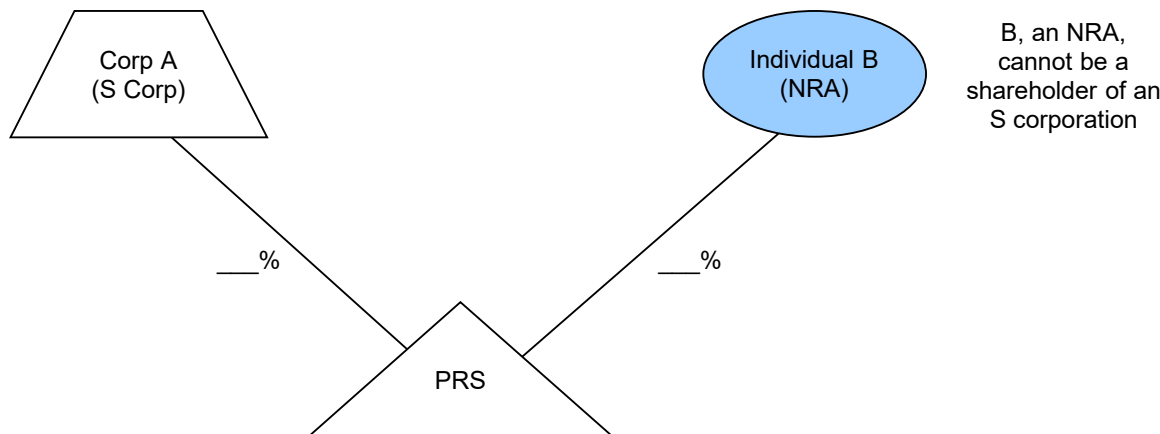


**Reg. 1.701-2(d),
Example 2**

**Avoidance of S Corp
Shareholder Requirements**

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B, an NRA,
cannot be a
shareholder of an
S corporation

A and B form partnership PRS to conduct a bona fide business. A is a corporation that has elected to be treated as an S corporation under subchapter S. B is a nonresident alien. PRS is properly classified as a partnership under Reg. 301.7701-2 and Reg. 301.7701-3. Because section 1361(b) prohibits B from being a shareholder in A, A and B chose partnership form, rather than admit B as a shareholder in A, as a means to retain the benefits of subchapter S treatment for A and its shareholders.

Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of Reg. 1.701-2(a)(1), (2), and (3) have been satisfied. Although it may be argued that the form of the partnership transaction should not be respected because it does not reflect its substance (inasmuch as application of the substance over form doctrine arguably could result in B being treated as a shareholder of A, thereby invalidating A's subchapter S election), the facts indicate otherwise. The shareholders of A are subject to tax on their pro rata shares of A's income (see section 1361 et seq.), and B is subject to tax on B's distributive share of partnership income (see sections 871 and 875). Thus, the form in which this arrangement is cast accurately reflects its substance as a separate partnership and S corporation. The Commissioner therefore cannot invoke Reg. 1.701-2(b) to recast the transaction.