust, provided it has only one “deemed owner” who’s a U.S. citizen or resident and meets certain other requirements,
- A testamentary trust established by a shareholder’s estate plan,
- A voting trust,
- A Qualified Subchapter S trust (QSST) — that is, one 1) that distributes all current income to a single beneficiary who’s a U.S. citizen or resident, and 2) for which the beneficiary files an election with the IRS, or
- An electing small business trust (ESBT) — to qualify, 1) all of the trust’s potential current beneficiaries (PCBs) must be eligible S corporation shareholders or nonresident aliens, 2) no beneficiaries may purchase their interests, and 3) the trustee must file a timely election with the IRS. Generally, PCBs are persons who are entitled to distributions or may receive discretionary distributions.

Be aware that grantor and testamentary trusts are eligible shareholders for only two years after the grantor dies or the trust receives the stock.

Avoiding termination

Preserving S corporation status requires due diligence. Among other things, you should:

- Continually monitor the number and type of shareholders, scrutinize the terms of any trusts that hold shares, and ensure that QSSTs or ESBTs have filed timely elections,
- Include provisions in buy-sell agreements that prevent transfers to ineligible shareholders,

Relief from inadvertent termination

In recent private letter rulings (PLRs), the IRS has provided S corporations with relief from inadvertent terminations. For example, in PLR 201941003, a trust that received S corporation stock filed an electing small business trust (ESBT) election that incorrectly stated that it had received the shares on a later date. As a result, the trust was an ineligible shareholder on the date it actually received the shares, terminating the S corporation election. The IRS allowed the trust to correct the election and restored the company’s S status.

Rulings like this one demonstrate how even minor missteps can undo the benefits of S corporation status, but also the IRS’s willingness to provide relief for innocent mistakes. Still, it’s important to be diligent in monitoring compliance with S corporation requirements. There are no guarantees that the IRS will grant relief for mistakes; plus, the user fee for requesting such relief is currently \$30,000 (excluding any advisory fees).

- If shares are transferred to an ESBT, make sure all PCBs are eligible shareholders or NRAs, and
- If shares are held by grantor or testamentary trusts, track the two-year eligibility period and make sure trusts convert into QSSTs or ESBTs or transfer their shares to an eligible shareholder before the period expires.

Also, avoid actions that may be deemed to create a second class of stock, such as making disproportionate distributions.

Don’t take your eye off the ball

If your business is organized as an S corporation, it’s critical to monitor your shareholders and activities continually to avoid inadvertent termination of your company’s S corporation status. At worst, termination means the loss of substantial tax benefits. At best, it means going through an expensive, time-consuming process to seek relief from the IRS and, if successful, have your S status restored retroactively. (See “Relief from inadvertent termination” above.) Contact your tax advisor with any business entity questions. ■

Do you own a closely held family business?

Sec. 6166 may help ease the sting of estate taxes

Assets such as an illiquid closely held business can pose unique estate planning challenges. Indeed, even with the gift and estate exemption amount at an inflation-adjusted \$11.58 million for 2020, these taxes can continue to be burdensome if a family has a significant amount of wealth tied to a family business.

The good news is that the tax code offers some relief in Internal Revenue Code Section 6166.

Deferring estate tax

For families with substantial closely held business interests, an election to defer estate taxes under Sec. 6166 can help them avoid having to sell business assets to pay estate taxes. It allows an estate to pay interest only (at modest rates) for four years and then to stretch out estate tax payments over 10 years in equal annual installments. The goal is to enable the estate to pay the taxes out of business earnings or otherwise to buy enough time to raise the necessary funds without disrupting business operations.

Be aware that deferral isn't available for the entire estate tax liability. Rather, it's limited to the amount of tax attributable to qualifying closely held business interests. For example, if the value of an interest in a closely held business were equal to 60% of the adjusted gross estate, 60% of the tax would be eligible for deferral. The remaining 40% would be payable within nine months after the decedent's death.

Qualifying for Sec. 6166

Estate tax deferral is available if 1) the deceased was a U.S. citizen or resident who owned a closely held business at the time of his or her death, 2) the value of the deceased's interest in the business exceeds 35% of his or her adjusted gross estate, and 3) the estate's executor or other personal representative makes a Sec. 6166 election on a timely filed estate tax return. Typically, the estate is required to provide security for future tax payments by furnishing a bond or allowing a tax lien to be filed against the business or other assets.

To qualify as a "closely held business," an entity must conduct an *active* trade or business at the time of the deceased's death (and only assets used to conduct that trade or business count for purposes of the 35% threshold). Merely managing investment assets isn't enough. Distinguishing between



an entity that conducts an active business and one that holds passive investments can be a challenge, particularly when it owns rental real estate.

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In addition to conducting an active trade or business, a closely held business must be structured as a sole proprietorship, partnership or corporation.

Several special rules make it easier to satisfy Sec. 6166's requirements. For example, if an

estate holds interests in multiple closely held businesses, and owns at least 20% of each business, it may combine them and treat them as a single closely held business for purposes of the 35% threshold. In addition, the section treats stock and partnership interests held by certain family members as owned by the deceased. That means the estate can count interests held by the deceased's spouse, siblings, ancestors and lineal descendants toward the 35% and 20% thresholds.

On the other hand, the interests owned by corporations, partnerships, estates and trusts are attributed to the underlying shareholders, partners or beneficiaries. This can make it harder to stay under the 45 partner/shareholder limit.

Turn to your advisor

As detailed above, there are many variables that go into qualifying for an estate tax deferral under Sec. 6166. Your estate planning advisor can help you make that determination. ■

How to avoid tax scams

When there's money involved, scam artists seem to come out of the woodwork, and tax season is no exception. Fortunately, if you familiarize yourself with common tax scams and understand what the IRS will and will not do, it's easy to avoid them.

Common scams

Here are some common tax scams:

Calls from IRS impersonators. Fraudsters impersonating IRS employees call or leave a message, typically using fake names and phony identification badge numbers and often altering the caller

ID to make it look like a legitimate IRS number. They tell victims that they owe money to the IRS and threaten them with arrest, suspension of business or driver's licenses, or even deportation unless they pay promptly using gift cards, prepaid debit cards or wire transfers.

Phishing. Fraudsters send fake emails, designed to look like official communications from the IRS, tax software companies, or even victims' tax advisors, in an effort to gain access to victims' financial information or trick them into downloading malware that allows access to their computers. These emails often contain links to bogus websites that

mirror the official IRS site and ask victims to “update your IRS e-file immediately.” Fraudsters use this information to file false income tax returns or engage in other identity theft schemes.

Property lien scam. With this fraud type, a thief sends a letter from a nonexistent agency asserting that the victim owes overdue taxes and threatening an IRS lien or levy on the victim’s property. Typically the fake agency has a legitimate-sounding name, like Bureau of Tax Enforcement.

These are just a few examples of the hundreds of tax-related scams the IRS sees on a regular basis. Fraudsters are continually developing new, more sophisticated scams as well as variations of tried and true schemes. So it’s important to be on high alert whenever you receive communications that purport to be from the IRS, a state or local tax authority or a collection agency working on their behalf.

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Things to remember

Tax scams can be complex and widely varied, but they’re easy to avoid if you keep in mind what the IRS will — and, more important, will not — do. The IRS will *not* initiate contact about a tax matter by phone, email or in person, without first sending you a bill or notice by regular mail delivered by the U.S. Postal Service. There may be special circumstances — such as an overdue tax bill, delinquent return, audit or criminal



investigation — that prompt a visit from an IRS representative. But these visits are almost always preceded by a series of notices in the mail.

In addition, the IRS won’t:

- Demand that you pay taxes immediately without an opportunity to question or appeal the amount they say you owe,
- Demand payment using a specific method, such as a prepaid debit card, gift card or wire transfer,
- Threaten you with arrest for nonpayment of taxes, or
- Threaten you with deportation or revocation of a driver’s or business license.

Where to turn

If you receive suspicious communications, contact your tax advisor. In addition, if you receive a suspected phone scam, consider reporting it to the Federal Trade Commission using the FTC Complaint Assistant at [FTC.gov](https://www.ftc.gov). You can forward suspected phishing emails to phishing@irs.gov, and report IRS impersonation scams to the Treasury Inspector General for Tax Administration at [treasury.gov/tigta](https://www.treasury.gov/tigta). ■

Businesses: It's time to revisit your sales tax obligations

It's been more than a year and a half since the U.S. Supreme Court ruled in *South Dakota v. Wayfair* that states may require out-of-state sellers to collect sales and use tax even if they lack a physical presence in a state. Since that time, most states that have a sales tax have enacted "economic nexus" laws that expand the reach of their sales tax collection obligations beyond their borders.

Many of these laws are similar to the one upheld in *Wayfair*, which applies to sellers that, on an annual basis, deliver more than \$100,000 in goods or services into the state or engage in 200 or more separate transactions for the delivery of goods and services into the state. Some states have eliminated the number-of-transactions threshold, to avoid applying their laws to small sellers, such as one that sells 250 items at \$1.50 each.

If your business sells products or services in states in which it lacks a physical presence, review the economic nexus laws in those states and assess their impact on your sales tax compliance strategies. ■

Should you forgive intrafamily loans?

If you have outstanding loans to your children, grandchildren or other family members, now may be the time to consider forgiving them to take advantage of the record-high gift and estate tax exemption and the gift and generation-skipping transfer (GST) tax exemption. For 2020, the amount of both exemptions is an inflation-adjusted \$11.58 million (\$23.16 million for married

couples), but in 2026 it's scheduled to drop down to \$5 million (\$10 million for married couples), indexed for inflation.

An intrafamily loan can be an effective estate planning tool if you've used up your exemption or want to conserve it for future gifts. But if you have exemption

to spare, forgiving these loans may be the best way to transfer wealth to your loved ones free of gift taxes and to take advantage of the higher exemption amount before it disappears. In some cases, debt forgiveness has income tax implications, so be sure to consult your tax advisor before taking action. ■



Related-party transactions: Handle with care

If you own related businesses, it's critical to structure and document transactions between them carefully to avoid unwelcome tax consequences. In one U.S. Tax Court case, a taxpayer learned this lesson the hard way. The taxpayer owned three related real estate businesses and used one business's funds to pay the others' debts without formally documenting the payments as loans. The court held that the payments were contributions to capital, not loans. These contributions, the court found, were constructive dividends to the taxpayer, subject to both income and employment taxes. ■