# S CORPORATION ELECTION
# FOR A
# LONG-TIME C CORPORATION

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## 1. "C Corporations" and "S Corporations"

All corporations are "C corporations" for tax purposes unless they elect to be treated as "S corporations" (or their parent corporations elect to treat them as Qualified Subchapter S Subsidiaries ("QSubs")

## 2. Benefits of Electing S Corporation Status

The S corporation election may offer to a C corporation (and to its shareholders) substantial benefits:

- The S corporation election reduces or avoids a second tax on an eventual sale of substantially all of the assets of the corporation, including goodwill (because the sale by an S corporation generally would be subject to a single tax paid by the shareholders, while a sale by a C corporation would be subject to a tax on the corporation's gain and another tax on the receipt by the shareholders of the balance of the sale proceeds).[1]

- If the business grows rapidly and retains a substantial portion of its earnings to finance growth, the S corporation election minimizes the gain on an eventual sale of stock (because earnings that are retained by an S corporation and not distributed to the shareholders will in-

[1] But see the discussion below of the "built in gain tax."

crease their basis in their stock of an S corporation, but not a C corporation).[2]

- If the business throws off more cash than (a) necessary to grow or maintain the business and (b) the shareholders can reasonably take as compensation, rent, royalties and other deductible payments, then an S corporation can distribute that cash as tax-free dividends to its shareholders. Those distributions would be taxable to C corporation shareholders. Tax-free distributions from an S corporation are especially helpful for family members who own shares but have a small role in the business.

- An S corporation otherwise eligible to use the cash method of accounting can retain that method, even if the corporation's receipts exceed $5 million for three consecutive years. A C corporation otherwise eligible to use the cash method of accounting cannot use that method if the corporation's average receipts exceed $5 million over a three-year period

- In years for which the S corporation and QSub elections are in effect, neither the S corporation or its QSub would be subject to the penalty tax that otherwise might apply to its excess accumulated earnings.[3] If a C corporation has more liquid assets that it can prove that it needs for working capital, this penalty tax is a significant risk.[4]

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[2] All of these benefits (and a few others) could be achieved by converting to a **limited liability company** that is classified as a partnership for tax purposes. However, the conversion would be treated as a liquidation of the corporation for tax purposes and would trigger both corporate and shareholder taxes. If the S parent was an LLC and held stock of the historic operating corporation, that corporation could not be an S corporation or a QSub – it would have to remain a C corporation.

[3] The S corporation election does not reduce the risk for C corporation years.

[4] The effect of the penalty tax is to enable the IRS to force on audit a dividend that will be subject to the "double tax," described below.

- There is little reason for tax authorities to question whether the compensation of the shareholder of an S corporation is unreasonably large. In contrast, tax authorities may and sometimes do assert that the compensation of a shareholder of a C corporation is unreasonably large and that the excessive portion should be recharacterized as a dividend, for which no corporate deduction is allowed. If this position prevails, the C corporation would be subject to substantial additional tax.

- If the business generates losses or tax credits, the S corporation rules allow the shareholders to use those losses and credits to reduce their tax on income from other sources, subject to the basis, at risk and passive loss limitations (discussed below).

- An S corporation cannot take advantage of the 15% and 25% tax rates that apply to the first $75,000 of a C corporation's income. However, while the corporation is very profitable, the value of the ability to make tax-free cash distributions as an S corporation can substantially exceed the value of the benefit derived from the lowest C corporation tax rates.

## 3. Benefits of Retaining C Corporation Status

Retaining C corporation status would allow income from business operations of to be taxed at lower rates and should be used:

- If business operations will generate losses that can be carried back against taxes previously paid; or

- If the business will have zero profit each year and the business will not increase substantially in value.

- It would also be necessary to retain C corporation status if the current shareholders or prospective investors in the corporation demand the partial exclusion for gain on "qualified small business stock," which is not available for S corporations. For an investor who expects to cash out by selling stock, the tax benefit from the stock basis increases resulting from an S corporation election must be weighed against the benefits of this exclusion, which often will result in tax at an effective 28% AMT rate, not half of the long-term capital gain rate.[5]

4. **Timing of the Election**

- The S corporation election can be made at any time before the first day of the taxable year for which it will be effective.

- If made by the 15th of the third month of the taxable year, and the other eligibility requirements are satisfied, the election would be effective as of the first day of the tax year.[6]

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[5] An individual investor excludes from regular taxable income 50% of the capital gains on certain "qualified small business stock" that he or she holds for five years. The anticipated effect is a reduction in the federal long-term capital gain tax rate, but this benefit might be illusory. For alternative minimum tax ("AMT") purposes, a portion of the excluded gain is a preference item. The highest AMT rate is now 28%. Taxpayers with substantial excluded gains probably will be subject to the AMT tax on the gain, not preferential rate long-term capital gain. California taxes, including the tax on the gain from the stock sale, are not deductible for AMT purposes. So for the investor, founder or employee who hits a home run with "qualified small business stock," the AMT preference substantially reduces or eliminates the benefit of the exclusion. The maximum amount of excludable gain is the greater of 10 times investor's tax basis in the shares or $10 million.

A "qualified small business" is a C corporation engaged in an active trade or business with capitalization of less than $50 million at all times from January 1, 1993 (or, if later, since its incorporation) through date of stock purchase. The banking, leasing, real estate, farming, mineral extraction, hospitality and personal service businesses cannot be "qualified small businesses." (Note that these rules differ from the S corporation qualification rules.)

To qualify for the exclusion, the stock must be issued after August 10, 1993.

- The election must be signed by each shareholder (and by each spouse of a shareholder if the spouse has a community property or other interest in the shares) and filed with the Internal Revenue Service.

- Eligibility requirements must be satisfied by the corporation and each shareholder.[7]

  ⇨ These requirements must be satisfied at all times while the election is in effect.

  ⇨ If the requirements fail to be satisfied at any time, the S election will terminate.[8]

    ❖ If the S election for an S parent terminates, each QSub will become a C corporation (a tax disaster).

5. **Selecting a Tax Year**

S corporations have a limited range of permissible tax years.

- Generally an S corporation can use the calendar year or, by paying a corporate-level federal tax for the privilege, it may use a year ending in September, October, or November.

  ⇨ Consequently, an S corporation may adopt a fiscal year ending in September.

  ⇨ To adopt a tax year ending in September, the corporation should file Form 8716 with its S corporation election.[9]

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6 The fully-signed election form should be mailed to the Internal Revenue Service on or before the last day to make the election.

7 See "Actions That Could Terminate S Corporation Status" below.

8 See "Actions That Could Terminate S Corporation Status" below.

- Using a September year can minimize the "income bunching" problem when a fiscal-year S corporation makes an S corporation election.[10]

## 6. Federal Taxation of the S Corporation and Its Shareholders

Subject to the tax for using a fiscal year and the two taxes described below, S corporations generally are not subject to federal income tax. Instead, each shareholder is taxed directly on his or her share of the corporation's taxable income.

- As noted above, an S corporation cannot use the 15% and 25% federal income tax rates that apply to the first $75,000 of a C corporation's income.
  - ⇨ As a result of S corporation election and QSub elections, the taxable income of the business will be taxed at the federal and California tax rates for individuals.
  - ⇨ The maximum average federal income tax rates for individuals (33% and 35%) is approximately equal to the maximum average federal income tax rates for C corporations (34% and 35%).

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[9] Although the corporation could file Form 8716 after the S corporation election, it is a good idea to file Form 8716 it with the S corporation election.

[10] For example, a C corp with a January year might pay bonuses to its shareholders in January 2008. If the S corporation election is effective on February 1, 2008 and the corporation changes to a calendar year, the shareholders will take into income for 2008 the January bonuses and 11 months of income from the S corporation. In contrast, if with the S corporation election the corporation changed to a September year, the shareholders would take into income for 2008 the January bonus and only 8 months of S corporation income. There is bunching either way, but less bunching if the corporation changes to a September year rather than a calendar year.

- The maximum California personal income tax rate (9.3%) is somewhat higher than the California franchise tax rate (8.84%) for C corporations.[11]

- The S corporation election avoids a "double tax" when the corporation sells or distributes cash or other assets to its shareholders (ignoring, for the moment, the built-in gains tax on sales or distributions of appreciated assets, discussed below).

  - The effective double tax rate can be over 55%.

  - This is the effective tax rate if tax authorities recharacterize some compensation as a dividend, or force a C corporation to make a substantial dividend to avoid the penalty tax on excess accumulated earnings.

  - Avoiding or minimizing the double tax is an important benefit of the S corporation election.

## 6.1. Corporate-Level Taxes

### 6.1.1. The Built-In Gains Tax

If the S corporation or its QSub sells or distributes appreciated property during first ten tax years that the S corporation election is in effect, a federal corporate tax probably will apply to a portion of the actual or "deemed" gain on the sale.[12]

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[11] The California taxes are deductible for federal tax purposes. The federal and California itemized deduction cut-backs based on adjusted gross income increase the effective federal income tax rate for individuals by almost two percentage points over the nominal rates mentioned in this paragraph. The California personal income tax rate is 10.3% for income over $1 million.

[12] For a discussion of distributions that are treated as "deemed" sales, see "Distributions" below.

- Only the portion of the gain attributable to the appreciation in the property's value *before* the effective date of the S corporation election (the "**built-in gain**") is subject to the corporate-level tax.

- Assets with an actual value greater than their depreciated or amortized value for tax purposes (that is, more than their adjusted tax basis) on the election date would also have "built-in gains."[13]

- The built-in gains recognized during the ten-year period is taxed to the S corporation at the highest income tax rate applicable to C corporations (currently 35% for the federal income tax and 8.84% for California franchise tax).[14]

- All gain of the S corporation during the recognition period is presumed to be built-in gain.

  ⇨ The S corporation must prove that (a) it did not own the asset when the S election was made, (b) that the asset was not tainted (with built-in gain) when acquired after the election or (c) that some or all of the gain is attributable to post-election appreciation.

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[13] Built-in loss is also measured, and the maximum amount of built-in gains that can be taxed is the "net" built-in gain (built-in gains minus built-in loss) on the day the S election becomes effective. So if all the built-in gains are recognized before any built-in loss, the S corporation will pay built-in gains tax sooner than if the losses were also recognized, but the S corporation will not pay more built-in gains tax than if all the built-in loss assets were sold at the same time.

[14] Note that the tax on built-in gains would apply to a sale of an S corporation's business assets, but not to a sale of its stock. The built-in gains tax would apply to a sale by an S parent of its QSub stock.

This discussion omits several important limitations on the built-in gains tax, such as the reduction in pass-through income by the amount of the built-in gains tax.

- To minimize the risk of a costly dispute with the Internal Revenue Service or the Franchise Tax Board over the value of assets on the effective date of its S corporation election, it is helpful to have an appraisal of the total value of the operating businesses as of that date.[15]

    ⇨ The appraisal report should be kept with the S corporation's permanent tax records.

    ⇨ The officers should prepare a list of the built-in gain assets that the S parent or its disregarded subsidiaries might sell or exchange in its first three years after the S corporation election.

- Consider strategies to minimize problems resulting from this tax.[16]

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[15] More protection would be afforded by obtaining an appraisal of each of the assets, including goodwill and other intangibles. The overall value of the corporation sets the maximum amount of built-in gains tax and will be very helpful if the entire business is sold, but it will not be very helpful in a dispute with a tax authority over the amount of built-in gain for a particular asset. It is certainly possible to obtain an appraisal of each of the major assets, but it would take longer and would increase the cost.

Does the corporation have any major built-in gain items other than its goodwill? If so, you might want to explore with an appraiser the additional cost and time that might be involved in a more detailed appraisal.

Finally, if you seek an appraisal for this purpose, consider having the corporation's attorney retain the appraiser, so that the corporation or shareholders can assert that the report is protected (to the extent possible) by the attorney work-product privilege from involuntary disclosure (for example, in a legal action unrelated to the S corporation election).

[16] For example, for a cash method business, one or more shareholders might buy from the corporation its accounts receivable at the end of its last C corporation year. The buyer would pay when the AR was collected. The corporation would elect out of the installment method of accounting for the sales

- Some C corporations with loss carry forwards will want to defer the S corporation election until the corporation has profits sufficient to absorb the loss carry forwards.[17]

- *The built-in gains issue merits your careful attention before the effective date of the S corporation election.*

### 6.1.2. **The Excess Passive Receipts Tax**

If in any year as an S corporation (a) more than 25% of the gross receipts of the S Parent and its QSub are from passive sources (defined as rents, royalties, interest, dividends, annuities, or sales of stock or securities), and (b) at the end of the year the S parent and its QSub have undistributed earnings and profits earned in C corporation years, then the S parent would be subject to a federal corporate tax on a portion of its passive income.

- If the S corporation met both tests for three consecutive years (even if the tax did not apply in one or more of those years because the S corporation had no taxable income), its S election would terminate.[18]

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proceeds. The effect is to accelerate the income into the last C corporation year, but to avoid recognizing built-in gain in the first S corporation year, when the AR is collected.

17 If the corporation is increasing in value as it becomes profitable, deferring the S corporation election also means there will be more built-in gain when the S corporation election is made. Recall also that the 10-year built-in gain period does not start until the S corporation election is made.

18 An S corporation would not be subject to this tax or to termination of its S corporation status for this reason if, before the end of its first year in which it has excess passive receipts, it distributes to its shareholders all of its undistributed earnings and profits accumulated during C corporation years and makes a special tax election. Because such a distribution would be taxable to the shareholders, it should be avoided except in extraordinary circumstances.

⇨ It is unlikely that this tax would apply to an S corporation while it continued to operate a going business.

### 6.1.3. **Interest Charge DISCs**

C corporations are allowed a deduction for dividends received from other U.S. corporations.

- S corporations are not entitled to a dividends-received deduction.

  ⇨ Consequently, dividends from an interest-charge DISC to its S parent, as its sole shareholder, would be taxable to the shareholders of s parent.[19]

  ⇨ When a C corporation becomes an S corporation, the corporation will not be allowed to deduct its "interest" payments on the deferred DISC income tax.

- *Note*: The built-in gain tax (discussed above) will be a consideration in any disposition of DISC stock after the S corporation election is effective. The built-in gain tax must also be considered if the DISC terminates its DISC status.

- A DISC cannot make an S corporation election.

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[19] Note that these distributions would also be taxable if before the S corporation election the DISC issued a dividend to its C corporation parent and the C corporation parent then distributed that amount to its shareholders.

#### 6.1.4. **Other Corporate-Level Tax Issues**

- Net operating losses ("NOLs") incurred in S corporation years cannot be carried back to generate tax refunds for C corporation years.

- If the C corporation or its subsidiaries have carry forwards of passive activity losses or of regular or alternative minimum tax credits, consider the possible effects of the S election.

- S corporations are not subject to the penalty tax on personal holding companies.[20]

## 7. **Shareholder-Level Taxes**

Generally, the income, gain, loss and credits of the S corporation after the effective date of the S corporation election would flow through to its shareholders in proportion to their share ownership and would be included on their individual tax returns.[21]

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[20] The "excess passive receipts" tax, discussed above, can probably be managed by buying interests in pass-through companies with low gross margins – like natural gas pipelines.

[21] If any S corporation shares change hands during a year, 1/365th of the corporation's taxable income would be allocated among the shareholders for each day of the year in proportion to their share ownership on that day.

As a consequence of the interaction of this tax rule with the corporate law rules regarding distributions, the Board of Directors of the S corporation should consider declaring distributions immediately before each stock issuance or transfer that occurs while the S election is effective. See "Distributions" below. The issuee or transferee should acknowledge such distributions in writing to avoid misunderstandings as to the motives for the distribution.

## 8. **Losses**

For S corporation years in which the S corporation has tax losses (for the combined operations of it and its QSubs or single-member LLCs subsidiaries), the losses would flow through to the shareholders' individual income tax returns -- but the losses could offset other income only for those shareholders who have sufficient tax basis in their S corporation stock and any loans from them to the S corporation to absorb the losses.[22]

- Accordingly, before each tax year ends, the officers of the S corporation and the S corporation's accountant should review its tax position.

- If losses are likely, they should determine whether any action should be taken to enable the shareholders to derive the maximum benefit from the losses.

## 9. **Tax Basis in Stock**

After the S corporation election, each shareholder's adjusted tax basis in his or her S corporation stock will equal the sum of his or her capital contributions to the corporation plus his or her share of the income of the S corporation

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[22] See "Tax Basis in Stock" below. Borrowing by the S corporation or its subsidiaries does *not* increase the shareholders' stock basis for this purpose (in contrast to the partnership rule). A shareholder's guarantee of a debt of the S corporation or one of its subsidiaries will *not* give the shareholder basis in the guaranteed debt or increase his or her basis in his or her stock or his or her loans to the S corporation.

A shareholder is not entitled to deduct the pass-through loss unless he or she is "at risk" for tax purposes.

The "passive activity loss" limitations could also prevent shareholders from using the corporation's tax losses immediately to offset their income from other sources. These limitations might apply if the corporations have tax losses from rentals, royalties, or other inherently passive activities or if a shareholder is not involved in the business on a day-to-day basis. Losses that a shareholder could not use immediately because he or she lacks sufficient basis, at-risk amounts or passive income can be carried forward indefinitely while he or she holds the shares. If the shareholder dies, the carry forwards might not be able to be used by any other person.

(both taxable and tax-free, such as life insurance proceeds), minus the distributions from the S corporation to him or her and his or her shares of the losses, deductions and nondeductible expenses (such as life insurance premium payments) of the S corporation.

- Generally, the stock basis is adjusted at the year end of the S corporation or when a shareholder disposes of shares.[23]

- As a result of these rules, each year in which the S corporation is profitable but distributes only enough cash to enable its shareholders to pay their taxes on its income, their tax basis in their stock will increase.

  ⇨ These basis increases will reduce the gain on an eventual sale of the stock.

  ⇨ While the business is growing rapidly growing, this can be an important benefit of S corporation status.[24]

10. **Distributions**

- All distributions to the shareholders should be made from the S parent, and not directly from a subsidiary to the shareholders of the parent.

  ⇨ Subsidiaries should make distributions only to the S parent.

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[23] Upon a partner's transfer of his partnership interest, a partnership may make a "Section 754" election to adjust the tax basis of a portion of its assets. An S corporation cannot make this election (which is often advantageous).

[24] When a shareholder dies, each heir's basis in the decedent's shares is adjusted to the value on the date of death. Consequently, for shares held until death, the benefit of the pre-death basis increase is lost, but the heirs may benefit from post-death basis increases resulting from the S corporation status. This law is scheduled to change, but most observers believe that new legislation will prevent it from changing.

- After the S corporation election, each shareholder will be required to pay the income tax on his or her share of the corporation's taxable income (the "S corporation tax").

- The S corporation election permits the shareholders to receive distributions from the S corporation which, with adequate planning, will not be considered income to them for tax purposes.

  - ⇨ Accordingly, the shareholders probably will expect the S corporation to distribute regularly at least enough cash to enable them to pay their S corporation taxes.

  - ⇨ If the S corporation does not make such distributions, the shareholders will be required to obtain from other sources enough cash to pay their S corporation taxes.

  - ⇨ Without an agreement requiring the corp to make such minimum distributions, neither tax nor corporate law requires an S corporation to make any distributions.

  - ⇨ Whether, when and in what amounts distributions are made, and whether distributions are made in cash or other property, are all decided by the Board of Directors, subject to applicable agreements, if any, and certain legal limitations designed to protect creditors of the corporation.

    - ❖ The agreement could require the S corporation to make minimum distributions to enable shareholders to pay their S corporation taxes.[25]

    - ❖ Shareholders who do not control the Board of Directors might want the Company to agree to make a minimum level of distributions before they sign the S corporation election.«

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25 See "Buy-Sell Agreements" below.

- ⇨ As another possible consequence of the tax-free distributions, the "free cash" generated by the business will probably tend to be distributed according to shareholdings. In this situation, it tends to become more difficult over time for the shareholders who are active in the business to receive large salaries based on merit. The active shareholders might want to restructure their shareholdings or make agreements regarding compensation levels now, before the inactive shareholders become accustomed to large cash distributions.

- Special tax rules will apply to distributions by the S corporation to its shareholders after the effective date of the S corporation election.

  - ⇨ The S corporation will maintain a fictitious tax account (the "accumulated adjustments account" or – somewhat redundantly – the "AAA" account ) to which its taxable income is credited at the end of each S corporation year.

  - ⇨ The AAA account is debited for the tax losses of the S corporation and any distributions to shareholders during an S corporation year.[26]

  - ⇨ To the extent that a cash distribution does not exceed the balance of this tax account, *the distribution is tax-free to the shareholders*.[27]

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[26] For purposes of determining the tax effect of a distribution by an S corporation, all distributions are deemed to be made on the last day of the corporation's tax year.

[27] Before the corporation makes any distribution, its credit agreements and other arrangements should be reviewed to determine whether the distribution would be an event of breach or default or would have other adverse consequences.

If the S corporation or a subsidiary acquires assets from another corporation in a transaction that is partly or fully tax-free, the S corporation may also acquire C corporation "earnings and profits" that, if distributed, would be taxable to the shareholders.

- ❖ This rule is very important because it will allow the S corporation to make tax-free distributions.

- ⇨ As long as the S corporation generates more cash flow than it needs to grow the business, this will be a substantial benefit of the S corporation status.

- ⇨ Tax-free distributions will enable the S corporation shareholders to pay their tax on their shares of the S corporation's earnings. Before they sign the S corporation election, shareholders who do not control the Board of Directors might want the S corporation to agree to make a minimum level of distributions.[28]

- If in any year as an S corporation the distributions from the corporation exceed the balance of the AAA account (generally determined at year end), the shareholders will be subject to tax on the excess distributions as follows:

1. The S corporation and/or QSub has undistributed excess earnings and profits generated in C corporation years, such distributions from the S corporation will be taxed to the shareholders as dividends from a C corporation to the extent of those earnings and profits;

2. Distributions that exceed those earning and profits will reduce the shareholder's basis in his or her S corporation stock; and

3. When those earnings and profits are exhausted and his or her basis is reduced to zero, any additional distributions will be taxable to him or her as capital gain.[29]

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[28] See "Buy-Sell Agreements" below.

[29] See "Tax Basis in Stock" above.

- If the S corporation distributes to its shareholders property with a fair market value greater than the tax basis of the S corporation in the property, the S corporation will be deemed for tax purposes to have sold the property to the shareholders at its fair market value.

  - ⇨ The S corporation will recognize gain on the deemed sale, that gain will pass through to the individual tax returns of the shareholders and they will pay tax on that gain.[30]

  - ⇨ Each shareholder would have a tax basis in the property equal to his or her share of the property's fair market value on the distribution date.

  - ⇨ If the adjusted basis of the S corporation in the distributed property is less than the property's value, no loss would be recognized (by the shareholders or the S corporation) when the property is distributed, but the property's fair market value on the distribution date would become the shareholders' initial basis in the property.[31]

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[30] The "deemed gain" may also be subject to the "built-in gains" tax discussed above.

In contrast, appreciated property distributed by a partnership to its partners in proportion to their partnership interests generally does not result in tax to the partners. For this reason and several others, *appreciating property should not be acquired by a corporation (whether an S corporation or a C corporation) absent compelling reasons to do so*. Instead, assets such as land, buildings, collectibles and fine art should be acquired by the business owners individually or as partners in a separate partnership. The corporation can then *lease* the property from them or their partnership. We can discuss methods of limiting any liability exposure that might result from not holding the assets in a corporation.

[31] Thus, the shareholders suffer a basis reduction without the benefit of a tax loss. Accordingly, it is often preferable to have the corporation sell the property, recognize the loss, and then distribute the sale proceeds to the shareholders. (Here too, the partnership rule is generally more favorable, allowing partners to take the property tax-free and at the partnership's basis in many cases, but not in liquidating distributions.)

## 11. **Other Considerations**

- Items of expense paid by an accrual-method S corporation to a shareholder are not deductible by the corporation until paid. A similar rule applies to C corporations, but only for shareholders who own *more than* 50% of the corporation's stock. If the corporation uses the accrual method of accounting for tax purposes and it makes the S election, this rule would delay the corporation's deduction for salaries, bonuses, royalties and rents that are owed to shareholders at year end.

- A C corporation can deduct the costs of fringe benefits it provides for its employees, including employees who are also its shareholders, and for income tax purposes the employees do not include in their income the value of most of these fringe benefits.

  ⇨ If a corporation elects S status, employees who are also shareholders must include in their income the value of group life insurance premiums, accident or health plan premiums and death benefits that the corporation pays on their behalf and meals and lodging furnished by the employer; the corporation deducts those amounts.

- An S corporation cannot have a class of stock that gives its holders preferential rights to receive distributions from the corporation (for example, convertible preferred stock, a favorite of venture capital firms and private equity funds).[32]

- All compensation paid by a C corporation is subject to the Medicare tax (1.45% paid by the employee and 1.45% paid by the employer; the employer's portion is deductible for federal and California purposes).

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[32] An S corporation *can* issue classes of stock with different voting rights or a class of nonvoting stock.

- ⇨ Compensation paid by an S corporation is also subject to the medicare tax.

- ⇨ However, amounts distributed to shareholders from S corporations (assuming the corporation pays a reasonable amount of wages for any services actually rendered by the shareholders to the corporation) are not subject to the Medicare tax.[33]

- If the Company uses the tax credit for research and development, uses the LIFO (last-in-first-out) or completed contract method of accounting for tax purposes, or has carry forwards of passive activity losses or of regular or alternative minimum tax credits, the effect of the S corporation election should be analyzed before making the S election.

## 12. Actions That Could Terminate S Corporation Status

Generally, if an S corporation election is terminated, even unintentionally, the corporation cannot re-elect S corporation status for five taxable years.[34]

- If the corporation ceases to be an S corporation, then each of its QSubs will become a C corporation, which will be a tax disaster.

  - ⇨ The tax status of a status as DISC would not be affected.

- The S corporation status will terminate if the number of families holding the S corporation's stock exceeds 100, or if any shares are

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[33] The profits from which the distributions are made would be subject to the 1.5% California franchise tax, discussed below, which is deductible by the shareholders for federal tax purposes.

[34] While it is a C corporation it may generate earnings and profits that will be troublesome for excess passive receipts tax purposes if it re-elects S corporation status. At the re-election a new ten-year period will begin for built-in gain tax purposes and the built-in gain will be measured at the effective date of the re-election. See "Corporate-Level Taxes" above.

acquired by a person or entity that is not eligible to hold shares of S corporation stock.

- Generally, only individuals who are U.S. citizens are eligible to hold shares of an S corporation.

  ⇨ Non-citizens who are U.S. residents for tax purposes, bankruptcy estates, estates of decedents, most living trusts[35] and certain other trusts are also eligible to hold shares of S corporations, but strict limitations apply.

  ⇨ *Ineligible shareholders include all corporations, partnerships, limited liability companies, banks, individual retirement accounts ("IRAs") and nonresident aliens, as well as certain trusts and nonprofit organizations and most venture capital companies.*

- An S corporation can hold any amount of the stock of another corporation or any percentage interest in a partnership or LLC.[36]

- Organizations that are exempt from income tax under Section 501(c)(3) of the Internal Revenue Code can hold S corporation shares, but other nonprofit organizations cannot.

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35 Shares are often held in a living trust to avoid probate. A typical living trust is a grantor trust for tax purposes. A grantor trust is permitted to hold shares of an S corporation. If the individuals who created the trust (the "trustors" or "settlors") can withdraw the property from the trust or amend the trust at any time, it is a grantor trust. Usually all or part of the trust ceases to be a grantor trust when a trustor dies. At that point, the trust must qualify as a "qualified subchapter S trust" (a "QSST") or an "electing small business trust" (an "ESBT") and the beneficiary must promptly make an election to preserve the S corporation election.

36 A subsidiary corporation cannot be or remain a QSub unless it is owned 100% by the S corporation parent. Consequently, if an S corporation owns less than all of the shares of another corporation, the other corporation generally must be a C corporation. Export would be an exception, if it is a DISC.

- Certain qualified retirement plans may hold S corporation shares.

- If (1) an S corporation or its QSub has undistributed C corporation earnings and profits and (2) the combined receipts of the S corporation and its disregarded subsidiaries from passive sources account for more than 25% of all of their receipts for three consecutive years, the S corporation election would be terminated.[37]

- Examples of other actions by a S corporation that (under current law) could terminate its S corporation status are:

  ⇨ Issuing a second class of stock (or issuing debt or options or entering into another arrangement that could be *treated for tax purposes as a second class of stock) unless the classes differ only as to voting rights; or*

  ⇨ *Issuing stock to an ineligible shareholder* or causing the number of families holding S corporation shares to exceed 100.

- Examples of actions by shareholders that (under current law) could terminate the S corporation status are:

  (a) Transferring shares (during life or at death) to an ineligible shareholder or to a number of shareholders that would cause the total number of families holding S corporation shares to exceed 100;

  (b) Transferring shares to themselves or others as trustees of ineligible trusts;

  (c) Amending or reforming a qualified subchapter S trust (a "QSST") so that it would no longer qualify as a QSST;

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[37] See "The Excess Passive Receipts Tax" above.

(d) Amending or reforming an electing small business trust (an "ESBT") so that it would no longer qualify as an ESBT;

(e) For a beneficiary of a QSST, refusing to consent to, or obtaining the consent of the Service to revoke the tax election to have the trust treated as a QSST;

(f) For a shareholder who is a resident alien for tax purposes, moving out of the U.S. (and thus becoming a nonresident alien);[38]

(g) For a U.S. citizen, moving abroad and renouncing U.S. citizenship (and thus becoming a nonresident alien); or

(h) For a qualified retirement plan, losing its tax qualification; or

(i) For a nonprofit organization exempt from income tax under Section 501(c)(3), losing that exemption.

- Note that the special federal income tax status of an S corporation can be lost by seemingly harmless events, including gifts, transfers or issuance of stock, a resident alien's change of personal residence or a change in tax status.

13. **California Taxes**

The federal S corporation election is effective for California tax purposes.

- S corporations are subject to California franchise tax at a rate of 1.5% (rather than the 8.84% rate that applies to most C corporations).[39]

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[38] If a shareholder is also an employee, his spouse can acquire a community property interest in his shares under California law. If that spouse is not a U.S. citizen and then moves out of the U.S. (thus becoming a nonresident alien), the corporation's S corporation status probably would terminate because a nonresident alien would own a community property interest in its shares.

- The top California tax personal income rates is 9.3%, which is higher than the franchise tax rates for C corporations.40

- A minimum annual franchise tax applies to both C and S corporations, even if the corporation has a tax loss for the year, and is payable with the first estimated tax payment each year. The annual minimum tax is currently $800.

- The California corporate alternative minimum tax does not apply to S corporations.

- California also imposes a built-in gains tax and an excess passive receipts tax, with rules similar to the federal rules.[41]

- As under federal law, the shareholders of a California S corporation are taxed on the corporation's taxable income.

  - ⇨ The 1.5% California franchise tax is deductible by the shareholders for federal -- but not for California -- tax purposes.

- Credits apply at both the corporate and shareholder levels, subject to a reduction at the corporate level.

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[39] The S corporation will not be allowed to file a combined report for California franchise tax purposes unless the Franchise Tax Board requires it to do so, which will not affect the California S corporation status.

[40] The California personal income tax rate is 10.3% for income over $1 million.

[41] However, the California version of the built-in gain tax results in a surprisingly high tax. This is because the California rules reduce the pass-through gain by the amount of the California corporate-level tax, but not the federal corporate-level tax. As a result, the effective can and federal tax rate on built-in gain is much higher than the effective 55% double tax rate on income of a C corporation that is distributed to the shareholders.

## 14. **Buy-Sell Agreements**

Because the special federal and California tax status of an S corporation can be destroyed by a seemingly harmless gift or transfer of stock or a change of personal residence (as discussed above), and because an inadvertent termination of that status could result in significant additional federal and California tax, we strongly recommend that any S corporation with more than one shareholder adopt a buy-sell agreement to prohibit such transfers.

- No stock should be issued to new shareholders until they sign an appropriate buy-sell agreement.

- Because each shareholder is taxed directly on his or her share of an S corporation's taxable income, the S corporation election for a profitable corporation will increase the income tax burden of each shareholder.

  - ⇨ However, the corporation is not required to make any distributions to its shareholders to enable them to pay the additional income tax.[42]

  - ⇨ For the benefit of the shareholders, provisions concerning distributions, damages, and other subjects could also be

## 15. **Non-Tax Considerations**

- The S corporation election does not affect the limited liability of shareholders that is achieved by doing business as a corporation.

  - ⇨ It is important to have the Board of Directors formally authorize each distribution to the shareholders.

  - ⇨ Failing to adhere to these formalities could influence a court to disregard the corporation and to hold the shareholders lia-

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[42] See "Distributions" above.

ble for claims successfully asserted against the S corporation or its subsidiaries.

- Shareholders should ask their accountants about the effects that the S corporation election would have on the financial statements of the S parent and its subsidiaries.

- Each shareholder might also want to consider the effect, if any, that the election might have on his or her personal financial statements.

[End of outline.]