PacificCPE

COURSE
33203D

Partnership Taxation: S Corporation Considerations in Planning

Not every business fits neatly into one entity type, and practitioners often need to understand how S corporation rules intersect with partnership and LLC structures. This course focuses on planning strategies and key distinctions that arise when S corporations are part of the picture. With multiple planning pointers highlighted throughout, it offers actionable guidance for tax professionals helping clients choose, compare, or coordinate entity structures to achieve the best tax outcomes.

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

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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

- Identify the requirements of an S corporation.

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Publication Date: September 2025

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Chapter 1: S CORPORATIONS

Chapter Objective

After completing this chapter, 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—

A. Have more than 100 shareholders,

B. 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,

C. Have a nonresident alien as a shareholder, and

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. [4] 152(f)(1)(C)), will be treated as a child of the individual.

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.

iv. Atrust created primarily to exercise the voting power of stock transferred to it.

v. The estate of an individual in bankruptcy.

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

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 [11] or on a specified date a sum certain in money" if it meets the following requirements:

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).

Shareholder recognition of income. In general, each shareholder's pro rata share of any item for any taxable year will be determined based on the number of days the shareholder held the shares and the percentage ownership the shareholder had on the days they held the shares. [12]

Example 3-1

The Able Corporation elected S status for the current year, in which its taxable income was $730,000. Each day of the year would be allocated $730,000/365 = $2,000, and each shareholder on those days would share the income allocated to that day ($2,000) based on their ownership percentage on that day. If shareholder Mark had a 25% interest for the first 100 days of the year, Mark would be allocated $2,000 × 25% × 100 days=$50,000 of the income from the Scorporation, and that would bereflectedon his Schedule K-1. If the $730,000 in income was 20% long-term capital gain, then Mark's K-1 would reflect $40,000 of ordinary income from the S corporation and $10,000 of long-term capital gain.

If any shareholder terminates their interest in the corporation during the taxable year and all "affected shareholders" (the shareholder whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the taxable year) and the corporation agree, income will be allocated to the shareholders as if the taxable year consisted of two taxable years, the first of which ends on the date of the termination. [13]

Fringe benefits. With respect to employee fringe benefits, an S corporation is treated as a partnership, and any 2-percent shareholder of the S corporation will be treated as a partner of the partnership. A "2-percent shareholder" is any person who owns (directly or indirectly) on any day during the taxable year more than 2% of the outstanding stock of the corporation or stock possessing more than 2% of the total combined voting power of all stock of the corporation. [14]

.02 Election

An S corporation election is valid only if all shareholders as of the day on which the election is made consent to the election. [15] An S corporation election may be made for the current taxable year:

A. At any time during the preceding taxable year, or

B. At any time on or before the 15th day of the third month of the current taxable year.[16]

On the other hand, if the election is made after the 15th day of the third month of the current taxable year and on or before the 15th day of the third month of the following taxable year, then the election will be treated as made for the following taxable year.

Example 3-2

A calendar year small business corporation begins its first taxable year on January 7, 2024. To be an S corporation beginning with its first taxable year, the corporation must make the election during the period that begins January 7, 2024, and ends before March 22, 2024. Because the corporation had no taxable year immediately preceding the taxable year for which the election is to be effective, an election made earlier than January 7, 2024, would not be valid. [18]

If the election is made on or before the 15th day of the third month of the year, but for at least one day on or prior to the election day the corporation did not qualify as an S corporation, then the election will be treated as made for the following taxable year. Similarly, if there was at least one day on or prior to the election day when one or more of the shareholders for any day during the taxable year before the election was made did not consent to the election, then the election is treated as made for the following taxable year. [19]

If the taxable year of the S corporation election has less than two and one half months, the election will be considered timely if it is made during the first two and one half months following the beginning of the short taxable year. [20]

Example 3-3

A calendar year corporation decides to convert to S corporation status. It makes the election on May 15, 2024. The earliest that the election can be effective is March 1, 2024. If it chooses to make the election effective as of March 1, 2024, it must file a short period return for the period January 1, 2024 through February 28, 2024 as a regular corporation (i.e., Form 1120). Its first S corporation return (Form 1120-S) will cover the short period from March 1, 2024 through December 31, 2024. Alternatively, the corporation may treat the election as being effective for calendar year 2025.

The IRS may allow a late election to be considered timely if it determines that there was reasonable cause for the failure to make a timely election. [21] Once made, the S corporation election is effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, until the election is terminated. [22]

A corporation must make the S corporation election by filing a completed Form 2553, Election by a Small Business Corporation. The election form must be filed with the service center designated in the instructions applicable to Form 2553. The election is not valid unless all shareholders of the corporation at the time of the election consent to the election. However, once a valid election is made, new shareholders need not consent to the election. [23] An eligible entity that timely elects to be an S corporation is treated as having made an election to be classified as an association, provided that the entity meets all other requirements to qualify as a small business corporation. [24]

Example 3-4

On January1,2024, two individuals and a partnership ownallof the stock ofacalendar year subchapter C corporation. On January 31, 2024, the partnership dissolved and distributed its shares in the corporation toitsfive partners, all individuals. On February 28, 2024, the seven shareholders of the corporation consented to the corporation's election of subchapter S status. The corporation files a properly completed Form 2553 on March 2, 2024. The corporation is not eligible to be a subchapter S corporation for the 2024 entire calendar year because during the period of the calendar year prior to the election it had an ineligible shareholder, the partnership. So the S corporation must either file a short period return for January 1 through January 31 as a regular corporation, or treat the election as being made for the corporation's 2025 taxable year.

.03 Corporate Contributions

Except for the treatment related to the pass-through of income, S corporations are generally treated the same as C corporations for tax purposes. They are therefore subject to the rules of Code Sec. 351 when it comes to the taxability of contributions to the corporation in exchange for stock of the corporation. Under Code Sec. 351, no gain or loss is recognized by the shareholder if (1) property is transferred to the corporation (2) solely in exchange for stock in the corporation and (3) immediately after the exchange the participants to the exchange are in control of the corporation. [25] For this purpose the term "control means the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. [26]

If "boot" (money or property that is not stock of the S corporation) is received by the contributing shareholder in the exchange, the shareholder will recognize any realized gain (but not loss) on the exchange, up to the amount of boot (fair market value of property or the amount of money) received. [27]