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Abstract: The S corporation continues to be a popular entity choice, combining the liability protection of a corporation with many of the tax benefits of a partnership. But these benefits come at a price: S corporations must comply with strict requirements that limit the number and type of shareholders, prohibit complex capital structures, and impose other restrictions. This article explains the requirements and advantages of an S corporation status and what needs to be done to avoid S corporation termination.

The proper care and feeding of your S corporation

Diligence required to avoid inadvertent termination and loss of tax benefits

The S corporation continues to be a popular entity choice, combining the liability protection of a corporation with many of the tax benefits of a partnership. But these benefits come at a price: S corporations must comply with strict requirements that limit the number and type of shareholders, prohibit complex capital structures, and impose other restrictions.

Advantages of S corporation status

Like a traditional corporation, an S corporation shields its shareholders from personal liability for the corporation's debts. At the same time, it provides many (though not all) of the tax benefits associated with partnerships.

The most important tax benefit is that an S corporation, like a partnership, is a "pass-through" entity, which means that all of its profits and losses are passed through to the owners, who report their allocable shares on their personal income tax returns. This allows S corporations to avoid the double taxation that plagues traditional C corporations, whose income is taxed at the corporate level and again when distributed to shareholders.

S corporations, unlike partnerships, lack the flexibility to allocate profits and losses among their shareholders without regard to their relative capital contributions. But S corporations have one important advantage over partnerships: Shareholders need not pay self-employment taxes on their shares of the profits, provided they receive "reasonable" compensation.

S corporation requirements

To qualify as an S corporation, Form 2553 — *Election by a Small Business Corporation* — must be filed with the IRS. In addition, the corporation must:

- Be a domestic (U.S.) corporation,
- Have no more than 100 shareholders (certain family members are treated as a single shareholder for these purposes),
- Have only "allowable" shareholders (see below),
- Have only one class of stock (generally, that means that all stock confers identical rights to distributions and liquidation proceeds; differences in voting rights are permissible), and

- Not be an “ineligible” corporation, such as an insurance company, a domestic international sales corporation or a certain type of financial institution.

Allowable shareholders include individuals, estates and certain trusts. Partnerships, corporations and nonresident aliens are ineligible. A trust is an allowable shareholder if it’s domestic and qualifies as one of the following:

- A grantor trust, provided it has only one “deemed owner” who’s a U.S. citizen or resident and meets certain other requirements,
- A testamentary trust established by a shareholder’s estate plan,
- A voting trust,
- A qualified subchapter S trust (QSST) — that is, one 1) that distributes all current income to a single beneficiary who’s a U.S. citizen or resident, and 2) for which the beneficiary files an election with the IRS, or
- An electing small business trust (ESBT) — to qualify, 1) all of the trust’s potential current beneficiaries (PCBs) must be eligible S corporation shareholders or nonresident aliens (NRAs), 2) no beneficiaries may purchase their interests, and 3) the trustee must file a timely election with the IRS. Generally, PCBs are persons who are entitled to distributions or may receive discretionary distributions.

Be aware that grantor and testamentary trusts are eligible shareholders for only two years after the grantor dies or the trust receives the stock.

Avoiding termination

Preserving S corporation status requires due diligence. Among other things, you should:

- Continually monitor the number and type of shareholders, scrutinize the terms of any trusts that hold shares, and ensure that QSSTs or ESBTs have filed timely elections,
- Include provisions in buy-sell agreements that prevent transfers to ineligible shareholders,
- If shares are transferred to an ESBT, make sure all PCBs are eligible shareholders or NRAs, and
- If shares are held by grantor or testamentary trusts, track the two-year eligibility period and make sure trusts convert into QSSTs or ESBTs or transfer their shares to an eligible shareholder before the period expires.

Also, avoid actions that may be deemed to create a second class of stock, such as making disproportionate distributions.

Don’t take your eye off the ball

If your business is organized as an S corporation, it’s critical to monitor your shareholders and activities continually to avoid inadvertent termination of your company’s S corporation status. At worst, termination means the loss of substantial tax benefits. At best, it means going through an expensive, time-consuming process to seek relief from the IRS and, if successful, have your S status restored retroactively. Contact your tax advisor with any business entity questions.

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