PART VIII: S CORPORATIONS

7736. What is an S corporation?

An S corporation is one that elects to be treated, in general, as a passthrough entity, thus avoiding most tax at the corporate level.[1] To be eligible to make the election, a corporation must meet certain requirements as to the kind and number of shareholders, classes of stock, and sources of income. An S corporation must be a domestic corporation with only a single class of stock and may have up to 100 shareholders (none of whom are nonresident aliens) who are individuals, estates, and certain trusts. An S corporation may not be an ineligible corporation. An ineligible corporation is one of the following: (1) a financial institution that uses the reserve method of accounting for bad debts; (2) an insurance company; (3) a corporation electing (under IRC Section 936) credits for certain taxes attributable to income from Puerto Rico and other U.S. possessions; and (4) a current or former domestic international sales corporation (DISC). Qualified plans and certain charitable organizations may be S corporation shareholders.[2]

Members of a family are treated as one shareholder. "Members of the family" is defined as "the common ancestor, lineal descendants of the common ancestor, and the spouses (or former spouses) of such lineal descendants or common ancestor." Generally, the common ancestor may not be more than six generations removed from the youngest generation of shareholders who would be considered members of the family.[3]

Trusts that may be S corporation shareholders include: (1) a trust all of which is treated as owned by an individual who is a citizen or resident of the United States under the grantor trust rules (see Q 664); (2) a trust that was described in (1) above immediately prior to the deemed owner's death and continues in existence after such death may continue to be an S corporation shareholder for up to two years after the owner's death; (3) a trust to which stock is transferred pursuant to a will may be an S corporation shareholder for up to two years after the date of the stock transfer; (4) a trust created primarily to exercise the voting power of stock transferred to it; (5) a qualified subchapter S trust (QSST); (6) an electing small business trust (ESBT); and (7) in the case of an S corporation that is a bank, an IRA, or Roth IRA.[4]

A QSST is a trust in which: (1) there is only one current income beneficiary (who must be a citizen or resident of the U.S.), (2) all income must be distributed currently, and (3) corpus may not be distributed to anyone else during the life of such beneficiary. The income interest must terminate upon the earlier of the beneficiary's death or termination of the trust, and if the trust terminates during the lifetime of the income beneficiary, all trust assets must be distributed to that beneficiary. The beneficiary must make an election for the trust to be treated as a QSST.[5]

1. See IRC Secs. 1361, 1362, 1363.
2. IRC Sec. 1361.
3. IRC Sec. 1361(c)(1).
4. IRC Secs. 1361(c)(2), 1361(d).
5. IRC Sec. 1361(d).

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An ESBT is a trust in which all of the beneficiaries are individuals, estates, or charitable organizations.[1] Each potential current beneficiary of an ESBT is treated as a shareholder for purposes of the shareholder limitation.[2] A potential current beneficiary is generally, with respect to any period, someone who is entitled to, or in the discretion of any person may receive, a distribution of principal or interest of the trust. In addition, a person treated as an owner of a trust under the grantor trust rules (see Q 664) is a potential current beneficiary.[3] If for any period there is no potential current beneficiary of an ESBT, the ESBT itself is treated as an S corporation shareholder.[4] Trusts exempt from income tax, QSSTs, charitable remainder annuity trusts, and charitable remainder unitrusts may not be ESBTs. An interest in an ESBT may not be obtained by purchase.[5] If any portion of a beneficiary's basis in the beneficiary's interest is determined under the cost basis rules, the interest was acquired by purchase.[6] An ESBT is taxed at the highest income tax rate under IRC Section 1(e) (39.6 percent in 2014).[7]

7737. What is a qualified subchapter S subsidiary (QSSS)?

An S corporation may own a qualified subchapter S subsidiary (QSSS). A QSSS is a domestic corporation that is not an ineligible corporation, if 100 percent of its stock is owned by the parent S corporation and the parent S corporation elects to treat it as a QSSS. Except as provided in regulations, a QSSS is not treated as a separate corporation, and its assets, liabilities, and items of income, deduction, and credit are treated as those of the parent S corporation.[8] Regulations provide special rules regarding the recognition of a QSSS as a separate entity for tax purposes if an S corporation or its QSSS is a bank.[9] A QSSS will also be treated as a separate corporation for purposes of employment taxes and certain excise taxes.[10] For tax years beginning after 2014, a QSSS will be treated as a separate corporation for purposes of the shared responsibility payment under the Affordable Care Act.[11]

If a QSSS ceases to meet the above requirements, it will be treated as a new corporation acquiring all assets and liabilities from the parent S corporation in exchange for its stock. If the corporation's status as a QSSS terminates, the corporation is generally prohibited from being a QSSS or an S corporation for five years.[12] Regulations provide that in certain cases following a termination of a corporation's QSSS election, the corporation may be allowed to elect QSSS or S corporation status without waiting five years if, immediately following the termination, the corporation is otherwise eligible to make an S corporation election or QSSS election, and the election is effective immediately following the termination of the QSSS election. Examples where this rule would apply include an S corporation selling all of its QSSS stock to another

1. IRC Sec. 1361(e).
2. IRC Sec. 1361(c)(2)(B)(v).
3. Treas. Reg. §1.1361-1(m)(4).
4. Treas. Reg. §1.1361-1(h)(3)(i)(F).
5. IRC Sec. 1361(e).
6. Treas. Reg. §1.1361-1(m)(1)(iii).
7. IRC Sec. 641(c).
8. IRC Sec. 1361(b)(3).
9. Treas. Reg. §1.1361-4(a)(3).
10. Treas. Regs. §§1.1361-4(a)(7) and 1.1361-4(a)(8).
11. Treas. Reg. §1.1361-4(a)(8)(i)(E).
12. IRC Sec. 1361(b)(3).

S corporation, or an S corporation distributing all of its QSSS stock to its shareholders and the former QSSS making an S election.[1]

7738. What is the requirement that an S corporation have only one class of stock and how is it met?

A corporation will be treated as having one class of stock if all of its outstanding shares confer identical rights to distribution and liquidation proceeds.[2] "Bona fide agreements to redeem or purchase stock at the time of death, disability or termination of employment" will be disregarded for purposes of the one-class rule unless a principal purpose of the arrangement is to circumvent the rule. Similarly, bona fide buy-sell agreements will be disregarded unless a principal purpose of the arrangement is to circumvent the one-class rule and they establish a purchase price that is not substantially above or below the fair market value of the stock. Agreements that provide for a purchase price or redemption of stock at book value or a price between book value and fair market value will not be considered to establish a price that is substantially above or below fair market value.[3] Regulations provide that agreements triggered by divorce and forfeiture provisions that cause a share of stock to be substantially nonvested will be disregarded in determining whether a corporation's shares confer identical rights to distribution and liquidation proceeds.[4]

7739. How is an S corporation taxed?

An S corporation is generally not subject to tax at the corporate level.[5] However, a tax is imposed at the corporate level under certain circumstances described below. When an S corporation disposes of property within 10 years after the S election has been made, gain attributable to pre-election appreciation of the property (built in gain) is taxed at the corporate level to the extent such gain does not exceed the amount of taxable income imposed on the corporation as if it were not an S corporation.[6] (ARRA 2009 provided that, in the case of a taxable year beginning in 2009 or 2010, no tax was to be imposed on built in gain if the 7th taxable year of the 10-year recognition period preceded such taxable year. The Creating Small Business Jobs Act of 2010 provided that, for a taxable year beginning in 2011, no built in gain tax was to be imposed if the 5th year of the recognition period preceded that year. The American Taxpayer Relief Act of 2012 extended that rule for taxable years beginning in 2012 and 2013.)

For S elections made after December 17, 1987, a corporation switching from a C corporation to an S corporation may also be required to recapture certain amounts at the corporate level in connection with goods previously inventoried under a LIFO method.[7]

In addition, a tax is imposed at the corporate level on *excess* "net passive income" of an S corporation (passive investment income reduced by certain expenses connected with the production

1. Treas. Reg. §1.1361-5(c).
2. Treas. Reg. §1.1361-1(l)(1).
3. Treas. Reg. §1.1361-1(l)(2)(iii). See IRC Secs. 1361, 1362.
4. Treas. Reg. §1.1361-1(l)(2)(iii)(B).
5. IRC Sec. 1363(a).
6. IRC Sec. 1374.
7. IRC Sec. 1363(d).

of such income) but only if the corporation, at the end of the tax year, has accumulated earnings and profits (either carried over from a year in which it was a nonelecting corporation or due to an acquisition of a C corporation), and if passive investment income exceeds 25 percent of gross receipts. The rate is the highest corporate rate (currently 35 percent).[1] "Passive investment income" for this purpose is rents, royalties, dividends, interest, and annuities.[2] However, passive investment income does not include rents for the use of corporate property if the corporation also provides substantial services or incurs substantial cost in the rental business,[3] or interest on obligations acquired from the sale of a capital asset or the performance of services in the ordinary course of a trade or business of selling the property or performing the services. Also, passive investment income does not include gross receipts derived in the ordinary course of a trade or business of lending or financing; dealing in property; purchasing or discounting accounts receivable, notes, or installment obligations; or servicing mortgages.[4] Regulations provide that if an S corporation owns 80 percent or more of a C corporation, passive investment income does not include dividends from the C corporation to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business.[5] If amounts are subject to tax both as built-in gain and as excess net passive income, an adjustment will be made in the amount taxed as passive income.[6]

Also, tax is imposed at the corporate level if investment credit attributable to years for which the corporation was not an S corporation is required to be recaptured.[7]

Furthermore, an S corporation may be required to make an accelerated tax payment on behalf of its shareholders if the S corporation elects not to use a required taxable year.[8] The corporation is also subject to estimated tax requirements with respect to the tax on built in gain, the tax on excess net passive income, and any tax attributable to recapture of investment credit.[9]

Like a partnership, an S corporation computes its taxable income similarly to an individual, except that certain personal and other deductions are allowed to a shareholder but not to the S corporation, and the corporation may elect to amortize organizational expenses.[10] Each shareholder then reports on the shareholder's individual return his or her proportionate share of the corporation's items of income, loss, deductions, and credits; these items retain their character on passthrough.[11] Certain items of income, loss, deduction, or credit must be passed through as separate items because they may have an effect on each individual shareholder's tax liability. For example, net capital gains and losses pass through as such to be included with the shareholder's own net capital gain or loss. Any gains and losses on certain property used in a trade or

1. IRC Sec. 1375(a).
2. IRC Secs. 1362(d)(3), 1375(b)(3).
3. See Let. Ruls. 9837003, 9611009, 9610016, 9548012, 9534024, 9514005.
4. Treas. Reg. §1.1362-2(c)(5).
5. Treas. Reg. §1.1362-8(a).
6. IRC Sec. 1375(b)(4).
7. IRC Sec. 1371(d).
8. IRC Sec. 7519.
9. IRC Sec. 6655(g)(4).
10. IRC Sec. 1363(b).
11. IRC Secs. 1366(a), 1366(b).

business are passed through separately to be aggregated with the shareholder's other IRC Section 1231 gains and losses. (Gains passed through are reduced by any tax at the corporate level on gains.) Miscellaneous itemized deductions pass through to be combined with the individual's miscellaneous deductions for purposes of the 2 percent floor on such deductions. Charitable contributions pass through to shareholders separately subject to the individual shareholder's percentage limitations on deductibility. Tax exempt income passes through as such. Items involving determination of credits pass through separately.[1]

Before passthrough, each item of passive investment income is reduced by its proportionate share of the tax at the corporate level on excess net passive investment income.[2] Items that do not need to be passed through separately are aggregated on the corporation's tax return and each shareholder reports his share of such nonseparately computed net income or loss on his individual return.[3] Items of income, deductions, and credits (whether or not separately stated) that flow through to the shareholder are subject to the "passive loss" rules (see Q 7918 through Q 7929) if the activity is passive with respect to the shareholder. See Q 7919. Apparently, items taxed at the corporate level are not subject to the passive loss rule unless the corporation is either closely held or a personal service corporation. See Q 7918.

Thus, whether amounts are distributed to them or not, shareholders are taxed on the corporation's taxable income. Shareholders take into account their shares of income, loss, deduction, and credit on a per-share, per-day basis.[4] The S corporation income must also be included on a current basis by shareholders for purposes of the estimated tax provisions. See Q 567.[5]

The Tax Court determined that when an S corporation shareholder files for bankruptcy, all the gains and losses for that year flowed through to the bankruptcy estate. The gains and losses should not be divided based on the time before the bankruptcy was filed.[6]

7740. How is the basis of stock in an S corporation determined? How are the earnings, profits, distributions and redemptions of an S corporation treated?

The basis of each shareholder's stock is *increased* by the shareholder's share of items of separately stated income (including tax-exempt income), by his share of any non-separately computed income, and by any excess of deductions for depletion over basis in property subject to depletion.[7] An S corporation shareholder may *not* increase basis due to excluded discharge of indebtedness income.[8] The basis of each shareholder's stock is *decreased* (not below zero) by items of distributions from the corporation that are not includable in the income of the shareholder, separately stated loss and deductions and non-separately computed loss, any expense

1. IRC Sec. 1366(a)(1).
2. IRC Sec. 1366(f)(3).
3. IRC Sec. 1366(a).
4. IRC Sec. 1377(a).
5. Let. Rul. 8542034.
6. *Williams v. Comm.*, 123 TC 144 (2004).
7. IRC Sec. 1367(a)(1).
8. IRC Sec. 108(d)(7)(A).

of the corporation not deductible in computing taxable income and not properly chargeable to capital account, and any depletion deduction with respect to oil and gas property to the extent that the deduction does not exceed the shareholder's proportionate share of the property's adjusted basis.

For tax years beginning after 2005 and before 2014, if an S corporation makes a charitable contribution of property, each shareholder's basis is reduced by the pro-rata share of his or her basis in the property.[1] If the aggregate of these amounts exceeds the basis in the stock, the excess reduces the shareholder's basis in any indebtedness of the corporation to the shareholder.[2] A shareholder may not take deductions and losses of the S corporation that, when aggregated, exceed the basis in his or her S corporation stock plus the basis in any indebtedness of the corporation to the shareholder.[3] Such disallowed deductions and losses may be carried over.[4] In other words, the shareholder may not deduct in any tax year more than he or she has "at risk" in the corporation.

Generally, earnings of an S corporation are not treated as earnings and profits. A corporation may have accumulated earnings and profits for any year in which a valid election was not in effect or as the result of a corporate acquisition in which there is a carryover of earnings and profits under IRC Section 381.[5] Corporations that were S corporations before 1983 but were not S corporations in the first tax year after 1996 are able to eliminate earnings and profits that were accumulated before 1983 in their first tax year beginning after May 25, 2007.[6]

A distribution from an S corporation that does not have accumulated earnings and profits lowers the shareholder's basis in the corporation's stock.[7] Any excess is generally treated as capital gain.[8]

If the S corporation does have earnings and profits, distributions are treated as distributions by a corporation without earnings and profits, to the extent of the shareholder's share of an accumulated adjustment account (i.e., post-1982 gross receipts less deductible expenses, which have not been distributed). Any excess distribution is treated under the usual corporate rules. That is, it is a dividend up to the amount of the accumulated earnings and profits. Any excess is applied to reduce the shareholder's basis. Finally, any remainder is treated as a gain as if the stock had been sold.[9] However, in any tax year, shareholders receiving the distribution may, if all agree, elect to have all distributions in the year treated first as dividends to the extent of earnings and profits and then as return of investment to the extent of adjusted basis and any excess as capital gain.[10] If the IRC Section 1368(e)(3) election is made, it will apply to all distributions made in the tax year.[11]

1. IRC Sec. 1367(a)(2), as amended by TEAMTRA 2008, TRUIRJCA 2010, and ATRA 2012.
2. IRC Sec. 1367(b)(2)(A).
3. IRC Sec. 1366(d)(1).
4. IRC Sec. 1366(d)(2).
5. IRC Sec. 1371(c).
6. SBWOTA 2007 Sec. 8235.
7. IRC Sec. 1367(a)(2)(A).
8. IRC Sec. 1368(b).
9. IRC Sec. 1368(c).
10. IRC Sec. 1368(e)(3).
11. Let. Rul. 8935013.

Certain distributions from an S corporation in redemption of stock receive sale/exchange treatment. (Generally, only gain or loss, if any, is recognized in a sale.) In general, redemptions that qualify for "exchange" treatment include redemptions not essentially equivalent to a dividend, substantially disproportionate redemptions of stock, complete redemptions of stock, certain partial liquidations, and redemptions of stock to pay estate taxes.[1]

If the S corporation distributes appreciated property to a shareholder, gain will be recognized to the corporation as if the property had been sold at fair market value; the gain will pass through to shareholders like any other gain.[2]

The rules discussed above generally apply in tax years beginning after 1982. Nonetheless, certain casualty insurance companies and certain corporations with oil and gas production will continue to be taxed under the rules applicable to Subchapter S corporations in effect prior to these rules.[3]

1. See IRC Secs. 302, 303.
2. IRC Secs. 1371(a), 311(b).
3. Subchapter S Revision Act of 1982, Sec. 6.