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A Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary: Part V – Spouses Owning Shares of an S Corporation

By Larry Brant on 4.4.24 | Posted in Internal Revenue Code, Tax Laws, Tax Planning

This fifth installment of my multi-part series on Subchapter S is focused on married individuals who own shares of an S corporation. While the rules relating to shareholder eligibility seem straightforward, their application relative to spouses may create traps for unwary taxpayers and their tax advisers.

BACKGROUND

Number of Shareholders Limitation

Prior to 1996, an S corporation could have no more than 35 shareholders. The Small Business Job Protection Act of 1996 ("SBJPA") amended Code Section 1361(b)(1)(A), increasing the maximum number of permitted shareholders of an S corporation to 75. In 2004, Congress enacted the American Jobs Creation Act ("AJCA"). The AJCA further amended Code Section 1361(b)(1)(A), increasing the maximum number of permitted shareholders of an S corporation to 100. This change was effective for tax years beginning in 2005. Today, the maximum number of permitted shareholders of an S corporation remains at 100.

The AJCA contained many other provisions that directly impacted Subchapter S, including an amendment to Code Section 1361(c)(1), whereby a "family" may "elect" to be treated as one shareholder for purposes of determining the number of shareholders of an S corporation.[1] For this purpose, "family" includes a common ancestor and all lineal descendants of the common ancestor, and spouses and former spouses of these persons. A few limitations apply to the "family" election:

- "Family" is limited to six generations; and
- A spouse and former spouse are treated as the same generation as the person to whom the person is or was married.

Generally, any member of a "family" may make the election. The election, once made, remains effective until expressly terminated. Shares owned by a "family" may be held directly or indirectly (e.g., as a beneficiary of an ESBT or QSST).

Shareholder Eligibility

In addition to the number of shareholders limitation, pursuant to Code Section 1361(b), (c) and (d), all shareholders of an S corporation must be eligible shareholders. Several rules accompany this requirement.

Each shareholder must be an individual, a decedent's estate, a bankrupt's estate under Title 11 of the U.S. Code, a specified trust, or a Code Section 401(a), 501(c)(3) or 501(a) organization. Expressly excluded from the eligibility list are foreign trusts and nonresident aliens; they may not be shareholders of an S corporation.

In accordance with Code Section 1361(b), individuals are eligible shareholders. Provided, however, as stated above, nonresident aliens are ineligible shareholders. For this purpose, an alien resident of Puerto Rico is ineligible.[2]

Spouses

If taxpayers and their advisers are not careful, spouses owning shares of an S corporation can cause the corporation to run afoul of the (i) shareholder eligibility rule and/or (ii) number of shareholders limitation.

For purposes of the 100-shareholder limitation, spouses (and their estates) that jointly own shares of an S corporation are treated as one shareholder.

PRACTICE ALERT: This rule with respect to the 100-shareholder limitation is only valid as long as a couple is legally married. Once divorced, each of the former spouses will be considered a separate shareholder provided they each own shares of the S corporation. Assuming the corporation does not run afoul of the 100-shareholder limitation, this mundane rule may never create a problem.

PRACTICE ALERT: If one spouse is a nonresident alien, however, their joint ownership of shares of an S corporation will render them together to be an ineligible shareholder.[3] The result is the loss of the corporation's S election.

EXAMPLE 1: Spouses jointly own stock in an S corporation. They are both eligible S corporation shareholders. While legally married, they are treated as one shareholder.

EXAMPLE 2: Same facts as Example 1. Spouse dies and the stock of the S corporation is transferred to his/her estate. Surviving spouse and deceased spouse's estate constitute one shareholder for purposes of the 100-shareholder rule.

EXAMPLE 3: Same facts as Example 1. Both spouses pass away, and their jointly owned shares of the S corporation are transferred equally to their respective estates. The estates are treated collectively as one shareholder for purposes of the 100-shareholder rule.

EXAMPLE 4: S corporation is owned by 100 shareholders. 200 shares are outstanding. 198 shares of are owned equally by 99 married couples and two shares are owned by a single person. One of the married couples gets divorced and each spouse ends up with one share of S corporation. The result is that the S corporation has 101 shareholders, thereby terminating its S election because the corporation is in violation of Code Section 1361(b)(1)(A). This result could have possibly been avoided if some of the shareholders qualified for and one of the shareholders had made a "family" election.

Obscure Aspects of the Spousal Ownership Rules

There are at least two obscure aspects of the rule whereby spouses constitute one shareholder:

- If one spouse is a nonresident alien, their joint ownership of shares of an S corporation will render them together to be an ineligible shareholder. The result is that the S corporation election is terminated.
- Community property laws may impact spouses and affect the validity of an S election. In *Ward v. United States*,[4] a shareholder's spouse (a citizen and resident of Mexico) had a community property interest in the stock of an S corporation owned by her husband, a U.S. citizen. The nonresident alien spouse's ownership interest in the shares created by community laws caused the corporation to lose its S election. Even the "family" election under the provisions added to Subchapter S by the AJCA would not have changed that result.

PRACTICE ALERT: Be careful where community property laws apply. If you have an S corporation whose shares are owned by a person subject to community property laws, carefully consider the impact these laws may have on the S election. If the community property laws could put the S election in peril, it may be necessary for the eligible shareholder to hold the shares as his or her separate property. For that purpose, a formal agreement to that effect is generally required.

EXAMPLE: Spouses own shares of an S corporation as community property. One spouse is a citizen of the United States. The other spouse is a citizen of Canada but is currently a resident of the United States. If the non-citizen spouse leaves the United States, returning to Canada and is thereafter no longer considered a resident of the United States, the S corporation election is terminated because the corporation has an ineligible shareholder (i.e., the Canadian spouse). If the shares were owned by the U.S. citizen spouse as his or her separate property, no termination would have occurred.

CONCLUSION

Subchapter S, due to numerous legislative changes, as well as cases, rulings and regulations, has become complex. The rules relating to shareholder eligibility and spouses only illustrates some of the complexity and obscurity that has been created over the years. I hope this blog post is helpful.

I will provide guidance on some of the other not-so-obvious aspects of Subchapter S in upcoming blog posts. Stay tuned!

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[1] § 231 of the AJCA. Public Law 108-357.

[2] *See* Rev. Rul. 73-478, 1973-2 CB 310.

[3] Code § 1361 (c)(1).

[4] 661 F2d 226 (Ct. Cl. 1981).

Tags: A Journey Through Subchapter S, American Jobs Creation Act of 2004, community property laws, family election, married individuals, number of shareholders limitation, S corporation, shareholder eligibility, shareholders, spousal ownership rules