

# S Corporations

Corporations that elect to be taxed as small business corporations under IRC Sec. 1362 are taxed similarly to a partnership. The corporation (as long as it qualifies for S corporation status) generally pays no tax.<sup>1</sup> All profits and losses flow through the corporation to the shareholders and they are taxed on the profits whether or not they are taken out of the corporation.

The S corporation is often used to spread corporate income among family members who own the company stock (after employees receive adequate salaries).



Business losses, often incurred in the early years of a business, can be passed through to the shareholders and can be used to offset other ordinary income. Deductible losses are limited to shareholder's basis in stock including loans to the corporation.

## Requirements to Elect S Corporation Treatment

- Election must be made on or before the 15<sup>th</sup> day of the 3<sup>rd</sup> month of a corporation's tax year to be effective for that year.
- The number of shareholders cannot exceed 100, with all members of a family (and their estates) automatically being treated as one shareholder. The members of a family include a common ancestor, lineal descendent of the common ancestor, and the spouses, or former spouses, of such lineal descendants or common ancestor, spanning no more than six generations. See IRC Sec. 1361(c)(1).
- Each shareholder must be an individual, a decedent's estate, a bankrupt's estate or certain trusts specified in IRC Sec. 1361(c)(2), including a qualified subchapter S trust provided for by IRC Sec. 1361(d)(1).<sup>2</sup> Eligible shareholders also include an electing small business trust,<sup>3</sup> charities, and qualified pension, profit sharing and stock bonus plans,<sup>4</sup> and certain IRAs holding bank corporation stock.<sup>5</sup>
- There must not be more than one class of stock, although there can be voting and nonvoting shares.
- All stockholders must consent to the election.

<sup>1</sup> Some states impose a tax on income.

<sup>2</sup> A shareholder's agreement can be used to prevent stockholders from transferring S corporation stock to a nonqualifying trust.

<sup>3</sup> Each beneficiary of the trust is counted in determining whether the shareholder limit has been exceeded. An interest in these trusts must be acquired by gift or bequest (not purchased).

<sup>4</sup> See IRC Secs. 1361(b)(1)(B) and 1361(c)(6).

<sup>5</sup> IRC Sec. 1361(c)(2)(A)(vi).

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## Termination of the S Election<sup>1</sup>

- S corporation status is automatically terminated if any event occurs that would prohibit the corporation from making the election in the first place. The election terminates as of the date of the disqualifying event.
- The S election can be revoked with the consent of more than 50% of the outstanding stock held by shareholders.
- If a corporation, for three consecutive years, has both accumulated earnings and profits, as well as passive investment income exceeding 25% of its gross receipts, its election will be revoked beginning with the following tax year.

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<sup>1</sup> If the election is terminated or revoked, the corporation cannot re-elect S status without IRS consent until the 5<sup>th</sup> year after the year the termination or revocation is effective.