An S corporation is formed by first establishing a corporation under state law. If the corporation meets certain requirements, an election can be made to have the corporation taxed under subchapter S of the Code.

The S corporation has three distinct advantages over a C corporation.

- Distribution amounts that exceed reasonable compensation are not subject to payroll taxes.
- There is no corporate-level double taxation.
- Corporate profits and losses to shareholders can be passed through.

Note. IRC §§1361 through 1379 comprise subchapter S of the Code.

**S CORPORATION REQUIREMENTS**

An entity must meet certain prerequisites to qualify as a “small business corporation (S corporation).”¹ If all the prerequisites are met, the corporation can obtain subchapter S tax treatment by making the appropriate election. The following are prerequisites to qualify for the S election.

- The corporation must be a **domestic corporation**.
- There can be **no more than 100 shareholders**.
- The corporation **cannot have more than one class of stock**.
- All shareholders must be **qualified shareholders**.²

The above prerequisites must be satisfied at the time the corporation files its S election. In addition, once S status is obtained, these prerequisites must be **continually maintained** or the corporation risks losing its S status. The tax election and the maintenance of these prerequisites are discussed later in this chapter.

Note. An LLC that meets the above requirements may elect to be taxed as an S corporation.

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¹ IRC §1361(a)(1).
² IRC §1361(b)(1).
DOMESTIC CORPORATION

Generally, an S corporation must meet the **domestic corporation** requirement of IRC §1361(b). A “domestic corporation” is a corporation created or organized in the United States or under federal or state law.³ A state or federal corporate charter meets this requirement.

Entities that are not traditional state law corporations may also meet the domestic corporation requirement. The term “corporation” includes any domestic entity classified as an association under the “check-the-box” rules of Treas. Reg. §301.7701-3. These rules provide that any unincorporated entity may elect to be an “association,” which qualifies it for corporate tax treatment. If the association meets all the prerequisites for an S corporation, a timely election can be made to obtain subchapter S status. Examples of entities that are not traditional state law corporations but are eligible for subchapter S status include the following.

- An Arizona “statutory close corporation”¶
- A Massachusetts business trust⁵
- A limited liability company (LLC)

The Code specifically prohibits some types of corporations from becoming S corporations.⁶ **Ineligible** corporations include the following.

- A bank or other financial institution that uses the reserve method of accounting for bad debts, as described in IRC §585
- An insurance corporation
- A corporation electing a Puerto Rico and possessions tax credit under IRC §936
- A domestic international sales corporation as defined in Treas. Reg. §1.992-1

100 SHAREHOLDER LIMIT

An S corporation cannot have more than 100 shareholders at any time during the tax year.⁷ For S corporation purposes, the determination of shareholder status is a question of federal law rather than state law. Ordinarily, a person who would be required to include in gross income dividends distributed from the stock (if the corporation were a C corporation) is considered a shareholder of the S corporation. As a matter of federal law, **beneficial ownership** in the corporation is determinative of shareholder status as opposed to being listed as a shareholder of record or having shareholder rights under applicable state law.⁸ “Beneficial ownership” exists when an individual or entity enjoys the rights of share ownership, such as the receipt of distributions or the ability to exercise control over the S corporation, without actual share ownership.

**Example 1.** Sherman Yachts, Inc., is an S corporation with 98 shareholders. Additional shares are sold to James and Bryan during 2012. James and Bryan own their shares jointly. Because James and Bryan each must report their respective share of any dividends, they are considered two shareholders. This results in the S corporation reaching the maximum of 100 shareholders.

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³ Treas. Reg. §301.7701-5(a).
⁵ Ltr. Rul. 8342088 (Jul. 20, 1983).
⁶ IRC §1361(b)(2).
⁷ IRC §1361(b)(1)(A).
⁸ Kean v. Comm’r, 469 F.2d 1183 (9th Cir. 1972).
**Example 2.** Guido and Francesco are brothers who each own half of the stock in Bellissimo Italian Foods, Inc., a C corporation. They purchase shares in Mezzo Scales, Inc., an S corporation, but they pay for their shares using a Bellissimo Italian Foods corporate check. The purchase was charged to their shareholder loan accounts. Guido and Francesco can demonstrate a repeated, recurring pattern of making purchases together in this fashion without any written agreements or other documentation. This history of conduct will likely make the brothers the beneficial owners of the S corporation shares instead of the C corporation, which is not an eligible shareholder.9

**Note.** Eligible shareholders are discussed later in this section.

**Related Party Share Ownership**
Under IRC §1361, there are special rules relating to spousal share ownership and family share ownership.

A **husband and wife** who own shares count as one shareholder.10 If one or both spouses die, this share attribution extends to their estates.

**Example 3.** Creative Bakeries, Ltd. is an S corporation with 99 shareholders. During 2012, the corporation issues shares to Harvey Slotnick. Later in 2012, the corporation issues shares to Harvey’s wife, Inga Slotnick. Neither Harvey nor Inga were shareholders prior to 2012. Under the spousal share ownership rules, Harvey and Inga count as only one shareholder. Creative Bakeries has not exceeded the 100-shareholder limitation and continues to qualify as an S corporation.

All **family shareholders** are treated as one shareholder.11 The term “family shareholders” is defined broadly to include:

- Individuals with a common ancestor,
- The lineal descendants of the common ancestor, and
- The spouses (or former spouses) of the lineal descendants or common ancestor.12

**Example 4.** Use the same facts as **Example 3**, except that before the end of 2012, Mr. and Mrs. Slotnick are divorced. After the divorce, the spouses are still considered one shareholder under the family shareholder attribution rules. These rules continue to treat a former spouse as a family shareholder. Creative Bakeries continues to have 100 shareholders after the Slotnick divorce.

Family share ownership attribution only applies with a common ancestor that is not more than six generations removed from the youngest generation of shareholders13 as of the **earliest** of the following dates.

- The effective date of the subchapter S election
- The earliest date that a family member became a shareholder in the S corporation
- October 22, 200414

Under the family ownership rule, spouses are considered of the same generation.15 Moreover, the estate or trust of a family shareholder may also be considered a family shareholder in connection with the application of these rules.16

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9. Ibid.
10. IRC §1361(c)(1)(A)(i).
11. IRC §1361(c)(1)(A)(ii).
12. IRC §1361(c)(1)(B)(i).
16. IRC §1361(c)(2).