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Subchapter S

Tax option for small corporations

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Subchapter S of the Internal Revenue Code allows special income tax treatment to certain small business corporations. Under this option, they usually pay no income tax. Instead, shareholders are taxed directly for corporate income. Subchapter S permits corporations to pay no corporate income tax, but it still may provide many of the advantages of corporations, such as limited liability and ease of ownership transfer. For more information on corporations, see Guide 400, "Should You Incorporate Your Farm."

This guide sheet explains the general operating rules for Subchapter S corporations, including those changes made by the Subchapter S Revision Act of 1982. But don't rely on this guide sheet for legal service; consult an attorney when legal questions arise.

Income tax advantages

A Subchapter S corporation has three principal tax advantages over a regular corporation:

- no double taxation of earnings,
- net operating loss flows through to shareholders, and
- preferential treatment of capital gains income.

These three income tax advantages are the primary reasons corporations elect Subchapter S tax treatment.

Double taxation

A regular corporation pays federal income tax on all earnings, whether reinvested or distributed to shareholders, at the rates in Table 1.

Besides the federal corporate income tax, Missouri regular corporations must also pay a 5 percent Missouri corporate income tax. Subchapter S corporations pay no Missouri corporate income tax.

Table 1. Corporate income tax rates.

Taxable Income	1982	1983 & later
0 to $ 25,000	16%	15%
$25,000 to $ 50,000	19	18
$50,000 to $ 75,000	30	30
$75,000 to $100,000	40	40
More than $100,000	46	46

Suppose a regular corporation distributes all earnings to shareholders. Besides income taxes paid by the corporation on earnings, the shareholders pay individual income tax on distributed earnings or dividends. Thus, all earnings of a regular corporation, distributed as dividends, are taxed twice.

Subchapter S corporations avoid this double taxation. If you choose Subchapter S tax treatment for your corporation, 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.

So the primary advantage of Subchapter S status is that the federal government collects taxes on corporate earnings only once from the shareholder. If you don't elect the Subchapter S option, taxes on earnings may be collected twice; once from the corporation as taxable income, and later from the shareholders if they declare dividends. The *flow through* of corporate earnings to the shareholder under Subchapter S avoids this double taxation.

In a Subchapter S corporation, all shareholders pay income tax on the sum of the corporate income actually dispersed to them and on their individual share of undistributed earnings, determined by the shareholder's percentage of ownership in the corporation.

Suppose that John, Jane, and Jerry Doe own respectively 40, 35, and 25 percent of the stock in the Doe Family Corporation. They have elected the Subchapter S tax treatment. Last year, this corporation realized net profit of $80,000 before salaries. John and Jane each received $20,000 as salaries for services rendered. They must report this salary as income. The remaining $40,000 that was not distributed will be taxed to the shareholders in proportion to their stock ownership.

So John will pay income tax on his $20,000 salary and also on his percentage of ownership (40 percent)

of $40,000 or $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). That's $34,000. Jerry's taxable income is his 25 percent of $40,000 or $10,000. The corporation itself will pay no tax.

Note that Jerry has a tax liability on $10,000 of corporate income even though he did not receive any money from the corporation.

Investment tax credit earned by a Subchapter S corporation also flows through to the shareholders. Therefore, shareholders may receive investment credit to offset their taxes.

Once shareholders have paid taxes on their shares of undistributed taxable income, the later distribution of that income is generally not taxable. However, if the corporation fails to retain Subchapter S status for the entire tax period, this later distribution may be taxable to shareholders. Thus, shareholders would be taxed twice on the same income. Complicated legal requirements must be met continuously to ensure that these subsequent distributions will be non-taxable. Shareholders must work closely with their attorneys to avoid such undesirable tax consequences.

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 the corporate tax rates would be. The option may prove unfavorable for these shareholders, if the corporation reinvests its earnings. However, if the corporation distributes earnings, the Subchapter S election may still be useful because it prevents double taxation of corporate income.

Ask your accountant to help you decide whether the Subchapter S election will reduce or increase your income tax liability.

Flow through of losses

Losses, like income, also flow through to shareholders in a Subchapter S corporation. This feature of the Subchapter S option may be particularly attractive to ***new*** corporations that expect substantial net operating losses at first. Corporate losses flow through to the shareholders in proportion to their percentage of ownership. Shareholders may use these losses to offset other income, such as salary income received from the corporation.

A regular corporation cannot pass losses through to shareholders. In an unprofitable year, shareholders of a regular corporation may be paying taxes on their salaries and other income while the corporation has a net operating loss. Established corporations anticipating substantial operating losses may realize significant tax savings by electing Subchapter S.

Capital gains

Individual taxpayers are taxed differently for capital gains income than for ordinary income. Individuals may exclude 60 percent of long-term capital gains income and, therefore, must pay taxes on only the remaining 40 percent. That's a very desirable tax treatment for capital gains income.

Note that this tax-free portion (called preference income) may be subject to a special tax called the *alternative minimum tax*. This tax may diminish the advantage of taking 60 percent of the capital gains tax free.

Subchapter S corporations usually pay no income taxes. Capital gains income earned by a Subchapter S corporation flows through to the shareholders. The shareholders can then take advantage of the 60 percent exclusion.

Regular corporations do pay taxes, and earnings do not flow through to shareholders. In a regular corporation, corporate income may arise from capital gains, but the distribution of this corporate income is ordinary income to the shareholders and not capital gains income. Therefore, there is no tax advantage to the shareholder when a regular corporation has capital gains income. In addition, corporations are not eligible for a 60 percent exclusion on capital gains income. No portion of the corporate capital gain is tax free. Capital gains income earned by a regular corporation is 100 percent taxable at a maximum rate of 28 percent. All capital gains of the regular corporation are considered *preference income*. Thus, a regular corporation is more likely to have to pay the alternate minimum tax than is an individual taxpayer.

Other tax considerations

Subchapter S corporations are not allowed net operating loss or investment credit carryover from years in which the corporation was not a Subchapter S corporation.

Beginning in 1983, the Subchapter S law allows the flow-through of additional tax benefits to the shareholders. These include tax-exempt interest, capital losses, gains and losses on property used in the business (Section 1231 property), charitable contributions, depletion allowances, and foreign income, losses and credits.

Ordinary income, long-term capital gains, operating losses and investment tax credit earned by a Subchapter S corporation flow through to the shareholders on a daily basis.

Social security and Subchapter S

Many families find the Subchapter S election attractive because of possible social security advantages. Dividends distributed to shareholders are not subject to social security taxes. An incorporated farm does not have to pay social security taxes on *profits,* but individuals in the corporation pay taxes on their salaries. 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 through dividends rather than salaries (that is, when salaries are unreasonably low). The IRS will reclassify the dividends as salary to reflect accurately the work done by the shareholder-employee. Dividends reclassified as salary ***are*** subject to the social security tax.

Retired persons between the ages of 65 and 72 may earn up to $6,600 (1983) before their earnings reduce their social security benefits. Persons under 65 may earn up to $4,440. There is no limit after age 70 (1983). Benefits decrease 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 of ownership in Subchapter S earnings.

Corporate fringe benefits

The Subchapter S Revision Act of 1982 greatly restricted the non-taxable benefits that a Subchapter S corporation can provide to any shareholder owning more than 2 percent of the stock.

Employee fringe benefits provided by a Subchapter S corporation are now treated like benefits provided by a partnership. Specifically, any death benefits, accident or health plan contributions, life insurance premiums, or meals and lodging furnished for the convenience of the employer are taxable income to the employee, if the employee owns more than 2 percent of the outstanding stock.

Cash vs. accrual accounting

Tax advantages are not the only positive attributes of the Subchapter S corporation. The Subchapter S election 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 $1 million 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 35 shareholders.

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 if 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 as one shareholder.

2. Generally, only individuals, estates and some types of trusts may be shareholders in a Subchapter S corporation.

Neither a corporation nor a partnership may be a shareholder. Only certain trusts may be shareholders; those are voting trusts or grantor's trusts (where the trust creator retains management powers and a beneficial interest in the trust property) or a Subchapter S trust.

A Subchapter S trust is one with a single person as its beneficiary. The possibility of multiple beneficiaries upon the death of the initial beneficiary does not disqualify the trust. If the initial beneficiary dies and more than one person become the beneficiaries, the trust can continue to be an eligible Subchapter S shareholder for a period of 60 days.

Either the estate of a deceased individual or the estate of an individual in bankruptcy is eligible to hold stock in a Subchapter S corporation.

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

On the date of election, each shareholder of the corporation must sign a written consent to the Subchapter S election. When stock is held in some form of co-ownership, each co-owner must consent to the election. Once the Subchapter S election is made, all shareholders need not consent.

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

The 1982 Act permits differences in voting rights in common stock. No preferred stock may be issued. For some time, there have been questions regarding debt securities held by shareholder-creditors. Debt securities held by a person eligible to hold Subchapter S corporation stock do not constitute a second class of stock if they involve a written, unconditional promise to pay. That promise cannot be contingent on the profits of the corporation or other action of the corporation.

5. The sources of income of the Subchapter S corporation may be restricted by the Internal Revenue Code.

Before 1982, a corporation making the election could not 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. The 1982 Act eliminates this restriction, if the Subchapter S corporation has no accumulated earnings and profits from years it was taxed as a regular corporation. A Subchapter S corporation cannot own 80 percent or more of the stock of another corporation.

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.

The election can be made any time before the 16th day of the third month of the taxable year. If the election is too late for the current tax year, it is treated as made for the following year.

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

In the past, Subchapter S corporations could elect either a calendar year or a fiscal year. Under the 1982 Act, new Subchapter S corporations must use a calendar year unless they can convince IRS that there is a business reason for doing otherwise.

Existing Subchapter S corporations using fiscal years may continue to do so as long as at least 50 percent of the corporate stock is owned by the same persons who owned the stock on December 31, 1982. Transfer of stock to family members by gift or inheritance does not count against this 50 percent rule, nor do transfers to a family member under a buy-sell agreement in effect on September 28, 1982.

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 it is filed before the 16th day of the third month of the corporation's taxable year. After termination, it is taxed as a regular corporation.

Revocation is made by filing a statement of revocation with the IRS. There is no specific form for revocation. Under the 1982 Act, a Subchapter S election may be voluntarily revoked only if holders of more than half of the corporate stock consent to the revocation.

The Subchapter S election can also be automatically terminated. In this case, termination is effective the day the disqualifying event occurs.

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

- 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, or non-qualifying trust becomes a shareholder of the corporation.
- The corporation acquires a subsidiary.

Automatic termination can lead to adverse tax consequences for the shareholders and the corporation. After termination, the Subchapter S corporation will be taxed as a regular 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. If automatic termination occurs, the 1982 Act authorizes IRS to waive the effects when the corporation acts quickly to correct the problem and when the corporation and the shareholders agree to be treated as though the election had been continuously in effect.

Re-election after termination

Once an election has been terminated, a new election generally cannot be made for the next five years. 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 at your local University of Missouri Extension Center for Guide 400, "Should You Incorporate Your Farm," and for 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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