DOES THE "S" IN S CORPORATION STAND FOR "SUPERSCARY"?

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I. BASICS

A. Pass-through treatment.

1. S corporations are corporations that elect to pass corporate income, losses, deductions, and credits to their shareholders for federal tax purposes.

B. No tax at corporate level.

1. C corporation business income is generally taxed twice – once at the corporate level and again at the shareholder level.

2. S corporation business income generally is not taxed at the corporate level. Instead, shareholders report pass-through income on their personal income tax returns. This avoids double taxation.

C. Liability protection.

1. S corporation shareholders, like C corporation shareholders, generally are not personally liable for debts and liabilities of the corporation.

D. Creation of federal tax law.

1. "S" is an elected federal tax status.

2. Otherwise, it is a for-profit corporation, incorporated under and governed by state law in the same manner as C corporations.

II. REQUIREMENTS

A. Domestic corporation.

1. The corporation must be incorporated in one of the 50 states.

B. Number of shareholders.

1. Cannot have more than 100 shareholders.

2. The S corporation shareholder limit applies to the number of persons who are shareholders at the same time. Thus, more than 100 persons may be shareholders during the taxable year as long as there are not more than 100 shareholders at any point during the year.

3. Special rules apply to family members and trusts as shareholders.

C. Permitted shareholders.

1. Individuals.

2. Grantor trusts.

a. These are trusts all of which are deemed owned by a U.S. person.

b. See Sections 671 through 678 of the Internal Revenue Code.

c. A revocable trust is a grantor trust and eligible S corporation shareholder. However, once the grantor dies, there are limits on the trust's continuing eligibility as an S corporation shareholder (see further discussion below).

3. Qualified Subchapter S Trusts (QSSTs).

a. Requirements:

i. All income must be distributed (or must be required to be distributed) to one individual who is a U.S. citizen or resident.

ii. Only one current income beneficiary.

iii. Any corpus distributed must be distributed to the current income beneficiary.

iv. The current income beneficiary's income interest must terminate on the earlier of termination of the trust or the death of that income beneficiary.

v. Upon trust termination during the life of the current income beneficiary all corpus and income must be distributed to that beneficiary.

b. Election.

i. Must contain the information and representations provided in Treasury Regulation Section 1.1361-1(j)(6)(ii).

ii. Signed by the current income beneficiary.

iii. The income beneficiary must elect within the two-month-and-sixteen-day window that opens on the day the trust acquires the stock, failing which the S corporation loses its S status as of the date on which the trust acquired the S stock (although late election relief may be available).

iv. A separate election must be made with respect to each corporation the stock of which is held by the trust.

v. Once made, the election is irrevocable.

4. Electing Small Business Trusts or ESBTs.

a. Requirements:

i. Beneficiaries must be individuals, estates, or charitable organizations.

ii. No interest in the trust may have been acquired by purchase.

iii. Unlike a QSST, an ESBT need not be limited to a single current income beneficiary, nor must it make annual distributions of income.

b. Election.

i. Must contain the information and representations provided in Treasury Regulation Section 1.1361-1(m)(2)(ii).

ii. Signed by the trustee.

iii. The trustee must elect within the two-month-and-sixteen-day window that opens on the day the trust acquires the stock, failing which the S corporation loses its S status as of the date on which the trust acquired the S stock (although late election relief may be available).

iv. A separate election generally need not be made with respect to each corporation the stock of which is held by the trust.

v. Once made, the election can be revoked only with the consent of the Commissioner.

5. Estates.

a. The term includes a decedent’s estate, a revocable trust treated as part of decedent’s estate under Section 645 of the Internal Revenue Code, and the estate of an individual in bankruptcy.

b. The term does not include the estate of a minor or an incompetent person.

c. Unduly prolonging the administration of a decedent's estate may cause the estate to become a trust for federal tax purposes (in which case the trust will need to qualify as an eligible shareholder).

D. Prohibited shareholders.

1. Corporations (except in the case of Qualified Subchapter S Subsidiaries).

2. Partnerships.

3. Nonresident aliens.

E. Single class of stock.

1. Special allocations not permitted.

2. Distribution preferences not permitted.

3. However, voting and nonvoting stock is permitted.

F. S corporation election.

1. All shareholders must consent to election.

2. An election may be made during the tax year for which it is to be effective if made on or before the 15th day of the third month of that tax year.

3. An election may be made at any time during the tax year preceding the tax year for which it is to be effective.

4. Relief may be available for late or nonexistent elections.

5. An election is effective for the first taxable year for which it is made and for all succeeding years until it is terminated by revocation or otherwise.

G. Ineligible corporations.

1. Certain financial institutions like banks and credit unions.

2. Insurance companies.

3. Domestic international sales corporations.

III. TERMINATION

A. Termination events.

1. An election may be terminated by revocation if shareholders holding more than one-half of the shares of stock of the corporation on the day on which the revocation is made consent to the revocation.

2. An election will be automatically terminated whenever the corporation ceases to be a small business corporation (i.e., fails one of the requirements above). For example, the corporation makes disproportionate distributions, thereby creating a second class of stock, or stock in the corporation is transferred to an ineligible shareholder.

3. An election will be automatically terminated where passive investment income exceeds 25% of gross receipts for three consecutive taxable years and the corporation has accumulated earnings and profits.

B. Tax consequences.

1. If the election is revoked or terminated, the election terminates as of the day the revocation or termination is effective. The corporation is an S corporation through the day before the effective date of the revocation or termination and is a C corporation on and after that effective date.

2. If the effective date is other than the first day of the corporation's taxable year, the taxable year is split into an S short year beginning on the first day of the taxable year and ending on the day before the effective date, and a C short year

beginning on the effective date and ending on the last day of the taxable year.

3. The corporation allocates items of income, gain, loss, deduction, and credit between the S short year and the C short year on a daily, pro rata basis. Alternatively, the corporation may override the general principle of proration and elect to close its books on the day before the S election termination date.

C. Relief.

1. If termination can be shown to be inadvertent, the IRS may grant relief.

2. Steps must be taken within a reasonable period to correct the condition that caused the corporation to cease to be an eligible S corporation.

3. The corporation and persons who were shareholders during the period of the termination must agree to make any adjustments the IRS requires that are consistent with the treatment of the corporation as an S corporation.

D. No re-election for five years.

1. Once a corporation's status as an S corporation terminates, the corporation generally may not re-elect under subchapter S until the fifth taxable year after the year of termination, unless the IRS consents.

IV. SUCCESSION PLANNING

A. Shareholder agreements.

1. Avoid inadvertent terminations!

2. Shareholder agreements typically contain “defensive S provisions” and agreements to join in corrective action to cure inadvertent terminations of the S election.

3. There are often prohibitions against transfers of stock to an ineligible shareholder or otherwise outside of family circles.

4. The shareholders should consider mandatory or permissive buyouts on death, disability, or termination of employment. These can be structured as redemption (the corporation buys the shares) or cross purchase (the other shareholders buy the shares). In order to provide liquidity for a purchase, buyouts can be funded with life and disability buyout insurance.

5. Shareholders are taxed on their proportionate share of the corporation’s taxable income, even if no distributions are made. Shareholder agreements often require the corporation to make minimum annual distributions to shareholders to enable them to pay tax on their share of the corporation’s taxable income. However, care needs to be taken to ensure distributions are not disproportionate.

B. Gifts.

1. Freeze.

a. Make current gift of stock to family members.

b. This “freezes” the value of the stock as of the date of the gift and removes all future appreciation from the stockholder’s estate.

c. If the gift is made to an irrevocable trust, be sure the trust qualifies as an eligible S corporation shareholder (e.g., grantor trust, QSST, or ESBT).

2. Income shifting.

a. Gifts of stock can result in the shifting of income to taxpayers with lower marginal rates.

3. Nonvoting stock may be used.

a. Recapitalizing the stock between voting and nonvoting does not violate the prohibition against having a second class of stock.

b. This prevents children from having a voice in corporate operations, including distributions.

c. Be careful not to have any differences in beneficial interests other than voting.

4. Loss of step up in basis.

a. Any gifting strategy should take into consideration the loss of the step up in basis that would have occurred had the donor retained the stock.

C. Active versus inactive children.

1. Distrust and resentment can develop between the children who are active in the business and the children who are inactive.

2. Problems can also arise between active children, including where one child is given more stock than the other or one is the clear “heir apparent.”

V. <u>POST-MORTEM PLANNING</u>

A. Stock owned by estate.

1. As noted above, a decedent’s estate is an eligible S corporation shareholder (but not in perpetuity).

B. Stock owned by formerly revocable trust.

1. After the death of the grantor of a revocable trust, the trust may continue to be an S corporation shareholder for a two-year period beginning on the day of the deemed owner's death (unless the trust continues otherwise to qualify as an S corporation shareholder).

2. Thereafter, unless the stock is distributed to an individual beneficiary, the trust will otherwise need to qualify as an S corporation shareholder and an appropriate election will need to be made.

a. QSST. A qualified terminable interest (QTIP) trust ordinarily will meet the requirements of a QSST.

b. ESBT. This is more flexible than a QSST (you can have multiple beneficiaries and the trust is not required to distribute all income), although the S corporation portion of an ESBT’s income is subject to the highest rate of income tax on ordinary income, regardless of whether the income is distributed.

C. 645 election.

1. An Internal Revenue Code Section 645 election creates a federal income tax fiction that the assets of a decedent’s revocable trust are deemed owned by the decedent’s estate, even if there is no probate estate.

2. Part of that fiction is that the stock is deemed owned by the “estate” during the 645 election period (typically two years).

3. Another part of that fiction is that the stock, if not previously transferred, is deemed transferred from the “estate” to the decedent’s revocable trust upon expiration of the 645 election period (even though in fact the stock has been in the decedent’s revocable trust since death).

4. The decedent’s revocable trust then is an eligible S corporation shareholder for (an additional) two years under 1361(c)(2)(A)(iii).

5. Thus, a 645 election (among its other potential benefits) can extend the period of time that the S corporation stock will be deemed owned by an eligible shareholder (e.g., before a decision between a QSST and ESBT need be made).