Many wealthy clients, especially owners of closely-held firms, have interests in subchapter-S corporations. The tax policies proposed by the Trump administration will have a significant impact on them, according to Toni Nitti.

Nitti is a tax partner with the Aspen, CO-based accounting firm, WitmumSmithBrown, PC. He spoke on June 13 at the AICPA ENGAGE 2017 conference, held in Las Vegas.

“Tax policy is going to be at the forefront of public consciousness over the next few months,” Nitti said.

Nitti went through Trump’s agenda and the changes it would have for those with significant S-corporation earnings. He also reviewed some recent legal cases and their implications for S-corporation owners and shareholders.

**Tax reform and its impact on subchapter-S corporations**

Nitti reviewed the key elements of Trump’s proposed tax reform:

- The tax rate would decrease from 35% to 15% for C corporations;
- For pass-through entities (partnerships, LLCs and sole proprietorships), tax rates go from 43.4% to 15%;
- It would repeal the 3.8% net-income investment tax (NII), which would reduce the tax on S-corporation income and on S-corporation capital gains if a company is sold;
- There would be a one-time “repatriation” tax of 10% on off-shore earnings; and
- The worldwide taxation system would change so that U.S. taxpayers would pay taxes in the country where income is earned instead of in the U.S.

A key element, Nitti said, is that there would be a 15% unified business tax rate, which would apply to S-corporation income and to partnerships, LLCs and sole proprietorships.

“But,” he warned, “there is no proposed legislation and no detail.”
Nitti said that one could sell an S corporation to escape the 3.8% NIII tax in 2018, based on the Obamacare repeal act which would take effect January 1, 2018.

The unified business rate is the most controversial aspect of Trump’s proposal, he said. The idea is that it is a middle-class tax break, but many in that demographic are already paying a rate of around 15%, according to Nitti. “The windfall will be to the wealthy,” he said, who pay at rates in excess of 40%.

He said the other big controversy is that many employees of S-corporations could leave and set up a S-corporation for themselves, lowering their tax rate to 15%. They would also save on self-employment tax. This is an abuse that could give rise to one of the “greatest tax shelters of the modern era,” Nitti said.

**Legal cases affecting subchapter-S corporations**

At the end of 2015, Congress passed what is known as the “Path Act” and addressed the “extender package.” Nitti said there were 56 tax-related provisions in that legislation, and that 30 were made permanent, four were extended for five years and the rest “died” at the end of 2016. He reviewed the implications for subchapter S corporations.

Two provisions were made permanent under section 1367 of the tax code. If an S corporation makes a charitable contribution of property, the stock basis is reduced based on the basis of the property, not based on its market value. The other provision is the “built-in gains tax.” When a C corporation liquidates, shareholders are subject to double taxation (at the corporate and individual levels). But that is not true of S corporations, he said, which just pay tax at the investor level.

C corporations that want to liquidate are thereby incentivized to make an S election, Nitti said. To preserve the difference between C and S corporations, the IRS makes sure you pay double taxation, according to Nitti. Section 1374 says that if you liquidate a C corporation you still pay corporate-level tax. Previously, this requirement was for 10 years; now it is permanently reduced to five years, he said, but with some limitations including the fact that shareholders can’t pay taxes in excess of their S corporation income over that five-year period.

An implication of this ruling is that the assets of a C corporation must be valued on the date of an S-corporation election, Nitti said.

A 2% S-corporation shareholder can deduct health insurance paid for or reimbursed by the S corporation and are included in the shareholder’s gross income. However, Nitti said there was a stiff penalty for insurance bought on the open market, but this has been resolved.

Reasonable compensation is one of the biggest issues for S-corporation shareholders, Nitti said, because distributions are not subject to payroll tax. He cited revenue ruling 59-211 and said that taxpayers have “abused the hell out of it.”

If an S-corporation employee takes no salary, then the IRS has ruled that all distributions would be
treated as salary. The IRS now has determined that if you are an S-corporation officer, you must draw reasonable compensation.

But what is reasonable? That has changed as a result of two cases dealing with accountants, Nitti said, where the IRS determined that compensation wasn’t enough relative to distributions. The IRS takes a systematic, analytical approach to determine reasonable compensation, he said, looking at the health of the S corporation, the individual’s compensation as a percentage of sales, the salaries of other employees (particularly lower-level workers) and what other, similar firms are paying as compensation.

The “game has changed,” he said, and you can “read the cases to see how reasonable compensation is determined.” Most S corporations still don’t pay salaries in excess of the Social Security wage base, he said, because it is unlikely that the IRS will re-characterize more than this amount as income.

Nitti discussed the Ball case, which dealt with when Subchapter S corporations were required to increase the basis for any tax-exempt income. In that case, an S corporation bought a C corporation with highly appreciated assets, made an S election and liquidated to create a tax-free event. It effectively deferred the tax on the gains on those assets. The Ball cases made it so that events such as this don’t increase the basis.

In another case, Nitti said that guaranteeing S corporation debt doesn’t give your debt a basis until you pay the guarantee.

If a client makes a loan to an S corporation and the loan defaults, he or she can use losses, but repaying the debt is a taxable event, because the basis of the debt is reduced by any losses, Nitti said. In general, he advised, loans should not be repaid without seeking tax advice.

Nitti said that if individuals get income related to services provided to an S corporation, it must be to the S corporation and not to you personally. If you have contracts, they must be made with the S corporation and not with the individual. Otherwise, he said, the income could be taxed at the personal income rate and payroll tax would be due.

In the sale of a corporation, he said that sellers generally want to sell stock, but buyers want to buy assets (and not the liabilities of the corporation). There is now a way to buy stock for legal purposes and buy the assets for accounting purposes, according to Nitti. He said that section 336 allows this. Until a couple of years ago, he said that section 336 didn’t apply to S corporation, but now it does. “Everything that you want to accomplish in a 338(h)10 sale can be done through 336,” he said, which is very similar to 338(h)10. However, it is more expansive, because it can be used to acquire S corporations.