

## **Summary of Subchapter S Corporations**

### **What is a Subchapter S Corporation?**

A Subchapter S corporation is a state law corporation that satisfies the requirements for Sub S of the Internal Revenue Code (“IRC”) and makes the election to be taxed under IRC Subchapter S. The election is made by submitting IRS Form 2553 to the Internal Revenue Service (“IRS”). A separate S election may be required to avoid the state corporate income tax.

### **Why Elect Subchapter S status?**

The benefit of Subchapter S is that there is only one level of tax, rather than double taxation. A publicly traded corporation like DuPont is taxed under Subchapter C of the Internal Revenue Code. DuPont pays as much as 35% tax on its net taxable income. When the profit (net of tax) is distributed to the stockholders, they pay a second level of tax on the dividend distribution—currently taxed at a maximum rate of 20%. Thus, if DuPont has \$100 million of net taxable income for the year, \$35 million of corporate tax will be due, and if the remaining \$65 million of profit (net of tax) is distributed to the shareholders, they will pay another \$13 million in individual income tax on the dividend distribution. That makes \$48 million of total income tax owed to the IRS. On the other hand, if a Subchapter S corporation has \$100 million of profit, the shareholders are allocated their respective share (based on stock ownership per day). The shareholders will include their share of the profits on their individual income tax returns (IRS Form 1040), whether or not they actually receive the cash. This is just like partnership tax treatment. The shareholders receive a Schedule K-1 reporting their share of the corporation’s net taxable income. The Subchapter S corporation does not pay tax federal income tax. The individual shareholders will pay at their individual income tax rate, which reaches a maximum of 39.6%. Many states also accept Subchapter S corporations for their state income tax. For example, in Pennsylvania an S corporation does not pay the 10% corporate income tax, rather the individual shareholders pay the personal income tax at the 3% rate. That is a big savings.

### **How does a corporation Qualify for Subchapter S status?**

First, to elect S corporation status, the corporation must be eligible. It can have no more than 100 shareholders, who (with a few exceptions) must all be human beings. (A few special types of trusts are permitted where a shareholder dies.) There can be no corporate, partnership, or LLC shareholders. (Banks and insurance companies are not eligible for Subchapter S.) No stockholder can be a “nonresident alien.” For example, an S corporation cannot have a French citizen living in Paris as a shareholder. The corporation can have only one class of stock—although different classes in voting rights are allowed. No preferred shares. The qualifying corporation must then elect to be taxed under Subchapter S. In general to be effective for a year the election must be filed with the IRS on or before the 15th day of the third month of the taxable year. So for example, a corporation formed on January 1, 2013 would have to file the election by March 15. The election (made on IRS Form 2553) is a simple form that must be signed by all the shareholders.