



S Corporations

Tax and Business Update

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Considering S Status

An S election means that a corporation has chosen a special set of tax rules. It has no effect on the corporation for any other purposes (for example, liability protection under state law). Thus, S status lets business owners combine the legal and economic benefits of a corporation with favorable taxation as a pass-through entity. However, there are potential drawbacks to S status and situations where not electing S status (that is, remaining a C corporation) is more beneficial.

Observation: To be an S corporation, the taxpayer must make an affirmative S election. Also, it may help to note that the terms "S corporation" and "S election" come from the fact that the rules for S corporations are found in Chapter 1, Subchapter S of the Internal Revenue Code—thus, the use of "S" when referring to this type of corporation.

Distributions

How S Corporation Distributions Are Taxed	
Corporation Has No AE&P ¹	Corporation Has AE&P
<ul style="list-style-type: none">Distributions up to the shareholder's stock basis = nontaxable return of basis.Distributions in excess of basis = capital gain.	<ul style="list-style-type: none">Distributions come first from AAA.²<ul style="list-style-type: none">Tax-free up to the shareholder's stock basis.Distributions from AAA over the stock basis = capital gain.Next, distributions from AE&P = taxable dividend.After AAA and AE&P are gone, distributions are tax-free up to remaining stock basis, then capital gain.

¹ AE&P = accumulated earnings and profits from a C corporation year.

² AAA = undistributed S corporation income that has been taxed to the shareholders.

S Election Considerations

When an S election can be advantageous:

- New business expected to incur start-up losses, which will be passed through to the shareholders.
- A profitable, cash-rich corporation that can distribute enough cash to shareholders to pay the income tax on the pass-through income.
- An established corporation in a mature industry that accumulates earnings even when substantial dividends are paid can avoid double taxation on distributions and is not exposed to the corporate-level accumulated earnings tax.

Situations where S election may not be advantageous:

- Rapidly growing corporation in a competitive market that will use cash to fund growth. Then, the corporation may be unable to distribute enough cash to shareholders to pay their tax on the S corporation income.
- Most of the corporation's shareholders are employees. Common fringe benefits provided to owner/employees that are otherwise tax-free will be taxable if the corporation elects S status.
- One class of stock rule limits corporation's ability to raise capital.
- Corporate income is expected to be less than \$100,000. Here, taxing the income at the graduated corporate rates may result in less tax than taxing it at the shareholder's rates, especially if the corporation doesn't intend to make significant shareholder distributions.

Qualification

Qualifying for S Status	
No more than 100 shareholders at any time during the tax year	<ul style="list-style-type: none"> Husband and wife counted as one, except in certain cases of divorce. Certain family members are treated as one shareholder. Tenants in common or joint tenants counted separately. Trust beneficiaries counted as shareholders if trust owns the stock.
Only one class of stock permitted	<ul style="list-style-type: none"> Differences in voting rights only are OK. No preferential rights allowed for distributions or liquidation proceeds. Holders of restricted stock generally not considered unless shareholder has elected to include value of stock in income. Buy/sell agreements don't create a second class of stock unless the sales price is substantially different than stock's fair market value (FMV) at creation date AND a principal purpose of the agreement is avoiding the one-class-of-stock rule. However, agreements to buy stock at a shareholder's death, disability, divorce or termination never create a second class of stock. Debt must be real debt, not disguised equity.
Eligible shareholders	<ul style="list-style-type: none"> Individuals who are U.S. citizens or resident aliens. Estates. Certain types of trusts.

Notes



Family Member Shareholders

All family members (and their estates) are treated as one shareholder for purposes of determining the number of shareholders in an S corporation.

Family members include:

- A common ancestor (whether or not alive) and that ancestor's lineal descendants (up to six generations), as well as the ancestor's and descendants' spouses and former spouses.
- Observation:** The six-generation limit does not provide much hindrance to counting family members as one shareholder because the first generation to be excluded would be a great-great-great-grandparent of a shareholder in the youngest generation.
- A husband and wife (including divorced spouses who are family members).
- The estate of a deceased family member when the estate or a testamentary trust holds stock in the S corporation.
- Beneficiaries of certain trusts owning the S corporation stock when the beneficiaries are family members.
- The owner of a disregarded entity, such as a single-member LLC, if the owner is a family member.

Caution: Treating separate shareholders as one applies only when determining if the corporation has exceeded the allowable number of shareholders. Shareholders are treated separately for other purposes, such as the pass-through of the S corporation's items of income, gain, loss or deduction. Furthermore, if a corporation is making the S election, each person holding shares must separately consent to the S election.

Observation: The family member rule greatly expands the number of actual shareholders an S corporation is permitted to have. For example, if 20 members of 50 different families held stock in an S corporation, the actual number of shareholders would be 1,000, but for purposes of the number of shareholders test, there would be only 50 shareholders.

The information contained in this handout was not intended or written to be used and cannot be used for the purpose of (1) avoiding tax-related penalties prescribed by the Internal Revenue Code or (2) promoting or marketing any tax-related matter addressed herein.

The handout is designed to provide accurate information regarding the subject matter covered. However, before completing any significant transactions based on the information contained herein, please contact us for advice on how the information applies in your specific situation.

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