

S corporation passive income tax

Dear Reader:

You've told me that you are currently considering whether to convert your C corporation to an S corporation. You should be aware that if your corporation has any "earnings and profits," then, even if it elects S corporation status, it may be subject to a *corporate-level* tax on its passive investment income.

This tax would apply in any year the S corporation's passive investment income exceeds 25% of its gross receipts. If that happens, the net passive income (after applicable deductions) that exceeds 25% of gross receipts is taxed at the highest corporate tax rate (currently 35%). Thus, a corporation that has (for the sake of simplicity) \$100,000 of passive investment income and no other income or deductions would pay a tax of \$26,250, i.e., 35% of \$75,000 (the excess of \$100,000 gross receipts over 25% of \$100,000).

The tax does reduce the amount of income passed through by the S corporation to the shareholders. Thus, in the above example, the S corporation would pass through income of only \$73,750 (\$100,000 minus the \$26,250 of tax), rather than \$100,000. However, there would still be double taxation, since a tax was imposed at the corporate level. In addition, if the tax applies for three consecutive years, the corporation's S corporation election will terminate.

"Earnings and profits" defined. Since even the smallest amount of accumulated earnings and profits from C corporation years will subject an S corporation to a potential passive investment income tax, it's important to know (a) whether the corporation has any accumulated earnings and profits, and (b), if so, exactly how much the corporation has (because the corporation can eliminate its tax risk completely by distributing all the earnings and profits, see below). You can think of accumulated earnings and profits, generally, as any net income, from any year of the corporation's existence, that hasn't been distributed by the corporation. We can help you determine just what your earnings and profits are for tax purposes (and therefore how much the corporation would have to distribute in order to eliminate its accumulated earnings and profits from C corporation years).

Passive investment income and gross receipts defined. These are also defined by the tax Code and don't necessarily mean what they do for normal business purposes. Passive investment income generally includes items, such as dividends, interest, rents, and royalties. (For tax years beginning before May 26, 2007, passive investment income also includes stock gains.) However, there are exceptions for royalties and rents derived from an active trade or business. Passive investment income does not include dividends received from an 80%-or-more owned C corporation subsidiary when those dividends are generated by the C corporation's active conduct of a trade or business. Gross receipts generally includes all amounts realized by the corporation, without reduction for cost of goods sold, returns, allowances, or other deductions.

Avoiding the tax. You can avoid the tax by either (1) eliminating the accumulated earnings and profits from C corporation years, or (2) limiting the corporation's passive investment income to 25% of its gross receipts.

Specifically, you can avoid *any* risk of the tax by having the corporation make an actual or deemed distribution of its accumulated earnings and profits from C corporation years before the end of the first S corporation tax year. However, the distribution would be

taxed to the recipients as ordinary income. You should consider making a distribution if the amount of the accumulated earnings and profits from C corporation years is small. However, if a distribution would mean too much tax to the shareholders, you can still elect S corporation status and avoid the passive investment income tax as long as the passive income the corporation generates doesn't exceed 25% of its gross receipts. If you decide to elect S status, but not to distribute the corporation's accumulated earnings and profits from C corporation years, you would have to carefully watch the corporation's future income to be sure that it doesn't exceed the 25%-of-gross-receipts threshold. We can work with you to develop strategies to reduce the passive investment income and/or increase the corporation's nonpassive income.

