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*presents*

# **S Corporations and Inadvertent Terminations**

## **Navigating Complex Federal Rules for Termination Triggers and Relief**

**A Live 80-Minute Teleconference/Webinar with Interactive Q&A**

**Today's panel features:**

Sydney S. Traum, Of Counsel, **Levey Filler Rodriguez Kelso & De Bianchi LLP**, Miami, Fla.

Laura Howell-Smith, Director, **Deloitte Tax**, Washington, D.C.

**Tuesday, October 12, 2010**

The conference begins at:

**1 pm Eastern**

**12 pm Central**

**11 am Mountain**

**10 am Pacific**

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# **S Corporations And Inadvertent Terminations Webinar**

**Oct. 12, 2010**

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# Today's Program

Causes Of Termination  
(*Sydney S. Traum*)

Slides 6-19

Situations When Terminations Have Material  
Ramifications  
(*Laura Howell-Smith*)

Slides 20-39

# **Causes Of Termination**

**Sydney S. Traum**

# Causes Of Termination

- Failure to meet S corporation definition, or
- C corporation E&P and too much passive investment income for three consecutive years

# S Corporation Definition

- Domestic corporation, not ineligible
- Limit on number of shareholders
- Limit on types of shareholders
  - Only individuals, estates, certain trusts, certain exempt organizations
  - No non-resident aliens (NRAs)
- Limit on classes of stock
  - Differences in voting rights is okay
  - No differences allowed in rights to distributions

# Ineligible Corporations

- Financial institution using Sect. 585 reserve method of accounting for bad debts
- Insurance company taxed under Subchapter L
- Corporation electing Sect. 936 Puerto Rican and possessions tax credit
- Domestic international sales corporation (DISC) or a former DISC

# Limit On Number Of Shareholders

- Current limit is 100
  - In 1958, it was 10
- Spouses count as one
- Family members from up to six generations count as one

# Limit On Types Of Shareholders

- Individuals: U.S. citizens and resident aliens
- Estates: Decedent's estates and bankruptcy estates
- No non-resident aliens
- Certain trusts
- Certain exempt organizations
  - Sect. 401(a) or Sect. 501(c)(3)

# Trusts Permitted As Shareholders

- Qualified Subpart E trusts: Either grantor or other person is deemed owner under sections 671 through 678
- Grace period of two years after deemed owner dies
- Testamentary trust for two years
- Voting trust

# Trusts Permitted As Shareholders (Cont.)

- Qualified Subchapter S trust (QSST)
- Electing small business trust (ESBT)
- Tax-exempt Sect. 401(a) or Sect. 501(c)(3) trust
- IRA holding bank S corp. stock in 2004

# QSST

- One beneficiary at a time during beneficiary's life
- All fiduciary accounting income is distributed currently
- Beneficiary is U.S. citizen or resident
- Beneficiary makes QSST election for each S corp. for which he wishes to maintain S corp. status
- Treated as grantor-type trust for S corp. elected

# ESBT

- Beneficiaries are individuals, estates and/or tax-exempt organizations under Sect. 170(c)(2) through Sect. 170(c)(5)
- No beneficiary's interest acquired by purchase
- Trustee makes ESBT election
- Taxed at highest bracket

# Limits On Classes Of Stock

- Voting rights: Differences are permitted
- Only outstanding stock is considered
- Distributions: Must be identical
  - Governing provisions
  - Regulations Sect. 1.1361-1
- Debt as second class of stock

# How To Avoid Loss Of S Status

- Passive investment income rules
  - Pay out all C corp. E&P, or
  - Increase active types of income, or
  - Sell or distribute assets producing passive investment income

# How To Avoid Loss Of S Status (Cont.)

- Shareholder limitations
  - S corp. transfers its business to partnership and becomes a partner with disqualified shareholders
  - That can avoid loss of status due to investments in the business by NRAs or too many shareholders

# How To Avoid Loss Of S Status (Cont.)

- Second class of stock
  - Avoid disproportionate distributions
  - Comply with straight debt regulations
  - Careful drafting of articles of incorporation, by-laws and shareholder agreements

# **Situations When Terminations Have Material Ramifications**

**Laura Howell-Smith, Deloitte Tax**

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# Agenda For This Section

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Terminating Events

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Results Of Termination

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Inadvertent Terminations Or Invalid Elections And Relief

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Possible Causes Of Termination

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Relief Opportunities

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# Terminating Events

## Terminating Events

- Terminating event
  - Revocation
  - Corporation ceases to qualify as an S corporation
  - Corporation has excess net passive income
  
- Results of termination
  - Effective date differs depending on event
  - Potential for two short years
  - Corporation becomes C corporation
  - Re-election is not permitted for five years, unless a waiver is granted.

## Revocation

### – Procedure

- Requires consent of holders owning more than 50% of outstanding shares
- Statement required to be filed with the IRS

### – Effective date

- If filed within 2 ½ months from beginning of tax year; revocation is retroactively effective as of the beginning of the taxable year
- If revocation is filed after 2 ½-month period, then the revocation is effective at the beginning of the following taxable year.
- Exception: If prospective effective date is stated, revocation is effective as of prospective date; an exception is available for revocation filed anytime during the year.

### – Results

- If it is effective as of prospective date (i.e., during taxable year), the taxable year must be split between S corporation (final short-year return) and C corporation (initial short-year return).

# Ceasing To Qualify

- Some causes
  - More than 100 shareholders
  - Ineligible shareholders
  - More than one class of stock
  - Loss, lack of, or invalid QSST or ESBT election
  
- Effective date
  - On the date the entity ceases to qualify
  
- Results
  - Taxable year must be split between S corporation (final short-year return) and C corporation (initial short-year return)

## Excessive Passive Income

### – Causes

- Accumulated earnings and profits at the end of the three consecutive years, and
- More than 25% of gross receipts from passive sources for those three consecutive years

### – Effective date

- First day of fourth taxable year, following three consecutive taxable years in which corporation meets the two terminating events

### – Results

- No split year





# Termination During Taxable Year

- Creation of two short periods
  
- Allocation of income
  - General rule is pro rata allocation; each item of income and deduction for the entire year is allocated to the two short years on a per-day basis
  - The closing of books method may be elected but is mandatory when there is a termination to the S election and a sale or exchange of 50% or more of stock during the year or sale with an IRC § 338(h)(10) election.
  
- C corporation: Annualization of income required for C corporation short year

# **Inadvertent Terminations Or Invalid Elections And Relief**

## Inadvertent Termination

- IRS may grant relief from the consequences of an inadvertent termination.
- Private letter ruling request must be filed
- Several conditions must be satisfied
  - The IRS must determine that the circumstances resulting in the termination were inadvertent.
  - The corporation must take steps to ensure that it is a small business corporation.
  - The corporation and all shareholders agree to make adjustments consistent with the status as an S corporation.
- Factors that appear to influence the IRS decision
  - Corporation and shareholders treated themselves consistent with being an S corporation.
  - If adjustments are required, they are required in only open tax years.

# Possible Causes Of Termination: Missing Shareholder Consents

- Spouse did not consent in a community property state
  - Automatic relief available under Rev. Pro. 2004-35
  
- Some shareholders did not consent
  - Those that were redeemed out prior to S election
  - Joint owners (tenants in common, joint tenants)
  - Beneficial owners
  - Relief may be requested through regulatory procedure

# Possible Causes Of Termination: Late Or Missed Elections

- Late elections for S corporation status, QSST, ESBT and QSub
- Missed election for a QSub
- Ineligible shareholder due to invalid or late election for QSST or ESBT
- Election signed by unauthorized person
- Transfer by sale or gift to an ineligible shareholder

## Possible Causes Of Termination: Second Class Of Stock – Disproportionate Distributions

- Each shareholder of an S corporation must have pro rata rights to distributions and liquidations, or else the corporation may be treated as having a second class of stock.
  
- Other not so obvious rights or interests of shareholders or unrelated persons may be considered a second class of stock.
  - Penny options to non-employees
  - An employee/shareholder who forgoes or accepts unreasonably low or high compensation
  - Unrepaid loans to shareholders or shareholders' family members
  - State tax or composite payments for shareholders

## Possible Causes Of Termination: Second Class Of Stock – Disproportionate Distributions (Cont.)

- Other examples of disproportionate distributions
  - Shareholder waives any right to one or more distributions
  - Shareholder may fail to “draw” a distribution, while retaining the right to receive the distribution in the future
  - Shareholder may have stock redeemed in a redemption subject to IRC § 302(d)
  - Shareholder may receive a distribution in a different taxable year than the others
  - Shareholder may receive a distribution in a different form from other shareholders
  
- Issues usually uncovered during a due diligence review for a transaction- disproportionate distributions were made and never “trued up” within a reasonable period of time, e.g., a 50/50% ownership ends up 51/49%

## Possible Causes Of Termination: Second Class Of Stock – Disproportionate Distributions - Example

- An agreement for the corporation to make distributions to shareholders for both varying interests during the tax year and to pay taxes may not result in disproportionate distributions.
- Making the distributions proportionate will not resolve the second class of stock issue, because it is an agreement and not just a practice.

## Possible Causes Of Termination: Second Class Of Stock – Constructive Distributions

- Corporate payment for shareholder personal services such as personal tax and financial assistance, security, lawn service, etc.
- Fringe benefits made to non-employee/shareholder
  - Use of company assets such as planes or yachts
  - Personal club dues
- It does not matter if the corporation deducts the item; it still may be a second class of stock that results in terminating the S status.
  - Shareholder who receives the benefit should bear the cost of these expenses.
  - There is a risk of second class of stock, unless each shareholder received value for each expense equal to their stock ownership.
  - Would be difficult to prove – valuation issue

# Possible Causes Of Termination: Ineligible Shareholders

- If the terms of a QSST do not require current distribution of all income, then a trustee of a QSST must distribute all income annually to the current income beneficiary.
  
- If the trustee does not distribute income currently, then the trust will not qualify as a QSST, and thus the S corporation status terminates as it now has an ineligible shareholder.

## Possible Causes Of Termination: Ineligible Shareholders (Cont.)

- If the terms of a QSST do not require current distribution of all income, then a trustee of a QSST must distribute all income annually to the current income beneficiary.
- If the trustee does not distribute income currently, then the trust will not qualify as a QSST, and thus the S corporation status terminates as it now has an ineligible shareholder.

# Relief Opportunities

- Missing shareholder consents
  
- Late elections
  - Rev. Proc. 97-48
  - Rev. Proc. 2007-62
  - Rev. Proc. 2003-43
  - IRC § 1362(b)(5): Private letter ruling request
  - IRC § 9100: Private letter ruling request
  
- Inadvertent invalid elections or terminations
  - IRC § 1362(f): Private letter ruling request
  
- Re-election within five years for intentional terminations or revocations
  - IRC § 1362(g): Private letter ruling request