

PRESENTED AT

63rd Annual Taxation Conference

December 2-3, 2015

Austin, TX

S Corporation Opportunities and Pitfalls

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Christi Mondrik, attorney, dedicates her practice to resolving state and federal tax controversies and litigation. She is board certified in Tax Law by the Texas Board of Legal Specialization. Ms. Mondrik has handled IRS cases involving substantial corporate, individual and estate taxes. Her state tax experience includes disputes arising under Texas franchise tax, sales and use tax, fuel taxes, severance taxes, motor vehicle sales tax, and other state taxes. Ms. Mondrik is also a CPA.

Ms. Mondrik and her associates represent the firm's state tax clients in administrative and legal proceedings before the Comptroller's office, the State Office of Administrative Hearings and the Texas state courts. They also represent federal tax clients in audits, at the administrative appeals level and in proceedings before the United States Tax Court and the United States District Courts. Ms. Mondrik is licensed to practice in the United States Tax Court, the United States District Court, Western District of Texas, and all of the Texas state courts.

Ms. Mondrik and members of her firm are frequent authors and lecturers on federal tax controversies and state taxation.

Ms. Mondrik has served on the State Bar of Texas Tax Section's governing council and has served as chair and vice-chair of its Tax Controversy, CLE and Solo and Small Firms Committee Committees. After completing her 2010-13 SBOT Tax Section council member term, Ms. Mondrik served as annual meeting committee chair for 2013-14. She is also State Bar Tax Section Leadership Academy chair for 2016-17.



The TSCPA awarded Ms. Mondrik the Young CPA of the Year Award for 2009-10. She also received the 2012 TSCPA Rising Star Award. The Austin Chapter of CPAs awarded Ms. Mondrik the Distinguished Service Award in 2015.

Ms. Mondrik currently serves on Texas Society of Certified Public Accountants (TSCPA) Executive Board, the State Bar of Texas and TSCPA State Taxation Committees, and the TSCPA Federal Tax Policy Committee. Ms. Mondrik was the 2009-10 President of the Austin Chapter of CPAs. She has also served as manager of education and leadership and chair and vice-chair of its Oversight Council. Ms. Mondrik was the 2009-10 chair of the State Tax Conference Committee and the 2009-13 chair of the TSCPA state taxation committee. As chair of the state taxation committee, she was a principal drafter of comments submitted by the TSCPA in response to legislation implementing the Texas margin tax and various administrative rules. She currently serves as commenting subcommittee chair for the TSCPA Federal Tax Policy Committee.

Ms. Mondrik earned her B.B.A. in Accounting and her J.D., with honors, both from the University of Texas at Austin. She has been licensed as an attorney by the State of Texas since 2001.

S Corporation Opportunities and Pitfalls

I. Disclaimer

This paper provides information on general tax issues and is not intended to provide advice on any specific legal matter or factual situation. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this information without seeking professional counsel.¹

II. Introduction

S corporations derive their name from Subchapter S of Chapter 1 of the Internal Revenue Code, which sets forth their general requirements and treatment. S corporations are defined as “small business corporations.”² S corporation elections are popular, especially among small business owners. In many ways, since the S corporation allows for flow-through entity treatment, it may simplify reporting by requiring payment of tax only at the shareholder level. However, it may complicate reporting as well. Many business owners who have made the election to have their corporations treated as S corporations are unaware of the requirements to qualify for and maintain the S corporation election, and face potential risks related to assignment of income, reasonable compensation requirements, and other lurking issues. This paper discusses common audit issues related to S Corporations, how businesses may avoid them, and considerations to discuss with taxpayers related to their choice of entity and whether it continues to make sense as time progresses.

III. S Corporation Prerequisites

In order to qualify to make an S corporation election, and to maintain S corporation status, an entity must be formed as a domestic corporation and must meet the following requirements:

1. 100 or fewer shareholders.
2. Shareholders must be individuals.
3. Shareholders must not be nonresident aliens.
4. Only one class of stock.

While this may seem simple, the details of these requirements are not as straightforward. Issues arise in connection with each of these categories, potentially causing the S corporation to fail its qualifications and default to “C corporation” status. Unlike the flow-through nature of S corporations, if an S corporation loses its status and is treated as a C corporation, it will be

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² IRC § 1361(a)(1).

required to pay income tax twice, once at the entity level and a second time at the individual level when the shareholders receive corporate payments as dividends.

A. Number of Shareholders

The shareholder limitation presents interesting issues. Members of a family are treated as one shareholder. This includes a husband and wife (and their estates).³ This also includes all members of a family (and their estates). Members of a family are defined to include a common ancestor, any lineal descendent of the common ancestor, any spouse or former spouse of a common ancestor or any such lineal descendent. A common ancestor includes individuals not more than six generations removed from the youngest generation of shareholders who would be considered family members. For these purposes, spouses (and former spouses) are treated as being part of the same individual to whom the spouse is (or was) married. Family members also include legally adopted children and eligible foster children.⁴ This means it's not as straightforward as it seems to count to 100.

B. Individuals Only

IRC § 1361(b)(1)(B) provides an exception for an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6). For these purposes an individual's estate includes not only the estate of a deceased person, but also the bankruptcy estate of an individual who files for bankruptcy protection under Title 11 of the US Code.

IRC § 1361(c)(2) allows for certain domestic trusts to be treated as individual shareholders. These include (i) domestic individual grantor trusts, (ii) grantor trusts surviving a decedent for a two-year period beginning on the day of the deemed owner's death, (iii) trusts to which stock is transferred pursuant to the terms of a will, for the two-year period following the day the stock is transferred to the trust, (iv) a trust created primarily to exercise the voting power of the stock transferred to it, (v) an electing small business trust, and (vi) an IRA, including a Roth IRA, held by a bank or depository institution, subject to IRC §1351(c)(2)(A)(vi). Foreign trusts may not be treated as S corporation shareholders.

IRC § 1361(c)(6) allows certain exempt organizations to be treated as S corporation shareholders.

C. No Non-Resident Aliens

Non-resident aliens may not be shareholders of an S corporation. If a US shareholder's spouse is a nonresident alien with a current ownership interest under community property law or the law of a foreign country, or some other provision, the corporation cannot qualify as an S corporation

³ IRC § 1361(c)(1).

⁴ Further defined under IRC §152(f)(1)(C).

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First appeared as part of the conference materials for the
63rd Annual Taxation Conference session

"S Corporation Opportunities and Pitfalls"