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**LOOK AT THAT S CAR GO:  
SUBCHAPTER S STOCK OWNERSHIP BY TRUSTS -  
DRAFTING THE TRUST INSTRUMENT AND ELECTIONS,  
UNDERSTANDING DEADLINES**

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## I. Introduction

The vast majority of businesses in the United States are organized as flow-through businesses – S corporations, partnerships, limited liability companies, and sole proprietorships.<sup>1</sup> In 2008, flow-through businesses comprised approximately 94% of all business entities, employed 54% of the private-sector workforce and reported 36% of all business receipts. The S-Corporation Association of America claims that there are more than 4.6 million S corporations in United States in 2014.<sup>2</sup>

Given the commonplace of S corporations in family businesses, it is important for attorneys to understand the ownership restrictions applicable to S corporations, including the limitations on the types of trusts that are eligible S corporation shareholders.

## II. S Corporations

### A. One Layer of Tax

An S corporation is any “small business corporation” that elects (an “**S election**”) to be taxed as an S corporation – that is, a corporation subject to taxation under subchapter S of chapter 1 of subtitle A of the Code.<sup>3</sup> In an S corporation, the shareholders are required to take into account on their respective tax returns their respective pro rata share of the corporation’s income, loss, deduction, credit and separately stated items thereof, whether or not distributed.<sup>4</sup> When the S corporation ultimately distributes money (including money attributable to the earnings and profits of the S corporation) to its

<sup>1</sup> Robert Carroll & Gerald Prante, *The Flow-Through Business Sector and Tax Reform: The Economic Footprint of the Flow-Through Sector and the Potential Impact of Tax Reform*, Ernst & Young LLP, April 2011. Available at <http://s-corp.org/wp-content/uploads/2013/11/2-Flow-Through-Report-Final-2011-04-081.pdf>; see also Kyle Pomerleau, *An Overview of Pass-through Businesses in the United States*, Tax Foundation, January 2015. Available at [http://taxfoundation.org/sites/taxfoundation.org/files/docs/TaxFoundation\\_SR227.pdf](http://taxfoundation.org/sites/taxfoundation.org/files/docs/TaxFoundation_SR227.pdf).

<sup>2</sup> See <http://s-corp.org/our-history/>.

<sup>3</sup> Unless otherwise indicated, any reference to the “Code” or “IRC” is a reference to the Internal Revenue Code of 1986, as amended, and any reference to “Treas. Reg.” or “Reg.” is a reference to the Treasury regulations promulgated under the Code.

<sup>4</sup> IRC § 1366(a).

shareholders in the form of dividends, the shareholders do not pay tax on the dividends.<sup>5</sup> Consequently, it is often said that the earnings of an S corporation are subject to only one layer of taxation.

Absent the filing of an S election, the small business corporation would be taxed as a C corporation – that is, a corporation subject to taxation under subchapter C of chapter 1 of subtitle A of the Code. A corporation is taxed on the income that it earns. Generally, when the C corporation’s earnings are distributed to its shareholders in the form of dividends, the shareholders are taxed on the dividends.<sup>6</sup> Consequently, it is often said that the earnings of a C corporation are subject to double taxation.

The difference between the taxation of an S corporation and a C corporation is demonstrated by the following examples.

Example (1) Assume S owns both CCo, a C corporation, and SCo, an S corporation. S is active in both companies and all income is subject to tax at the highest marginal federal income tax rates. Both companies have net income and cash available for distribution (before tax) of \$100. As shown below, S’s effective tax rate for the income distributed through CCo is 50.47% compared to an effective tax rate of 39.6% for the income distributed through SCo.

	<u>CCo</u>	<u>SCo</u>
Corporate Tax		
Income	\$100.00	\$100.00
Tax Liability (35%/0%)	<u>\$35.00</u>	<u>—</u>
Net Available Cash	\$65.00	\$100.00
Individual Tax		
Income	\$65.00	\$100.00
Tax Liability (23.8%/39.6%)	<u>\$15.47</u>	<u>\$39.60</u>
Net Available Cash	<u>\$49.53</u>	<u>\$60.40</u>
Effective Tax Rate	50.47%	39.60%

The effective tax rate disparity is even greater if the income earned by the corporations is attributable to the sale of a long-term capital asset.

<sup>5</sup> Like all tax rules, there are exceptions, such as dividends paid in excess of a shareholder’s basis in his S corporation stock or, in the case of an S corporation with accumulated C corporation earnings and profits, dividends paid in excess of a shareholder’s accumulated adjustment account (AAA).

<sup>6</sup> IRC § 301(c). Like all tax rules, there are exceptions, such as the dividends-received deduction and the consolidated group provisions.

Example (2) Assume the same facts as in Example (1) except that the income is attributable to the sale of an appreciated capital asset that has been held more than one year and that is not subject to depreciation recapture. In this case, S's effective tax rate for the income distributed through CCo is 50.47% compared to an effective tax rate of 20% for the income distributed through SCo.

	<u>CCo</u>	<u>SCo</u>
Corporate Tax		
Income	\$100.00	\$100.00
Tax Liability (35%/0%)	<u>\$35.00</u>	<u>—</u>
Net Available	\$65.00	\$100.00
Individual Tax		
Income	\$65.00	\$100.00
Tax Liability (23.8%/20%)	<u>\$15.47</u>	<u>\$20.00</u>
Net Available	<u>\$49.53</u>	<u>\$80.00</u>
Effective Tax Rate	50.47%	20.00%

Because of their single layer of taxation, S corporations are often used in family business settings. The Code, however, imposes strict requirements for electing and maintaining S corporation status.

## B. Small Business Corporation

### 1. General Requirements

Only a "small business corporation" is eligible to elect to be taxed as an S corporation. A small business corporation is any "domestic corporation" that is not an "ineligible corporation" and that does not:<sup>7</sup>

- have more than 100 shareholders;
- have as a shareholder a person (other than an estate, certain trusts and certain tax-exempt organizations) who is not an individual;
- have as a shareholder a person who is a nonresident alien; and
- have more than one class of stock.

If the foregoing restrictions impede the use of an existing S corporation (see Figure 1), it may be possible to work around the S corporation restrictions by contributing the S corporation's assets and business into a lower-tier limited partnership ("LP") or limited liability company ("LLC"), with the S corporation owning an interest in the LP/LLC (see Figure 2). The

<sup>7</sup> IRC § 1361(b)(1); Reg. § 1.1361-1.

other interests in the LP/LLC could be owned by people who are not eligible S corporation shareholders or those interest could consist of varying classes of interests that the S corporation itself could not issue.<sup>8</sup>

Figure 1

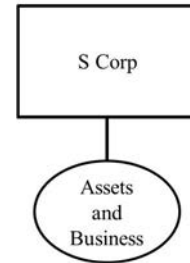
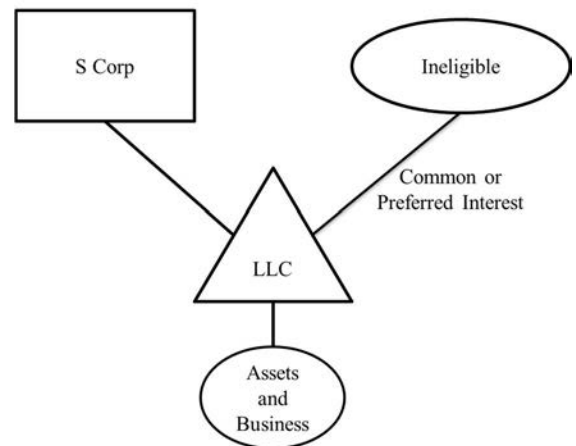


Figure 2



### 2. Domestic Corporation

A domestic corporation is any business entity that is created or organized in the United States, or under the law of the United States or of any state, and that is classified as an association taxable as a corporation.<sup>9</sup>

A domestic corporation does not have to be organized as a state law corporation. In fact, there may be advantages to organizing as a state law LLC that elects to be taxed as a corporation for federal income tax purposes.<sup>10</sup>

<sup>8</sup> See Reg. §1.701-2(d), Ex. (2).

<sup>9</sup> Reg. §§ 1.1361-1(c); 301.7701-5(a); 301.7701-2.

<sup>10</sup> An LLC is an eligible entity that can elect to be taxed as a corporation by timely filing Form 8832, Entity Classification Election, with the Internal Revenue Service (the "Service"). A copy of Form 8832 is included as Attachment A. If the owners intend for an LLC to be taxed

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