

Tax Bulletin

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S Corporations—Newly Issued Guidance Regarding Family Elections

In 2004, some significant changes were made to the Internal Revenue Code provisions that govern the federal income tax treatment of S corporations. Most notably, the maximum number of shareholders that an S corporation may have was increased from 75 to 100 and, for purposes of this S corporation shareholder limitation, an election (the “family election”) was created that allows a shareholder to elect to treat all family members as a single shareholder. For purposes of the family election, family members include a common ancestor (who is designated by the electing shareholder) and the lineal descendants of the common ancestor (and their current and former spouses). An individual cannot be a common ancestor if, as of the later of (i) the corporation’s first tax year beginning after 2004 or (ii) the time the S corporation election is made, the individual is more than six generations removed from the youngest generation of shareholders who would (but for this limit) be family members.

After a long delay, the Internal Revenue Service has finally issued interim guidance (IRS Notice 2005-91) regarding the requirements for properly making the family election and its effect. The key points of this interim guidance are as follows:

- The family election may be made by any family member who is a shareholder.
- The family election is made by the family member simply providing the corporation with the required information. No filing with the Internal Revenue Service is required.
- To be effective, an election must identify: (i) the family member making the election, (ii) the common ancestor, and (iii) the first taxable year of the corporation for which the election is effective.
- The common ancestor designated by the electing shareholder does not have to be alive at the time of the election.
- Family members will be deemed to include estates (and certain trusts) of deceased family members (for the periods during which the estates or trusts hold stock), beneficiaries of certain trusts who are family members, and owners of disregarded entities who are family members.
- The family election is effective as of the first day of the corporation’s tax year designated by the electing shareholder and will remain in effect until terminated, as provided by Treasury regulations that have not yet been issued.
- If two shareholders make separate family elections and the family members of one of the electing shareholders are considered to be family members of the other electing shareholder (and therefore covered by the family election made by the other electing shareholder), then the families of both electing shareholders will be treated as a single shareholder.
- Any elections made prior to the issuance of IRS Notice 2005-91 that do not conform to the rules contained in the Notice must be supplemented or amended to conform to the interim guidance.

Since the family election has no effect other than for purposes of the limitation on the number of shareholders an S corporation may have, we recommend that all S corporations request that their shareholders execute family elections whenever the 100 shareholder limitation might be an issue. However, it should be noted that even with this interim guidance, there remain uncertainties concerning the family election. In addition, the ability to make (and the effect of) the family election may be limited or affected by the S corporation's governing documents (such as shareholder agreements, by-laws, buy-back agreements, etc.). Therefore, please contact a member of the Vedder Price Tax & Estate Planning Group for additional information and assistance.

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Vedder, Price, Kaufman & Kammholz, P.C. is a national, full-service law firm with approximately 225 attorneys in Chicago, New York City and New Jersey.

The Vedder Price Tax & Estate Planning Group

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Due to the complexity and constantly changing nature of the federal, state and local tax laws, the tax aspects of almost every type of business and personal transaction require scrutiny by a tax attorney. At Vedder, Price, Kaufman & Kammholz, P.C., this experience is provided by the members of the tax group, each of whom has had substantial formal tax education, including in some cases advanced degrees in taxation, as well as practical experience in resolving tax problems.

In addition to advising the firm's business clients with respect to the tax issues involved in the everyday operation of a corporation, limited liability company, partnership or sole proprietorship, Vedder Price's tax attorneys plan for and provide advice on the tax aspects of taxable and nontaxable acquisitions of business entities, mergers, recapitalizations, the organization and liquidation of entities, taxable and nontaxable sales and exchanges of assets, foreign operations, redemptions, distributions, and the public and private offering of securities.

Besides representing corporations, limited liability companies, partnerships and sole proprietorships, members of Vedder Price's tax group have substantial experience with respect to a wide variety of other entities, including S corporations, professional service

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Estate and financial planning is a highly complex and sophisticated area of practice whose importance to individuals and businesses is widely recognized. Virtually every personal and financial transaction in which individuals engage, and many common business transactions, involve estate and financial planning ramifications. Given the continuing changes in the tax laws, the increasing complexity of financial products and the unprecedented growth of personal wealth, Vedder, Price, Kaufman & Kammholz, P.C. believes that this area of the law will continue to be an important part of our lives.

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