

The Legal Strategist

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TEXAS ESOTERIC FACTS

An S Corporation (S corp) is a business elected for S Corp status through the IRS. This status allows the taxation of the company to be similar to a partnership or sole proprietor as opposed to paying taxes based on a corporate tax structure. While an s corp is limited to one class of stock, the taxation benefits may be enough to make this type of entity right for your business.

The Feature Topic is a cursory review. If you would like more information on this, or any other topic previously covered in our newsletter, which can be viewed on [The Legal Strategist](#) tab of my web site, please contact my office at 713.526.1883.

Scott Barrett

- ◆ It is illegal to throw litter out of an aircraft in Galveston.
- ◆ There are stalactites and stalagmites in the breezeway at the University of Texas Law School.

FEATURE TOPIC: BASIC REQUIREMENTS FOR AN S CORP

An S corp is simply a C corporation that makes a special election for tax purposes. Instead of having to pay the corporate tax, an S corporation passes its income and losses through straight to the shareholders. The election is made with IRS Form 2553. However, not all corporations qualify to be S corps.

Function - The limitations on who can be an S corp shareholder derive from the manner in which taxes are imposed on the corporation. The IRS permits shareholders of this type of entity to report what is called "flow-through" income and losses on their individual personal tax returns. Taxes are not assessed at the corporate level when an S corp election is made with the IRS.

Individual Shareholder Requirements—Only individuals that are either U.S. citizens or U.S. residents can be shareholders. Non-resident aliens and citizens of foreign countries who are not residents are not permitted to own stock in an S corp. For example, if the S corp needs cash and issues shares to a Canadian citizen who is not a U.S. resident, the S corp would violate shareholder requirements.

Entity Shareholder Requirements—Most entities, such as partnerships and corporations, are prohibited from being shareholders in S corporations. However, there are a few exceptions. The estates of deceased shareholders can hold the S corp stock. Nonprofit organizations under section 501(c)(3) and tax-exempt organizations under section 501(a) are also permitted to own stock. Although most trusts are excluded from ownership, certain types of trusts, such as qualified sub-chapter S trusts (QSSTs) and electing small business trusts (ESBTs), are permitted to own stock without disqualifying the S corp election.

Total Shareholder Limits—An S corporation is limited to no more than 100 shareholders. However, there are exceptions that permit family members to elect to be counted as just one shareholder, which can greatly increase the limit. Family members include the descendants of a common ancestor, no more than six generations above the youngest owner at the time of the elections. Spouses are also included. For example, if you, your spouse, your children, and your sister and her children own shares, you can elect to count all of you as just one shareholder.

Consequences of Violations—If a prohibited person or entity gains ownership of S corp stock, the S corp election is revoked immediately. For example, if you sell some of your stock to a non-resident alien, the S corp goes back to being a C corp on the date of the sale, even if it is in the middle of the tax year. After a violation, you usually can't elect to go back to an S corp for at least five years even if the violation is fixed before then.

If you would like more information on how rules and regulations and statutes will affect your S corp, please contact [Scott Barrett](#) to set up a consultation.