PacificCPE

COURSE
32802A

S Corporations: Eligibility and Qualification Requirements

Before a corporation can enjoy pass-through taxation, it must meet a strict set of requirements—and staying qualified takes ongoing attention. This course covers the rules a corporation must satisfy to elect and maintain S corporation status, including shareholder limitations, eligible shareholder types, and stock class restrictions. Whether you're helping a client make the initial election or reviewing an existing structure for compliance risk, understanding these foundational requirements is essential. A practical resource for tax professionals advising closely held businesses at any stage.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize statutory requirements to be an S corporation.

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Chapter 1: REQUIREMENTS TO BE AN S CORPORATION

Chapter Objective

After completing this chapter, you should be able to:

- Recognize statutory requirements to be an S corporation.

201 BASIC REQUIREMENTS

Because an S corporation is a creature of statute, Congress has prescribed that all of the following requirements be met for a corporation to achieve S corporation status:

- Have no more than 100 shareholders
- Have only eligible shareholders (e.g., individuals, decedents' estates, certain prescribed trusts, but not nonresident aliens)
- Be a domestic corporation
- Have only one class of stock

Tax Pointer 1

Even if a corporation meets all of the above requirements, it may not want S status because of the shareholder limitations. When parents who are eligible shareholders undertake estate planning, the S corporation limitations on trusts may make them opt for another business structure, such as a limited liability company classified as a partnership for tax purposes.

Tax Pointer 2

In terms of the definition of "domestic corporation," it may be advantageous for a business to operate as a partnership for state tax purposes, but as an S corporation for federal tax purposes. For a discussion of this area, see 206.

202 COUNTING THE SHAREHOLDERS

.01 Meeting the 100-Shareholder Limit

An S corporation may not have more than 100 shareholders at any time during the tax year or it will lose its S status. Cumulatively, an S corporation may show more than 100 shareholders during a tax year due to transfers of stock, but the total shareholders at any one time cannot exceed 100.

In the case of S corporations which will exceed one hundred shareholders, shareholders may consider doing an "end run" around Code Sec. 1361(b)(1)(A)'s one hundred shareholder limit by forming a partnership of S corporations. Rev. Rul. 94-43 approved such a procedure. In Rev. Rul. 94-43, the IRS sustained a partnership of three S corporations, where each S corporation had the maximum number of shareholders permitted. So if three hundred shareholders wanted to operate as a single business, they could form three S corporations comprised of one hundred shareholders each, and have these three S corporations enter into a partnership to do business.

Care must be practiced in establishing partnerships with S corporations since the partnership anti-abuse regulations, Reg. § 1.701-2, will strike down attempts to utilize a partnership unless (1) the partnership is bona fide and each partnership transaction or series of related transactions (individually or collectively), is entered into for a substantial business purpose, and (2) the form of each partnership transaction is respected under substance over form principles.

.02 Stock Held by a Husband and Wife

When stock is held jointly by a husband and wife, either as joint tenants or as tenants in common, the husband and wife are treated as one shareholder, although both spouses must personally consent to the S corporation election. If a husband and wife each own stock separately as well as jointly, they are still treated as one shareholder.

Community property states. In a community property state, the husband and wife are treated as one shareholder if they each own stock, regardless of whether or not they each own stock as common property.

Death of a spouse. If a spouse dies, stock owned by the surviving spouse and the estate of the deceased spouse will be treated as one shareholder. Likewise, if both spouses die, the two estates will be treated as one shareholder.

.03 Stock Held with Children, Grandchildren, or Parents

An individual who owns stock with his or her children, grandchildren, or parents is counted separately along with the shareholder children, grandchildren, or parents (e.g., if a father and his two children are shareholders of an S corporation, they count as three shareholders, not one, for the 100-shareholder numerical limit). Constructive ownership rules do not apply in determining the 100-shareholder numerical limit.

Tax Pointer

See discussion at 202.08 where the family can file an election to be treated as one shareholder.

.04 Stock Held by a Nominee or Agent

If stock is held by a nominee, only the beneficial owner will be treated as a shareholder for the 100-shareholder numerical limit. Likewise, stock held by an agent is deemed to be stock owned only by the principal.

Example 2-1

ADF Inc., an S corporation, issued 15 stock certificates: 13 to individuals; one to Commerce Bank, who is the agent for Don Adams; and one to Bob Jones, who is holding the stock as a nominee for his three sisters, Doris, Martha, and Sally Jones. ADF Inc. has the following 17 shareholders, although only 15 certificates were issued: the 13 individuals, Adams, and the three Jones sisters.

.05 Stock Held by a Custodian

When stock is held by a custodian under the Uniform Transfer to Minors Act (UTMA), the minor is deemed the owner, not the custodian. Thus, if one person acts as a custodian for four different minors, there are four shareholders.

.06 Stock Held by Unmarried Joint Tenants and Tenants in Common

If two or more unmarried persons own S corporation stock as joint tenants, tenants in common, and so on, each person counts as a shareholder.

.07 Beneficial Ownership

Occasionally, stock is not issued to a shareholder; yet, the parties and the S corporation treat the taxpayer as a shareholder. Such a situation arose in the case of *Feraco*. In Feraco, a father and son owned the stock of the corporation. A third taxpayer, Bob Butler ("Butler") was given an option to purchase stock in the S corporation; however, no stock was issued to him. Nevertheless, the S corporation issued a Form 1120S, Schedule K-1 to Butler each year that he was involved in the corporation. The Court held that Butler was a shareholder of the S corporation, even though he lacked legal title to the shares. In reaching its decision, the Court noted that besides Butler being listed as a shareholder on the S corporation's tax return, Butler held executive positions typical of an owner of a corporation.

If an S corporation has beneficial owners before it issues stock, Reg. §1.1377-1(a)(2)(i) treats the taxpayer as a shareholder for any day on which the corporation has not issued any stock.

.08 Family Members Treated as One Shareholder

Effective for tax years beginning after December 31, 2004, Code Sec. 1361(c)(1) has been amended to provide that, for purposes of counting the number of shareholders of an S corporation, "members of the family" can elect to be treated as one shareholder. Code Sec. 1361(c)(1)(B)(i) defines the term "members of the family" as the common ancestor, the lineal descendants of the common ancestor, and the spouses (or former spouses) of the lineal descendants or common ancestor. However, Code Sec. 1361(c)(1)(B)(ii) prescribes that the common ancestor cannot be more than six generations removed from the youngest generation of shareholders at the time the S election is made, or the effective date for tax years beginning after December 31, 2004. A spouse (or former spouse) will be treated as being of the same generation as the individual to which he or she is (or was) married.

Code Sec. 1361(c)(2)(B) prescribes that the members of a family may be treated as one shareholder, for the purposes of determining the number of shareholders, whether a family member holds stock directly or is treated as a shareholder by reason of being a beneficiary of an electing small business trust or qualified subchapter S trust. A legally adopted child, a child who is lawfully placed with a household for legal adoption, and a foster child are considered a member of the family.

The Internal Revenue Service in Notice 2005-51 prescribed certain rules of operation and definitions for the family provisions for ownership of S corporate stock, namely:

> [any] member of the family who is (or is treated under Section 1361 and the regulations thereunder as) a shareholder of the S corporation may make the election. The election is made by notifying the corporation to which the election applies. The notification shall identify by name the member of the family making the election, the "common ancestor" of the family to which the election applies, and the first taxable year of the corporation for which the election is to be effective. For purposes of making the election the common ancestor does not have to be alive at the time the election is made.

For purposes of the election, the estate of a deceased member of the family will be considered to be a member of the family during the period in which the estate, or a trust described in Code Sec. 1361(c)(2) (A)(iii), holds stock in the S corporation. The members of the family will include:

1. Each potential current beneficiary of an electing small business trust (ESBT) who is a member of the family,
2. The income beneficiary of a qualified subchapter S trust (QSST) who makes the QSST election, if that income beneficiary is a member of the family,
3. Each beneficiary of a trust who is a member of the family, if the trust was created primarily to exercise the voting power of stock transferred to it,
4. The member of the family for whose benefit a trust described in Section 1361(c)(2)(A)(vi) was created,

5. The deemed owner of a trust treated as wholly owned under subpart E of Part I of subchapter J of Chapter 1 of course 32801D of Subtitle A of the Internal Revenue Code, if that deemed owner is a member of the family, and
6. The owner of an entity disregarded as an entity separate from its owner under §301.7701-3 of the Procedure and Administration Regulations, if that owner is a member of the family.

If a corporation has two or more elections in effect and the members of one family for which the election has been made (the inclusive family) include all the members of another family for which the election was also made (the subsumed family), then the members of the inclusive family will be counted as one shareholder for purposes of Code Sec. 1361(b)(1)(A) as long as the inclusive family's election is in effect, and the members of the subsumed family will not be counted as separate and additional shareholder.

The election will be effective as of the first day of the corporation's taxable year designated by the shareholder making the election. Any election will remain in effect until terminated as provided in the regulations.

If taxpayers have already taken certain actions in order to make this election by various forms of notification to the corporation or to the IRS, in order for the election to be effective for taxable years beginning after December 31, 2004, taxpayers will need to provide the information described in Notice 2005-91 to the corporation (to the extent not already provided to the corporation).

The corporation is required to keep records in accordance with Code Sec. 6001 and the regulations thereunder.

Tax Pointer 1

To protect family members and the S corporation from one family member electing termination, provisions should be inserted in the S corporate shareholders agreement mandating that all family members vote to maintain the election, with the proviso that if a family member wants to break the election, leave the corporation, etc., the corporation and/or the remaining shareholders must purchase this shareholder's interest.

Tax Pointer 2

Code Sec. 1361(c)(1) does not detail what happens if a member of this six-generation family S corporate group conveys stock to a member outside the family group. Presumably, this will not cause the destruction of the six-generation family group, with the recipient of the stock being counted as an additional shareholder.

One of the primary benefits in having various generations of a family treated as one shareholder is that it makes it easier to make other individuals, such as employees, shareholders.

.09 Resident Alien Can Be a Shareholder in an S Corporation

A simple reading of Code Sec. 1361(b)(1)(C) indicates that a resident alien is a permitted shareholder; IRS Letter Ruling 201032034 (April 12, 2010) confirms it. In the case of a dual resident (a person subject to both U.S. taxation and that of a country with which the United States has a tax treaty), Proposed Reg. §301.7701(b)-7(a)(4)(i), (ii), (iii), (iv) states that this individual cannot be an S corporation shareholder if he or she takes advantage of his or her dual resident status to claim a tax benefit under the treaty. This prohibition can be avoided, however, if the shareholder and the S corporation agree that the shareholder's income will be subject to tax and withholding by the United States.

203 ELIGIBLE SHAREHOLDER ENTITIES

Limitations are imposed on what types of entities can be shareholders of an S corporation. Discussed briefly below are five types of entities that can and should be considered for shareholders of an S corporation because of their tax-planning opportunities.

.01 Estates

Because of the transitory nature of estates, in that they act as conduits for disposing of a decedent's net assets, estates are not often thought of as a tax-planning device. However, they can, in certain circumstances, provide assistance and prevent adverse tax consequences from arising.

In the case of an S corporation, if an S corporation shareholder left his or her estate by will to a nonresident alien (who cannot be an S corporation shareholder), the corporation's S status would terminate when the nonresident received the S corporation shares. However, if the shareholder's estate was kept alive and delayed making the bequest, the S corporation status could be maintained until the crisis generated by the decedent's bequest to the nonresident alien was resolved. Steps the S corporation could take would be to redeem the shares bequeathed to the nonresident alien, or have the nonresident alien become a resident alien. Alternatively, the stock could be sold by the estate to a permitted shareholder.

From a tax-planning perspective, it may be desirable for an estate of a deceased C corporation shareholder (where the decedent owned 100 percent of the corporation's stock) to elect S status for the corporation to take advantage of the S status's single level of taxation.

.02 Six Types of Trusts

Only certain trusts can be shareholders of an S corporation. If an ineligible trust is admitted as a shareholder (e.g., a foreign trust or trust for an individual retirement account (IRA)), the S

corporation election will be terminated when the nonpermitted trust becomes a shareholder. As discussed in Chapter 1 of course 32802D, only the following six types of trusts are permitted to be S corporation shareholders:

1. Grantor trusts
2. Code Sec. 678 trusts
3. Testamentary trusts
4. Voting trusts
5. Electing small business trusts (ESBTs)
6. Qualified subchapter S trusts (QSSTs)

.03 Bankrupt Shareholders and Bankruptcy Estates

A shareholder who has filed under any provision of the bankruptcy code can be an S corporation shareholder. A bankruptcy estate can also be a shareholder in an S corporation. In the case of a husband and wife where just one of the spouses goes bankrupt, presumably, on the bankruptcy of one of the spouses, two shareholders will be created: one, the bankrupt spouse's estate, and the other, the nonbankrupt spouse.

An S corporation can revoke its status whereupon it becomes a C corporation. If an S corporation revokes its status in a bankruptcy, this revocation can have enormous tax consequences. For instance, in *The Majestic Star Casino, LLC v. Barden Development, Inc.,* a case involving a Qualified Subchapter S Subsidiary ("QSUB"), the court held that S corporation status is not a property right; thus, creditors cannot object if the S corporation shareholders revoke S status. The result was that approximately 2.26 million dollars of estimated income tax was not paid to the Indiana Department of Revenue for 2010 by the shareholders on revocation. The court in reaching its decision acknowledged *In re Trans-Line West,* Inc. and its ilk, but stated that it "decline[d] to follow the rationale of Trans-Line West and its progeny, and we conclude that S-corp status is not 'property' within the meaning of the Code."

.04 Charitable Organizations

A charitable organization can be a shareholder in an S corporation provided that the charitable organization is exempt from taxation and, therefore, classified as a "qualified tax-exempt shareholder." Thus, an individual shareholder can donate S corporation stock to a charitable organization (e.g., church, synagogue, private foundation, Red Cross, community chest) and receive a charitable contribution for it. The charitable organization will be counted as one shareholder for establishing the 100-shareholder limit, according to the Small Business Job Protection Act (SBJPA) Committee Reports.