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Subchapter S

Tax Option for Small Corporations

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Certain small business corporations are allowed special income tax treatment under Subchapter S of the Internal Revenue Code. Under this option, the corporation pays no income tax. Shareholders are taxed directly for corporate income. Although the Subchapter S corporation pays no corporate income tax, it still may use the various tax fringe benefits available to corporations and provide the other advantages of corporations, such as limited liability and ease of ownership transfer.

Only certain types of small business corporations may elect to use the Subchapter S option. The organization must meet and maintain specific requirements. The option terminates automatically if these requirements are not maintained. Shareholders may also voluntarily terminate the Subchapter S election. After termination, the election cannot usually be made again for another five years.

Effect of Subchapter S Election

Election of Subchapter S tax treatment for your corporation means the corporation itself will *not* be taxed on any income. The income of the corporation "flows through" to the shareholders and is reported as income on their individual tax returns. The primary advantage of Subchapter S status is that corporate earnings are only taxed once: to the shareholder. If the Subchapter S election is not made, earnings may be taxed twice: once to the corporation as taxable income and later to the shareholders if dividends are declared. The "flow through" of corporate earnings to the shareholder under Subchapter S avoids this double taxation.

When deciding whether to use the Subchapter S option, consider the corporate earnings. Earnings may be either reinvested in the business or distributed as dividends to shareholders. Usually some earnings are reinvested and some are distributed. For simplicity in following examples, we will assume the corporation either reinvests all earnings in the business or distributes all earnings to the shareholders.

Under legislation effective through 1978, a regular corporation pays income tax on all earnings, whether reinvested or distributed, at the following rates: 20 percent on the first $25,000 of income; 22 percent on the next $25,000 of income; and 48 percent on all income above $50,000. These rates are to change after 1978 to 22 percent on the first $25,000 and 48 percent on all income above $25,000. However, for tax years after 1978, Congress as of September 1978 is considering continuing the lower rates or perhaps substiuting still lower rates. See your tax adviser for the latest information.

Suppose a regular corporation distributes all earnings to shareholders. In addition to income taxes paid by the corporation on earnings, the shareholders pay individual income tax on distributed earnings (dividends). The Subchapter S election can prevent this double taxation. Income "flows through" to the shareholders who pay individual income tax on the earnings. The Subchapter S *corporation* thus has no tax liability.

Now suppose a regular corporation reinvests all earnings in the business; for example, a farm corporation may buy more land or new machinery. A regular corporation pays corporate tax on the earnings, but the shareholders have no dividend income and, thus, no tax liability on the earnings. The Subchapter S option, however, makes corporate earnings flow through to the shareholders for tax purposes. In this case, the shareholders would have to pay individual income tax on the earnings even though the money is reinvested in the corporation. Therefore, the Subchapter S election is less attractive to a corporation that plans to reinvest most earnings.

Another consideration in analyzing the Subchapter S option is the income of the individual shareholders. Some shareholders may be in income brackets with higher income tax rates than corporate tax rates. The option may prove disadvantageous for these shareholders, especially if the corporation reinvests earnings. However, if the corporation distributes earnings, the Subchapter S election may still be useful since it prevents double taxation of corporate income. Consult your tax adviser to help you decide whether the Subchapter S election will reduce or increase your income tax liability.

Under a Subchapter S election, all corporate income is taxed to the shareholders. Each shareholder pays income tax on the sum of the corporate income actually dispersed to him and on his share of undistributed earnings, which is determined by the shareholder's percentage ownership in the corporation.

Suppose that John, Jane, and Jerry Doe respectively own 40, 35, and 25 percent of the stock in Doe Family Corporation.

They have elected the Subchapter S tax treatment. Last year, this corporation realized net profit of $100,000 before salaries. Each shareholder received $20,000 as a salary for services rendered. The shareholders must report this salary as income. The remaining $40,000 not distributed will be taxed to the shareholders in proportion to their stock ownership. John will pay income tax on his $20,000 salary and also on his percentage ownership (40 percent) of $40,000, which is $16,000. Thus, John will pay income tax on $36,000. Jane's taxable income is her $20,000 salary plus 35 percent of $40,000 ($14,000), or $34,000. Jerry's taxable income is his $20,000 salary, plus 25 percent of $40,000 ($10,000) or $30,000. The corporation will pay no tax.

As a general rule, once a person has paid tax on his share of undistributed taxable income, the later distribution of that income is not taxable to the shareholder. However, if the corporation fails to retain Subchapter S status for the entire tax period, this later distribution may be taxable to the shareholder. Thus, the shareholder would be taxed twice on the same income. Complicated legal requirements must continuously be met to assure these subsequent distributions will be non-taxable. Shareholders must work closely with their attorney to avoid such undesirable tax consequences.

Corporate Fringe Benefits

The corporate structure, whether Subchapter S or regular, provides the small business with other tax advantages. First, the corporation may set up qualified pension plans that do not lead to any immediate income to the shareholder-employee. Second, the corporation may provide health and accident plans for the shareholder-employee. The premiums on these policies are not included in the employee's gross income. An individual taxpayer who sets up a similar program receives none of these tax advantages. Third, the corporation can provide life insurance for employees. Within liberal limits, premiums are not included in the gross income of the employee. Fourth, meals and lodging provided on the business premises for the convenience of the corporation may be received tax free by the employee. Fifth, the farm corporation may give certain death benefits tax free to the surviving spouse of a deceased employee. Last, the Subchapter S corporation pays no Missouri income tax. These benefits are generally not available to the unincorporated farm.

Capital Gains

The Subchapter S election may also provide certain capital gains tax advantages. The individual tax (for a joint return) on long-term capital gains up to $50,000 is a flat rate of 25 percent with a limit of 35 percent on gains above $50,000, or half the gain is added to the taxpayer's *other* income tax. (The other half of the capital gain income is tax-free.) The latter method is more commonly used for small amounts of capital gains.

Note that this tax-free portion (called *preference income*) may be subjected to a special tax called the "minimum tax." This tax diminishes the advantages of taking half the capital gains tax free. Basically, the minimum tax applies to the otherwise untaxed portion of capital gains and amounts to 15 percent of that portion after a deduction allowance for income taxes due on ordinary income. Note that as of September, 1978, the U.S. House of Representatives had passed a bill to lower the minimum tax as well as to significantly change the calculation procedure. Check with your tax adviser to see what, if anything, finally passed into law and to see whether your capital gains will be subject to the minimum tax.

A regular corporation also has capital gains tax alternatives. None of its options are as advantageous as those available to individuals, however. The corporate tax on long-term corporate capital gains is 30 percent of the gain, or alternately, the corporate ordinary tax rate (20 percent on the first $25,000, 22 percent on the next $25,000, and 48 percent of the gain above $50,000) on all of the gains. No portion of the corporate capital gain is tax free. However, all capital gains of the regular corporation are considered *preference income*. Thus, a regular corporation is more likely to have to pay a "minimum tax" than is an individual taxpayer.

In a regular corporation, corporate income may arise from capital gains, but the distribution of this corporate income is ordinary income to the shareholders, not capital gains income. The Subchapter S corporation is an exception to this rule. Corporate capital gains income in the Subchapter S corporation is also capital gains income to the shareholders. Capital gains income, like ordinary corporate income, "flows through" the corporation to the shareholders. The shareholders may then use either of the long-term capital gains options available to individuals.

This non-taxable "flow through" of capital gains to shareholders in the Subchapter S corporation may be limited. The Subchapter S *corporation* must also pay tax on the capital gain if (1) its income is greater than $25,000, and (2) the capital gain is greater than $25,000, and (3) 50 percent of the corporation's income would have been taxable had the corporation not elected Subchapter S. The amount of the tax is 25 percent of the gain above $25,000 *or* the regular corporate tax the corporation would have paid on the gain had it not elected Subchapter S, whichever amount is less.

For example, suppose a Subchapter S farm corporation has ordinary income of $60,000 and long-term capital gains of $40,000. The capital gain above $25,000 ($15,000) is taxable to the corporation even though it has elected Subchapter S. The first $25,000 of capital gains flows through to the shareholders.

The Subchapter S corporation has no preference income as long as all capital gains flow through to the shareholders. However, if the corporation is taxed on a capital gain, it has *preference income* in the amount of the capital gain for which the corporation is taxed. This amount may be subjected to the additional "minimum tax" on preference income. In the example above, the $15,000 taxable to the Subchapter S corporation may be subjected to the minimum tax.

Losses and Their Flow Through

Losses, like income, also flow through to shareholders in a Subchapter S corporation. A regular corporation cannot pass losses through to shareholders. This feature of the Subchapter S option may be particularly attractive to *new* corporations that expect substantial net operation losses initially. The corporate losses flow through to the shareholders in proportion to their percentage ownership. The shareholders may use the losses to offset salary income received from the corporation. Established corporations anticipating substantial operating losses may also realize significant tax savings by using Subchapter S. Note though, that if a corporation terminates the Subchapter S election, it cannot re-elect Subchapter S until five years have passed.

Social Security and Subchapter S

Many families find the Subchapter S election attractive because of possible social security advantages. First, dividends distributed to shareholders are not subject to social security taxes. However, under certain circumstances the Internal Revenue Service (IRS) may reclassify dividends received by shareholders who work for the corporation as salary income. Reclassification usually occurs when the shareholders receive compensation for their services via dividends rather than salaries, that is, when salaries are unreasonably low. The IRS will reclassify the dividends as salary to accurately reflect the work done by the shareholder-employee. Dividends reclassified as salary *are* subject to the social security tax.

Second, persons between the ages of 65 and 72 may earn up to $4,000 (1978) before their earnings reduce their social security benefits. Persons under 65 may earn up to $3,240. There is no limit after age 72. Benefits are decreased as earnings increase above the exempted amounts. Salaries earned by social security recipients are included as "earnings." Dividends are not considered earnings, nor is the recipient's percentage ownership of Subchapter S earnings.

Cash vs. Accrual Accounting

Tax advantages are not the only positive attributes of the Subchapter S corporation. The Subchapter S election automatically enables the corporation to use cash accounting rather than accrual accounting. Basically, cash accounting allows more end-of-year juggling of expenses and income for tax reporting purposes. Cash accounting is also available to any farm regular corporation with less than a million dollars of gross income.

Election Requirements

A corporation must meet the following requirements before it may elect the Subchapter S option:

1. *A Subchapter S corporation may have no more than 10 shareholders.*

The number of shareholders may increase to 15 if the new shareholders inherit their stock from a former shareholder. For example, if the corporation has 10 shareholders and a shareholder dies leaving his stock to his three daughters, the corporation will continue to be a Subchapter S corporation even though there are now 12 shareholders. The number of shareholders may also increase to 15 if the corporation maintains its Subchapter S status for five consecutive years.

If the shares are held in joint tenancy or tenancy in common, each tenant is counted as a shareholder. For example, if the corporation has 100 shares outstanding and Jerry, John, and Jane own them all as tenants in common, the corporation has three shareholders. However, if a husband and wife co-own the stock in any fashion, they are considered to be one shareholder.

2. *Generally, only individuals or estates of deceased individuals may be shareholders in a Subchapter S corporation.*

Neither a corporation nor a partnership may be a shareholder. Only certain trusts may be shareholders: voting trusts or grantor's trusts (where the trust creator retains management powers over and a beneficial interest in the trust property). No other trust can be a shareholder in a Subchapter S corporation. Also, a shareholder may not be a nonresident alien.

3. *All of the shareholders of the corporation must approve the election.*

Each shareholder of the corporation must sign a written consent to the Subchapter S election. New shareholders are assumed to consent unless they make a written refusal to consent within 60 days of acquiring the stock. When stock is held in some form of co-ownership, each co-owner must consent to the election.

4. *The corporation may have only one class of stock.*

This restriction applies only to outstanding shares of stock. A Subchapter S corporation may have more than one class of stock as long as only one class is issued.

Two major problems arise in regard to this requirement. First, variations of voting rights in stock in the same class may in fact make the stock two different classes. The courts and Congress have not resolved this problem yet. Second, shareholder loans to the corporation may also constitute a second class of stock. These loans, the argument goes, are essentially a class of preferred stock. If the corporation liquidates, the shareholder-lender can have his loan repaid before the rest of the corporate assets are divided among all the shareholders. Recent cases and changes in the Internal Revenue Code have discredited this argument. Still, shareholder loans to the corporation are hazardous to the Subchapter S election and should be made only as recommended by your tax advisor.

5. *The sources of income of the Subchapter S corporation are restricted by the Internal Revenue Code.*

First, a corporation making the election cannot have gross receipts greater than 20 percent from passive sources. Passive sources are defined as royalties, rents, dividends, interest, annuities, or the sale and exchange of stocks and securities. Second, a Subchapter S corporation cannot have more than 80 percent of its gross receipts come from sources outside the United States.

How to Make the Election

Shareholders may elect Subchapter S taxation by filing Form 2553 with the district director of the IRS. The consent of each shareholder must be attached to this form.

A valid election of Subchapter S tax treatment can be made at any time during the two month period beginning one month before the beginning date of the corporate taxable year. The election (IRS Form 2553) must be signed by all the shareholders by the first day of the corporation's taxable year or by the date of the election, whichever is later.

Once an election is made, it remains in effect for all subsequent taxable years until it is voluntarily or automatically revoked.

Termination of the Election

A Subchapter S election can be voluntarily revoked at any time after the first year the election becomes effective. A revocation is not effective in the year it is made unless filed in the first month of the corporation's taxable year. After termination, the corporation will be taxed as an ordinary one. (See UMC Guide 400 for more information on ordinary corporations.)

Revocation is made by filing a statement of revocation with the IRS. There is no specific form for revocation. The consent of all shareholders on the books on the date of revocation must accompany the revocation statement.

The Subchapter S election can also be automatically terminated. In this case, termination is retroactive to the first day of the taxable year in which the disqualifying occurs. For example, suppose a corporation reports on a calendar year basis. Jones, a shareholder in the corporation, sells his stock to Smith on December 31, 1977. Smith files a written refusal to consent to the election. The election will terminate for the entire calendar year 1977 and all succeeding years. This prevents the shareholders from using Subchapter S taxation during the 1977 tax year, even though they met the Subchapter S requirements for 364 of the 365 days in the year.

Automatic termination of the election takes effect when one or more of the following occurs:

- A new shareholder files a refusal to consent to the Subchapter S election with the district director of the IRS. The refusal must be made within 60 days after becoming a shareholder;
- The corporation has more than the maximum number of shareholders allowed;
- The corporation issues a second class of stock;
- A partnership, corporation, non-resident alien, non-qualifying trust, or bankrupt estate of one of the shareholders becomes a shareholder of the corporation;
- More than 20 percent of the corporation's gross receipts are from royalties, rents, dividends, interest, annuities, or gains from the sale or exchange of stock or securities; that is, *passive income;*
- 80 percent or more of the gross receipts of the corporation are from sources outside the United States.

Automatic termination can lead to adverse tax consequences for the shareholders and the corporation. After termination, the Subchapter S corporation will be taxed as an ordinary corporation. The IRS may characterize distributions to the shareholders as dividends. These distributions will then be taxed to the corporation as income and to the shareholders as dividends. Thus, take extreme care to avoid automatic termination. The Subchapter S corporation and its shareholders should work closely with their tax adviser to avoid these problems.

Re-election After Termination

Once an election has been terminated, a new election generally cannot be made for the next five years. This rule applies whether the termination was voluntary or involuntary. For example, suppose Jones Farm Corporation elected Subchapter S taxation in 1965 and reports its income on a calendar year basis. The election is automatically terminated in 1974 because the company derives more than 20 percent of its gross receipts from passive income in the form of rents and interest. The shareholders may not elect Subchapter S taxation again until 1979.

The shareholders may avoid the five-year rule if the commissioner of the IRS consents to an earlier election. The shareholders may also attempt to avoid the rule by creating a new corporation, but an IRS regulation makes this technique ineffective if it is used solely for avoiding the five year ban on a re-election.

More Information

For additional information on corporations as they relate to farming and small businesses, ask your local University of Missouri Extension Center for Guide 400, *Should You Incorporate Your Farm,* and North Central Regional publication 11, *The Farm Corporation*. Write down your questions about corporations; then seek professional advice from attorneys, accountants, and bankers.

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