ABCs of S Corporations

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Federal taxes on corporations—generally

- For substantive law purposes, a corporation is an artificial, intangible being created under state or federal law or the law of a foreign country; federal tax law treats corporations in the same way—they are considered to be separate tax entities, independent of their shareholders.
- A corporation adopts its own fiscal year and accounting methods [I.R.C. §§ 441, 444], computes its own income or loss [IRC §§ 61 et seq.], files its own income tax returns [IRC § 6012(a)(2)], and unless it has elected to be taxed as an S corporation, pays its own tax. [IRC § 11]
- If a corporation distributes income to its shareholders as a dividend or if the shareholders sell stock at a premium to reflect the income, such income generally is subject to a second tax.

Tax advantages of corporations—generally

- Corporations can provide certain tax-favored fringe benefits to their shareholder-employees that are not available to owners of sole proprietorships, partnerships, or limited liability companies because those persons are not employees for tax purposes.
- Holders of 2% or more of the stock of an S corporation are treated as partners for fringe benefit purposes and are denied the right to receive these benefits; fringe benefits available to shareholder-employees of C corporations (but not owners of other forms of business entity) include group-term life insurance, health care benefits, child care assistance, and cafeteria plan benefits. [IRC §§ 79, 104 et seq., 125, 129]

Tax advantages of corporations—generally (cont.)

- A corporation's income, including an S Corporation, is not subject to employment tax at the time it is earned; if income is used to pay compensation to employees, the compensation is subject to Social Security tax and hospital insurance tax, but this tax is not due until the compensation is paid. [IRC §§ 3101, 3102]
- Such taxes are only imposed on "wages," and income paid out in the form of dividends is not subject to these taxes. [IRC § 3121(a)]
- Aggregate of the Social Security tax and hospital insurance taxes are imposed at the same rates as the self-employment tax. [IRC § 3101(a), (b)] corporation, as employer, pays one-half of these taxes, and the other half is paid by the employee through withholding. [IRC §§ 3101, 3111]

Tax disadvantages of corporations

- Income of a C corporation is subject to a double tax
- A corporation must pay tax on its income when it is earned; when the income is distributed to shareholders, or they realize the value of the income by selling their shares for an increased price, the income is subject to a second income tax imposed on the shareholders.
- C corporations that suffer losses and their owners generally are also in a less favorable position than other forms of business entity and their owners; a C corporation's losses generally belong to the corporation and can only be used to reduce corporate income on a current basis. However, the shareholders of a corporation may obtain a tax benefit from corporate losses when they sell their stock at a loss.

Double taxation

- Unless a corporation elects to be taxed as an S corporation, it pays tax on its income when it is earned, and its shareholders pay a second tax on this income when it is distributed to them or they realize gains on the sale of their stock attributable to the income.
- Note: some of the disadvantage of C corporation double-taxation was mitigated by changes made by the 2017 Tax Cuts and Jobs Act (the TCJA), including the lowering of the previous multiple and tiered corporate tax rates (as high as 35%) to a singular 21% corporate tax rate.

Taxation of corporate income and losses

- Corporations engaged in providing professional services in fields such as health, law, and engineering previously were not entitled to take advantage of the former graduated corporate income tax rates; these corporations formerly were taxed at a flat rate of 35% on all income; however, pursuant to the TCJA, for taxable years beginning after Dec. 31, 2017, these corporations now also will benefit from the lower singular 21% tax rate for corporations.
- Prior to amendment by the TCJA in 2017 to remove such applicability, corporations also formerly were subject to the alternative minimum tax, which is a tax imposed on taxpayers with substantial deductions or credits that reduce the tax that such taxpayers are required to pay; the alternative minimum tax imposes a tax on such taxpayers' incomes at a minimum rate to insure that these taxpayers pay some amount of tax.

Taxation of corporate income and losses (cont.)

- Following the changes made to the NOL rules by the TCJA, generally applicable to NOLs arising in taxable years ending after Dec. 31, 2017, the deduction for a taxable year will be an amount equal to the lesser of (1) the aggregate of the net operating loss carryovers to such year, plus the net operating loss carrybacks to such year, or (2) 80% of taxable income (as computed without regard to the NOL deduction allowable under IRC § 172); moreover, no carry back will be allowed of the loss deduction (with some exceptions for farm losses and NOLs of insurance companies, which still will be allowed to be carried back for two years), and the forward carryover of NOLs will be allowed indefinitely (i.e., with no maximum number of years).

S corporations—generally

- An S corporation is an entity classified as a corporation for federal income tax purposes that has elected (using IRS Form 2553) to be taxed as a pass-though entity in a manner similar to a partnership. [IRC § 1361(a)(1)]
- Unlike a C corporation, an S corporation generally is not subject to federal income—its income is reported on the tax returns of its shareholders, and they are responsible for the tax. [IRC § 1366(a)]
- Any losses suffered by the corporation also pass through and are reported on its shareholders' income tax returns. [IRC § 1366(b)]

Eligibility to elect S corporation status

- In order to be eligible to make an S corporation election, a corporation must be a "small business corporation"; that does not mean that the corporation is small in terms of assets or income.
- All of the following requirements must be met to be eligible:
  - It must have been created under the law of the United States or one of the states. [IRC § 1361(b)(1)]
  - It may not have more than 100 shareholders. [IRC § 1361(b)(1)(A)]
  - As a general rule, all shareholders must be individuals, certain types of trusts, estates (decedent's or bankruptcy), or certain types of tax-exempt entities. [IRC § 1361(b)(1)(B)]

Eligibility to elect S corporation status (cont.)

- No shareholder who is an individual may be a nonresident alien. [IRC § 1361(b)(1)(C)]
- Except for classes of stock that differ only with respect to their voting rights, the corporation may only have one class of stock. [IRC §§ 1361(b)(1)(D)]
- The corporation may not be an ineligible entity, e.g., a financial institution that uses the reserve method of accounting for bad debts, an insurance company, et al. [IRC § 1361(b)(2)]

- An S corporation must meet these requirements not only to make its initial S corporation election, but also to retain its S corporation election. [IRC § 1362(d)(3)]

Eligibility to elect S corporation status—entity type

- An entity need not be a corporation as a matter of state law to be eligible to be taxed as an S corporation; a non-corporate entity that elects to be classified as a corporation for federal income tax purposes may make an election to be taxed as an S corporation. [Treas. Reg. § 301.7701-3(h)(3)]
- An eligible limited liability company (LLC) can make an S election, and in fact is a popular entity choice for an S corporation election.

Eligibility to elect S corporation status—shareholders

- A partnership cannot be a shareholder, but a single-member LLC can be a shareholder because the separate existence of the LLC is disregarded for tax purposes; however, the sole member of the LLC also must be a qualified S corporation shareholder, such as an individual who is not a nonresident alien. [Treas. Reg. § 1.1361-1(e)(3)(ii)(F)]
- An S corporation may have a shareholder that is an S corporation, but only if all of its stock is held by the S corporation and an election is made to treat the S corporation as a qualified subchapter S subsidiary, or Qsub [IRC § 1361(b)(3)]; a Qsub is not recognized as a separate entity for federal income tax purposes, and all of its income, losses, and other tax items are considered to be those of its parent corporation.

Eligibility to elect S corporation status—shareholders (cont.)

- In applying the 100-shareholder limit, groups of family members are counted as one shareholder. [IRC § 1361(c)(1)]
- Most of the types of trusts that can be shareholders feature the pass through of income or loss on a current basis to a single beneficiary who qualifies as an S corporation shareholder. [IRC § 1361(c)(2)(a)]
- Revocable living trusts and testamentary trusts (i.e., those created by wills) also may be S corporation shareholders for up to two years after the death of the grantor or testator. [IRC § 1361(c)(2)(A)(ii), (iii)]

One class of stock

- The one class of stock requirement means that all shares must have equal rights with respect to dividends and liquidating distributions. [Treas. Reg. § 1.1361-1(l)(1)]
- This prevents an S corporation from issuing preferred stock.
- Options, warrants, and similar instruments are not generally considered a second class of stock. [Treas. Reg. § 1.1361-1(l)(4)(iii)(A)]

One class of stock (cont.)

- Debt obligations of an S corporation can be a second class of stock if they are classified as equity rather than debt for tax purposes. However, the Code and regulations identify three situations in which S corporation debt will not be treated as a second class of stock:
  - *Straight debt.* Defined as an obligation payable to an individual, estate, or trust that qualified to hold S corporation stock or to a person engaged in lending money that meets specified terms. [IRC § 1361(c)(5)]
  - *Unwritten advances.* These are advances made to an S corporation by one of its shareholders that do not exceed $10,000 in the aggregate [Treas. Reg. §1.1361-1(l)(4)(ii)(B)(2)]
  - *Debt held proportionately.* Debt held by an S corporation's shareholders in proportion to their stock interests. [Treas. Reg. § 1.1361-1(l)(4)(ii)(B)(2)]

S corporation election

- An eligible corporation wishing to be taxed as an S corporation must file an election with the Internal Revenue Service on Form 2553. [IRC § 1377(c); Treas. Reg. § 1.1362-6(a)(2)]
- Consent of all shareholders is required when the election is made, but consent of new shareholders who acquire stock after the election is made is not required to keep it in effect.

S corporation election (cont.)

- The S corporation election may be filed at any time during the 12 months prior to the beginning of the taxable year for which it is to be effective; an election filed on or before the 15th day of the third month of a corporation's taxable year also can be retroactive to the beginning of the year if the corporation was qualified to make the election from the beginning of the taxable year until the election is made. [IRC § 1362(b)(1)]
- If the corporation is newly organized, the election cannot be filed until after it has shareholders, owns assets, or begins doing business. [Treas. Reg. § 1.1362-6(a)(2)(ii)(C)]

Termination and revocation of S corporation election

- A corporation's S corporation election can be revoked voluntarily at any time with the consent of a majority of its shareholders by filing a revocation with the Internal Revenue Service. [IRC § 1362(d)(1)]
- An S corporation's election is terminated involuntarily if the corporation ceases to meet the qualifications to be a small business corporation. [IRC § 1362(d)(1)]
- A termination is effective when the cessation occurs and does not require action by the Internal Revenue Service. [IRC § 1362(d)(2)]
- If an S corporation has undistributed earnings and profits, its S corporation election terminates if more than 25% of its gross receipts for three consecutive taxable years is composed of passive investment income. [IRC § 1362(d)(3)]

Termination and revocation of S corporation election (cont.)

- When an S corporation election is revoked or terminated, the corporation immediately becomes taxable as a C corporation—even if the revocation or termination occurs in the middle of a tax year.
- If the revocation or termination occurs during a tax year, the corporation's income, loss, and other tax items are divided between the two short tax years, one in which the corporation is an S corporation and the other in which it is a C corporation. [IRC § 1362(e)(1)]

S corporation taxable year

- As a general rule, an S corporation must use a calendar year as its taxable year unless it satisfies the Internal Revenue Service that there is a business purpose for using another taxable year. [IRC §§ 441(i), 1378]
- An S corporation may elect to use a fiscal year that does not defer income for more than three months without the need to show a business purpose. [IRC § 444]

Pass-through of income and loss

- An S corporation is not generally taxable on its income for federal income tax purposes [IRC § 1362(a)]
- Rather, its income or loss passes through to its shareholders; the shareholders must include the income in their own taxable income and may deduct the S corporation's losses in computing their taxable income. [IRC § 1366(a), (c)]
- With certain exceptions, such as denial of the personal exemption and net operating loss deductions, the taxable income of an S corporation is computed in the same manner as that of an individual. [IRC § 1363(b)]

Pass-through of income and loss (cont.)

- If the character of items of an S corporation's income, gain, loss, deduction, and credit may affect the tax liability of a shareholder, these items must be separately stated in computing an S corporation's income and not treated as part of the taxable income of the corporation; these items, which retain their character when passed through to shareholders, include capital gains and losses, charitable contributions, and tax-exempt income. [IRC § 1366(a), (b)]
- The decrease for deductions by reason of a charitable contribution (as defined in IRC § 170(c)) of property is the amount equal to the shareholder's pro rata share of the adjusted basis of such property. [IRC § 1362(a)(2) (flush paragraph)]
- Most states that impose corporate income taxes (including Oregon) treat S corporations as pass-through entities.

Allocation of income and loss

- An S corporation's income or loss is allocated among its shareholders in proportion to their stock ownership [IRC § 1377(a)]; any other allocation generally would cause the corporation to have two classes of stock, terminating its S corporation election.
- If a change in stock ownership occurs during a taxable year, the S corporation's income or loss is allocated on a per share-per day basis as if an equal fraction of the income or loss was realized on each day of the taxable year [IRC § 1377(a)(1)]; this avoids the need to close the corporation's books whenever stock is transferred.
- However, the corporation and its shareholders can elect to close the books for purposes of allocating income or loss if they believe the result would be more fair, for example because a new shareholder did not participate in generating profits that accrued early in the year. [IRC § 1377(a)(2)]

Allocation of income and loss (cont.)

- Unlike sole proprietorships and partnerships, the income of an S corporation is not considered self-employment income and is not subject to self-employment tax. [IRC §§ 1401, 1402(a)]
- Federal employment taxes are imposed on S corporation income only if it is paid to shareholders in the form of compensation. [IRC §§ 3101, 3111]
- S corporation income is not subject to self-employment tax even it is distributed to shareholders, so long as the distribution takes the form of a dividend.

Limitation on loss deductions

- The aggregate amount of losses and deductions for any taxable year that can pass through to an S corporation shareholder and be used to reduce the shareholder's taxable income from other sources cannot exceed the sum of the adjusted basis of the shareholder's stock in the S corporation and the adjusted basis of any debt owed to the shareholder by the S corporation. [IRC § 1366(d)(1)]
- Basis is computed at the end of the tax year and reflects any distributions made to the shareholder; any loss deduction disallowed under this rule carries forward indefinitely and is treated as having been incurred by the S corporation in succeeding years with respect to the shareholder to whom the deduction was denied until the shareholder has sufficient basis to fully use the loss or deduction. [IRC § 1366(d)(2)]

Limitation on loss deductions (cont.)

- A shareholder's deduction of S corporation losses may also be limited by the passive loss rules; losses from passive activities are only deductible from a taxpayer's income from other passive activities and not from income from businesses in which the taxpayer actively participates. [IRC § 469(a)]
- A passive activity is a trade or business in which a taxpayer does not materially participate and most rental activity regardless of the taxpayer's participation [IRC § 469(c)]; whether a trade or business activity of an S corporation is passive is determined on a shareholder-by-shareholder basis considering each shareholder's participation in the activity. [Temp. Treas. Reg. § 1.469-2T(e)(1)]
- Material participation generally requires that a shareholder devote more than 500 hours per year to the activity. [IRC § 469(h); Temp. Treas. Reg. § 1.469-5T(a)]

Sec. 199A qualified income business deduction

- The 2017 TCJA added a new 20% deduction for pass through entities such as sole proprietorships, partnerships, limited liability companies, and subchapter S corporations, which went into effect January 1, 2018. [IRC § 199A)]
- The 20% deduction, which is applied to the individual owner's "qualified business income" (which is based on what is distributed to him or her each year as an owner/partner in the business, not the amount he or she takes out in salary for services rendered to the business), applies only to small businesses engaged in manufacturing, retail, non-professional services (e.g., restaurants and lawn care), and some professional services (e.g., architecture and engineering).
- A taxpayer engaged in a "specified service trade or business" – defined as health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services – or "any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees," only is ineligible for the deduction if his or her taxable income is less than certain statutory limits.

Sec. 199A qualified income business deduction—application to S corporations

- The IRC § 199A deduction is calculated at the shareholder level with respect to each separate qualified trade or business of the taxpayer and is available to an individual shareholder to offset AGI.
- The limitations are similarly applied at the shareholder level by allocating to each shareholder such shareholder's pro rata share of the S corporation's W-2 wages and unadjusted basis in qualified property.
- Thus, Schedules K-1 issued by S corporations will now need to identify each separate trade or business of the entity that qualifies for the IRC § 199A deduction, as well as all items of income, gain, loss, deduction, and credit, plus W-2 wages and the unadjusted basis of qualified property attributable to each such qualified trade or business.

Questions?

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Form **2553**
(Rev. December 2017)
Department of the Treasury
Internal Revenue Service

Election by a Small Business Corporation

(Under section 1362 of the Internal Revenue Code)
(Including a late election filed pursuant to Rev. Proc. 2013-30)

▶ You can fax this form to the IRS. See separate instructions.
▶ Go to *www.irs.gov/Form2553* for instructions and the latest information.

OMB No. 1545-0123

Note: This election to be an S corporation can be accepted only if all the tests are met under *Who May Elect* in the instructions, all shareholders have signed the consent statement, an officer has signed below, and the exact name and address of the corporation (entity) and other required form information have been provided.

Part I Election Information

Type or Print		
	Name (see instructions) Acme, Inc.	**A Employer identification number** 99-999999
	Number, street, and room or suite no. If a P.O. box, see instructions. 0000 Any St. #111	**B** Date incorporated 1/1/2017
	City or town, state or province, country, and ZIP or foreign postal code Anytown, OR 99999	**C** State of incorporation Oregon

D Check the applicable box(es) if the corporation (entity), after applying for the EIN shown in **A** above, changed its ☐ name or ☐ address

E Election is to be effective for tax year beginning (month, day, year) (see instructions) . . . . ▶ 1/1/2017

Caution: A corporation (entity) making the election for its first tax year in existence will usually enter the beginning date of a short tax year that begins on a date other than January 1.

F Selected tax year:
(1) ☑ Calendar year
(2) ☐ Fiscal year ending (month and day) ▶ ________
(3) ☐ 52-53-week year ending with reference to the month of December
(4) ☐ 52-53-week year ending with reference to the month of ▶ ________
If box (2) or (4) is checked, complete Part II.

G If more than 100 shareholders are listed for item J (see page 2), check this box if treating members of a family as one shareholder results in no more than 100 shareholders (see test 2 under *Who May Elect* in the instructions) ▶ ☐

H Name and title of officer or legal representative whom the IRS may call for more information	Telephone number of officer or legal representative
John O. Taxpayer	503-000-0000

I If this S corporation election is being filed late, I declare I had reasonable cause for not filing Form 2553 timely. If this late election is being made by an entity eligible to elect to be treated as a corporation, I declare I also had reasonable cause for not filing an entity classification election timely and the representations listed in Part IV are true. See below for my explanation of the reasons the election or elections were not made on time and a description of my diligent actions to correct the mistake upon its discovery. See instructions.

Sign Here

Under penalties of perjury, I declare that I have examined this election, including accompanying documents, and, to the best of my knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete.

▶ **Signature of officer**	President **Title**	**Date**

Name	Employer identification number
Acme, Inc.	99-999999

Part I **Election Information** *(continued)* **Note:** If you need more rows, use additional copies of page 2.

J Name and address of each shareholder or former shareholder required to consent to the election. (see instructions)	K **Shareholder's Consent Statement** Under penalties of perjury, I declare that I consent to the election of the above-named corporation (entity) to be an S corporation under section 1362(a) and that I have examined this consent statement, including accompanying documents, and, to the best of my knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete. I understand my consent is binding and may not be withdrawn after the corporation (entity) has made a valid election. If seeking relief for a late filed election, I also declare under penalties of perjury that I have reported my income on all affected returns consistent with the S corporation election for the year for which the election should have been filed (see beginning date entered on line E) and for all subsequent years.		L Stock owned or percentage of ownership (see instructions)		M Social security number or employer identification number (see instructions)	N Shareholder's tax year ends (month and day)
	Signature	Date	Number of shares or percentage of ownership	Date(s) acquired		
John O. Taxpayer		1/1/2017	500	1/1/2017	000-00-0000	Dec. 31
Jane U. Taxpayer		1/1/2017	500	1/1/2017	000-00-0000	Dec. 31

ABCs of S corporations

Federal taxes on corporations—generally

For substantive law purposes, a corporation is an artificial, intangible being created under state or federal law or the law of a foreign country. Federal tax law treats corporations in the same way—they are considered to be separate tax entities, independent of their shareholders. A corporation adopts its own fiscal year and accounting methods [I.R.C. §§ 441, 444],[1] computes its own income or loss [IRC §§ 61 et seq.], files its own income tax returns [IRC § 6012(a)(2)], and unless it has elected to be taxed as an S corporation, pays its own tax.[2] [IRC § 11] If a corporation distributes income to its shareholders as a dividend or if the shareholders sell stock at a premium to reflect the income, such income generally is subject to a second tax. This second tax is imposed when a dividend is paid or stock is sold.

This is to be contrasted with a sole proprietorship, which generally is not considered to be an entity separate from its owner for federal income tax purposes. [Treas. Reg. § 301.7701-3(a).] With a sole proprietorship, the business's income is included in the owner's income in the year it is earned and the business's losses are treated as having been borne by the owner in the year incurred.

The taxation of corporations is also to be contrasted with that of so-called "pass-through" entities such as partnerships and S corporations. Pass-through entities are separate from their owners for income tax purposes and may adopt their own accounting methods. [IRC § 441] However, their choice of fiscal year is effectively limited to that of their owners. [IRC §§ 444, 1378] Pass-through entities compute their own income and loss and file information returns reporting it to the government, but the income or loss passes through and is reported on the owners' income tax returns.[3] [IRC §§ 701, 1363(a)] If distributions are made by pass-through entities, they are generally tax free because the owners have already paid tax on income included in the distribution. [IRC §§ 731, 1368]

Corporations that have not elected to be taxed as S corporations are sometimes called C corporations to differentiate them from S corporations. [IRC §§ 465(a)(1)(B), 469(a)(2), 1371(b)] This name derives from the fact that such corporations are taxed under the rules of subchapter C of the Internal Revenue Code. [IRC §§ 301 et seq.] The name of S corporations similarly derives from the fact that these corporations fall under the rules of subchapter S of the Internal Revenue Code.

Tax advantages of corporations

Corporations can provide certain tax-favored fringe benefits to their shareholder-employees that are not available to owners of sole proprietorships, partnerships, or limited liability companies because those persons are not employees for tax purposes. Holders of two percent or more of the stock of an S corporation are treated as partners for fringe benefit purposes and are denied the right to receive these benefits. The fringe benefits available to shareholder-employees of C corporations but not owners of other forms of business entity include group-term life insurance, health care benefits, child care assistance, and cafeteria plan benefits. [IRC §§ 79, 104 et seq., 125, 129]

In addition, corporations can provide exemption from, or at least a deferral for, the payment of employment taxes. The income of a sole proprietorship or entity taxed as a partnership is treated as income from self-employment. [IRC § 1402(a)] Unless the income is paid to a limited partner in a limited partnership, each sole proprietor, partner, or LLC owner must pay self-employment tax on his or her share of the entity's income. [IRC § 1401] The rate of this tax is 12.4 percent of the amount of the self-employment income for such taxable year and 2.9 percent on the balance. [IRC § 1401(a), (b)][4] The self-employment tax is imposed in the year the entity earns it, regardless of whether any portion of the earnings is distributed to owners. [IRC § 1402(a)]

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[1] References to "IRC" are to the most recent version of the Internal Revenue Code, unless otherwise noted.

[2] Comptroller of Treasury of Maryland v. Wynne, 135 S. Ct. 1787, 191 L. Ed. 2d 813 (2015).

[3] Comptroller of Treasury of Maryland v. Wynne, 135 S. Ct. 1787, 191 L. Ed. 2d 813 (2015).

[4] The ceiling on the higher rate of tax, which includes Social Security tax, is subject to annual cost-of-living adjustments.

In contrast, a corporation's income is not subject to employment tax at the time it is earned. If the income is used to pay compensation to employees, the compensation is subject to Social Security tax and hospital insurance tax, but this tax is not due until the compensation is paid. [IRC §§ 3101, 3102] These taxes are only imposed on "wages," and income paid out in the form of dividends is not subject to these taxes. [IRC § 3121(a)] The aggregate of the Social Security tax and hospital insurance taxes are imposed at the same rates as the self-employment tax. [IRC § 3101(a), (b)] The corporation, as employer, pays one-half of these taxes, and the other half is paid by the employee through withholding. [IRC §§ 3101, 3111] Note that these employment tax sections were impacted by the 2010 Patient Protection and Affordable Care Act,[5] the Health Care and Education Reconciliation Act of 2010,[6] the Hiring Incentives to Restore Employment Act,[7] and the 3% Withholding Repeal and Job Creation Act.[8] More recently, these provisions further were revised by the Tax Increase Prevention Act of 2014 (TIPRA)[9] and the Consolidated Appropriations Act, 2016.[10]

An S corporation is treated like a C corporation for self-employment tax purposes and can distribute income in the form of a dividend without its being subject to self-employment tax.[11] If an S corporation's income is paid to its shareholders in the form of compensation, it is subject to Social Security and hospital insurance taxes with one-half being paid by the S corporation and one-half by the shareholder employee. [IRC §§ 3101, 3111]

Tax disadvantages of corporations

The income of a C corporation is subject to a double tax, which makes this form of business organization disadvantageous as compared to others. A corporation must pay tax on its income when it is earned. When the income is distributed to shareholders, or they realize the value of the income by selling their shares for an increased price, the income is subject to a second income tax imposed on the shareholders. By comparison, the income of sole proprietorships, partnerships, and limited liability companies is taxed to the owners when it is earned, and there is no second tax when it is distributed to the owners or they sell their interests in the business. The same is true of S corporations, as discussed below.

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[5] Pub. L. 111-148, Title IX, § 9015(b)(1), Title X, § 10906(b), 124 Stat. 871, 1020 (Mar. 23, 2010), newly added IRC § 1301(b)(2) and IRC § 1401(b)(2), which each imposed on every taxpayer (other than a corporation, estate, or trust) for each taxable year beginning after December 31, 2012, a tax equal to 0.5 percent of the self-employment income for such taxable year which is in excess of $200,000 ($250,000 in the case of a joint return); these sections both were amended to increase the amount to 0.9 percent by the Health Care and Education Reconciliation Act of 2010, and amended to add a $125,000 floor in the case of a married taxpayer (as defined in IRC § 7703) filing a separate return.

[6] Pub. L. 111-152, Title I, § 1402(b)(1)(B), 124 Stat. 1063 (Mar. 30, 2010). In addition to the changes described in footnote 5 above, this Act newly added IRC § 1302(f), which clarified the rules with regard to collection and payment of the additional tax under IRC § 1301(b)(2), as added by the Patient Protection and Affordable Care Act, and clarified that the additional tax imposed under IRC § 1401(b)(2), as also added by the Patient Protection and Affordable Care Act, will not be deductible for purposes of calculating "net earnings from self-employment."

[7] Pub. L. 111-147, Title I, § 101(a), 124 Stat. 72 (Mar. 18, 2010). This Act newly added IRC § 3111(d), which provided a limited time tax break from the IRC § 3111(a) employment tax to qualified employers for hiring certain new qualified employees during 2010. Note that this short-term provision, applicable only to the 2010 tax year, was subsequently struck (repealed) by the Consolidated Appropriations Act, 2018 [Pub. L. 115-141, Div. U, Title IV, § 401(b)(34), 132 Stat. 1204, Mar. 23, 2018].

[8] Pub. L. 112-56, Title II, § 261(e)(2), 125 Stat.730 (Nov. 21, 2011). This Act newly added IRC § 3111(e), which provided a limited time tax credit from the IRC § 3111(a) employment tax for the employment of certain qualified veterans by qualified tax-exempt organizations.

[9] Pub. L. 113-295, Div. A, Title II, § 221(a)(99)(B), 128 Stat. 4051 (Dec. 19, 2014).

[10] Pub. L. 114-113, Div. Q, Title I, § 121(c)(2), 129 Stat. 3051 (Dec. 18, 2015).

[11] Rev. Rul. 59-221, 1959-1 CB 225.

C corporations that suffer losses and their owners generally are also in a less favorable position than other forms of business entity and their owners. If a sole proprietorship, partnership, limited liability company, or S corporation incurs a tax loss, it generally can be reported on the income tax returns of its owner or owners at the time it occurs and can be used to reduce income received by owners from other sources. A C corporation's losses generally belong to the corporation and can only be used to reduce corporate income on a current basis. However, the shareholders of a corporation may obtain a tax benefit from corporate losses when they sell their stock at a loss.

Double taxation

Double taxation is a dominant theme in federal corporate income taxation. Unless a corporation elects to be taxed as an S corporation, which is a pass-through entity, a corporation pays tax on its income when it is earned, and its shareholders pay a second tax on this income when it is distributed to them or they realize gains on the sale of their stock attributable to the income. Note, however, that some of the disadvantage of C corporation double-taxation was mitigated by changes made by the 2017 Tax Cuts and Jobs Act,[12] including the lowering of the previous multiple and tiered corporate tax rates (as high as 35%) to a singular 21% corporate tax rate, as discussed further below. The result is that business activities involving corporations result in a tax at two different levels. Evaluating the income tax impact of these activities requires information about the taxation of shareholders, as well as the corporation. For this reason, the discussion of various types of business activities and transactions involving corporations includes shareholders as well as corporations.

Taxation of corporate income and losses

A C corporation is a separate taxable entity, independent of its shareholders, for federal income tax purposes. Such a corporation computes its own income or loss and pays its own tax. [IRC §§ 11, 61 et seq.][13] Note that the 2017 Tax Cuts and Jobs Act removed the previous multiple and tiered tax brackets for corporations (with a rate as high as 35%) and replaced it with a lower and singular corporate tax rate of 21%, as discussed further below.[14]

Taxation of corporate income and losses—corporate income tax rates (current and former rules)

Pursuant to the 2017 Tax Cuts and Jobs Act, the previous multiple and tiered tax brackets for corporations (with a rate as high as 35%) were replaced with a singular corporate tax rate of 21%, generally applicable to taxable years beginning after December 31, 2017.[15] Accordingly, the information below in regard to the former tax rates of corporations needs to be read in that context.

For taxable years prior to January 1, 2018, corporate income was subject to federal income tax at rates ranging from 15% to 35%. The tax was imposed at graduated rates, with the first $50,000 of income being taxed at 15% and the next $25,000 at 25%. Income from $75,001 to $10 million was taxed at 34%, and amounts exceeding $10 million were taxed at 35%.[16]

Prior to amendment by the 2017 Tax Cuts and Jobs Act to remove such provisions, if a corporation's income exceeded $100,000, it formerly also was subject to a surtax designed to eliminate the benefit of the graduated rates. The surtax was five percent of the amount by which the corporation's income exceeded $100,000, or $11,750, whichever was less. If a

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[12] Pub. L. 115-97, 131 Stat. 2054 (Dec. 22, 2017).

[13] See also, Comptroller of Treasury of Maryland v. Wynne, 135 S. Ct. 1787, 191 L. Ed. 2d 813 (2015).

[14] Pub. L. 115-97, Title I, § 13001(a), 131 Stat. 2096 (Dec. 22, 2017), amending IRC § 11(b), generally applicable to taxable years beginning after December 31, 2017.

[15] Pub. L. 115-97, Title I, § 13001(a), 131 Stat. 2096 (Dec. 22, 2017), amending IRC § 11(b), generally applicable to taxable years beginning after December 31, 2017.

[16] Former IRC § 11(b)(1), eliminated by the 2017 Tax Cuts and Jobs Act [Pub. L. 115-97, Title I, § 13001(a), 131 Stat. 2096 (Dec. 22, 2017)], generally applicable to taxable years beginning after December 31, 2017.

corporation had income of more than $15 million, then an additional surtax was imposed equal to three percent of the excess over $15 million, or $100,000, whichever was less.[17]

Corporations engaged in providing professional services in fields such as health, law, and engineering were not entitled to take advantage of the former graduated corporate income tax rates. These corporations formerly were taxed at a flat rate of 35% on all income.[18] However, pursuant to the 2017 Tax Cuts and Jobs Act, for taxable years beginning after December 31, 2017, these corporations now also will benefit from the lower singular 21% tax rate for corporations.

The tax on a corporation's net long-term capital gains formerly also was limited to 35% of such gains.[19] Note that this was of no practical benefit because the limit was equal to the former highest rate of tax on a corporation's ordinary income. However, this no longer is applicable with the reduction of the corporate tax to a singular rate of 21% and the repeal of the former corporate capital gain tax by the 2017 Tax Cuts and Jobs Act.

Prior to amendment by the 2017 Tax Cuts and Jobs Act to remove such applicability, corporations also formerly were subject to the alternative minimum tax, which is a tax imposed on taxpayers with substantial deductions or credits that reduce the tax that such taxpayers are required to pay. The alternative minimum tax imposes a tax on such taxpayers' incomes at a minimum rate to insure that these taxpayers pay some amount of tax. The alternative minimum tax rate for corporations formerly was 20%,[20] with a $40,000 exemption which formerly also was allowed in computing the tax.[21] Corporations whose regular tax exceeded their alternative minimum tax formerly were not subject to the alternative minimum tax.[22] Prior to repeal by the 2017 Tax Cuts and Jobs Act, so-called “small corporations” (i.e., those with average gross receipts of $7.5 million or less) formerly also were exempt from the alternative minimum tax (for such “small corporations” in their first three years of existence, the exemption formerly was $5 million).[23] For corporations in their first taxable year of existence, their tentative minimum formerly tax was treated as zero for purposes of the alternative minimum tax.[24] The 2017 Tax Cuts and Jobs Act removed all such applicability of the alternative minimum tax to corporations.

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[17] Former IRC § 11(b)(1) (flush language), eliminated by the 2017 Tax Cuts and Jobs Act [Pub. L. 115-97, Title I, § 13001(a), 131 Stat. 2096 (Dec. 22, 2017)], generally applicable to taxable years beginning after December 31, 2017.

[18] Former IRC § 11(b)(2), eliminated by the 2017 Tax Cuts and Jobs Act [Pub. L. 115-97, Title I, § 13001(a), 131 Stat. 2096 (Dec. 22, 2017)], generally applicable to taxable years beginning after December 31, 2017.

[19] Former IRC § 1201, repealed by the 2017 Tax Cuts and Jobs Act [Pub. L. 115-97, Title I, § 13001(b)(2)(A), 131 Stat. 2096 (Dec. 22, 2017)]. Prior to the full repeal of IRC § 1201 in 2017, former IRC § 1201(b) (with regard to the special rate for qualified timber gains) was modified by the Consolidated Appropriations Act, 2016 [Pub. L. 114-113, Div. Q, Title III, § 334(a), 129 Stat. 3108 (Dec. 18, 2015)] to modify the applicable rate, effective for taxable years beginning after Dec. 31, 2015.

[20] IRC § 55(a), as amended by the 2017 Tax Cuts and Jobs Act [Pub. L. 115-97, Title I, § 12001(b)(3)(A), 131 Stat. 2092 (Dec. 22, 2017)] to eliminate all references and applicability of the alternative minimum tax to corporations, generally applicable to taxable years beginning after December 31, 2017.

[21] Former IRC § 55(d)(2), as eliminated by the 2017 Tax Cuts and Jobs Act [Pub. L. 115-97, Title I, § 12001(b)(5)(A), 131 Stat. 2092 (Dec. 22, 2017)], generally applicable to taxable years beginning after December 31, 2017.

[22] IRC § 55(a), as amended by the 2017 Tax Cuts and Jobs Act [Pub. L. 115-97, Title I, § 12001(b)(3)(A), 131 Stat. 2092 (Dec. 22, 2017)] to eliminate all references and applicability of the alternative minimum tax to corporations, generally effective for taxable years beginning after December 31, 2017.

[23] Former IRC § 55(e)(1)(A) and (B), as eliminated by the 2017 Tax Cuts and Jobs Act [Pub. L. 115-97, Title I, § 12001(b)(6), 131 Stat. 2092 (Dec. 22, 2017)], generally applicable to taxable years beginning after December 31, 2017.

[24] Former IRC § 55(e)(1)(C), as eliminated by the 2017 Tax Cuts and Jobs Act [Pub. L. 115-97, Title I, § 12001(b)(6), 131 Stat. 2092 (Dec. 22, 2017)], generally applicable to taxable years beginning after December 31, 2017.

Finally, corporations other than registered investment companies and real estate investment trusts formerly were subject to an environmental tax equal to 0.12 percent of the amount by which their alternative minimum taxable income (computed with certain adjustments) exceeded $2 million.[25]

The former tax rates applicable to the income of corporations (prior to the change made by the 2017 Tax Cuts and Jobs Act) generally were comparable to those rates currently applicable to individuals, estates, and trusts. Non-corporate taxpayers also are subject to income taxes imposed at graduated rates, previously with a maximum rate of 39.6% [37% for taxable years 2018 through 2025, as modified by the 2017 Tax Cuts and Jobs Act].[26] However, the rate of tax on long-term capital gains received by non-corporate taxpayers is limited to 20%.[27] Long term capital gains are those realized on property held for more than one year. [IRC §§ 1222, 1223] Pursuant to the American Taxpayer Relief Act of 2012,[28] for taxable years beginning after December 31, 2012, the previous top rate of 39.6% was instituted for certain high income wage earners (in essence, a reinstitution of the former top rate that existed prior to 2001), subject to the modification for taxable years 2018 through 2025 (reducing the top rate to 37%), as instituted by the 2017 Tax Cuts and Jobs Act.

The alternative minimum tax rates for non-corporate taxpayers are 26 percent and 28 percent, depending on the level of their alternative minimum taxable income. [IRC § 55(b)(1)(A)] The exemptions available to non-corporate taxpayers in computing alternative minimum tax range from $22,500 (for trusts and estates) to $78,750 (for married individuals filing joint returns) [$109,400 for married individuals filing joint returns for taxable years 2018 through 2025].[29] These exemptions have been increased on a regular basis to avoid the imposition of alternative minimum tax on middle-income taxpayers. The American Taxpayer Relief Act of 2012[30] made the exemption amounts in the statute permanent, and newly added IRC § 55(d)(4) [now IRC § 55(d)(3)] to provide cost-of-living adjustments for taxable years beginning after 2012, which have been provided by the IRS by annual revenue procedures.[31]

Taxation of corporate income and losses—corporate losses (current and former rules)

Prior to the substantial overhaul of the carry back and carryover (carryforward) rules applicable to net operating losses (NOLs) made by the 2017 Tax Cuts and Jobs Act, if a corporation had a net loss deduction for a taxable year (the aggregate of the NOL carryovers to such year, plus the NOL carrybacks to such year), such loss deduction could be carried back for two years and (if the loss was not used up in the prior two years) carried over (forward) for 20 years. The loss could be used

[25] Former IRC § 59A ("Environmental Tax"), repealed on December 19, 2014, by the Tax Technical Corrections Act of 2014 (as part of the Tax Increase Prevention Act of 2014), Pub. L. 113-295, Div. A, Title II, § 221(a)(12)(A), 128 Stat. 4038, Dec. 19, 2014, effective on the day of the Act.

[26] See IRC § 1(a) to (e), as modified by IRC § 1(j) [applicable for taxable years 2018 through 2025], newly added by the 2017 Tax Cuts and Jobs Act, Pub. L. 115-97, Title I, § 11001(a), 131 Stat. 2054 (Dec. 22, 2017).

[27] See IRC § 1(h). This maximum amount previously had been reduced from 20% to 15% by the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. 108-27, Title III, § 301(a)(1), (a)(2)(A), (b)(1), 117 Stat. 754 (May 28, 2003) (and which Act also provided for taxation of certain dividends at capital gain rates [Title III, 302(a)]), but was raised again to 20% (for certain high income earners) by amendments made by the American Taxpayer Relief Act of 2012, Pub. L. 112-240, Title I, § 102(b)(1), 126 Stat. 2316 (Jan. 2, 2013).

[28] Pub. L. 112-240, Title I, § 101(b)(1), 126 Stat. 2316, 2318, 2319 (Jan. 2, 2013).

[29] IRC § 55(d)(1), as modified by IRC § 55(d)(4) [applicable for taxable years 2018 through 2025], newly added by the 2017 Tax Cuts and Jobs Act, Pub. L. 115-97, Title I, § 12003(a), 131 Stat. 2095 (Dec. 22, 2017).

[30] Pub. L. 112-240, Title I, § 102(b)(2), (c)(2), 104(a)(1), (b), (c)(2)(J), 126 Stat. 2319, 2320, 2322 (Jan. 2, 2013).

[31] For adjustments of the exemption amounts for alternative minimum tax under IRC §§ 55(b)(1), 55(d)(1), and 55(d)(3) for taxable years beginning in 2015, see section 3.11 of Rev. Proc. 2014-61, 2014-47 I.R.B. 860; for adjustments of the exemption amounts for alternative minimum tax under IRC §§ 55(b)(1), 55(d)(1), and 55(d)(3) for taxable years beginning in 2018, see section 3.10 of Rev. Proc. 2017-58, 2017-45 I.R.B. 489, as modified and superseded by Rev. Proc. 2018-18, 2018-10 I.R.B. 392, and as modified and superseded in part by Rev. Proc. 2018-22, 2018-18 I.R.B. 524.

to reduce the corporation's income in the carry back and carryover years until it was exhausted.[32] Following the changes made to the NOL rules by the 2017 Tax Cuts and Jobs Act, generally applicable to NOLs arising in taxable years ending after December 31, 2017, the deduction for a taxable year will be an amount equal to the lesser of (1) the aggregate of the net operating loss carryovers to such year, plus the net operating loss carrybacks to such year, or (2) 80% of taxable income (as computed without regard to the NOL deduction allowable under IRC § 172); moreover, no carry back will be allowed of the loss deduction (with some exceptions for farm losses and NOLs of insurance companies, which still will be allowed to be carried back for two years), and the forward carryover of NOLs will be allowed indefinitely (i.e., with no maximum number of years).[33]

A corporation is entitled to deduct capital losses only against capital gains. [IRC § 1211(a)] Such losses may not be used to reduce a corporation's ordinary income. Nondeductible capital losses may be carried back three years and carried over five years. [IRC § 1212(a)]

With some important modifications, individuals, estates, and trusts are subject to similar rules relating to net operating losses.[34] However, they may deduct $3,000 of capital losses against ordinary income each year as well as deducting such losses in full against capital gain. [IRC § 1211(b)] Capital losses of individuals and other non-corporate taxpayers can be carried over indefinitely until they are fully applied against ordinary income or capital gains. [IRC § 1212(b)] Special rules also exist for the treatment of net operating loss carryovers in certain corporate acquisitions,[35] as well as a special limitation on net operating loss carryovers in the case of a corporate change of ownership.[36]

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[32] IRC § 172, as modified by the 2017 Tax Cuts and Jobs Act, Pub. L. 115-97, Title I, §§ 11011(d)(1), 13302(a) to (c)(2)(A), (d), 13305(b)(3), 14202(b)(1), 131 Stat. 2071, 2121, 2123, 2126, 2216 (Dec. 22, 2017).

In the case of losses incurred in 2008, the American Recovery and Reinvestment Act of 2009, Pub. L. 111-5, Feb 17, 2009, 123 Stat. 115, extended the carryback period to five years for certain small business corporations with annual receipts of $15 million or less. This provision (former IRC § 172(b)(1)(H)) subsequently was eliminated by the Tax Increase Prevention Act of 2014, Pub. L. 113-295, Div. A, § 221(a)(30)(A)(i), 128 Stat. 4033 (Dec. 19, 2014). The same Act also eliminated former IRC § 172(b)(1)(I) [relating to electric transmission property capital expenditures and pollution control facility capital expenditures], former IRC § 172(b)(1)(J) [relating to certain losses attributable to federally declared disasters], and former IRC § 172(g) [relating to bad debt losses of commercial banks].

[33] IRC § 172(a) and (b), as modified by the 2017 Tax Cuts and Jobs Act, Pub. L. 115-97, Title I, §§ 13302(a) to (b), 131 Stat. 2121 (Dec. 22, 2017).

The 2017 TCJA [Pub. L. 115-97, Title I, §§ 13302(b) to (d), 131 Stat. 2121 (Dec. 22, 2017)] also eliminated or re-designated certain special NOL rules for real estate investment trusts (REITs), for certain specified liability losses under former IRC § 172(f) (including for product liability losses), certain "excess interest" losses, certain federally-declared disaster losses, certain farm losses (which had been allowed a special 5-year carryback), the disallowance of the former IRC § 199 manufacturing deduction) [which section and deduction itself was eliminated by the 2017 Act], and certain "corporate equity reduction interest" losses, among other changes. Former IRC §§ 172(b)(1)(B) to (F), 172(f), 172(g), and 172(h).

The 2017 TCJA also added provisions to disallow from the calculation of any NOL any qualified business income deduction under IRC § 199A [as newly added by the 2017 Act], and any deduction for foreign-derived intangible income under IRC § 250 [as newly added by the 2017 Act]. See IRC § 172(d)(8) and (9), as newly added by the 2017 Tax Cuts and Jobs Act, Pub. L. 115-97, Title I, §§ 11011(d)(1) and 14202(b)(1), 131 Stat. 2071, 2216 (Dec. 22, 2017).

[34] IRC § 172, as modified by the 2017 Tax Cuts and Jobs Act, Pub. L. 115-97, Title I, §§ 11011(d)(1), 13302(a) to (c)(2)(A), (d), 13305(b)(3), 14202(b)(1), 131 Stat. 2071, 2121, 2123, 2126, 2216 (Dec. 22, 2017).

[35] IRC § 172(g)(1), as re-designated from IRC § 172(i)(1) by the 2017 Tax Cuts and Jobs Act, Pub. L. 115-97, Title I, §§ 13302(d)(2), 131 Stat. 2121 (Dec. 22, 2017). See IRC § 381.

[36] IRC § 172(g)(2), as re-designated from IRC § 172(i)(2) by the 2017 Tax Cuts and Jobs Act, Pub. L. 115-97, Title I, §§ 13302(d)(2), 131 Stat. 2121 (Dec. 22, 2017). See IRC § 382.

Types of specially-taxed corporations

Several types of corporations are subject to special income tax rules. The most common of these is S corporations, which can be engaged in a range of businesses, but elect to be taxed as pass-through entities with their income and loss being passed through to shareholders and included on their individual returns. S corporations themselves are not subject to federal income tax.

Tax-exempt corporations are exempt from federal income tax except on income generated outside the functions that qualify them for tax exemption. The income of these corporations is not taxed at all.

Personal service corporations and closely-held corporations also are subject to federal income tax but are subject to special tax rules designed to prevent tax abuses stemming from operating a business as a corporation rather than as a sole proprietorship or entity taxed as a partnership.

S corporations—generally

An S corporation is an entity classified as a corporation for federal income tax purposes that has elected to be taxed as a pass-though entity in a manner similar to a partnership. [IRC § 1361(a)(1)][37] Unlike a regular corporation, or C corporation, an S corporation is generally not subject to federal income—its income is reported on the tax returns of its shareholders, and they are responsible for the tax. [IRC § 1366(a)] Any losses suffered by the corporation also pass through and are reported on shareholders' income tax returns. [IRC § 1366(b)] S corporations derive their name from the fact that the rules regarding their taxation appear in subchapter S of chapter 1 of the Internal Revenue Code. [See IRC §§ 1361 to 1379] Those that apply to C corporations appear in subchapter C. [IRC §§ 301 to 385]

Since only the shareholders, and not the corporation, are taxed, S corporations avoid the problem of double tax associated with C corporations. For this reason, this form of business organization is extremely popular, particularly for closely-held corporations. Use of S corporations for publicly-held corporations is impractical because of the restriction on the number and types of shareholders they may have. [IRC § 1361(b)(1)]

Eligibility to elect S corporation status

In order to be eligible to make an S corporation election, a corporation must be a "small business corporation." This does not mean that the corporation is small in terms of assets or income. However, all of the following requirements must be met:

- The corporation must have been created under the law of the United States or one of the states. [IRC § 1361(b)(1)]
- The corporation may not have more than 100 shareholders. [IRC § 1361(b)(1)(A)]
- As a general rule, all shareholders must be individuals, certain types of trusts, estates (decedent's or bankruptcy), or certain types of tax-exempt entities. [IRC § 1361(b)(1)(B)]
- No shareholder who is an individual may be a nonresident alien. [IRC § 1361(b)(1)(C)]
- Except for classes of stock that differ only with respect to their voting rights, the corporation may only have one class of stock. [IRC §§ 1361(b)(1)(D)]
- The corporation may not be a financial institution that uses the reserve method of accounting for bad debts, an insurance company, a Puerto Rican tax credit corporation, or domestic international sales corporation (DISC) or former DISC. [IRC § 1361(b)(2)][38]

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[37] See also, Comptroller of Treasury of Maryland v. Wynne, 135 S. Ct. 1787, 191 L. Ed. 2d 813 (2015).

[38] Note also IRC § 1361(g), added by Small Business and Work Opportunity Tax Act of 2007, Pub. L. 110-28, Title VIII, § 8233(a), 121 Stat. 197, 198 (May 25, 2007).

An S corporation must meet these requirements not only to make an election to be taxed as such but also to retain its S corporation election. [IRC § 1362(d)(3)]

Eligibility to elect S corporation status—type of entity

An entity need not be a corporation as a matter of state law to be eligible to be taxed as an S corporation. A non-corporate entity that elects to be classified as a corporation for federal income tax purposes may make an election to be taxed as an S corporation. [Treas. Reg. § 301.7701-3(h)(3)] Therefore, an eligible limited liability company (LLC) can make an S election.

Eligibility to elect S corporation status—shareholders

In applying the 100-shareholder limit, groups of family members are counted as one shareholder. [IRC § 1361(c)(1)]

Most of the types of trusts that can be shareholders feature the pass through of income or loss on a current basis to a single beneficiary who qualifies as an S corporation shareholder. [IRC § 1361(c)(2)(a)] However, living trusts and trusts created by wills may be S corporation shareholders for two years after the death of the grantor or testator. [IRC § 1361(c)(2)(A)(ii), (iii)]

The limitation on the types of shareholders an S corporation may have means that a partnership or limited liability company cannot be a shareholder. However, a single-member LLC can be a shareholder because the separate existence of the LLC is disregarded for tax purposes. But the sole member of the LLC must be a qualified S corporation shareholder such as an individual who is not a nonresident alien. [Treas. Reg. § 1.1361-1(e)(3)(ii)(F)] An S corporation may, however, have a shareholder that is an S corporation but only if all of its stock is held by the S corporation and an election is made to treat the S corporation as a qualified subchapter S subsidiary, or Qsub. [IRC § 1361(b)(3)] A Qsub is not recognized as a separate entity for federal income tax purposes, and all of its income, losses, and other tax items are considered to be those of its parent corporation.[39]

One class of stock

The one class of stock requirement means that all shares must have equal rights with respect to dividends and liquidating distributions. [Treas. Reg. § 1.1361-1(l)(1)] This prevents an S corporation from issuing preferred stock. Options, warrants, and similar instruments are not generally considered a second class of stock. [Treas. Reg. § 1.1361-1(l)(4)(iii)(A)]

Debt obligations of an S corporation can be a second class of stock if they are classified as equity rather than debt for tax purposes. However, the Internal Revenue Code and regulations identify three situations in which S corporation debt will not be treated as a second class of stock.

• *Straight debt.* The Internal Revenue Code defines "straight debt" as an obligation payable to an individual, estate, or trust that qualified to hold S corporation stock or to a person engaged in lending money that meets specified terms. [IRC § 1361(c)(5)(B)] Straight debt is not a second class of stock even if it is classified as equity for federal income tax purposes. [IRC § 1361(c)(5)(A)]

• *Unwritten advances.* Under the regulations, unwritten advances made to an S corporation by one of its shareholders that do not exceed $10,000 in the aggregate are, in many circumstances, not treated as a second class of stock despite the fact that the advances could be considered equity rather than debt under general tax law principles. [Treas. Reg. §1.1361-1(l)(4)(ii)(B)(2)]

• *Debt held proportionately.* The regulations also provide that debt held by an S corporation's shareholders in proportion to their stock interests are not considered to be a second class of stock. [Treas. Reg. § 1.1361-1(l)(4)(ii)(B)(2)]

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[39] Treas. Reg. § 1.1361-4(a), and former Temp. Treas. Reg. § 1.1361-4T, finalized by T.D. 9670, 79 FR 36205 (June 26, 2014).

S corporation election

An eligible corporation wishing to be taxed as an S corporation must file an election with the Internal Revenue Service on Form 2553. [IRC § 1377(c); Treas. Reg. § 1.1362-6(a)(2)] Consent of all shareholders is required when the election is made, but consent of new shareholders who acquire stock after the election is made is not required to keep it in effect. [Treas. Reg. § 1.1362-6(a)(2)]

The election may be filed at any time during the 12 months prior to the beginning of the taxable year for which it is to be effective. An election filed on or before the 15th day of the third month of a corporation's taxable year can be retroactive to the beginning of the year if the corporation was qualified to make the election from the beginning of the taxable year until the election is made. [IRC § 1362(b)(1)] If the corporation is newly organized, the election cannot be filed until after it has shareholders, owns assets, or begins doing business. [Treas. Reg. § 1.1362-6(a)(2)(ii)(C)]

An existing C corporation can elect to be taxed as an S corporation. However, the Internal Revenue Code contains the following four provisions designed to prevent C corporations from taking advantage of this election in order to shift taxable income to their shareholders in order to avoid the double tax that would otherwise be imposed on this income.

• *LIFO recapture.* The first provision limiting the shifting of income requires a C corporation that maintains its inventory using the last-in-first-out method to include the amount of income deferred by the use of this accounting method in its income prior to the conversion to S corporation status. [IRC § 1363(d)] This prevents the C corporation from transferring the obligation to pay tax on the sale of low-basis inventory to its shareholders by making an S corporation election.

• *Built-in gains tax.* If a C corporation has assets with unrealized gain at the time it elects to be taxed as an S corporation, the S corporation is subject to tax on gains from any such property realized within (formerly) 10 years after the conversion (subject to some special rules for tax years 2009-2010 temporarily reducing the recognition period to a period of 7 years, and for tax years 2011-2014 temporarily reducing the recognition period to a period of 5 years);[40] note further that the 5-year built-in gains period subsequently was made permanent, applicable to taxable years beginning in 2015.[41] This tax is imposed on the S corporation and taxes the gain based on what the converting corporation would have paid on the gain if the conversion had not been made.

• *Tax on passive investment income.* An S corporation with earnings and profits is subject to tax if it derives a substantial portion of its income from rents, dividends, royalties, annuities, and interest. [IRC § 1375(a)] S corporations themselves do not accrue earnings and profits but may have earnings and profits if they were C corporations at one time (i.e., from "accumulated earnings").

• *Termination of election as a result of passive investment income.* If an S corporation with earnings and profits has substantial passive investment income for three years in a row, its S corporation election terminates.[IRC § 1362(d)(3)] S corporations themselves do not accrue earnings and profits, and those with earnings and profits often were C corporations at one time (i.e., from "accumulated earnings").

If a C corporation previously had an S corporation election in effect that was terminated or revoked, there is a five-year waiting period before a new S corporation election can be made. [IRC § 1362(g)]

Termination and revocation of S corporation election

A corporation's S corporation election can be revoked voluntarily at any time with the consent of a majority of its shareholders by filing a revocation with the Internal Revenue Service. [IRC § 1362(d)(1)]

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[40] IRC § 1374(a), (d)(7), as amended by the American Recovery and Reinvestment Act of 2009, Pub. L. 111-5, Div. B, Title I, § 1251(a), 123 Stat. 342 (Feb. 17, 2009), the Creating Small Business Jobs Act of 2010, Pub. L. 111-240, Title II, § 2014(a), 124 Stat. 2556 (Sept. 27, 2010) and the American Taxpayer Relief Act of 2012, Pub. L. 112-240, Title III, § 326(a), (b), 126 Stat. 2334 (Jan. 2, 2013).

[41] IRC § 1374(a), (d)(7), as amended by the Protecting Americans from Tax Hikes Act of 2015, Pub. L. 114-113, Div. Q, Title I, § 127(a), 129 Stat. 3054 (Dec. 18, 2015).

An S corporation's election is terminated involuntarily if the corporation ceases to meet the qualifications to be a small business corporation. [IRC § 1362(d)(1)] A termination is effective when the cessation occurs and does not require action by the Internal Revenue Service. [IRC § 1362(d)(2)]

If an S corporation has undistributed earnings and profits, its S corporation election terminates if more than 25 percent of its gross receipts for three consecutive taxable years is composed of passive investment income. [IRC § 1362(d)(3)] Passive investment income means gross receipts from rents, dividends, royalties, annuities, and interest. However, both rents and dividends are defined in a way that reflects the fact that the passive investment income limitation is intended to apply only to S corporations that are not engaged in the active conduct of a business. "Dividends" does not include those derived from the active conduct of a trade or business by a C corporation in which the S corporation owns at least 80% of the stock, and "rents" does include those derived from the active conduct of a real estate rental business in which the S corporation incurs substantial costs or provides substantial services to tenants. [IRC § 1362(d)(3)(C)(i); Treas. Reg. § 1.1362-2(c)(5)(ii)(B)(2)] Since an S corporation's income passes through and is taxed to its shareholders, such corporations do not have earnings and profits unless they were once C corporations or acquired a C corporation in a tax-free reorganization (i.e., from possible "accumulated earnings").

When an S corporation election is revoked or terminated, the corporation immediately becomes taxable as a C corporation—even if the revocation or termination occurs in the middle of a tax year. If the revocation or termination occurs during a tax year, the corporation's income, loss, and other tax items are divided between the two short tax years, one in which the corporation is an S corporation and the other in which it is a C corporation. [IRC § 1362(e)(1)]

S corporation taxable year

As a general rule, an S corporation must use a calendar year as its taxable year unless it satisfies the Internal Revenue Service that there is a business purpose for using another taxable year. [IRC §§ 441(i), 1378] This prevents tax on an S corporation's income from being deferred by using a tax year other than that of its shareholders. Since an S corporation's income is included in the taxable income of its shareholders in the tax year during which the corporation's tax year ends, tax on 11 months of income could be deferred if an S corporation had a tax year ending January 31 and its shareholders were taxed on a calendar year basis. [IRC § 1366(a)(1)]

An S corporation may elect to use a fiscal year that does not defer income for more than three months without the need to show a business purpose. [IRC § 444] This allows for the use of a tax year ending September 30 or later, but the election cannot be made unless a deposit is made with the IRS that is greater than the amount of tax deferred. [IRC §§ 444(c)(1), 7519] The deposit must be maintained, and the amount is adjusted annually to reflect changes in the S corporation's income. [IRC §§ 7519(b), 7519(e)(2)]

S corporation shareholders' tax basis

An S corporation's shareholders initially acquire a tax basis in their stock that is the same as that of C corporation shareholders. If a shareholder transfers property to the S corporation in a tax-free exchange for stock, the shareholder's basis in the stock equals his or her basis in the property. If the stock is purchased or acquired in a taxable exchange, the shareholder's basis is a cost basis equal to the price paid or the fair market value of the property transferred in the exchange.

This initial basis is adjusted to reflect the pass through of the S corporation's income and loss to its shareholders. Basis is increased by the amount of S corporation's income or gain passed through and taxed to the shareholder. [IRC § 1367(a)(2)] Basis is decreased by the amount of losses and deductions passed through and reported on an S corporation shareholder's income tax return and by the amount of any nontaxable distributions made to the shareholder. [IRC § 1367(a)(2)]

An S corporation's basis does not include any debt owed by the corporation to a third party, even if the shareholder has personally guarantied its payment.[42] This is to be contrasted with a partnership, where such debt increases basis. [IRC § 752(a)]

[42] See, e.g., Raynor v. Commissioner of Internal Revenue, 50 T.C. 762, 1968 WL 1515 (T.C. 1968).

Pass-through of income and loss

An S corporation is not generally taxable on its income for federal income tax purposes. [IRC § 1362(a)] Rather, its income or loss passes through to its shareholders. The shareholders must include the income in their own taxable income and may deduct the S corporation's losses in computing their taxable income. [IRC § 1366(a), (c)]

With certain exceptions, such as denial of the personal exemption and net operating loss deductions, the taxable income of an S corporation is computed in the same manner as that of an individual. [IRC § 1363(b)] If the character of items of an S corporation's income, gain, loss, deduction, and credit may affect the tax liability of a shareholder, these items must be separately stated in computing an S corporation's income and not treated as part of the taxable income of the corporation. These items, which retain their character when passed through to shareholders, include capital gains and losses, charitable contributions, and tax-exempt income. [IRC § 1366(a), (b)] The decrease for deductions by reason of a charitable contribution (as defined in section 170(c)) of property is the amount equal to the shareholder's pro rata share of the adjusted basis of such property. [IRC § 1362(a)(2) (flush paragraph)][43]

Most states that impose corporate income taxes treat S corporations as pass-through entities.[44] Some states treat S corporations as taxable entities but tax them at rates that are lower than those imposed on other corporations.[45]

Allocation of income and loss

An S corporation's income or loss is allocated among its shareholders in proportion to their stock ownership. [IRC § 1377(a)] Any other allocation generally would cause the corporation to have two classes of stock, terminating its S corporation election. This represents a significant difference between S corporations and partnerships—the latter can allocate income and loss in any way they choose so long as it has substantial economic effect. [IRC § 704(a), (b)]

If a change in stock ownership occurs during a taxable year, the S corporation's income or loss is allocated on a per share-per day basis as if an equal fraction of the income or loss was realized on each day of the taxable year. [IRC § 1377(a)(1)] This avoids the need to close the corporation's books whenever stock is transferred. However, the corporation and its shareholders can elect to close the books for purposes of allocating income or loss if they believe the result would be more fair, for example because a new shareholder did not participate in generating profits that accrued early in the year. [IRC § 1377(a)(2)]

Unlike sole proprietorships and partnerships, the income of an S corporation is not considered self-employment income and is not subject to self-employment tax. [IRC §§ 1401, 1402(a)] Federal employment taxes are imposed on S corporation income only if it is paid to shareholders in the form of compensation. [IRC §§ 3101, 3111] S corporation income is not subject to self-employment tax even it is distributed to shareholders so long as the distribution takes the form of a dividend.[46]

Limitation on loss deductions

The aggregate amount of losses and deductions for any taxable year that can pass through to an S corporation shareholder and be used to reduce the shareholder's taxable income from other sources cannot exceed the sum of the adjusted basis of the shareholder's stock in the S corporation and the adjusted basis of any debt owed to the shareholder by the S corporation. [IRC § 1366(d)(1)] Basis is computed at the end of the tax year and reflects any distributions made to the shareholder. Any loss deduction disallowed under this rule carries forward indefinitely and is treated as having been incurred by the S corporation

[43] Note that this language initially was added temporarily in 2006 and was finally made permanent in 2015.

[44] See, e.g., Oregon Rev. Stat. § 314.732; Minn. Stat. Ann. § 290.9725; Ohio Rev. Code § 5733.09(B).

[45] See, e.g., Cal. Rev. & Tax Code § 23802(b)(1); New York Tax Law § 210(1)(g), as amended by 2013 Sess. Law News of N.Y. Ch. 59 (S 2609-D).

[46] See, Rev. Rul. 59-221, 1959-1 CB 225.

in succeeding years with respect to the shareholder to whom the deduction was denied until the shareholder has sufficient basis to fully use the loss or deduction. [IRC § 1366(d)(2)]

A shareholder's deduction of S corporation losses may also be limited by the passive loss rules. Losses from passive activities are only deductible from a taxpayer's income from other passive activities and not from income from businesses in which the taxpayer actively participates. [IRC § 469(a)] A passive activity is a trade or business in which a taxpayer does not materially participate and most rental activity regardless of the taxpayer's participation. [IRC § 469(c)] Whether a trade or business activity of an S corporation is passive is determined on a shareholder-by-shareholder basis considering each shareholder's participation in the activity. [Temp. Treas. Reg. § 1.469-2T(e)(1)] Material participation generally requires that a shareholder devote more than 500 hours per year to the activity. [IRC § 469(h); Temp. Treas. Reg. § 1.469-5T(a)]

S corporation distributions to shareholders

The taxation of shareholders who receive distributions from an S corporation is different than that of shareholders who receive distributions from a C corporation. This is a result of the fact that S corporation income passes through and is recognized for income tax purposes at the shareholder level as it is earned while C corporation income is not taxed at the shareholder level until it is distributed as a dividend. The corporation's tax consequences of making a distribution are the same for S corporations as for C corporations.

Effect on shareholders of distributions to shareholders

A distribution made by an S corporation prior to its liquidation, or a current distribution, is tax free to shareholders if the corporation has no earnings and profits and the distribution does not exceed the shareholders' tax basis in their stock. [IRC § 1368(b)(1)] Amounts in excess of basis are treated as capital gains. [IRC § 1368(b)(2)]

If the S corporation has earnings and profits, an S corporation distribution is also tax free to the extent it does not exceed the corporation's accumulated adjustments account and does not exceed the shareholders' basis in their stock. [IRC § 1368(c)(1)] Distributed amounts that exceed the corporation's accumulated adjustment account are taxed as dividends to the shareholders up to the amount of the corporation's earnings and profits. [IRC § 1368(c)(1)] Additional amounts reduce shareholders' basis in their stock, and if the distribution exceeds this amount, the excess is capital gain. [IRC § 1368(c)(1)] In other words, the taxation of distributions exceeding an S corporation's accumulated adjustment account is similar to that of distributions to C corporations.

An S corporation can elect to treat a distribution as coming from earnings and profits before it comes out of the corporation's accumulated adjustments account. [IRC § 1368(c)(3)] Making this election reduces an S corporation's earnings and profits and may be useful if an S corporation has substantial passive investment income and wants to avoid the tax on this income and the termination of its S corporation election.

A former S corporation can make tax-free current distributions to its shareholders for a limited period of time after its S corporation election is revoked or terminated. Distributions made during the post-termination transition period are tax free to shareholders if the distributions: (a) are made in money; (b) are made with respect to the corporation's stock, and not to shareholders in their capacity as creditors; and (c) do not exceed the corporation's accumulated adjustments and the tax basis of shareholders in their stock. [IRC § 1371(e)]

When an S corporation is completely liquidated, its distributions are taxed to its shareholders in the same manner as those of a C corporation. The amount of money and the value of property distributed to a shareholder are treated as an amount received by the shareholder in exchange for his or her stock. The shareholder recognizes a gain or loss for tax purposes equal to the difference between the amount of the distribution and his or her basis in the stock. [IRC § 331(a)]

Effect on corporation from distributions to shareholders

The tax rules applicable to S corporation distributions are the same as those applicable to C corporations when it makes either a current or liquidating distribution. [IRC § 1371(a)] A current distribution of money has no tax consequences for the

corporation, but if property is distributed, the corporation recognizes gain equal to the amount by which the value of the property exceeds the corporation's tax basis in it. [IRC § 311] Both profits and losses may be recognized by the corporation if property is distributed as part of the complete liquation of the corporation. [IRC § 336(a)]

The difference is that a gain or loss recognized by an S corporation as the result of a distribution passes through to its shareholders. [IRC § 1366(a)] Gain increases the shareholders' basis in their stock, preventing tax from being imposed at both the corporation and shareholder level. [IRC § 1367(a)(1)] Losses reduce shareholders' basis in their stock, insuring that the loss is used by only one taxpayer. [IRC § 1367(a)(2)]

Accumulated earnings

Since their income is passed through and taxed to shareholders on a current basis, S corporations do not accrue earnings and profits. However, if a C corporation converts to an S corporation, its earnings and profits remain in existence. An S corporation can also have earnings and profits if it acquired a corporation with earnings and profits in a tax-free reorganization because the earnings and profits of the acquired corporation carryover to the S corporation.

In recognition of the pass through of corporate income, an S corporation has an accumulated adjustments account that is used to determine the source of current distributions made by the S corporation. [IRC § 1368(e)(1)] The ordering rules for determining the source of S corporation distributions to their shareholders provide that this previously-taxed income is distributed to shareholders tax free before the distribution is treated as including earnings and profits and therefore taxable as a dividend.

The accumulated adjustments account is a corporate level account that measures the amount of corporate income that has passed through and been taxed to the corporation's shareholders. An S corporation begins with an accumulated adjustments account of zero, and it is increased by the amount of income or gain passed through to shareholders. The accumulated adjustments account is reduced by distributions made to shareholders and corporate losses and deductions passed through to shareholders. No adjustment is made in the accumulated adjusted account for tax-exempt income and expenses related thereto. [IRC § 1368(e)(1)(A)]

S corporation entity-level taxes

As a general rule, S corporations are not subject to income tax. [IRC § 1363(a)] It is generally the shareholders who are taxed on an S corporation's income, not the corporation. [IRC § 1366(a)]

There are, however, two exceptions to this general rule. Both relate to S corporations that were C corporations before making an S corporation election or inherited tax attributes of a C corporation in a tax-free reorganization.

The first exception is that an S corporation created by the conversion of an existing C corporation is taxed on built-in gains realized on property held by the corporation that existed at the time of the conversion. [IRC § 1374] This is designed to prevent a C corporation from making an S corporation election immediately prior to a sale of its assets to avoid double taxation of gain realized on the sale.

Under this rule, the S corporation is taxed if the value of any of its assets exceeded their tax basis at the time the C corporation converts to S corporation status and the assets are sold within 5 years (formerly 10 years) after the conversion. [IRC § 1374(a), (d)(7)] The American Recovery and Reinvestment Act of 2009 reduced the prior 10-year period to 7 years for S corporations that recognize built-in gain in tax years beginning in 2009 and 2010; the Creating Small Business Jobs Act of 2010, the American Taxpayer Relief Act of 2012, and the Tax Increase Prevention Act of 2014 further temporarily reduced that period to 5 years for S corporations that recognized built-in gain in tax years beginning in tax years 2011-2014; the Protecting Americans from Tax Hikes Act of 2015 subsequently made the 5-year built-in gains period permanent, applicable to taxable years beginning in 2015.[47] The tax is imposed at the highest corporate rate on an amount equal to the difference between the value of the assets at the time of the conversion and their tax basis. [IRC § 1374(b)]

[47] Pub. L. 111-5, Div. B, Title I, § 1251(a), 123 Stat. 342 (Feb. 17, 2009); Pub. L. 111-240, Title II, § 2014(a), 124 Stat. 2556 (Sept. 27, 2010); Pub. L. 112-240, Title III, § 326(a), (b), 126 Stat. 2334 (Jan. 2, 2013); Pub. L. 113-295, Div. A, Title I, § 138(a), 128 Stat. 4020 (Dec. 19, 2014); Pub. L. 114-113, Div. Q, Title I, § 127(a), 129 Stat. 3054 (Dec. 18, 2015).

The second exception to the rule that S corporations are not taxable is designed to prevent a C corporation with substantial nonbusiness income from sheltering the income from double tax by converting to an S corporation. Under the second exception, an S corporation with earnings and profits must pay tax on its passive investment income if it exceeds 25 percent of its gross income. [IRC § 1375(a)] If the corporation receives sufficient passive investment income to incur this tax for three consecutive years, its S corporation election is terminated. [IRC § 1362(d)(3)]

Passive investment income means gross receipts from rents, dividends, royalties, annuities, and interest. However, both rents and dividends are defined in a way that reflects the fact that the tax on passive investment income is directed only at S corporations that are not engaged in the active conduct of a business. "Dividends" does not include those derived from the active conduct of a trade or business by a C corporation in which the S corporation owns at least 80% of the stock, and "rents" does include those derived from the active conduct of a real estate rental business in which the S corporation incurs substantial costs or provides substantial services to tenants. [IRC § 1362(d)(3)(C)(i); Treas. Reg. § 1.1362-2(c)(5)(ii)(B)(2)]

Coordination with subchapter C

Despite the fact that S corporations are pass-through entities and C corporations are taxable entities, the provisions of the Internal Revenue Code relating to C corporations apply to S corporations unless they are inconsistent with the S corporation rules. [IRC § 1371(a)] One consequence is that an S corporation can participate in most types of tax-free corporate reorganizations. The one exception is that an S corporation cannot be the target corporation in a type B reorganization because it may not have a corporate shareholder.

The rules relating to the redemption of stock by a C corporation apply equally to an S corporation.

But if a redemption fails to qualify for sale or exchange treatment as to the redeemed shareholder, the S corporation distribution rules, rather than those applicable to C corporations, will determine the federal income tax consequences to the redeemed shareholder. [IRC § 1368]

In addition, the liquidation rules applicable to C corporations also apply to S corporations. The liquidation of an S corporation is generally a taxable event as to both the corporation and the shareholders as it is with a C corporation. [IRC §§ 331, 336] This is another area in which S corporations differ in an unfavorable way from partnerships because partnerships can often liquidate tax free under IRC § 731.

However, the liquidation rules do not result in double taxation of gain when an S corporation is liquidated as they do when a C corporation is liquidated. This results from the fact that an S corporation's shareholders' basis in their stock is increased by the amount of gain recognized by the corporation and passed through to them for inclusion on their tax returns. As a consequence, there is only one tax imposed on the gain, and it is imposed at the shareholder level.

Another difference between C corporations and S corporations is that S corporation shareholders who own more than two percent of the corporation's stock are treated as partners for employee benefit purposes. [IRC § 1372] This means that shareholder-employees of S corporations are not entitled to many of the tax-favored fringe benefits such as group-term life insurance, health care benefits, child care assistance, and cafeteria plan benefits available to employee-shareholders of C corporations.

Nevertheless, S corporation shareholders are entitled to deduct their health insurance premiums, so they are on par with C corporation shareholders with regard to that benefit. [IRC § 162(l)] There also is no significant difference between the qualified retirement plan benefits available to shareholders of the two different types of corporations.

Sec. 199A qualified income business deduction—general

The 2017 Tax Cuts and Jobs Act[48] added a new 20% deduction for pass through entities such as sole proprietorships, partnerships, limited liability companies, and subchapter S corporations, which went into effect January 1, 2018. [IRC § 199A)] The 20% deduction, which is applied to the individual owner's "qualified business income" (which is based on what

[48] Pub. L. No. 115-97, § 11011, 131 Stat. 2054 (Dec. 22, 2017).

is distributed to him or her each year as an owner/partner in the business, not the amount he or she takes out in salary for services rendered to the business), applies only to small businesses engaged in manufacturing, retail, nonprofessional services (e.g., restaurants and lawn care), and some professional services (e.g., architecture and engineering). A taxpayer engaged in a "specified service trade or business" – defined as health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services – or "any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees," only is ineligible for the deduction if his or her taxable income is less than the following ceilings: if a taxpayer has less than $157,500 in taxable income for a single taxpayer or a married taxpayer filing separately, or $315,000 in taxable income for a married taxpayer filing jointly, then the taxpayer can take the 20% deduction even if he or she is engaged in a "specified service trade or business" (subject to a phase-out of the deduction). If a taxpayer has more than $207,500 in taxable income for a single taxpayer or a married taxpayer filing separately, or $415,000 in taxable income for a married taxpayer filing jointly, then the taxpayer cannot take any of the 20% deduction if he or she is engaged in a "specified service trade or business." Those with incomes between these thresholds are only eligible for a partial tax benefit. In other words, the deduction is available no matter the nature of the taxpayer's business, but the amount of qualified business income eligible for the deduction phases out for any "specified service trade or business." Determining eligibility for the deduction and computing the amount of the deduction likely will be challenging in many instances and generally will require input from qualified tax professionals (tax return prepares and advisors).

Sec. 199A qualified income business deduction—application to S corporations

The IRC § 199A deduction is calculated at the shareholder level with respect to each separate qualified trade or business of the taxpayer and is available to an individual shareholder to offset AGI. The limitations are similarly applied at the shareholder level by allocating to each shareholder such shareholder's pro rata share of the S corporation's W-2 wages and unadjusted basis in qualified property. Thus, Schedules K-1 issued by S corporations will now need to identify each separate trade or business of the entity that qualifies for the IRC § 199A deduction, as well as all items of income, gain, loss, deduction, and credit, plus W-2 wages and the unadjusted basis of qualified property attributable to each such qualified trade or business.

A taxpayer computes the W-2 wage limitations on a business-by-business basis, but IRC § 199A imposes a further limitation on the deduction equal to 20 percent of the taxpayer's taxable income (regardless of whether such taxable income is specified service trade or business income, but excluding any net capital gain and qualified cooperative dividends). If a taxpayer has a net loss with respect to all qualified businesses, this amount is carried forward to the next year and used to offset that year's qualified business income. Thus, the following scenarios could conceivably occur:

> ***Example 1***
>
> Businessman A owns an interest in two S corporations, X and Y, each of which operates a different qualified trade or business under IRC § 199A. During a taxable year, A 's share of X income is $100 and his share of X 's W-2 wages is $20. During that same year, A 's share of Y income is $0 and his share of Y 's W-2 wages is $20. Neither business owns any qualified property. A 's deduction under IRC § 199A is limited to $10, which is his deduction with respect to X (20 percent of net income, limited by 50 percent of his share of W-2 wages ($10) with respect to X). A receives no deduction with respect to his investment in Y because Y had zero net income. A is not entitled to use his share of Y 's W-2 wages to increase his W-2 wage limitation on X income.
>
> ***Example 2***
>
> Assume the same facts as in Example 1, except that A 's share of Y 's income is a $100 net loss. In this situation, assuming A has no other source of income, A would receive no deduction under IRC § 199A because his net taxable income for the year is $0.

The magnitude of the IRC § 199A deduction may compel businesses to rearrange their affairs in order to maximize the availability of such deduction. The following opportunities may exist:

- Acquiring commercial real estate leased by a specified service business in order to convert service income into income eligible for the IRC § 199A deduction
- Re-characterizing services provided in order to fall outside the specified service trade or business exclusion

• Minimizing reasonable compensation paid to S corporation shareholders in order to maximize pass-through income eligible for the IRC § 199A deduction

• Acquiring qualified property or retaining additional employees in order to increase relevant IRC § 199A deductions (note that this will put pressure on estimated tax projections near year-end as tax liability will be significantly impacted by such year-end expenditures)

Planning considerations following the 2017 TCJA

A historic S corporation considering whether to revoke its S election in light of the 2017 TCJA should evaluate the following issues:[49]

1. *Retained Earnings*. A 21 percent flat corporate tax rate is better, from a cash flow perspective, than a top individual tax rate of 37 percent. However, distributed earnings from a C corporation are subject to taxation as dividends to the extent of earnings and profits, generally at a tax rate of 20 percent. $100 of taxable income for a C corporation thus results in $63.20 of after-tax distribution (21 percent corporate tax rate, 20 percent tax rate on dividends), whereas $100 of taxable income in an S corporation that is ineligible for the IRC § 199A deduction results in $63 of after-tax distribution. A C corporation is only clearly superior, from a cash flow perspective, where earnings are retained and reinvested at the corporate level.

2. *State Tax*. While some states impose a relatively small tax on pass-through entities, including S corporations, nearly all states impose taxation on C corporations. The two levels of C corporation tax can quickly offset any cash flow benefit from retaining earnings and deferring taxation. However, where a taxpayer resides in a low-income-tax or zero-income-tax state, but the business operates in a high-tax jurisdiction, converting to a C corporation can create substantial tax efficiencies.

3. *Qualification for IRC § 1045 or IRC § 1202*. Gain from the sale of certain qualified small business stock, which must be stock of a C corporation, can be (1) deferred (if the stock is held for more than six months and proceeds are rolled into qualified small business stock) under IRC § 1045 or (2) eliminated entirely (if the stock is held for more than five years) under IRC § 1202. The potential to qualify under one of these provisions can be significant in the decision to elect S status.

4. *IRC § 199A*. IRC § 199A grants a 20 percent deduction to a noncorporate taxpayer who earns certain types of trade or business income. For those taxpayers who qualify for such a benefit (without limitation), the top rate of 37 percent is effectively reduced to 29.6 percent, thus making S corporation status much more appealing.

[49] Taken from Christian and Grant, *Subchapter S Taxation,* SST WGL ¶ 1.02 COMPARISON OF INCOME TAX RATES, 1999 WL 630481, *8.