A State-by-State Analysis of S Corporation Tax Treatment

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Before 1998, ESOPs were not eligible to hold shares of an S corporation. The 1996 tax law amended the provisions of Subchapter S to allow ESOP companies to make the S election.[1] An S corporation generally is not subject to federal income tax.[2] Instead, the shareholders of the corporation are subject to tax on the corporation's earnings, whether they are distributed to them as dividends or retained in the corporation.[3] The primary effect of the S election is that all items of an S corporation's income and loss are passed through to the corporation's shareholders.[4] Each shareholder is allocated his or her proportionate share of each item of corporate income, deduction, loss, and credit.[5] An important tax advantage of the S election is that only one tax is imposed on the earnings of an S corporation. Regular or "C" corporations are subject to a "double tax"—once at the corporate level[6] and again at the shareholder level when the after-tax corporate earnings are distributed to shareholders.[7] An important tax advantage of the S election where an ESOP is a shareholder is that an ESOP is a tax-exempt trust,[8] so any earnings attributable to the ESOP as a shareholder in the S corporation are tax-free.

Although most states recognize the federal S corporation election for purposes of their tax laws, many states impose additional requirements for state purposes. Some states require nonresident shareholders to consent to paying tax on their proportionate shares of the corporation's income; some states require a notice to be filed at the state level; some states allow corporations to opt out of federal S corporation treatment for state purposes; and some states require a separate state S corporation election to be made.

Once an S corporation election has been made, the tax treatment of the S corporation varies by state. Most states exempt an S corporation from income tax, but many states impose an income tax on the corporation (although often at a reduced rate). Even where a state exempts an S corporation from taxation, the state will frequently follow the federal provisions for taxes on built-in gains and passive investment income under Code Sections 1374 and 1375. Furthermore, most states do not exempt S

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1. Internal Revenue Code ("Code") § 1361(c)(6).

2. Code § 1363(a). See David Ackerman, et al., *S Corporation ESOPs*, 2nd ed. (NCEO, 2005).

3. Code § 1366(a).

4. Code § 1366.

5. Code § 1366(a).

6. Code § 11.

7. Code § 301.

8. Code § 501(a).

corporations from franchise taxes based on net worth, and many states impose a franchise tax on S corporations that operate as financial institutions. Corporations may also need to consider the state tax treatment of qualified subchapter S subsidiaries ("QSubs"). A subsidiary is a QSub if the following requirements are met: (1) the subsidiary is a domestic corporation; (2) the subsidiary is not otherwise disqualified under Code Section 1361(b)(2); (3) 100% of the stock of the subsidiary is owned by an S corporation; and (4) the S corporation parent elects to treat the subsidiary as a QSub.[9] When an election to treat a subsidiary as a QSub is made, all assets, liabilities, and items of income, deduction, and credit of the QSub are treated as the assets, liabilities, and items of income of the parent S corporation.[10]

Corporations considering making an election to be treated as an S corporation should be aware of the state tax consequences before making the election. The question whether an ESOP company should make an S election must be analyzed on a case-by-case basis, taking into consideration not only the federal tax benefits but also the tax consequences under state law.

This chapter analyzes the tax treatment of S corporations in each state. Table 3-1 sets forth (1) whether a state follows the federal S corporation election, (2) whether a state requires a separate state-level S election, (3) whether a state follows the federal treatment of QSubs, (4) whether a state holds an S corporation taxable or exempt for income tax purposes, and (5) whether a state imposes any other state taxes on an S corporation. The table is current as of December 31, 2007.

(Table 3-1 begins on next page)

State	State Follows Federal S Corporation Election	Separate State Level S Election	State Follows Federal Treatment of Qualified Subchapter S Subsidiaries (QSubs)	Income Tax Treatment of S Corporations	Imposition of Other State Taxes on S Corporations
Alabama[1]	Yes	No	Yes	Exempt	Subject to AL business privilege tax
Alaska[2]	Yes	No	Yes	Exempt	
Arizona[3]	Yes	No	Yes	Exempt (to the extent that income is not subject to federal income tax)	
Arkansas[4]	Yes	Yes	Yes	Exempt	Subject to AR franchise tax
California[5]	Yes	No	Yes	Taxable (at a reduced rate)	Subject to CA franchise tax at a reduced rate (minimum franchise tax of $800)
Colorado[6]	Yes	No	Yes	Exempt	
Connecticut[7]	Yes	No	Yes	Exempt	Subject to the CT Business Entity Tax

9. Code § 1361(b)(3)(B).

10. Code § 1361(b)(3)(A)(iii).

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Delaware[8]	Yes	No	Yes	Exempt	
District of Columbia[9]	No (an S corporation under federal law is treated as a regular corporation for DC purposes)	No	No	Taxable	
Florida[10]	Yes	No	Yes	Exempt (to the extent income is not subject to federal income tax)	
Georgia[11]	Yes (election allowed only if all shareholders are subject to tax in GA on their portion of the corporate income and all nonresident shareholders pay GA income tax on their portion of the corporate income)	No (but must file a consent form for each nonresident shareholder where the shareholders agree to pay GA income tax on their proportionate share of the corporation's GA taxable income)	Yes (treatment applies for income tax purposes but not for net worth tax purposes)	Exempt	Nonresident shareholders are subject to withholding tax
Hawaii[12]	Yes	No	Yes	Exempt (to the extent income is not subject to federal income tax)	S corporation that is a financial corporation under HI law is subject to HI bank franchise tax
Idaho[13]	Yes	No	Yes	Exempt (except for tax on excess net passive income, capital gains, and built-in-gains))	
Illinois[14]	Yes	No	Yes	Exempt	Subject to IL replacement tax at a reduced rate
Indiana[15]	Yes	No	Yes	Exempt (except built-in gains and passive investment income subject to federal tax)	
Iowa[16]	Yes	No	Yes	Exempt (except built-in gains and passive investment income subject to federal tax)	S corporation that is a financial institution is subject to the IA financial institution franchise tax

State	State Follows Federal S Corporation Election	Separate State Level S Election	State Follows Federal Treatment of Qualified Subchapter S Subsidiaries (QSubs)	Income Tax Treatment of S Corporations	Imposition of Other State Taxes on S Corporations
Kansas[17]	Yes	No	Yes	Exempt	S corporations that are banks and savings and loan associations are subject to KS bank privilege tax rather than KS income tax
Kentucky[18]	Yes	No	Yes	Exempt (except subject to tax on the same items of income and in the same manner as required for federal tax purposes)	Subject to limited liability entity tax
Louisiana[19]	No, but the corporation may be able to exclude income that is taxed to the shareholders based on the ratio of issued and outstanding shares owned by LA resident individuals to total issued and outstanding shares of the S corporation	N/A	Yes (if QSub qualifies for exclusion, S corporation that owns stock of QSub files a LA income tax return that includes all income of QSub)	Taxable (but may exclude a percentage of its LA net income for the taxable year)	
Maine[20]	Yes	No	Yes	Exempt (except subject to tax on built-in-gains and if the corporation has a resident shareholder or income derived from sources in ME)	S corporations that are financial institutions are subject to franchise tax
Maryland[21]	Yes	No	Yes	Exempt (to the extent income is not subject to federal income tax)	
Massachusetts[22]	Yes (excluding corporate trusts, security corporations, and public utility corporations)	No	Yes	Exempt (to the extent income is not subject to federal income tax and provided entity has less than $6 million in gross	Subject to the excise tax (not measured by

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				receipts) Entity with $6 million or more in gross receipts is subject to corporate excise tax (measured by net income) at a reduced rate	net income) or, if applicable, the minimum excise tax
Michigan[23]	No	No	Yes	Taxable (MI imposes the Single Business Tax rather than an income tax)	
Minnesota[24]	Yes	No	Yes	Exempt (except for tax on certain built-in-gains, capital gains, and passive investment income)	Subject to minimum fee
Mississippi[25]	Yes	Yes (within 60 days of filing Form 2553)	Yes	Exempt	Subject to franchise tax
Missouri[26]	Yes	No	Yes	Exempt	Subject to franchise tax
Montana[27]	Yes	No	Yes	Exempt	
Nebraska[28]	Yes	No	Yes	Exempt	S corporation that is a financial institution may be subject to financial institution tax if certain requirements met
Nevada	Nevada does not impose an income tax on businesses.	N/A	N/A	N/A	N/A
New Hampshire[29]	No (S corporation under federal law treated same as regular corporation)	N/A	No (QSub under federal law treated as a regular S corporation for business profits tax purposes, must keep detailed records, and must file its own return unless part of a combined return)	Taxable	Subject to NH business enterprise tax

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New Jersey[30]	Yes	Yes	Yes (QSub must meet certain additional requirements under NJ law)	Taxable (at a reduced rate)	
New Mexico[31]	Yes	No	Yes	Exempt	Subject to NM franchise tax
New York[32]	Yes	Yes	Yes	Taxable	
New York City [33]	No	Yes	No (QSub treated as separate corporation)	Taxable	
North Carolina[34]	Yes	No	Yes	Exempt	Subject to franchise tax
North Dakota[35]	Yes	No	Yes	Exempt (to the extent income not subject to federal income tax)	
Ohio[36]	Yes	No (although annual notice required)	Yes	Exempt from OH franchise tax (measured by net worth) Subject to OH commercial activity tax (measured by gross receipts)	
Oklahoma[37]	Yes	No	Yes	Exempt	Subject to franchise tax
Oregon[38]	Yes	No	Yes	Exempt (except subject to tax built-in-gain and excess net passive income)	Subject to a $10 minimum tax
Pennsylvania[39]	Yes	No (although to be a valid PA S corporation, must not make a valid election to opt out of treatment as a PA S corporation)	Yes	Exempt (except to the extent taxed on built-in-gains under federal law)	Subject to franchise tax
Rhode Island[40]	Yes	No	Yes	Exempt (to the extent income is not subject	Subject to franchise

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				to federal income tax)	tax
South Carolina[41]	Yes	No (but most notify Dept. of Rev. of intent to be S-corp)	Yes	Exempt (to the extent income is not subject to federal income tax)	Subject to the license fee
South Dakota	SD does not impose a tax measured by net income on businesses or individuals. Net income tax is imposed on financial institutions (even if S corporations).				
Tennessee[42]	No	N/A	No (QSub must file its own separate entity excise tax election)	Taxable	
Texas[43]	No	N/A	TX does not impose an income tax on businesses. S corporations are subject to a franchise tax in the same manner as regular corporations	Subject to franchise tax.	
Utah[44]	Yes	No	Yes	Exempt	
Vermont[45]	Yes	No	Yes	Exempt (except to the extent income is subject to federal income tax)	Subject to minimum tax of $250
Virginia[46]	Yes	No	Yes	Exempt	
Washington[47]	WA does not impose an income tax on businesses or individuals. S corporations are subject to WA Business and Occupation Tax	N/A			

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West Virginia[48]	Yes	No	Yes	Exempt	Subject to franchise tax
Wisconsin[49]	Yes	No (but must not have elected out of tax-option corporation status)	Yes	Exempt (except to the extent it is taxed on net recognized built-in-gains for federal tax purposes)	Subject to WI recycling surcharge as a percentage of net income
Wyoming	WY does not impose an income tax on businesses or individuals.				

Notes to the Table

1. Ala. Code § 14A-22(a), § 40-18-160(a), § 40-18-160(b).
2. Alaska Stat. § 43.20.021(a), § 43.20.300(a), § 43.126(A).
3. Ariz. Rev. Stat. Ann. § 43-1126(A).
4. Ark. Code Ann. § 26-51-409(a), § 26-51-409(b); § 26-54-104.
5. Cal. Rev. & Tax. Cd. § 23153, § 23800, § 23800.5(a), § 23801(a), § 23802(c).
6. Colo. Rev. Stat. § 39-22-103(5.3), § 39-22.103(10.5), § 39-22-302, § 39-22-322(1).
7. Conn. Gen. Stat. § 12-213(a)(22), § 12-214(a)(2)(J), § 12-217(c)(2), § 12-284b(b)(6).
8. Del. Income Tax Reg. § 1.1900.2(b), (c) & (d); Del. Code Ann. tit 30, § 1601(a)(2), § 1621(a), § 1902(b)(9).
9. D.C. Code Ann. § 47-1801.04(16), § 47-1807.02.
10. Fla. Stat. Ann. § 220.02(9); Fla. Admin. Code Ann. § 12C-1.022(1)(b)(1).
11. Ga. Code Ann. § 47-7-27(d)(2), § 48-7-21(b)(7)(B); Ga. Comp. R. & Regs. § 560-7-3-.06(6)(a).
12. Haw. Rev. Stat. § 235-2.45(f)-(g), § 235-122(a)-(b), § 241-3., § 235-122
13. Idaho Code § 63-3004(a)-(b) & § 63-3030(a)(4); 2006 Form 41 Instructions-Idaho Corporation Income Tax Return, § 63-3025
14. ILCS Chapter 35 § 5/1501(a)(28), 5/201(c), 5/205(c); Ill. Adm. Code § 100.9750(c)(1)-(2).
15. Ind. Code § 6-3-2-2.8(2).
16. Iowa Code § 422.36(5), § 422.60(3)(g), § 422.60; Iowa Admin. Code § 701-52.1(5)(e).
17. Kan. Stat. Ann. § 79-32,139 & § 79-1106.
18. Ky. Rev. Stat. Ann. § 141.010(27), § 141.206(11), § 141.040(14), § 141.0401(2).
19. La. Rev. Stat. Ann. § 47:287.732(A), (B), (C), § 47:287.732.1(C).
20. Me. Rev. Stat. Ann. tit. 36, § 5102(10), § 5200, § 5206.
21. Md. Code Ann. Tax-Gen § 10-101(i), § 10-104(6), § 10-304(3); 2006 Form 510 Instructions-Pass Through Entity Income Tax Return.
22. Mass. Regs. Code § 62.17A.1(2), § 62.17A.1(1)(c)(3), § 62.17A.1(3)(b); Mass. Gen. 2 § 32D.
23. Mich. Comp. Laws § 208.31(1), § 208.35(1)(a), § 208.37; Michigan Revenue Administration Bulletin 2000-5, June 19, 2000.
24. Minn. Stat. § 290.9725 & § 290.0922(Subd. 1(b)); Minnesota Revenue Notice 98-09, June 1, 1998.

25. Miss Code Ann. § 27-8-3(1)(g), § 27-7-5(2), § 27-8-7(1), § 27-13-1(c), § 27-13-5(1), & § 27-13-7(1); Miss. Income Tax R. § 803(B), § 803(C).
26. Mo. Rev. Stat. § 143.431, § 143.471(1), § 147.010(1), § 148.620.
27. Mont. Code Ann. § 15-30-1101(1) & § 15-30-1102(1)(b)
28. Neb. Rev. Stat. § 77-2734.01(1), § 77-2734.04(3), § 77-3801(4), § 77-3802(1).
29. N.H. Rev. Stat. Ann. § 77-A:1(I), § 77-E:2, § 77-E:1(III); N.H. Admin. Rules, Rev. § 302.01(a)-(b).
30. NJ Rev. Stat. § 54:10A-5:22(a), § 54:10A-5(c)(2); N.J. Admin. Code § 18:7-20.2, § 18:7-1-18, § 18:7-11.16(a).
31. NM Stat. Ann. § 7-2A-2(G), § 7-2A-3(B); New Mexico Taxation and Revenue Dept. Ruling No. 200-01-02, June 14, 2001.
32. NY Tax Law § 208(1-A), § 210(1)(g), § 208(1-B), § 660(a)-(b).
33. NYC Admin. Code § 11-602(8)(ii); NYC Reg. § 11-27(a).
34. NC Gen. Stat. § 105-114(b)(2), § 105-122(a), § 105-130.3, § 105-131.1(a), § 105-131(b)(8), § 105-228.90(1)(b).
35. N.D. Cent. Code § 57-38-01.1, § 57-38-01.4(1).
36. Ohio Rev. Code Ann. § 5733.09(B), § 5733.01(F), § 5745.01(D); 2006 Form FT-1120 Instructions –Ohio Corporation Franchise Tax Report.
37. Okla. Stat. § 2365; Okla. Admin. Code § 710: 40-1-15.
38. Or. Rev. Stat. § 314.730(2), § 314.732(1), § 314.740, § 314.742, § 317.070, § 317.090.
39. Pa. Stat. Ann. tit. 72, § 7301(s.2), § 7301(n.1), § 7307, § 7307.9(e), § 7307.8, § 7601(2), § 7602(a), § 7602(b).
40. R.I. Gen. Laws § 44-11-2(d)(1); R.I. Reg. CT 98-13.
41. SC Code Ann. § 12-20-10(3), § 12-20-10(4), § 12-20-20(A), § 12-6-590(A) & (B), § 12-6-4430(A), § 12-6-4910(3).
42. Tenn. Code Ann. § 67-4-2006(a)(2), § 67-4-2007(e), § 67-4-2105(a).
43. Tex. Admin. Code § 3.556(b)(3), Tex. Tax Code Ann. § 171.001(a).
44. Utah Admin. R. R865.6F-34; Utah Code Ann. § 59-7-701.
45. Vt. Stat. Ann. tit. 32, § 5811(18)(B), § 5910(a)(6), 32, § 5911(a).
46. Va. Code Ann. § 58.1-401(4).
47. Wash. Rev. Code § 82.04.220, § 82.04.030.
48. W. Va. Code § 11-24-5(d), § 11-23-1, § 11-2303(b)(6).
49. Wis. Stat. § 71.34(1)-(2), § 71-35, § 71-93(1), § 71.94(1)(a).