



S Corporations

Course #33203C

Taxes

2 Credit Hours

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S CORPORATIONS

This chapter outlines the general tax implications and benefits of business-related insurance policies. It explains the rules for deducting premiums, differentiates between business and personal insurance, and details the treatment of key person insurance, employee group policies, and self-insured plans. The chapter also reviews how proceeds are taxed and when exceptions apply. Understanding these rules helps ensure proper reporting and maximization of available tax benefits for both employers and employees.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

SUBJECTS

S Corporations

Study the course materials

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

Objectives:

- Identify the requirements of an S corporation.

NOTICE

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Program publication date **9/23/25**

EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.
- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.
- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.
- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.
- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

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S CORPORATIONS

Chapter Objective

After completing, you should be able to:

- Identify the requirements of an S corporation.

¶301 ELIGIBILITY, ELECTION, AND FORMATION

S corporations, like partnerships, are flow-through entities and are generally not subject to the federal income tax. Instead, in a manner much like that of a partnership, the income of the S corporation flows through to the individual shareholders and is reported by them on their individual (or entity) returns. In fact, S corporations were created in order to give closely held corporations the ability to avoid income tax on corporate income at the entity level. Like a partnership, the S corporation must file a tax return, and in fact the tax return contains Schedule K and also K-1s that must be distributed to the S corporation shareholders. While the treatment of income items by a partnership and S corporation are strikingly similar, there are several differences in other areas of tax treatment. For example, distributions of appreciated property from a partnership are generally nontaxable, the distribution of appreciated property by an S corporation is fully taxable to the S corporation as if it had sold the property for FMV prior to making the distribution.

Although most S corporations are legal corporations under state law, it is not necessary that an S corporation (a tax entity for which there is no state law equivalent) be a statutory corporation. In fact, a statutory partnership or LLC that has elected to be taxed as an association can subsequently elect to be taxed as an S corporation rather than as a regular C corporation.¹

.01 Eligibility

An S corporation is defined as a “small business corporation” for which an election under Code Sec. 1362(a) is in effect for the taxable year. A C corporation, on the other hand, is defined as a corporation that is not an S corporation for a taxable year.² A “small business corporation” is a domestic corporation that is not an “ineligible corporation” and which does not—

- Have more than 100 shareholders,
- Have as a shareholder a person (other than an estate, a trust described in Code Sec. 1361(c)(2), or an organization described in Code Sec. 1361(c)(6)) who is not an individual,
- Have a nonresident alien as a shareholder, and

1. The entity chooses its tax status by filing Form 8832, *Entity Classification Election*, with the Internal Revenue Service. The election must be filed no later than 2½ months after the beginning of the first taxable year for which the election is filed. Late applications may be accepted if the taxpayer can show reasonable cause.

2. Code Sec. 1361(a).

- D. Have more than one class of stock.³

The term “ineligible corporation” (which may not be treated as an S corporation) means any corporation which is—

- A. A financial institution using the reserve method of accounting for bad debts described in Code Sec. 585,
- B. An insurance company subject to tax under subchapter L,
- C. A corporation to which an election under Code Sec. 936 applies, or
- D. A DISC or former DISC.

One hundred shareholder limitation. For purposes of computing the number of shareholders, spouses (and their estates) are treated as a single shareholder, as are all members of a family (and their estates). For this purpose, the term “members of a family” means a common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of such common ancestor or any such lineal descendant. Any legally adopted child of an individual, any child who is lawfully placed with an individual for legal adoption by the individual, and any eligible foster child of an individual (within the meaning of Code Sec. 152(f)(1)(C)), will be treated as a child of the individual.⁴

It should be noted that the 100 shareholder limitation in many cases is not an effective limitation on the number of owners of an enterprise, even where the owners of the enterprise will all be better served by being S corporation shareholders. The Service has taken the position that multiple S corporations can be partners in the same partnership. The Service in Revenue Ruling 94-43 concluded that three S corporations formed for the principal purpose of avoiding the S corporation shareholder limitation should not be considered a single corporation.⁵

Types of shareholders allowed. Trusts are generally eligible shareholders in an S corporation so long as they do not provide a vehicle for investment for foreign shareholders. The following types of trusts are eligible shareholders under Code Sec. 1361:

- i. A trust all of which is owned by an individual who is a citizen or resident of the United States.
- ii. A trust which was “owned” by a citizen or resident immediately before the death of the deemed owner and that continues in existence after such death, but only for the two-year period beginning on the day of the deemed owner’s death.
- iii. A trust with respect to stock transferred to it pursuant to the terms of a will, but only for the two-year period beginning on the day on which such stock is transferred to it.

3. Code Sec. 1361(b)(1).

4. Code Sec. 1361(c).

5. Rev. Rul. 94-43, 1994-2 CB 199.

- iv. A trust created primarily to exercise the voting power of stock transferred to it.
- v. The estate of an individual in bankruptcy.⁶

Qualified retirement plan trusts (described in Code Sec. 401(a)) and charitable organizations (described in Code Sec. 501(c)(3)) may also be shareholders in an S corporation.⁷

More than one class of stock. The eligibility rules for S corporations require that the entity may have only one class of stock. The single class of stock requirement means that all outstanding shares of stock provide their owners (shareholders) the exact same claims against corporate assets. A separate class of stock will generally be deemed to exist if certain shareholders have special or preferred claims to S corporation distributions, or to claims against proceeds from sale of one or more corporate assets, or against proceeds from liquidation of the S corporation. Where a shareholder is entitled to a future payment or distribution based on the performance of individual services, such as under the terms of a deferred compensation plan, such rights do not terminate the single class of stock requirement. In such cases, the future payment is attributable to the shareholder's performance of services for the S corporation rather than to the shareholder's stock investment.⁸

Although S corporations are not allowed to have more than one class of stock, an exception to this rule is allowed with respect to voting rights. An S corporation will not be treated as having more than one class of stock solely because there are differences in voting rights among the shares of common stock.⁹ For example, an S corporation may have voting shares and non-voting shares without violating the single class of stock requirement as long as both the voting and non-voting shares have the same claims against corporate assets and income.¹⁰

In addition, a safe harbor provision allows that "straight" debt is not treated as a second class of stock if certain requirements are met. Straight debt means any "written unconditional promise to pay on demand or on a specified date a sum certain in money" if it meets the following requirements:¹¹

- i. It is not convertible, directly or indirectly, into stock;
- ii. The interest rate and interest payment dates are not contingent on profits, corporate discretion, etc.; and
- iii. The lender is a resident individual, an estate, a qualified trust, or a person actively and regularly engaged in the business of lending money.

6. Code Sec. 1361(c)(2) and (3).

7. Code Sec. 1361(c)(6).

8. Reg. §1.1361-1(b)(4). For example, see IRS Letter Ruling 201926008 (4-29-2019).

9. Code Sec. 1361(c)(4).

10. The IRS has the authority to ignore inadvertent violations of the single class of stock rule. See, for example, IRS Letter Ruling 201935010, where after making an S election, a corporation determined that its voting and non-voting shares had different liquidation rights. The corporation amended its articles of incorporation to eliminate this difference and the IRS did not hold it in violation of the single class of stock rule for the period prior to the amendment. The IRS will generally overlook violations of the single class of stock requirement when the S corporation takes steps to correct the violation upon discovery and no unequal distributions have been made to shareholders prior to the correction.

11. Code Sec. 1361(c)(5).