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

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Gene Wolf is a native El Pasoan. He earned his B.B.A. from Baylor University in 1988 and his J.D. from Baylor School of Law in 1991. He began practicing law at Kemp Smith LLP as an associate in 1991 and has been a partner since 1997. Gene is member of the Business Department with practice emphasis on tax, corporate, estate and business planning, is a member of the firm's Management Committee, and is currently serving as Managing Partner. Since 2012, Gene has served on the Board of Directors of Hunt Companies, Inc. and as chair of the Governance and Nominating and Ethics Committee. In 2017, Gene began serving on the Board of Directors of EP Holdings, Inc. Gene is a Fellow of the American College of Trust and Estate Counsel (ACTEC) and is Board Certified by the Texas Board of Legal Specialization in Estate Planning and Probate Law. Gene is currently serving as the President of the Texas Federal Tax Institute. Gene is a member of the American Bar Association Section of Taxation, the State Bar of Texas and the El Paso Bar Association. Gene is Past Chair of the State Bar of Texas Tax Section and Past Editor of the *Texas Tax Lawyer*. Gene has been recognized since 2006 as one of the "The Best Lawyers in America" in the sections of Tax Law and Trusts and Estates. In 2012, Gene was honored with the distinction of El Paso *Best Lawyers* "Tax Law Lawyer of the Year." He is qualified to practice in Texas, the Supreme Court of Texas, the United States District Court (Western District of Texas) and the United States Tax Court.

Gene's community affiliations include Rotary Club of El Paso (since 1992), Rotary Club of El Paso Foundation (since 2001), El Paso Estate Planning Council (since 1995), El Paso Chapter of Financial Service Professionals (2000-2006), El Paso Lighthouse for the Blind (2002-2006), Greater El Paso Chamber of Commerce Foundation (2002-2005), Junior League of El Paso Endowment Fund (2002-2010), El Paso Club (2007-2014), the Paso del Norte Group (2005-2012), the Borderplex Bi-National Economic Alliance (since 2012), American Red Cross, El Paso Chapter (1994-1997), Kids Excel El Paso, Inc. (since 2017), Junior Achievement of the Desert Southwest (2010-2014), Yucca Council, Boy Scouts of America (2010-2014) and a member of First Baptist Church of El Paso. Gene is married to Sherri and they have three children, Tyler, Kayla and Clint.

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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.[1] 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.[2]

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.[3] 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.[4] 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 shareholders.[5] 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.[6] 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.[7]

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.

	CCo	**SCo**
Corporate Tax		
Income	$100.00	$100.00
Tax Liability (21%/0%)	$21.00	–
Net Available Cash	$79.00	$100.00
Individual Tax		
Income	$79.00	$100.00
Tax Liability (23.8%/37%)	$18.80	$37.00
Net Available Cash	$60.20	$63.00

[1] 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.

[2] *See* http://s-corp.org/our-history/.

[3] 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.

[4] IRC §1366(a).

[5] 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).

[6] IRC §301(c). Like most tax rules, there are exceptions, such as the dividends-received deduction and the consolidated group provisions.

[7] 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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