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## S CORPORATE TAX CHANGES

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S corporations have enjoyed both the liability protection of a corporation and the pass through benefits of a sole proprietorship and partnership. It is a hybrid of partnerships and corporations that actually enjoys the benefits of both worlds. With all its advantages, some shareholders and entities were shut out of because of numerous restrictions. Well, after years of being left out of major legislations, S corporations finally got a break with the passage of the Small Business Job Protection Act of and recently from the American Jobs Creation Act of 2004.

S corporations are now more flexible with fewer restrictions and less complexities while retaining their all important status as pass-through entities. This is certainly wonderful news for small and medium-sized businesses. Let's discuss 10 changes:

1. S corporations can now have a maximum of **100 shareholders** (up from 75).
2. The IRS will have **greater flexibility to permit S elections** to stand even if the S status is inadvertently terminated.
3. In fact, **late filing of elections** or even the non-filing of S elections can also be determined by the IRS as timely filed elections. This is a dramatic change from previous rules that disapproved S elections if filed one day late after two and a half months of the following year. It brings a sigh of relief to accountants and their clients who miss filing S Election Form 2553. In other words, Congress is imposing its will on the IRS to be kinder and gentler by giving the Service the authority to waive inadvertently invalid or missed elections.
4. **Terminated S corporations** do not have to wait five years to elect another S treatment. Current law requires corporations to wait five years after the status is revoked before it can reelect S status. New law repeals that provision and now allows corporations to reelect S status anytime.
5. Whereas under current law, all S corporate shareholders must **terminate** their interests when any shareholder terminates an interest, they are no longer affected by such terminations. Under the new law, only the corporation and shareholders actually affected by the termination must agree. The other shareholders' tax liabilities will not be affected by such election.
6. S corporation **audits** will be conducted at the shareholder level. Under current law, Subchapter S items of income, loss, deductions, and credit determined at the corporate level are audited at the corporate level and not in separate shareholder proceedings. The new law repeals and mandates that all S corporation audits be conducted on a shareholder-by-shareholder basis. The unified audit rules that treated S corporations, as partnerships for purposes of dealing with the IRS no longer apply.
7. After S status is **terminated**, the "post-termination transition period" has been expanded to allow shareholders to have a better chance of gaining tax benefits from refund claims and settlements with the IRS. During this transition period, distributions by former S corporations are treated as made by an S corporation tax-free out of its accumulated adjustments account (AAA). Distributions made after the transition period are then taxed as regular Subchapter C dividends.

8. Whereas current law has a long list of [disqualified shareholders](#), most are now eligible under new law. An Electing Small Business Trust (ESBT) can be an S corporation shareholder. This is a response to difficulties shareholders have had in attempting to transfer stock ownerships without terminating the corporation's S election.
9. Current rules prevent S corporations from being part of a [parent/subsidiary](#) group of 80% or more on corporations. S corporations under the new rules will now be able to function as parent corporations or as subsidiaries of other S corporations. Thus, multiple corporation ownership structures that make sense for business or legal reasons can now qualify. While S corporations still cannot have C corporation shareholders, S corporations can now own 100% of the stocks of C corporations. The subsidiary must still pay corporate level taxes and dividend passed up to the S corporation parent will still be income to the shareholders.
10. New law also allows S corporations to have one or more wholly owned [Qualified Subchapter S Subsidiaries](#) (QSSTs), and will be treated as an incorporated branch or division of the parent S corporation and, therefore, pass-through taxation will apply to the entire operation of the parent/subsidiary. They do not exist for Federal income tax purposes but will be treated as separate entities for legal purposes to protect the assets of the parent corporation from exposure to the liabilities of its subsidiaries.

In loss years, the basis of S corporation stock will be reduced first by distributions to shareholders, thereby, minimizing the likelihood that distribution will trigger taxable gains at the shareholder level.

Even mutual savings banks, domestic building and loan associations, cooperative banks, small banks, and large banks can now elect to be S corporations.

In conclusion, the advent of Limited Liability Companies (LLCs) and Limited Liability Partnerships (LLPs), the new kids on the block, S corporations lost some followings but seem to have regained some of its luster by these new advantageous tax provisions. For those of you who are still operating your businesses as regular C corporations, this is a good time to reconsider.

[The American Jobs Creation Act of 2004 included the following positive changes to S corporate rules:](#)

1. The new law allows family members to be treated as one shareholder.
2. It increases the number of shareholders from 75 to 100.
3. The new law also allows a beneficiary of a Qualified Subchapter S Trust (QSST) to deduct its share of suspended S corporation losses when the QSST disposes the related S corporation stock.
4. It even allows S corporate losses that were suspended due to basis limitations to be transferred to a spouse (or former spouse in divorce cases).