
Tax Bulletin

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S Corporations After the Small Business Job Protection Act of 1996

With the steady proliferation of the limited liability company, it appeared until recently that the S corporation - which generally lacks the structural flexibility offered by the limited liability company - had all but lost its status as the vehicle of preference for business owners seeking the combined benefits of limited liability and pass-through taxation. Perhaps recognizing the plight of the S corporation, which was first introduced in 1958, Congress recently did what it previously had done in 1982 and then again in 1986: it enacted legislation, embodied in certain provisions of the Small Business Job Protection Act of 1996 (the "1996 Act"), intended to revitalize the S corporation. The effectiveness of this legislation, the major provisions of which are summarized below, will be measured by the collective response of private businesses in the years to come.

Maximum Number of Shareholders Increased

Among the more basic restrictions currently applicable to S corporations is the restriction that an S corporation cannot have more than 35 shareholders. As a result of the 1996 Act, this restriction has been eased so that, effective for taxable years beginning after December 31, 1996, an S corporation will be permitted to have up to 75 shareholders.

Membership in Affiliated Groups Permitted

Under current law, an S corporation is prohibited from holding 80% or more of the stock of another corporation. Effective for taxable years beginning after December 31, 1996, the 1996 Act repeals this prohibition. Therefore, in taxable years beginning after December 31, 1996, S corporations generally will no longer be precluded from holding all or any portion of the stock of

another corporation. S corporations, however, will continue to be precluded from joining in the filing of consolidated tax returns, although their non-S corporation subsidiaries may still qualify to join in the filing of consolidated tax returns.

Ownership by Other S Corporations Permitted

Also under current law, the stock of an S corporation cannot be held by another corporation. While this rule generally remains unchanged by the 1996 Act, effective for taxable years beginning after December 31, 1996, the stock of a "qualified Subchapter S subsidiary" can be owned by another S corporation. A "qualified Subchapter S subsidiary" is any domestic corporation that is otherwise eligible to be an S corporation if: (i) its stock is wholly owned by an S corporation; and (ii) its parent affirmatively elects to treat it as a qualified Subchapter S subsidiary. A qualified Subchapter S subsidiary will not be treated as a separate corporation, and, accordingly, all of its assets, liabilities, and items of income, deduction, and credit will be treated as those of its parent.

Ownership by Electing Small Business Trusts Permitted

Currently, the stock of an S corporation cannot be held by trusts other than certain grantor trusts, voting trusts, testamentary trusts (for a limited period of time), and "qualified Subchapter S trusts" (or "QSSTs"), which generally must distribute all of their income to one individual. Effective for taxable years beginning after December 31, 1996, the 1996 Act adds another type of trust that can hold the stock of an S corporation: the "electing small business trust." A trust will be treated as an electing small business trust if: (i) it does not have any beneficiaries other than individuals, estates, or certain charitable organizations; (ii) no interests in the trust are acquired by purchase; (iii) the trust makes an election to be an electing small business trust; and (iv) the trust has not made an election to be a QSST and is not a tax-exempt trust. Special rules will apply in determining the tax liability of an electing small business trust. For purposes of determining the number of shareholders of an S corporation, an electing small business trust will be treated as one shareholder unless it has any potential current beneficiaries (i.e., persons who currently are or may be entitled to receive distributions from principal or income), in which case each potential current beneficiary will be treated as a shareholder of the S corporation.

Ownership by Qualified Tax-Exempt Shareholders Permitted

Effective for taxable years beginning after December 31, 1997, the 1996 Act further adds to the category of permissible S corporation shareholders certain qualified retirement plan trusts and charitable organizations. In order to preserve at least one level of taxation, however, the 1996 Act provides that all of the income allocated to a qualified tax-exempt shareholder will be treated as unrelated business taxable income. For purposes of determining the number of shareholders of an S corporation, a qualified tax-exempt shareholder will be treated as one shareholder.

Authority to Validate Elections Granted to the IRS

Under certain circumstances, the IRS has the authority to waive the effect of an inadvertent termination of S corporation status. Currently, however, the IRS does not have the authority to waive the effect of an invalid or late election to be an S corporation. Under the 1996 Act, the IRS now has the authority to treat as valid an Selection that was made for a taxable year beginning after December 31, 1982, and that technically was defective because the corporation failed to qualify as a small business corporation or because it failed to get the proper shareholder consents. Furthermore, the IRS now has the authority to treat as timely a late S election that was made for a taxable year beginning after December 31, 1982, where the IRS determines that there was reasonable cause for failing to file a timely Selection.

Ability to Reelect S Corporation Status Expanded

Prior to the 1996 Act, if a corporation's election to be treated as an S corporation was terminated or revoked, the corporation generally could not reelect S corporation status for five years without the consent of the IRS. The 1996 Act effectively eliminates this five-year waiting period for any termination or revocation occurring in a taxable year beginning before January 1, 1997.

Availability of Favorable Corporate Provisions Expanded

In general, an S corporation in its capacity as a shareholder of another corporation is treated as an individual. Effective for taxable years beginning after December 31, 1996, this rule is modified. As a result, an S corporation that is a shareholder in another corporation will be entitled to the benefits of certain favorable corporate tax provisions that were previously unavailable to S corporations. For example, an S corporation that holds at least 80% of the

stock of a subsidiary will be able to liquidate the subsidiary in a tax-free transaction.

Certain Other Miscellaneous Provisions

Potentially relevant to S corporations are other provisions of the 1996 Act that:

- allow certain financial institutions not using bad-debt reserves to be S corporations;
- permit certain financial institutions to hold straight debt of S corporations;
- expand the post-mortem ability of grantor trusts and testamentary trusts to hold the stock of S corporations;
- allow certain elections to close the books of an S corporation to be made by the affected shareholders alone rather than by all of the shareholders;
- expand the ability of S corporations to take advantage of certain post-termination transition-period rules;
- apply new audit rules to S corporations and their shareholders; and
- apply new rules requiring S corporation shareholders to file returns consistent with the S corporation's return unless they identify any inconsistencies in a statement to the IRS.

A note of caution regarding state taxation:

Under the laws of certain states, the provisions of the 1996 Act relating to S corporations should be operative for all or most state tax purposes. Under the laws of other states, however, including Massachusetts, it may not be clear whether or how these provisions operate for state tax purposes. Accordingly, caution is advised in relying on the provisions of the 1996 Act for state tax purposes.

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