

**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 individual tax returns their pro rata shares of the corporation’s income, losses, deductions, credits 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 shareholders in the form of dividends, the dividends are not taxable to the

<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 “Reg.” is a reference to the Treasury regulations promulgated under the Code.

<sup>4</sup> IRC §1366(a).

shareholders.<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 dividends are taxed to the shareholders.<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.<sup>7</sup>

Example (1) Assume T owns both CCo, a C corporation, and SCo, an S corporation. T is active in both companies and all income is subject to tax at the highest marginal federal income tax rates. Each company has net income and cash available for distribution (before tax) of \$100. As shown below, T’s effective tax rate for the income distributed through CCo is 39.8%, compared to an effective tax rate of 37% for the income distributed through SCo.

|                           | <u>CCo</u>     | <u>SCo</u>     |
|---------------------------|----------------|----------------|
| Corporate Tax             |                |                |
| Income                    | \$100.00       | \$100.00       |
| Tax Liability (21%/0%)    | <u>\$21.00</u> | <u>—</u>       |
| Net Available Cash        | \$79.00        | \$100.00       |
| Individual Tax            |                |                |
| Income                    | \$79.00        | \$100.00       |
| Tax Liability (23.8%/37%) | <u>\$18.80</u> | <u>\$37.00</u> |
| Net Available Cash        | <u>\$60.20</u> | <u>\$63.00</u> |

<sup>5</sup> Like most 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 most tax rules, there are exceptions, such as the dividends-received deduction and the consolidated group provisions.

<sup>7</sup> These examples ignore the IRC §199A qualified business income deduction which would be available to SCo., as well as the potential tax cost under the Federal Insurance Contributions Act (FICA).

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