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TAX AND BUSINESS Alert™

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Reevaluate Shareholder Loans

With all the angst about the economy, high gasoline prices, and the lousy real estate environment, you may not have noticed that most interest rates are near historically low levels. This includes the IRS-approved applicable federal rates (AFRs). In the context of loans from corporations to their shareholders, this is favorable news. Here's why: When a corporation makes a loan to a shareholder, the complicated below-market interest rules apply unless (a) the loan charges an adequate rate of interest (determined by comparison with the applicable AFR) or (b) all loans between the corporation and the shareholder aggregate to the *de minimis* amount of $10,000 or less. This is extremely important because the IRS can impute additional interest on a loan when the interest rate is below the AFR and then characterize that additional interest as either taxable compensation or a taxable, but nondeductible, dividend.

For the below-market interest rules, *adequate rate of interest* means a rate equal to or higher than the AFR. In other words, when the corporation charges at least the AFR on a shareholder loan, the nasty below-market interest rules are avoided. So, this is usually the tax-smart way to go.


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Since the current AFRs are low, now is a great time to take a fresh look at the idea of making additional low-interest loans from corporations to shareholders, replacing existing higher-interest shareholder loans with new ones that charge lower rates, or converting demand loans to term loans to lock in the low rates.

Once the AFR is determined, it continues to apply over the life of the loan, regardless of how interest rates may fluctuate. The exception is for a demand loan where the AFR is *not* fixed at the time the loan is made. Instead, the AFR is calculated using an annual blended rate that takes monthly AFR changes into account. Since demand loans don't lock in today's low AFRs, term loans are generally preferred—unless you believe future AFRs will be even lower.

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Increased IRS Mileage Rates

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The IRS has increased the optional standard mileage rates for the six-month period from July 1, 2008, through December 31, 2008. Although the IRS normally updates the mileage rates once a year (in the fall for the following calendar year), the IRS made this special adjustment in recognition of the recent run-up in gasoline prices. Taxpayers can use the increased standard rates to figure the deductible costs of operating an auto for business, medical, or moving purposes.

"Rising gas prices are having a major impact on individual Americans. Given the increase in prices, the IRS is adjusting the standard mileage rates to better reflect the real cost of operating an automobile," said IRS Commissioner Doug Shulman. "We want the reimbursement rate to be fair to taxpayers."

The rate will increase to 58.5¢ per mile for all business miles driven from July 1, 2008, through December 31, 2008. This is an increase of eight cents per mile from the 50.5¢ rate in effect for the first six months of 2008. The rate for computing deductible medical or moving expenses will also increase by eight cents per mile to 27¢ per mile, up from 19¢ per mile for the first six months of 2008. The rate for providing services for charitable organizations is set by statute, not the IRS, so that rate remains at 14¢ per mile.

Filing Requirements for Nonprofits Have Changed

If you serve on a nonprofit organization's board of directors, you should be aware of a recent law change that could put the organization's tax-exempt status at risk. Prior to this change, most exempt organizations, other than churches and their affiliated entities, were required to file an annual return with the IRS. However, entities whose average gross receipts are no more than $25,000 annually have traditionally been exempt from this requirement. Beginning in 2008, that's no longer true.

Small tax-exempt organizations must now electronically file Form 990-N with the IRS. This new form must be completed by organizations that are exempt from filing the more complex annual returns because their gross income is below the filing threshold for these returns.

Although the Form 990-N is relatively easy to file, organizations that fail to file it for three consecutive years will lose their tax-exempt status. The only way to regain a tax exemption at that point will be to reapply to the IRS—obviously a costly and time-consuming process.

The deadline for filing Form 990-N is the 15th day of the fifth month after an organization's year-end. Thus, for organizations using a calendar-year, the deadline for reporting 2007 information has already passed. However, there are no penalties for filing late, as long as the organization does not miss three years in a row and jeopardize its exemption. Nonetheless, it's important to set up procedures within the organization to make sure the Form 990-N is filed annually as each year's accounting is concluded. In addition, it is now more critical than ever to adequately record the organization's gross receipts to determine whether it is eligible to file Form 990-N or if a more robust form must be filed.

Funding Education Costs

The ability of high-income parents to use a child's lower tax rate to report significant income at a low tax cost is often referred to as the tax capacity of the child. A number of strategies exist for the efficient use of a child's tax capacity for college funding. These strategies differ depending on the method the parents choose to fund higher education expenses for their child.

For a student who is unlikely to qualify for financial aid, Education Savings Accounts (ESAs), 529 Plans, and assets positioned in the name of the child should all be incorporated as part of an effective college funding strategy. Taxpayers should first address the question of whether the use of an ESA, also known as a Coverdell, might provide benefit. One of the primary advantages of ESAs is that tax-free withdrawals can be taken from these accounts for K-12 education, whereas tax-free withdrawals from 529 Plans are limited to postsecondary educational institutions.

Higher income families generally do not have the availability of need-based college financial aid. If need-based financial aid is unlikely, the parents should consider strategies using the child's tax capacity to build income or recognize tax-advantaged asset-based gains that use the child's tax return to fund higher education costs. For example, a younger child claimed as a dependent without earned income will have a $900 standard deduction with which to offset investment income and capital gains.

A child is not allowed to claim himself/herself as a dependent if the child is eligible to be claimed on the tax return of another. However, for many higher income parents, the child's $3,500 (for 2008) dependency exemption provides little or no tax savings, due to the phase-out that occurs at upper income levels. If assets owned by the child (presumably acquired from prior gifts) are used to fund college educational costs that represent more than half of the child's support, the child is not eligible to be claimed as a dependent by the parents, but rather would claim his or her own dependency exemption. This favorable scenario allows the child to use his or her $3,500 dependency exemption, which was disallowed for the parents, to shelter $3,500 from taxation; a nice tax break.

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The Hope and Lifetime Learning credit regulations provide an elective opportunity for parents eligible to claim a child as a dependent. The parents may electively decline to claim the dependency exemption of the child, in which case the child becomes eligible to claim either the Hope or Lifetime Learning credit within the child's tax return. While the child gains the advantage of the $1,800 (for 2008) Hope or $2,000 (for 2008) Lifetime Learning credit as a result of this election, the child probably cannot claim his or her own personal exemption due to the child's ineligibility (i.e., the child is still eligible to be claimed by the parents, even though they elect not to claim him or her).

The ability to effectively use a child's tax capacity can result in a significant amount of money saved to pay for a college education. Please call us if we can answer questions on this innovative tax-saving technique and to ensure you are taking advantage of every available tax-saving opportunity.

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This topic might seem rather technical and complicated, but a little time and effort now will help avoid future problems, particularly with the IRS. Please call us to discuss shareholder loans, current AFRs, and the consequences of making below-market interest rate loans.

S Corporation Subsidiaries

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Many taxpayers are aware of the more common advantages of S corporation ownership, which include avoiding the double taxation of income; passing through losses, deductions, and credits of the corporation to the shareholders to be used on their personal returns; facilitating shareholder deduction of investment interest expense; and shifting income to other members of the family to reduce taxes, among others. But, S corporations also have a great deal of flexibility in structuring their corporate holdings. Opportunities currently exist for an S corporation to hold stock in other corporations, but not the stock of other S corporations.

S corporations can own up to 100% of the stock in another corporation, and ownership of 80% or more of the stock of another corporation establishes an affiliated group relationship. Thus, S corporations may have 80%-or-more-owned regular C corporation subsidiaries. These C corporation subsidiaries are allowed to file a consolidated return with any other C corporations they are affiliated with. However, the parent S corporation cannot be included in this return. In summary, S corporations can own and operate one or more chains of subsidiary C corporations or brother/sister C corporations, but cannot join in the filing of a consolidated return.

S corporations can receive tax-saving benefits from C corporation ownership. First, S corporations are subject to additional taxes or loss of their S status if passive investment income (e.g., dividends and interest) exceeds specific limits. However, dividends received from 80%-or-more-owned C corporation subsidiaries are generally exempt from this restriction. Next, S corporations may be subject to the built-in gains tax from asset sales, but the built-in gains tax would not apply to assets held by a subsidiary C corporation. Finally, for multi-state S corporations, there may be state tax planning advantages to C corporation ownership.

Because an S corporation cannot have a corporate shareholder, subsidiary corporations cannot be treated as S corporations. However, an S corporation can have one or more Qualified Subchapter S Subsidiaries (QSubs) if it owns 100% of the subsidiary corporation and makes the required election. A QSub is not treated as a separate corporation. Instead, its assets, liabilities, income, deductions, etc., are treated as those of the parent S corporation. Benefits of QSub ownership include the flow-through of tax benefits to the S corporation shareholders and avoiding double taxation, first at the corporate level, and then at the taxpayer level.

As you are probably aware by now, the tax consequences of dealing with S corporation subsidiaries can be complex, but the commensurate benefits may very well be worth the effort. If you are interested in exploring the benefits of these opportunities further, please contact us to discuss the options.

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