



State Recognition of Business Entity

States generally recognize both the corporate and partnership forms of doing business, and most impose a corporate income tax that generally conforms to the taxation of C corporations under the Internal Revenue Code. The states' treatment of S corporations is not uniform, however, and a few states actually tax these entities as C corporations.

Most states recognize the federal S corporation election, but they do so in varying degrees. The S corporation provisions in most states generally conform to the federal S corporation provisions. Some states, however, impose additional restrictions or limitations on their use. The most frequent restrictions result from state eligibility requirements that differ from federal conditions. For example, some states require an independent state S corporation election. Moreover, some states do not completely exempt S corporations from corporate level taxation.

Several states do not recognize the federal S corporation election at all, taxing federal S corporations as C corporations. The primary problem that these states' laws create for federal S corporations is the potential for double taxation. Specifically, the federal S corporations are required to pay a state income tax at the corporate level even though the shareholders include their pro rata share of the corporation's income in their individual adjusted gross income for resident state tax purposes. Unless state law provides a specific modification to individual state taxable income (or a credit for taxes paid at the corporate level), double taxation may occur.

The problem of double taxation may also arise when the law of one state differs from that of another. Consider a corporation that operates in a state that does not recognize the corporation's S status and has shareholders residing in states that *do* recognize the corporation's S election. This corporation's earnings may be subject to double taxation.

Suppose, for example, that D, a state F resident, owns 100% of the stock of Z, an S corporation conducting all of its business in state G. State F follows the federal treatment of S corporations. Thus, D is taxed on 100% of his pro rata share of Z's income. State G, however, does not recognize S corporation elections. Thus, Z's income is subject to the corporate income tax in state G. State F does not provide a credit for taxes paid to another state by the corporation. Hence, double taxation results.

Consider, alternatively, a corporation that operates in a state that recognizes the corporation's S status but has shareholders living in states that do not recognize the S election. Double taxation may result in this case as well.