THEME: S CORPORATIONS

By John W. Day

ACCOUNTING TERM: S Corporation

Here is a good definition of an S Corporation from the Nolo website:

A term that describes a profit-making corporation organized under state law whose shareholders have applied for and received subchapter S corporation status from the Internal Revenue Service. Electing to do business as an S corporation lets shareholders enjoy limited liability status, as would be true of any corporation, but be taxed like a partnership or sole proprietorship. That is, instead of being taxed as a separate entity (as would be the case with a regular or C corporation) an S corporation is a pass-through tax entity: Income taxes are reported and paid by the shareholders, not the S corporation.

FEATURE ARTICLE: The Accounting Structure of S corps

S corps are strange beasts. Some are very simple and straightforward to manage while others can be convoluted and mind-boggling depending on the circumstances. All of them have some funny quirks (special rules) that are important to know about regardless.
Essentially, the general ledger accounts are similar to any other business except for the equity section of the balance sheet. Normally, you will see an S corp equity section balance sheet looking exactly like a C corp's. For instance:

Common Stock
Paid-in-Capital
Retained Earnings
Current Year Net Profit or (Loss)

Yet, on the S-Corp tax return (1120S) a different concept is employed because an S-Corp is a "pass-through" entity similar to a partnership. Instead of the Paid-In-Capital and Retained Earnings accounts, an account called "Accumulated Adjustments Account" or (AAA) is used.

Unlike an S corp, a C corp is not a pass-through entity. This means that the C corp is taxed based on its net profit or loss. These "earnings" accumulate in the "retained earnings" account. If and when the retained earnings account amounts to $250,000 or more, the Internal Revenue Service (IRS) can require that a dividend be paid to the stockholders. This requirement can be avoided if the corporation is able to substantiate that there is an overriding business reason for not doing so. Dividends that are paid out decrease retained earnings.

A C corp pays tax on the net profit that is accumulated in retained earnings. When dividends are paid out of retained earnings to shareholders, the

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shareholders are required to report those dividends as income on their personal tax returns. This results in what is commonly known as “double taxation”.

S corps avoid this problem because the net profit or loss from the business is passed directly through to the shareholders. The S corp does not pay a corporate tax on net profit like a C corp.

To understand S corps you must grasp the difference between shareholder basis and the AAA:

Shareholder basis

What is “basis” and why is it important? Basis usually begins like this: When a shareholder purchases stock in a corporation an exchange takes place. The company receives property (usually money) in exchange for a certain percentage of ownership. The shareholder achieves what is called “basis” from the ownership of stock. In other words, basis represents the shareholder’s cost of investment. If you purchased shares of stock worth $10,000, you now have $10,000 in basis. Shareholder basis can also be increased by additional capital contributions and flow-through income from the business. Basis can be decreased by distributions of cash or property, flow-through losses, flow-through deductions (such as section 179 expense) and non-deductible corporation expenses (such as penalties and a portion of meals & entertainment expenses).

It is very important to keep track of the shareholder’s basis. This is because a shareholder’s basis determines whether a taxable event has occurred for the shareholder as a result of some activity within the business. For example, if a shareholder takes a distribution of $10,000 but only has basis of $8,000, then a $2,000 taxable event has occurred. On the other hand, if the shareholder takes a distribution of $5,000 but has basis of $8,000, then no taxable event has occurred.

Another way to say this is that basis can be seen as the shareholder’s capital investment paid for by pre-taxed dollars. When a distribution is taken it is essentially a return of that capital investment so it can’t be taxed again. A taxable event occurs when a distribution exceeds the capital investment (basis). In addition, when a loss occurs in the business that exceeds shareholder basis it is suspended. This means the shareholder is not allowed to report the loss on his/her personal tax return until basis is restored in a later year.

The AAA

The AAA tracks the amount of undistributed S corp income that has been taxed to the shareholders after 1982. The AAA is increased by S corp taxable income and separately stated taxable income items and decreased by S corp deductible losses and separately stated loss items, non-deductible expenses and non-dividend distributions.

Just think of the AAA as a running balance similar to your check register balance. It has a starting balance, increases, decreases and an ending balance.

Here is an example of how the AAA and Shareholder basis are affected differently:

	AAA	**STOCK BASIS**
Starting balance:	$25,000	$15,000
Pass-through loss	<30,000>	<15,000>
Balance 12/31/06	< 5,000>	$0 (Suspended loss of $15,000)
Distribution $6,000		$0 ($6,000 cap gain – distribution in excess of stock)
Loss $2,000	< 2,000>	
Balance 12/31/07	<7,000>	$0 (Increases suspended loss to $17,000)
Pass-through income $25,000	$25,000	$25,000
		<17,000>
Balance 12/31/08	$18,000	$ 7,000 The $25,000 is picked up as gain but $17,000 suspended loss offsets it.

If you look at this example closely you will see that the AAA simply keeps track of the running balance. The shareholder's basis is much different because it is measuring how much basis is available. Anytime there is a distribution in excess of the shareholder basis a taxable event occurs. At the same time, losses derived from the business are not able to be taken by the stockholder if there is no basis available. When this happens the losses are suspended and carried forward to the next year. These losses cannot be taken until basis is restored either by a year that produces enough income or by a capital contribution from the shareholder.

My example is fairly simple but depending on the situation, things can become very complex. For instance, loans from stockholders can increase basis, but only if it is a direct loan with no third party involved. By third party, I mean for example, when a bank loans money directly to the company and the shareholder signs as a guarantor. It gets tricky if a shareholder uses up loan basis via distributions and then pays back those loans at a later date because this also may trigger a taxable event. How can that be? If a distribution was not taxable due to the shareholder claiming to have loan basis, then, when the loan is paid back the basis preventing the taxable event is removed thereby triggering a taxable event.

If the business incurs net income, ordering rules come into play that require loan basis to be restored first. Obviously, I can't go into all the various scenarios that trigger particular rules. My intent is to caution you that S corps should not be treated like sole proprietorships.

Save yourself some headaches and consult with an accounting or tax professional to help you decide whether an S corp entity is for you. And, if you do decide to use an S corp, always consult with your advisor to make sure you are following all the rules.

QUESTION: Should an LLC choose to be taxed as an S corp?

Recently, one of my tax clients told me that she had set up a Limited Liability Company (LLC). She was planning to make big bucks right away from her new business. As you may know, the default tax entity for an LLC with one member is a sole proprietorship. However, she elected to have her LLC taxed as an S corp.

I asked her why she would want to do this and her answer was, "I don't know. They said I could". To me, this made no sense. She already had liability protection from the LLC and was going to be taxed personally as a sole proprietor. What she had done was redundant. The S corp provided the same liability protection and since it is a pass-through entity she is taxed on its income personally.

The point being that one should take the time to research which business entity most appropriately fits your needs. My client might have chosen an S corp instead of an LLC in the first place had she found out that California imposes a gross receipts tax on LLCs. This tax has the potential of being much higher than the 1.5% corporate tax.

If you are looking for liability protection an LLC, S corp or C corp might be a good idea. But, the corporate shield may not provide full protection from any kind of lawsuit. Check with your attorney as to what kind of liability protection you can expect from your business entity. Keep in mind, that insurance should be your first line of defense.

Some folks feel that a corporation automatically provides a certain kind of status. That may be, but unless the business is producing a decent amount of income to support the extra cost of incorporation then it is best to wait. Check with your state. In California, the privilege of being incorporated costs $800 per year. Filing a corporate tax return usually runs $500 or more depending on the circumstances. Just to establish the corporation will cost from $500 to $1,500 depending on whether you use an attorney or an organization like The Company Corporation that specializes in setting up these entities.

Tip: Officer's Salary vs. Draw in an S corp.

Often I receive questions on my Accounting for Non-Accountants BLOG from bookkeepers who are doing the books for an S corp where the shareholder/officer has taken a draw (distribution) rather than a salary.

When this situation occurs it can be messy to fix. First, a working shareholder in a S corp is "required" to take a salary. This means using a formal payroll system that withholds taxes and files all the requisite payroll reporting forms in a timely manner. If this hasn't been done, a payroll system has to be set up, the forms filed and the deposits made even though they are late. Penalties and interest will be assessed.

When an S corp shareholder/officer takes a distribution, no payroll or self-employment taxes are required. Self-employment taxes are FICA (social security) and Medicare. This appears to be a tax-loophole because shareholders could simply disregard payroll, take a distribution and avoid the payroll taxes. The Internal Revenue Service (IRS) caught onto this one real quick and said, "Not so fast". They require a working shareholder to take a "reasonable" salary first. What is "reasonable"? That apparently is determined by the facts and circumstances of the case. But here are some red flags to be aware of:

1. The business code indicates a service business (which usually requires significant services from employees to produce revenue).

2. Significant distributions are made to the shareholders.

3. Zero or nominal compensation, particularly to officers/shareholders.

Therefore, shareholders of S corps should avoid taking only a "draw" or "distribution" with the intent of avoiding self-employment taxes and the hassle of a formal payroll system.

Some shareholders take a draw when money is available because cash flow in the business is sporadic. They are not sure what their salary should be. What are they to do? Here is a solution:

Establish an asset account called Officer Advance. Post all the draws as a debit to this account. For instance:

DESCRIPTION	DEBIT	CREDIT
Officer Advance	1,500	
Cash		1,500

Next, go to an online payroll company such as www.paycycle.com. The cool thing about an online payroll company is that they do everything. All you have to do is plug in the hours, write the payroll check and you are done. They file all the forms electronically.

Set up your single employee with a minimum annual salary. You have to estimate what this might be according to how much his/her average draw is. Set this up for one pay period per month. For example, let's say it is $12,000 per year. Let's make the net check per month $600. Your payroll journal entry for the month would look like this:

DESCRIPTION	DEBIT	CREDIT
Officer Salary	1,000	
Employee P/R Taxes		400
Officer Advance		600

See how the Officer Advance account nets out $1,500 less $600 = $900.

Toward the end of the year figure out whether the shareholder has taken out more or less that the net salary. Adjust the gross salary to make sure that the amount taken out by the shareholder is close to or equals the annual net salary amount. You can accomplish this by issuing a bonus check at the end of the year.

To illustrate, let's say that the shareholder took $9,600 in draws during the year. According to our example his net checks total $7,200 (12 x $600). This leaves a debit balance of $2,400 in the Officer Advance account. At the end of the year you issue a bonus to the shareholder of $4,000. After subtracting $1,600 in payroll taxes the remaining $2,400 is recorded as a credit to Officer Advance. The remaining balance in the Officer Advance account is zero.

Officer Advance	
9,600	7,200
	2,400
	9,600

To use a gruesome metaphor, you have now "killed two birds with one stone". The stockholder can take random draws as needed and the S corp has complied with the IRS rules requiring a working shareholder to take a salary.

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