

“Small business corporation” IRC § 1361(b)

- Not an “ineligible corporation” (1361(b)(2))
- No more than 100 shareholders
 - Spouses + family = 1 shareholder (1361(c)(1))
- No nonresident alien shareholders
- Only one class of stock
- No shareholders who are not individuals
 - Except: decedent’s estates, some trusts, and charities
 - No partnerships, other corporations
- Except: S corporation parent owning 100% of stock (1361(b)(3))

Election: IRC § 1362

- All shareholders must consent
 - Watch community property problems
- Effective date of election
 - Generally, next taxable year
 - Can be good for current year if made within 2½ months of start of year
- Election good until revoked or terminated

Terminating S status

- Voluntary revocation - IRC § 1362(d)(1)
- Ceasing to be small business corporation - IRC § 1362(d)(2)
- *Some* S corps. that used to be C corps. - IRC § 1362(d)(3)
- Inadvertent terminations - IRC § 1362(f)
- Can’t go back to Sub S for five years - IRC § 1362(g)

S corporation operations

- Income, losses “pass thru” (1366)
 - Character (ordinary vs. capital) determined at corporate level
 - Elections (e.g., 1033) made at corporate level
- Stock basis increases/decreases accordingly (1367)
- If never was a C corporation, distributions are treated as return of stock basis, then capital gain (1368(b))
- Loss “pass-thru” limited to stock basis + debt basis (1366(d))
- Corporate debt to third parties does *not* create usable basis for shareholders (even if shareholders guarantee it!)
 - *Harris* and many other cases

S corps. formerly C corps.

- Electing S not a taxable event, but:
 - Double tax on appreciated property doesn't go away
 - E&P (dividend potential) doesn't go away
 - If E&P is present, excess passive investment income creates problems
- Tax at corporate level
- Eventual termination of S status

Former C corps. - appreciated property

- Can't eliminate corporate tax on asset appreciation inside C corporation
- Section 1374 taxes the S corporation on "built-in" gain (BIG) that was present when S election was made
- "Taint" persists for 5 years after S election is made (IRC § 1374(d)(7))

Former C corps. - dividends

- Distributions of old C corp. E&P are dividends - taxable to shareholders
- But previously "passed thru" S corp. income not taxed
- Distributions are treated as previously taxed S corp. income first - "AAA" account (1368(e)(1))
- Distributions beyond AAA are Sec. 301 - taxable to extent of remaining E&P

Former C corps. with E&P + passive investment income

- IRC § 1375 - corporation taxed on excessive passive income if it has old E&P
- IRC § 1362(d)(3) - lose S status after three years of that
- Clean out the old E&P before turning old C corp. into S holding company!