# S corporation basics

US business entities incorporated under state law are, by default, characterized as C corporations and governed by Subchapter C of the Internal Revenue Code. Eligible corporations, however, are permitted to make an election to be treated as an S corporation, which enables the shareholders to receive pass-through treatment for income tax purposes while still enjoying the benefits of limited liability that are afforded to the typical corporate form.

An election by itself will not guarantee S corporation treatment. To qualify as an S corporation, a corporation must first be eligible, and it must remain eligible.

The federal income tax requirements for S corporation eligibility are:

- The corporation must be a domestic corporation
- The corporation must have no more than 100 shareholders
- The shareholders must be of the allowable type of shareholders
- The corporation may issue only one class of stock
- The corporation must not be an ineligible corporation

If the business entity satisfies these requirements, the corporation may submit IRS Form 2553, "Election by a Small Business Corporation," which must be signed by all of the shareholders, to the appropriate Department of the Treasury Internal Revenue Service Center (based on where the corporation's principal business, office or agency is located).

If the corporation has a taxable presence in Arkansas, New Jersey or New York (states which require a separate state election), then the applicable state election form should also be signed and submitted. If the corporation has a taxable presence or shareholders in Ohio or Wisconsin, then additional forms or notices may be required.

Some states do not conform to the federal income tax treatment of an S corporation; therefore, a corporation's treatment for state income tax purposes would vary from its federal income treatment.

## Number and types of shareholders

An S corporation must be a domestic corporation with no more than 100 shareholders. Members of a family, however, are counted as one shareholder for this purpose. "Members of a family" includes not only husband and wife, but also "common ancestors" and also lineal descendants and spouses of their common ancestors, so long as the ancestor is no more than six generations removed from the youngest shareholders.

Certain types of shareholders are not eligible to be S corporation shareholders. Among these are non-resident aliens, foreign trusts, other corporations and partnerships.

Certain family trusts (grantor trusts with a US citizen or US resident grantor, a US trust which is an electing small business trust with only US citizen or US resident potential current beneficiaries, and a US trust which is a qualified subchapter S trust with US citizen or US resident beneficiaries) and estates, voting trusts and certain tax-exempt entities are permitted to be S corporation shareholders.

## One class of stock

An S corporation may issue only one type of stock. A corporation will not be treated as having more than one class of stock purely because there is some discrepancy in the voting rights among the shares of the common stock. Instead, stock will be considered to be the same class of stock as long as the stock has the same rights to distribution and liquidation proceeds.

When issuing debt, certain considerations should be taken into account, to ensure that the debt will not be recharacterized as equity (issued to an ineligible shareholder or creating a second class of stock).

A warrant is generally not a second class of stock, under a safe harbor, provided that the exercise price is not less than 90 percent of the fair market value of the underlying stock as determined on the issuance date, any date that the warrant is transferred to an ineligible shareholder, or any date that the warrant is materially modified.

"Straight debt," under a safe harbor, will not be treated as an additional class of stock, so long as the following requirements are met:

- There must be an unconditional promise to pay on demand or on a specified date a certain sum of money
- The interest rate and payment dates must not be contingent on profits, the S corporation's discretion, or have other similar features
- There must be no conversion option into the S Corporations stock and
- The creditor must be an individual (other than a non-resident alien), an estate, a permitted trust or a person which is actively and regularly engaged in the business of lending money (*ie*, banks).

## Election and termination

All of the shareholders of the entity (including spouses with a community property interest in the stock) must consent to the S corporation election, by signing IRS Form 2553, which must be submitted timely to the Department of the Treasury Internal Revenue Service Center.

After a successful election, S corporation status can be terminated if at any point the corporation no longer satisfies the requirements of Subchapter S, such as issuing a second class of stock or issuing stock to an ineligible shareholder. Furthermore, a majority of the shareholders of an S corporation may vote to revoke the corporations Subchapter S status in order to terminate the treatment. When an S corporation election is revoked or terminated, effective during a taxable year, there is generally an S short year and a C short year. Consideration should be given as to whether the books will be closed as of the end of the S short year and whether the S corporation's undistributed earnings in the accumulated adjustments account will be distributed during the post-termination period. If an S corporation election is terminated, then the corporation will typically not be able to make an S corporation election for five years after the date of termination.

## Benefits for startups

Owners of a startup business seeking pass-through treatment for income tax purposes while still receiving the benefits of limited liability may find it preferable to form as an S corporation rather than as a limited liability company.

As discussed above, an eligible business entity may obtain S corporation status by incorporating in the same manner as a C corporation and by filing IRS Form 2553. Depending on the business arrangement among the owners, the operating

agreement for a limited liability company can be complex and require more drafting considerations than the governing documents for a corporation. Furthermore, certain investors (such as venture capital firms) may prefer to invest in a business operating as a C corporation. An S corporation can easily convert to a C corporation upon a preferred financing because the issuance of preferred stock will automatically terminate the S corporation election for income tax purposes. In practice, however, startup businesses that plan to seek venture capital financing may choose to operate as a C corporation from the start, notwithstanding the tax benefits of a pass-through entity.

As discussed above, a business needs to meet a number of requirements to be eligible to make and retain a S corporation election and we recommend consulting a legal or tax advisor to determine whether a S corporation is appropriate for your startup business.

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