

# S

# Corporations

An Information Packet



Prepared by the Utah Division of Corporations and Commercial Code

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# "S" CORPORATIONS

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## INTRODUCTION

Certain small corporations may elect to be taxed as **S** corporations if they meet the requirements of the Internal Revenue Code. Congress decreed that all corporations are divided into two groups: **S** Corporations which have elected Sub-chapter **S** treatment, and **C** Corporations, which encompass all other corporations.

The **C** Corporation reports its income and expenses on a corporation income tax return and is taxed on its profits at corporation income tax rates. Profits are taxed to the **C** corporation before dividends are paid. In addition, dividends, when paid, are taxed to shareholders who report them as income. This results in "double taxation" of profits which are paid as dividends. By choosing **S** corporation status, this "double taxation" of corporate profits can be avoided.

An **S** corporation is an ordinary business formed and operated under a state's general corporation law. It is like any other corporation, except for this difference: It is like any other partnership for federal income tax purposes. The **S** corporation files an "information" tax return to report its income and expenses, but it is not separately taxed. Income and expenses of the **S** corporation "flow through" to the shareholders in proportion to their shareholders, and profits are taxed to the shareholders at their individual tax rates. Individual shareholders may benefit from the reduction in their taxable income during the first years of the corporation's existence when it may be operating at a loss.

This information packet is a condensed version of Publication 589, Tax Information on **S** Corporations, issued by the IRS. For a more comprehensive explanation of **S** corporations, please refer to Publication 589.

## HOW TO BECOME AN S CORPORATION

A corporation can become an S corporation if:

- 1) It meets the requirements of S corporation status.
- 2) All its shareholders consent to S corporation status.
- 3) It uses a permitted tax year, or is granted permission to use a tax year other than the permitted tax year.
- 4) It files Form 2553, Election by a Small Business Corporation, to indicate it chooses S corporation status.

### REQUIREMENTS OF AN S CORPORATION

To qualify for S corporation status, a corporation must meet all of the following requirements:

- 1) It must be a "domestic" corporation. This means that it must be organized in the United States or under federal or state law.**

Certain domestic corporations are ineligible to elect S corporation status. If a corporation is a member of an affiliated group of corporations, meaning one or more chains of corporations connected through stock ownership with a common parent corporation that is part of the group, it can not qualify for S status. Furthermore, a corporation does not qualify if it takes the Puerto Rico and possessions tax credit for doing business in a United States possession. In addition, financial institutions such as banks, mutual savings banks, cooperative banks, domestic building and loan associations, and insurance companies (taxed under Subchapter L of the Internal Revenue Code), are not eligible for S corporation status.

- 2) It must have only one class of stock.**

This generally means that the outstanding shares of the corporation must be identical as to the rights of the holders in the profit and assets of the corporation.

**3) It must have no more than 35 shareholders.**

When counting shareholders, the following rules apply:

- Count the persons who are considered shareholders if the stock is actually held by a trust.
- Count a husband and wife, and their estates, as one shareholder, even if they own stock separately
- Otherwise, count everyone who owns any stock, even if the stock is owned jointly with someone else.

**4) It must have as shareholders only individuals, estates, and certain trusts. Partnerships and corporations cannot be shareholders in an S corporation.**

The following trusts, other than foreign trusts, can be shareholders of an S corporation:

- A trust all of which is treated as owned by an individual who is a United States citizen or resident.
- A trust that qualified, as explained above, before the owner's death, and continues in existence after the owner's death, may continue to be an S corporation shareholder for stock held by the trust when the owner died, but for only a period no longer than 60 days, beginning on the day of the owner's death. However, if the entire corpus of the trust is included in the owner's gross estate, the 60-day period becomes a 2-year period.
- A trust created primarily to exercise the voting power of stock transferred to it.
- Any trust to which stock is transferred according to the terms of a will, but only for a period not longer than 60 days, beginning with the day the stock was transferred to the trust under the will.

**5) It must have shareholders who are citizens or residents of the United States. Nonresident aliens cannot be shareholders.**

## CONSENT OF SHAREHOLDERS

If a corporation seeks S corporation status, it must obtain the consent of the shareholders. A shareholder's consent is binding and may be withdrawn only by officially revoking the S corporation status (this will be explained later).

To consent, a shareholder must sign in the appropriate space on Form 2553, Election by a Small Business Corporation. Shareholders may also consent by signing a statement attached to Form 2553. This attachment must contain the following information:

- The name, address, and identification number of the corporation.
- The name, address, and identification number of the shareholder.
- The number of shares of stock owned by the shareholder and the date(s) acquired.
- The day and month of the end of each shareholder's tax year.

Each person who is a shareholder at the time the election is made must consent. If the election is made during the corporation's first tax year in which the S status is effective, each person who was a shareholder at any time during the part of the tax year before the election must also consent.

### TAX YEAR

A permitted tax year is a calendar year, or any other accounting period for which the corporation establishes a business purpose to the satisfaction of the IRS. A substantial business purpose exists if the corporation's requested year is a natural business year, or if the requested year satisfies an ownership tax year test. The ownership tax year test is discussed in Publication 538.

S corporation may elect to use a tax year that is different from the permitted tax year. Certain restrictions apply to this election. Details may be found in section 444 of Publication 538.

In addition, an S corporation may apply for permission to change its tax year to a year other than the year ending December 31. This application is found in Form 1128, Application for change in Accounting Periods.

## FILING FORM 2553

Form 2553, Election by a Small Business Corporation, must be filed to qualify as an **S** corporation. This form should also be to file shareholder consents and to select a tax year. Form 2553 should be filed with the Internal Revenue Service Center where the **S** corporation will file its income tax return.

**S** corporation status is effective for a tax year if Form 2553 is filed:

- Any time during the previous tax year, or
- By the 15th day of the 3rd month of the tax year to which the election is to apply.

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## ADDITIONAL INFORMATION

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### FIGURING S CORPORATION INCOME AND EXPENSES

To figure S corporation income, divide the S corporation's items of income, loss, expense, and credit into two categories:

- Separately stated items, and
- Items used to figure non-separately stated income or loss.

The separately stated items and the non-separately stated income or loss are collectively known as pass-through items because they are passed through to the shareholders on a pro rata basis.

#### **Separately Stated Items -**

The items of income, loss, expense, and credit that must be separately stated includes, but is not limited to:

- Net income or loss from rental real estate activity.
- Net income or loss from other rental activity.
- Portfolio income or loss:
  - Interest income
  - Dividend income
  - Royalty income
  - Short-term capital gain or loss
  - Long-term capital gain or loss
- Section 1231 net gain or loss
- Charitable contributions
- Section 179 expense deduction
- Expenses related to portfolio income or loss
- Credits:
  - Low-income housing credit
  - Qualified rehabilitation expenses
  - Other credits
- Investment interest expenses
- Tax preference and adjustment items needed to figure shareholder's alternative minimum tax.

#### **Non-separately Stated Items -**

Non-separately stated income or loss is the net income or loss (gross income minus allowable deductions) of the corporation stated after excluding all the items that must be separately stated.

## **Additional Income and Expense Information-**

The **S** corporation makes all the elections that affect the computation of items it has to report on its return.

A corporation that becomes an **S** corporation generally cannot have carry-overs or carry-backs from tax years when it was not an **S** corporation to years when it is an **S** corporation. There are exceptions to this general rule.

There is a limit on investment interest. If the **S** corporation borrows money to buy or carry investment property, interest expense from such debts must be identified and separately stated on Form 1120S for each shareholder, because the shareholders are subject to a limit on the deduction of such interest expense. Losses realized on sales or exchanges of property between related taxpayers generally may not be deducted.

An **S** corporation that distributes appreciated property will be treated as if it had sold the property to the distributee for fair market value. It will have to recognize any gain and pass that gain through to its shareholders.

For purposes of corporate tax provisions, if an **S** corporation is a shareholder in another corporation, the corporation is treated as an individual.

## **S CORPORATION TAXES**

The **S** corporation, like any other business, pays its own excise and employment taxes. However, it is subject to income tax only in certain instances. An **S** corporation may be subject to the following taxes:

### **1) The tax on excess net passive income.**

If an **S** corporation has pre-**S** corporation earnings and profits at the end of a tax year and its passive investment income is more than 25% of its gross receipts, the **S** corporation may be subject to a tax on excess net passive income. If passive investment income is more than 25% of gross receipts for 3 consecutive years and the corporation has pre-**S** corporation earnings and profits at the end of each of those tax years, the corporation's **S** status will be terminated.

By way of explanation, passive investment income includes gross receipts from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

The term "gross receipts" means the total amount an **S** corporation receives or accrues under the method of accounting it uses to figure its taxable income.



## **2) The capital gains tax.**

An S corporation that elected S corporation status before 1987 may be liable for a capital gains tax if:

- Its net long-term capital gain exceeds its net short-term capital loss by more than \$25,000,
- The excess is more than 50% of the corporation's taxable income, and
- The taxable income is more than \$25,000.

Taxable income is the gross income of the corporation minus most deductions, including the amortization deduction for corporate organization costs allowed to a corporation. But it does not include the net operating loss deduction or other special deductions for corporations, such as the dividends-received deductions.

If the S corporation is also liable for the tax on excess net passive income, it should figure that tax before it figures its capital gains tax.

## **3) Tax on built-in gains.**

If an S corporation has a net recognized built-in gain for any tax year beginning in the recognition period, a tax is imposed on the income of the S corporation for that tax year. The "recognition period" is the 10-day period beginning with the first tax year the corporation was an S corporation.

Generally, the amount of tax is figured by applying the highest corporate rate of tax (34%) to the net recognized built-in gain of the S corporation tax year. However, the amount of the net recognized built-in gain taken into account for any tax year cannot be more than:

- The net unrealized built-in gain, and
- The net recognized built-in gain for previous tax years beginning in the recognition period.

## **4) Tax from recomputing a prior-year investment credit.**

This tax may apply if the corporation claimed investment credit on a prior year's corporate income tax return before it became an S corporation. If the S corporation makes an early disposition of the property, the S corporation, and not its shareholders, will be liable for payment of the tax.

## **5) LIFO recapture tax.**

If a corporation made an election to be an S corporation after December 17, 1987, and used the LIFO (last in first out) inventory pricing method for its last tax year before its S election became effective, the corporation may be liable for LIFO recapture.

## FILING FORM 1120S

A domestic corporation must file Form 1120S, U.S. Income Tax Return for an S corporation, if:

- It elected to be taxed as an **S** corporation,
- The IRS accepted the election, and
- The election remains in effect.

### FIGURING SHAREHOLDER TAXABLE INCOME

Each shareholder reports a pro rata share of each item of income, loss, deduction, or credit that is separately stated and a pro rata share of non-separately stated income or loss on his or her tax return. When it is reported on the tax return, the character of any item included in a shareholder's pro rata share is determined as if the item were realized directly from the source from which the **S** corporation realized it, or incurred in the same manner in which the corporation incurred it.

**S** corporation shareholders who hold stock at any time during the year claim their share of corporate losses and deductions, subject to certain limitations, on their individual tax returns.

If a member of a family of shareholders in an **S** corporation renders service for the corporation or furnishes capital to the corporation without receiving reasonable compensation, the IRS can reallocate any items of income, deductions, etc., among shareholders who are members of the family to properly reflect the value of the services/capital. The family of any shareholder includes only the spouse, ancestors, and lineal descendants.

### DISTRIBUTIONS TO SHAREHOLDERS

How **S** corporation distributions to a shareholder are taxed depends on whether the corporation has earnings and profits.

If the corporation has no earnings and profits, any distribution a shareholder receives is a return of basis in the shareholder's stock in the **S** corporation, and, as such, it reduces the adjusted basis of his or her stock in the **S** corporation.

The existence of earnings and profits is important to an **S** corporation if it has passive investment income or makes distributions. The presence of earnings and profits can mean that a distribution is a taxable dividend or the corporation is liable for a tax on its excess net passive income.

An **S** corporation is not considered to have earnings and profits for tax years beginning after 1982 in which it was an **S** corporation. However, an **S** corporation can have earnings and profits from:

- Liquidations, redemptions, and reorganizations governed by the rules of Subchapter **C** of the Internal Revenue Code,

- Tax years in which the corporations was not an S corporation,
- Any of the S corporation's tax years that began before 1983, or
- A corporate acquisition that results in a carryover of earnings and profits under section 381 of the Internal Revenue Code.

Earnings and profits can be reduced by an S corporation for payment of the tax from recomputing a prior-year investment credit. This reduction of earnings may affect the tax treatment of distributions by an S corporation to its shareholders.

### TERMINATING S CORPORATION STATUS

The corporation's status as an S corporation may be terminated in any of the following ways:

#### **1) By revoking the election.**

An S corporation election may be revoked by the corporation for any tax year. It can only be revoked only if shareholders who collectively own more than 50% of the outstanding shares in the corporation's stock consent to the revocation. The consenting shareholders must own their stock in the S corporation at the time the revocation is made.

#### **2) By ceasing to qualify as an S corporation.**

A corporation's status as an S corporation will be terminated if at any time the corporation ceases to qualify as an S corporation. Certain events can cause the corporation to cease qualifying as an S corporation. Some of these include:

- Having more than 35 shareholders.
- Transferring stock in the S corporation to a corporation, partnership, an ineligible trust, or a nonresident alien.
- Creating a second class of stock
- Acquiring a subsidiary, other than certain non-operating subsidiaries.

#### **3) By violating the passive investment income restrictions.**

A corporation's status as an S corporation will be terminated if both of the following conditions occur for 3 consecutive tax years:

- It has pre-S corporation earnings and profits at the end of each tax year.
- Its passive investment income for each tax year is more than 25% of gross receipts.

Terminations are generally effective on the date of the termination event. If a corporation's status as an S corporation has been terminated, it must wait 5 years before it can again become an S corporation. If it gets the permission of the IRS, the waiting period may be less than 5 years.

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