S Corporations Can Benefit Many Closely-Held Hospitality Firms

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Abstract

In his discussion - S Corporations Can Benefit Many Closely-Held Hospitality Firms - by John M. Tarras, Assistant Professor, School of Hotel, Restaurant & Institutional Management at Michigan State University, Assistant Professor Tarras initially offers: “Organization as an S corporation has many advantages for hospitality firms since passage of the Tax Reform Act of 1986. The author discusses those advantages and lists the disadvantages as well.”

In the opening paragraphs Tarras alludes to the relationship between hospitality firms, S corporations, and the Tax Reform Act of 1986, and then defines what an S corporation is.

“An S corporation is a form of business entity that combines many of the tax advantages of partnerships with the legal attributes of a corporation, including limited liability for its shareholders. Its name is obtained from a subchapter of the Internal Revenue Code. Except for tax purposes, the S corporation is treated in the same manner as any regular corporation. Like a partnership, income and losses for an S corporation are generally passed through directly to shareholders for inclusion on their individual returns. An S corporation thus avoids the double tax problem facing regular corporations.”

There are certain criteria to be met and caveats to be avoided in qualifying for S corporation status. Tarras lists and cites these for you. “Due to the complicated nature of S corporations, the election may be inadvertently terminated if the eligibility requirements are violated,” Tarras expands and cites.

As the article suggests at the outset, there are advantages and disadvantages to S corporation status; the author outlines some examples for you.

“Traditionally, the S corporation has been used by hospitality firms wishing to avoid the “double tax” problem of a regular corporation,” Tarras informs you. “Regular corporations are taxed once at the corporate level, and again at the shareholder level when income is distributed to shareholders in the form of dividends.”

Tarras advises you as to why an S corporation is an advantage in this situation. “Since the S corporation generally is not subject to any corporate taxes, it generally makes no difference whether distributions to shareholders of S corporations are characterized as compensation or dividends,” thus the double tax is avoided. This is just one such positive illustration.

Assistant Professor Tarras wants you to know: “Perhaps the most important reason to consider the S corporation has to do with the downward revision of tax rates for both individuals and corporations.” He highlights a case study for you.

Some of the disadvantages of S corporation affiliation are the caveats alluded to earlier. They include, “the limitation of an S corporation of 35 shareholders,” Tarras cites. “Also, there are limits as to who may own stock in an S corporation.” These are but two of the limitations of an S corporation. Tarras closes with a further glimpse of the down-sides of an S corporation.

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S Corporations Can Benefit Many Closely-Held Hospitality Firms

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Organization as an S corporation has many advantages for hospitality firms since passage of the Tax Reform Act of 1986. The author discusses those advantages and lists the disadvantages as well.

The Tax Reform Act of 1986 (TRA)\(^1\) has had a tremendous impact upon the hospitality industry. The massive changes in TRA will affect the manner in which individuals and corporations will be taxed in the future. Because of these changes, many closely held hospitality firms which are incorporated should seriously consider organizing as S corporations.

An S corporation is a form of business entity that combines many of the tax advantages of partnerships with the legal attributes of a corporation, including limited liability for its shareholders. Its name is obtained from a subchapter of the Internal Revenue Code.\(^2\) Except for tax purposes, the S corporation is treated in the same manner as any regular corporation. Like a partnership, income and losses for an S corporation are generally passed through directly to shareholders for inclusion on their individual returns. An S corporation thus avoids the double tax problem facing regular corporations.\(^3\)

In order to qualify as an S corporation, a business has to meet the following criteria:

- The corporation may not have more than 35 shareholders. (A married couple filing a joint return is counted as one shareholder.\(^4\))
- All shareholders must be U.S. citizens or residents, and they must be natural persons, estates, or certain types of trusts.\(^5\)
- The corporation may have only one class of stock outstanding. (However, different voting rights are permitted for different shares of stock.\(^6\))
- The corporation may not own 80 percent or more of the stock of any other corporation.\(^7\)

If a hospitality firm can meet the above requirements, then the S election can be made by filing Form 2553 with the IRS.\(^8\) All shareholders of the corporation must sign the election form to make the election
valid. Although a husband and wife are considered one shareholder, both of them must sign the consent form in order to be treated as one shareholder.

Once an S election has been submitted, it will be effective January 1 of the year it was filed—if it was submitted before the fifteenth day of the third month of the corporation’s taxable year. Otherwise, the election will take effect on January 1 of the next taxable year.

After a valid election has been made, it will remain in effect until revoked or terminated. An S election can only be revoked by a majority vote of shareholders. Once the election is terminated or revoked, a new election cannot be made for five years without the consent of the IRS. The IRS has ruled, however, that a corporation that revoked its S election prior to enactment of the TRA may make a new election at any time.

Due to the complicated nature of S corporations, the election may be inadvertently terminated if the eligibility requirements are violated. For example, termination could result if stock is transferred to an ineligible shareholder, such as a corporation, or if the number of shareholders exceeds 35. It might be wise for shareholders to enter into an agreement restricting the transferability of shares. This could be accomplished by simply giving the other shareholders the right of first refusal with respect to any shares that a shareholder wishes to sell or transfer.

**S Corporations Have Advantages**

There are many advantages to operating as an S corporation.

- **Avoidance of Double Tax.** Traditionally, the S corporation has been used by hospitality firms wishing to avoid the “double tax” problem of a regular corporation. Regular corporations are taxed once at the corporate level, and again at the shareholder level when income is distributed to shareholders in the form of dividends. Almost all closely-held corporations initially avoid the problem by paying any excess earnings out to the shareholder-employees in the form of additional compensation (usually year-end bonuses). However, there comes a time when the compensation may exceed the amount that can be deemed “reasonable.” Any compensation which is in excess of a reasonable amount will be treated as a constructive dividend for income tax purposes. Since a constructive dividend is a non-deductible item for income tax purposes, the “double tax” situation would apply.

Under these circumstances the S corporation can be a very valuable tool. Since the S corporation generally is not subject to any corporate taxes, it generally makes no difference whether distributions to shareholders of S corporations are characterized as compensation or dividends.

Another technique for a regular corporation in avoiding the “double tax” problem is to accumulate earnings within the corporation and thus avoid paying any dividends. This has often been an effective tool for corporations to accumulate funds in anticipation of expansion. However, Congress prevents any accumulation of excess funds by im-
position of the "accumulated earnings tax." The purpose of the tax is to penalize corporations which fail to distribute earnings not needed for the conduct of business operations. Since the S corporation passes all income and losses directly through to its shareholders, an accumulated earnings tax would never be imposed on an S corporation.

Perhaps the most important reason to consider the S corporation has to do with the downward revision of tax rates for both individuals and corporations. The TRA has lowered the maximum tax rate for most individuals to 28 percent. The real rate can go as high as 33 percent (a maximum rate of 28 percent with a 5 percent surcharge for taxable income between $71,900 and $149,250 for a joint filer and between $43,150 and $89,560 for a single filer). The maximum tax rate for corporations is 34 percent (there is a 5 percent surcharge on taxable income between $100,000 and $335,000). For the first time in over 50 years, the maximum tax rate for corporations is higher than the maximum tax rate for individuals.

Here is an example of how an S corporation can save taxes over a regular corporation:

In 1988 a restaurant business with a sole shareholder (a joint filer with four dependents) generates $300,000 in taxable income. Taxes at the regular corporate rate are $100,250 (a $22,250 tax on the first $100,000, and a tax rate of 39 percent on the remaining $200,000, using the Corporate Tax Tables for 1988). An individual's tax on the same $300,000 is $86,184 (28 percent of $300,000, plus 28 percent of $7,800 personal exemptions, using the Individual Tax Tables for 1988). Thus, if this restaurant is organized as an S corporation it saves $14,066 in taxes. (Since this example is only intended to show the tax advantages of an S corporation, it ignores the issues of itemized deductions or other income.)

However, regular corporations are subject to only a 15 percent rate on taxable income on their first $50,000, and a 25 percent rate on taxable income between $50,000 and $75,000. Therefore, the regular corporate form of doing business may result in less overall tax than the S corporation for hospitality firms which do not generate a great deal of taxable income.

On the other hand, changing to an S corporation still may be advantageous for a regular corporation even if its taxable income is small, because as a regular corporation its shareholders will be subject to an additional tax on earnings distributed as dividends at some future date.

- **Start-up companies.** Since losses are passed through to shareholders in the same manner as income, start-up hospitality firm shareholders who are active in the business can generally benefit from initial start-up losses usually incurred in new ventures. With regular corporations such losses can only be used to offset prior or future corporate income. By electing S status from the very beginning, shareholders who are active in the business are able to utilize business losses on their individual returns. (Of course, this assumes that the
shareholders have sufficient income from other sources to utilize the losses generated by the S corporation.) After the corporation becomes profitable, the new venture may wish to consider revoking the S corporation, depending on anticipated income tax liability expected from operating as a regular corporation or an S corporation.

For shareholders who do not materially participate in the business, business losses will be deemed "passive" losses that can only be offset against "passive" income (subject to a five-year phase-in rule in certain cases under the TRA). Disallowed losses are carried forward to future years and are generally allowed in full when the corporation generates income or when the S corporation is revoked. Disallowed losses are also allowed in full when the shareholder disposes of his or her stock in a taxable transaction with an unrelated party.30

- **Cash method of accounting.** Under the TRA, regular corporations with annual gross receipts in excess of $5,000,000 cannot use the cash method of accounting.31 However, this rule does not apply to S corporations.

- **Avoidance of corporate alternative minimum tax.** As part of the TRA, Congress added a new corporate alternative minimum tax to replace the old add-on minimum tax.32 This tax works similarly to the individual alternative minimum tax that has been in effect for a number of years. What makes the new corporate minimum tax so much more troublesome is the so-called "book income" adjustment. Corporations under the "book income" adjustment will now need to include in their alternative minimum tax calculation one-half of the amount by which a corporation’s book income, as shown on its financial statements, exceeds its taxable income.33 This expanded concept of minimum tax will mean that more corporations will be subject to the alternative minimum tax. An S corporation is exempt from the alternative minimum tax rules.34

- **Sale or liquidation of the business.** Under prior law, a corporation generally was not subject to tax upon sale or liquidation of all of its assets if the sale was made pursuant to a valid plan of liquidation under Section 337 of the Internal Revenue Code, the General Utilities Doctrine, which was repealed as part of the TRA.35 Now shareholders of a corporation will be subject to a double tax upon the sale of their business assets. First, the corporation will pay a tax on the difference between the sale proceeds and its basis in its assets; second, shareholders will pay a tax on the distribution of the after-tax proceeds. In the case of a liquidation, the corporation will be treated as if it had sold all of its assets at their fair market value, and a similar double tax will result.

  Shareholders of a regular corporation can avoid double taxation by structuring the sale of the business as a sale of their stock, rather than as a sale of the corporate assets. But in many cases, buyers will want a discounted stock price because purchasing stock is contrary to most buyers’ tax and non-tax objectives. Most buyers want to buy assets in order to avoid the selling corporation’s unknown and contingent liabilities and to obtain a stepped-up basis for the purchased assets.
Buying stock results in a continuation of all liabilities and a carryover basis in the assets, rather than a stepped-up basis. Losing the economic benefits of the basis step-up resulting from a stock sale increases the after-tax costs to buyers. This increased cost and the added liability risk causes buyers to lower the price they are willing to pay sellers.

S corporations are unaffected by the change in the tax treatment of sales of businesses and liquidations. This is because they generally are not subject to any corporate tax. Therefore, by electing S status from the beginning, a hospitality firm can avoid the double taxation problem upon sale and liquidation of the firm's assets.

There are certain restrictions placed by the TRA to limit the benefits that a regular corporation can obtain from switching to an S corporation. A "built-in" gain tax is imposed on any gain that arose prior to the effective date of S status that is recognized by the S corporation within 10 years thereafter by reason of a sale or distribution of its assets. The amount of "built-in" gain subject to this tax is equal to the difference between the fair market value of the assets of the corporation on the date that the S election became effective, and the corporation's basis in such assets.

The highest corporate tax rate is assessed on built-in gain. The extent of built-in gain subject to tax is limited to the amount of taxable income of the corporation during the taxable year in which the sale or liquidation of assets takes place. Accordingly, losses from other transactions during the year may diminish the amount of any gain. The gain also may be reduced by any net operating losses carried forward that were incurred by the corporation prior to the effective date of its S election.

There is a presumption under TRA that gains realized by an S corporation on a sale or distribution of assets are built-in gains, and the burden is on the corporate taxpayer to establish that such gains are not subject to tax or that the amount subject to tax is limited. The hospitality firm will have to prove that either some or all of the assets sold or distributed were acquired after the effective date of the S election, or that the gain exceeds the difference that existed on the effective date of the S election between the fair market value of the corporation's assets and its basis in such assets. Therefore, any hospitality firm contemplating a switch from a regular corporation to an S corporation should give serious consideration to obtaining appraisals of assets as of the effective date of the S election.

Congress has provided some transition relief in the next two calendar years for certain qualified corporations which elect S status. There is a small business exception for "qualified corporations" which elect to be S corporations before January 1, 1989. A "qualified corporation" is defined as any corporation having more than 50 percent (by value) of its stock held by ten or fewer qualified persons and having an applicable value of not more than $10 million (the upper end of the phase-out range) on August 1, 1986, and at all times after that date. The applicable value of a qualified corporation that becomes an S corporation is the greater of the fair market value of all assets.
of the stock of the corporation on either the date a valid S election is made or August 1, 1986.45

Therefore, if a regular corporation elects S status before January 1, 1989, it may be afforded relief from the repeal of the General Utilities Doctrine. The transition rule will apply in full if the corporation’s value on either August 1, 1986, or the date of its S election is not in excess of $5 million. For companies valued between $5 million and $10 million, the transition rules are scaled back pro rata. If stock value exceeds $10 million, then the transition rules do not apply.

However, even if an S corporation can meet the transitional rules, the IRS has stated that built-in gain tax will apply to recognized built-in gains arising out of the sale or disposition of items of ordinary income property, capital assets held for not more than six months; and certain installment obligations.46 Also, S corporations would pay tax on gains that arose under sale of capital assets under the old S corporation rules (generally only those assets which are held by the S corporation for less than three years).47

This rule can be illustrated by the following example:

The Sky Hotel is an S corporation converted from a qualified C corporation before January 1, 1989. All of the stock is held by an individual taxpayer and his wife. The applicable value of the Sky Hotel is $3 million. Any gains realized on the sale of assets or from liquidation are 100 percent excluded from built-in gains since the applicable value of the corporation does not exceed $5 million.

- **Pass-through of “passive income.”** The TRA limits most taxpayers from using losses and deductions from “passive activities” to offset either active business income or “portfolio income” (such as dividends, interest, and royalties).48 An activity is considered “passive” if it involves the conduct of a trade or business and the taxpayer does not “materially participate” in such activity.49

All income earned by an S corporation will flow through to the shareholders and its character will be determined in the hands of the individual shareholder.50 Therefore, active business income or loss on an S corporation can be considered passive income in the hands of a shareholder who does not actively participate in the business.51 For shareholders who do not materially participate in the business, income from an S corporation can be used to offset passive activity losses (tax shelter losses, for example) which might otherwise be non-deductible.

The question of what constitutes “material” participation will depend on the facts and circumstances. Generally, taxpayers are treated as materially participating in an activity only if the taxpayer is personally involved in the operations of the activity on a basis which is “regular, continuous, and substantial.”52

- **Income splitting.** One of the important uses of an S corporation is the ability to shift income within the family unit to take advantage of the marginal tax brackets of different family members. This is usually accomplished by giving minority interest in the S corporation to family members.
members (usually children of the principal shareholders). In the S corporation, there is no problem with treating family members as shareholders of the corporation. However, the IRS has authority to reallocate income for failure to reasonably compensate shareholders (or their family members) for services or capital provided to the corporation.  

- **Distribute earnings to unpaid shareholders.** Electing S status may be appropriate when profits are expected and at least one of the important shareholders cannot withdraw part of the profits as compensation because he or she is not an employee of the corporation.

  For example, the non-employee shareholder may be an investor or an inactive family member. Where the objective is to share business earnings immediately with the shareholder, the corporation can either pay dividends or elect S status. Paying dividends is usually undesirable because of the double tax effect. Electing S status may be a suitable way for the inactive shareholder to withdraw earnings without the corporation being taxed.

**S Corporations Also Have Disadvantages**

There are also some disadvantages to operating as an S corporation.

- **Limitations in electing S status.** The limitation of an S corporation of 35 shareholders may limit the corporation's future ability to acquire equity financing. Also, there are limits as to who may own stock in an S corporation. A corporation will be ineligible to file an S election if any of its stock is owned by a partnership, by another corporation, or by any trust other than one of the specifically designated trusts.

  It is very important to remember that among the trusts which are not eligible are trusts adopted to administer tax-qualified retirement plans. This has the effect of preventing the S corporation from establishing an employee stock ownership plan (ESOP).

  Another requirement of the S corporation is that it not have more than one class of stock. However, differences in voting rights among shares of common stock are permitted. This one-class-of-stock requirement does not permit the S corporation from utilizing preferred stock in recapitalization with the aim of freezing the value of older shareholders' interests in the hospitality corporation so as to shift to the younger shareholders the benefits of future appreciation in the value of the corporation.

- **Fringe benefits.** The shareholder-employee of a regular corporation may receive tax-favored fringe benefits, such as medical expense reimbursement, disability insurance, and group-term life insurance, whereas an S corporation shareholder-employee (an employee or officer of an S corporation who owns more than 5 percent of the outstanding stock) generally may not. In addition, a shareholder-employee in a regular corporation that maintains a qualified pension or profit-sharing plan may borrow from the plan if it has a loan provision; the shareholder-employee of an S corporation may not. Regular corporations may use a variety of techniques to defer income to its shareholder-employees. This
may be especially valuable because individual tax rates are generally going down. S corporations are denied the deferral provisions available to a regular corporation.

- **Fiscal year of S corporations.** The IRS now requires the taxable year of an S corporation to be the calendar year, unless the corporation establishes a business purpose to the satisfaction of the Secretary of the Treasury for using a different fiscal year. The "grandfathering" provision of prior law that protected the fiscal year elections of S corporations for taxable years that included December 31, 1982, has been repealed. The code now specifically provides that the deferral of income to stockholders for a limited period of time shall not be treated as a business purpose.

The required change to a calendar year for many S corporations that could not justify a permitted fiscal year will accelerate taxable income into a short period beginning on the first day of the current fiscal tax year and ending with the calendar year end. However, a transitional rule is provided for existing S corporations which are required to change their fiscal year. The shareholders of such an S corporation may include items of income from the short year of the corporation in each of the first four taxable years beginning after December 31, 1986. However, this rule applies to income from an S corporation only if it was S corporation for a taxable year beginning in 1986.

In order for an S corporation to adopt a fiscal year other than a calendar year end, it must submit a request to the Secretary of the Treasury. Such a request will be approved only if the tax year adopted or retained coincides with the S corporation's natural business year. To qualify as a natural business year, the gross receipts earned in the last two months of the requested year must be 25 percent or more of annual gross receipts for each of the three previous years of the business.

- **Basis limitations.** Shareholders may deduct their pro rata share of an S corporation's losses and deductions on a per-share, per-day basis, but only to the extent of the total of their adjusted basis in the S corporation's stock and the adjusted basis in any indebtedness of the S corporation to them. Losses and deductions must be applied first to reduce stock basis; amounts exceeding stock basis are then applied to reduce debt basis. A shareholder is limited for loss allocation purposes to the adjusted basis of stock in the corporation, increased by the adjusted basis of direct loans advanced to the S corporation by the particular shareholder (A shareholder's guarantee of third-party debt normally does not increase the shareholder's debt). Restoration of basis is then applied first to the shareholder's post-1982 indebtedness and then to stock basis. If a debt is repaid before the debt basis is restored, the shareholder has a gain. The gain is treated as ordinary income if the debt is an open account. However, gain on debt evidenced by a bond or note is capital gain.

In light of the substantial tax benefits that can be obtained by operating a hospitality business as an S corporation, corporations with 35 or fewer shareholders (or which can reduce the number of their
shareholders to 35) should consider making an S election. It will be a rare case where the election will not prove to be desirable. If possible, the election should be made prior to January 1, 1989, so as to avoid the new tax on “built-in” gains. Also, corporations which are not currently eligible to make an S election should consider taking whatever steps are necessary to satisfy the eligibility requirements. Keep in mind, however, that the tax changes imposed by the TRA are very complex. Hospitality firms should examine their unique situations closely with the help of a tax professional in order to determine if the S corporate entity is best for them.
References

2Subtitle A, Chapter 1, Subchapter S of the Internal Revenue Code.
3IRC Secs. 1363 and 1366.
4IRC Sec. 1361(b)(1)(A), (c)(1).
5IRC Sec. 1361(b)(1)(B) and (C). In some situations, a corporation or a partnership may hold stock as a nominee for an individual without affecting the corporation’s S status. Reg. #1.1371-1(d)(1), adopted under former Section 1371.
6IRC Sec. 1361(b)(1)(D). Although different shares of stock may carry different voting rights, they must have the same economic rights. Therefore, an S corporation may have no issued and outstanding preferred stock.
7IRC Sec. 1361(b)(2)(A).
9IRC Sec. 1362(a)(2); Temp. Reg. #18.1362-2(b).
10John M. Seely, TC Memo 1986-216.
11IRC Sec. 1362(b)(2).
12IRC Sec. 1362(b)(3).
13IRC Sec. 1362(d).
14IRC Sec. 1362(d)(1)(B).
15IRC Sec. 1362(g).
17IRC Sec. 1362(d)(2).
19IRC Secs. 61, 301.
20Distributions to shareholders who are not employees of the corporation will not constitute deductible salary payments; when received by the shareholders, such distributions are included in ordinary income as dividends under Section 301.
21IRC Sec. 162(a).
23IRC Sec. 531.
24IRC Sec. 1363.
25IRC Sec. 1(g).
26IRC Sec. 11(b).
27id.
28IRC Sec. 1366(a)(1).
29IRC Sec. 172(b).
30IRC Sec. 469.
31IRC 448.
32IRC 57.
33IRC 56(c)(1).
34IRC Sec. 1366. However, an S corporation shareholder may be subject to the individual alternative, minimum tax as a result of the pass-through of the corporation’s items of tax preference. See Reg. #1.58-4(a).
35IRC Sec. 336.
36If the corporation formerly was a regular corporation, it might be subject to tax under the built-in gain rules of new Section 1374 or under the three-year capital gain “lookback” rule of old Section 1374.
37IRC Sec. 1374.
38IRC Sec. 1374(d)(1).
39IRC Sec. 1374(b)(1).
40IRC Sec. 1374(b)(1)(B).
41IRC Sec. 1374(b)(2).
42IRC Sec. 1374(d)(2).
44Tax Reform Act of 1986, Sec. 633(d).
46Old Sec. 1374. The corporation may be subject to tax under the three-year capital gain “lookback” rule of old Section 1374.
46IRC Sec. 469.
46IRC Sec. 469(a)(1), 469(d).
46IRC Sec. 1366(b).
46Conference Report at II-147.
46IRC Sec. 469(b)(1).
46IRC Sec. 1366(e).
46IRC Sec. 1361(b)(1)(A).
46IRC Sec. 1361(b)(1).
46IRC Sec. 1361(b)(1)(D).
46IRC Sec. 1361(c)(4).
46IRC Sec. 1372(a).
46IRC Sec. 4975(e)(1)(B).
46IRC Sec. 1378.
46IRC Sec. 1378(b).
46IRC Sec. 1378(b).
46IRC Sec. 1366(a) and (d)(1).
46IRC Sec. 1367.
46IRC Sec. 1366(d).
46IRC Sec. 1367(b)(2).