FINANCIAL PLANNING
PERSPECTIVES

NEW RULES MAKE LIFE EASIER FOR S CORPORATIONS

Although limited liability corporations have risen quickly in popularity, the S corporation remains a common format for family-owned businesses that want to limit liability and avoid the double taxation that C corporations face. Following new rules passed by Congress and the issuance of final regulations by the Internal Revenue Service, the picture has become a little clearer for S corporation owners, and experts think it is an improved picture. Of particular interest is that S corporations can now establish employee stock option plans (ESOPs).

More shareholders. Rules now allow an S corporation to have 75 shareholders, or 150 shareholders if spouses are shareholders. That's more than double the number under the old rules, and provides more flexibility if you want to share ownership more widely with family and employees.

Multiple subsidiaries. An S corporation may now have whollyowned subsidiaries, either as S corporations or as C corporations, eliminating the need to establish corporations with identical shareholders. In addition, multiple S corporation subsidiaries can be filed under a single return, and losses from one subsidiary can be used to offset gains from another. However, C corporation subsidiaries cannot be combined with the S corporation parent.

More trust beneficiaries. Trusts that own an interest in an S corporation can now have multiple beneficiaries—called an "electing small business trust." Certain types of trusts aren't allowed as owners, such as charitable remainder annuity trusts or charitable remainder unitrusts, but in general this change makes estate planning much more flexible for S corporation owners.

ESOPs allowed. One of the biggest changes is that employee stock option plans can now own S corporations shares. This allows S corporations to provide incentives for employees by allowing them to share in ownership. It also makes it possible for C corporations with ESOPs to consider converting to S corporation status.

What may not be known to some S corporation owners is that Congress modified some of the changes it had originally made in 1996 in this area. First, income the ESOP receives from an S

corporation is no longer exposed to the unrelated business income tax. An ESOP that owns 25 percent of the shares of the S corporation effectively shields 25 percent of the corporation's income from tax. Although ESOP participants eventually pay the tax when their shares are distributed to
them, they can roll the distribution into an IRA to further delay tax. By the way, the ESOP is the only nonprofit trust exempt from this tax.

Another important change is that S corporations can now require that distributions from ESOPs be in cash rather than stock. Initially, ESOPs were unattractive to S corporations because of the risk that a departing employee, taking distributions as company stock, might roll the stock into an IRA, which is not allowed to hold S corporation stock.

C corporations still offer more attractive tax benefits for using ESOPs, but the changes have narrowed the gap. Observers are cautioning S corporation owners interested in establishing an ESOP to monitor legislative activity in this area, since some of the new tax benefits regarding ESOPs are drawing criticism.

Nonetheless, the revisions and changes of S Corporation rules have revitalized this format. Existing C corporation owners or those preparing to establish a business may want to sit down with their financial advisors to determine if the S corporation is a suitable corporate structure. As part of that process, be sure to check local state regulations regarding S corporations. Some differ from federal regulations.

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