

Current Developments in S Corporations (Part II)

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Part I of this two-part article, in the October issue, examined recent S corporation operational tax issues. Part II of the article discusses S corporation eligibility, elections, and termination issues, including guidance for changes made by the American Jobs Creation Act of 2004⁴⁸ (AJCA) and the Gulf Opportunity Zone Act of 2005⁴⁹ (the GO Zone Act), significant issues related to second class of stock, and a notice that provides a simplified method to make an S election. In addition, numerous letter rulings on corporate and shareholder eligibility are discussed.

Recent Law Changes

There have been numerous tax law changes in the past few years, each of which has included provisions that affected S corporations. This year Treasury issued final regulations that provide guidance on changes made by the AJCA and the GO Zone Act to the rules governing S corporations.⁵⁰ Specifically, the regulations address three S corporation issues:

1. The S corporation family shareholder rules;
2. The definition of “powers of appointment” and “potential current beneficiaries” regarding an electing small business trust (ESBT); and
3. The allowance of suspended losses to the former spouse of an S corporation shareholder.

A major change in the AJCA was to treat family members as one shareholder. The regulations retain the provisions of

Notice 2005-91⁵¹ that describe certain entities other than individuals that will be treated as members of the family. In addition, the regulations clarify that the “six-generation” test is applied on the latest of (1) the date the S election is made; (2) the earliest date an individual who is a member of the family holds S stock; or (3) October 22, 2004.

A question that arises related to an ESBT is what provisions qualify as a power of appointment. The regulations state that the ability to add beneficiaries to an ESBT is generally a power of appointment but will be disregarded to the extent it is not exercised. Another important issue for ESBTs is who is considered a potential current beneficiary. The regulations amend the definition of “potential current beneficiary” to provide that all members of a class of unnamed charities that may receive distributions are to be treated as

48 American Jobs Creation Act of 2004, P.L. 108-357.

49 Gulf Opportunity Zone Act of 2005, P.L. 109-135.

50 T.D. 9422.

51 Notice 2005-91, 2005-2 C.B. 1164.

one potential current beneficiary. However, each named charity is treated as a separate potential current beneficiary and thus a separate shareholder.

Finally, the AJCA allowed ex-spouses to use suspended losses if the ex-spouse received the S stock under a divorce decree. The regulations explain how the suspended losses should be allocated between the two spouses. The transferor spouse will be allowed to use all of a suspended loss from previous years in the year the stock is transferred. Any loss that is not used in the year the stock is transferred must then be prorated between the shares owned by the transferor spouse and the transferee spouse based on their ownership at the beginning of the succeeding tax year.

Example: A owns all 100 shares of an S corporation. As of December 31, 2006, A has a zero basis in his S corporation shares. For 2006, the S corporation has \$100 in losses, which A cannot use because of the basis limitation under Sec. 1366(d)(1). On July 1, 2007, A transfers 50 shares to B, A's former spouse, pursuant to a divorce that qualifies under Sec. 1041(a). The S corporation has an \$80 loss in 2007.

For 2007, the year of the transfer, A may deduct the entire \$100 suspended loss from 2006 and his share of the 2007 loss [$\$60 = (80 \times .50$ for the first half of the year) + $(80 \times .25$ for the second half of the year)] if he has sufficient basis in the S corporation stock. B can deduct her share of the 2007 loss ($\$20 = 80 \times .25$) assuming she has sufficient basis in the stock.

However, if A cannot use any of the 2006 disallowed loss in 2007, that loss is prorated between A and B based on their stock ownership at the beginning of 2008. In this case, A will be deemed to have a \$50 suspended loss from 2006 and a \$60 suspended loss from 2007 at the beginning of 2008, while B will have a \$50 suspended loss from 2006 and a \$20 suspended loss from 2007.

Eligibility, Elections, and Terminations

The general definition of an S corporation includes restrictions on the type and number of shareholders, as well as the type of corporation that may qualify for the election. If an S corporation violates any of these restrictions, its S status is automatically terminated. However, the taxpayer can request an inadvertent termination ruling under Sec. 1362(f) and, subject to IRS approval, retain its S status continuously. Congress had requested that the IRS be lenient in granting inadvertent election and termination relief, and it is clear from the rulings presented below that the IRS has abided by congressional intent.

Late Elections

In an attempt to reduce the number of late filing requests, the IRS issued Rev. Proc. 2003-43,⁵² which grants S corporations, QSubs, ESBTs, and QSSTs a 24-month extension to file Form 2553, Election by a Small Business Corporation, Form 8869, Qualified Subchapter S Subsidiary Election, or a trust election without obtaining a letter ruling. This year the IRS issued Rev. Proc. 2007-62,⁵³ which supplements Rev. Proc. 2003-43 and provides an additional method for certain taxpayers to request relief for a late S corporation election and a late corporate classification election that is intended to be effective on the same day.

To obtain relief under Rev. Proc. 2007-62, the corporation must file a properly completed Form 2553 with its Form 1120S, U.S. Income Tax Return for an S Corporation, for the first year the corporation intended to be an S corporation. A statement explaining the reason for the failure to file a timely election must be included on the Form 2553. A corporation can request relief under Rev. Proc. 2007-62 if:

- The company fails to qualify for S corporation status solely because of the failure to file a timely Form 2553;
- The company has reasonable cause for its failure to timely file Form 2553;

EXECUTIVE SUMMARY

- Final regulations give guidance for changes made to S corporations by the AJCA and the GO Zone Act.
 - The IRS provided simplified relief procedures in Rev. Proc. 2007-62 for certain taxpayers for late-filed S corporation elections and late-filed entity classification elections that are intended to be effective on the same day.
 - The IRS granted numerous requests for relief to taxpayers who had failed to timely file an S corporation election or had terminated their S corporation elections through violations of the various S corporation eligibility rules or failures to timely file a QSST or ESBT election.
 - The company has not filed a tax return for the first tax year the election was intended;
 - The application for relief is filed no later than six months after the due date of the tax return, excluding extensions, of the corporation for the first tax year the corporation intended to be an S corporation; and
 - No taxpayer whose tax liability or tax return would be affected by the S corporation election has reported inconsistently with the S corporation election.
- It appears that Rev. Proc. 2003-43 is having its intended effect. Even though the IRS continues to receive late-filing requests,⁵⁴ the number of letter rulings

52 Rev. Proc. 2003-43, 2003-1 C.B. 998.

53 Rev. Proc. 2007-62, 2007-41 I.R.B. 786.

54 See, e.g., IRS Letter Rulings 200825003 (6/20/08), 200816017 (4/18/08), 200752006 (12/28/07), and 200746005 (11/16/07).

issued this year is considerably less than the number issued in years before the procedure's issuance. In most instances this year, the IRS allowed S status from inception under Sec. 1362(b)(5), as long as the taxpayer filed a valid Form 2553 within 60 days of the ruling.⁵⁵

In one instance,⁵⁶ the corporate minutes reflected the company's desire to be an S corporation, and the corporation contended that Form 2553 had been filed, but the IRS did not have a record of its being filed. Generally, in these situations, the corporation and the shareholder have treated the entity as an S corporation, and the only step they have forgotten is to file the Form 2553.

In several other situations,⁵⁷ the IRS ruled that the late filing was inadvertent and granted the corporation relief but did not rule on whether the entity would otherwise qualify for S corporation treatment. Thus, these companies may still have had some issues to resolve to make sure the S election was valid. Likewise, in Letter Rulings 200802005 and 200802017⁵⁸ the Service ruled that there was reasonable cause for the late election, but the ruling was contingent on the entity qualifying for S status.

The Service has been relatively lenient in the past few years about granting relief for a late S election. However, in Letter Ruling 200827019⁵⁹ the Service ruled against the taxpayer. In this situation, the corporation failed to file an S election. The corporation was also sporadic in filing its tax returns. A Form 1120, U.S. Corporation Income Tax Return (C corporation tax return), was filed for its first two years, no tax return was filed in year 3, and a late Form 1120S for year 3 was filed in year 4. The Service concluded that the corporation failed to establish reasonable cause for not filing a timely S election and disallowed the election. This ruling should remind taxpayers and tax advisers that relief from failing to file Form 2553 is not automatic, and the company must

be able to provide a valid reason for the failure.

In some situations an entity is formed as either a limited liability company (LLC) or a limited liability partnership (LLP) but wishes to be treated as an S corporation. In the past the entity had to file both Form 8832, Entity Classification Election, and Form 2553. However, for elections after July 20, 2004, Regs. Sec. 301.7701-3(c)(1)(v)(C) eliminates the need to file Form 8832. Instead, a partnership or disregarded entity that would otherwise qualify to be an S corporation and that makes a timely and valid election to be treated as an S corporation on Form 2553 will be deemed to have elected to be classified as an association taxable as a corporation. Even though Form 8832 does not need to be filed when the election is made, the corporation must attach a copy to its first tax return when filed.

Nonetheless, there were still several instances⁶⁰ in which the entity was required to file Form 8832, electing to be treated as a corporation, and then file Form 2553 to be taxed as an S corporation. However, in cases where the entity failed to file either of the elections, the Service granted these entities relief and allowed S status from inception, as long as both forms were filed within 60 days of the ruling.

Corporate Eligibility

Sec. 1361 does not allow certain types of corporations to elect S status, including certain financial institutions, insurance companies, foreign corporations, and corporations electing Sec. 936 status. In addition, there are restrictions regarding who can own the stock of an S corporation and the type of stock an S corporation can issue.

One class of stock: Sec. 1361(b)(1)(D) prohibits an S corporation from having more than one class of stock, defined as equal rights to distributions and liquidations (but not voting rights). In one rather obvious instance of two classes

of stock, the IRS was very lenient in its ruling. Under the facts of Letter Ruling 200820022,⁶¹ an S corporation might have been deemed to have a second class of stock due to its distributions to its shareholders. The company amended its articles of incorporation to provide Class A and Class B stock. The amendment included a provision for "disproportionate distributions" for the two classes of stock.

When the company realized that this amendment may have created a second class of stock and thus terminated its S election, it amended the articles of incorporation to delete the disproportionate distribution provisions and converted the Class B stock to Class A (presumably under the E reorganization provisions). The Service granted the S corporation relief. It found that the S election had been terminated but that the termination was inadvertent and allowed the corporation to retain its S status.

In a similar ruling,⁶² a corporation converted its stock into Class A and B shares. The articles of incorporation and original bylaws also contained disproportionate distribution language. When the stock was converted into the two classes, the disproportionate distribution language was removed from the articles of incorporation but not from the bylaws. Later, the bylaws were also amended to remove the disproportionate distribution clause. The IRS determined that the termination of the S election was inadvertent and that the corporation did not have a second class of stock.

In Letter Ruling 200817007,⁶³ a corporation asked the IRS to rule whether it was eligible to make an S election. In this instance the corporation was owned by a family through trusts, which met the requirements to be an ESBT, an eligible shareholder. The corporation had entered into agreements with some employees to provide payments that would constitute parachute payments under Sec. 280G(b)(2). None of the employees who

55 See, e.g., IRS Letter Rulings 200718015 (5/4/07), 200712014 (3/23/07), and 200649009 (12/8/06).

56 IRS Letter Ruling 200811008 (3/14/08).

57 See, e.g., IRS Letter Rulings 200820028 (5/6/08), 200816022 (4/18/08), 200814012 (4/4/08), and 200807007 (2/15/07).

58 IRS Letter Rulings 200802005 and 200802017 (1/11/07).

59 IRS Letter Ruling 200827019 (7/4/08).

60 See, e.g., IRS Letter Rulings 200827025 (7/4/08), 200820007 (5/16/08), 200809021 (2/29/08), and 200744018 (11/2/07).

61 IRS Letter Ruling 200820022 (5/16/08).

62 IRS Letter Ruling 200820024 (5/16/08).

63 IRS Letter Ruling 200817007 (4/25/08).

would receive these payments were either (1) shareholders of the corporation, (2) trustees or beneficiaries of the trusts, or (3) related to the owner family. Thus, the payments should not be a second class of stock. As such, the IRS found that the corporation was an eligible S corporation.

In another ruling,⁶⁴ the articles of incorporation authorized the issuance of two classes of stock. The intent was for those two classes to have identical economic rights but different voting rights. The two classes of stock may have inadvertently conferred different rights to distributions and liquidation proceeds. To prevent any problems, the corporation amended its articles of incorporation to eliminate the two classes of stock. The IRS found that the corporation did have two classes of stock that terminated the company's S election but that the termination was inadvertent.

In Letter Ruling 200752013,⁶⁵ a shareholder agreement provided for revenue to be distributed to the shareholders in a manner other than in accordance with their ownership percentages. When the company realized that this agreement could create a second class of stock, the agreement was amended to have revenue distributed in accordance with shareholder percentages. Before the amendment, the company had no taxable income and had not made any distributions. The IRS found that the company's S election was not valid because of the shareholder agreement. However, the election was inadvertently invalid and the Service allowed the company to retain its S status.

Note: This ruling might have been different if the company had had taxable income and made disproportionate distributions.

In another situation,⁶⁶ an S corporation made disproportionate distributions to its shareholders even though all shares had equal rights to liquidation proceeds and distributions and there was no agreement to change those rights. Corrective distributions were made, resulting in proportionate

distributions since the entity's inception. The Service said the distributions did not create a second class of stock, so the corporation's S election did not terminate. However, the IRS cautioned the taxpayer that if the corrective distribution was not made, the ruling would be voided and the S election terminated.

In Letter ruling 200807004,⁶⁷ an S corporation made a loan to one of its shareholders. The shareholder used the loan proceeds to buy the S stock from the other shareholders. The company paid the shareholder a bonus so that he could repay the loan, which the company's board of directors approved after the bonus was paid. Concerned that the bonus might be construed as excess compensation that would be treated as a constructive distribution, thus creating a second class of stock, the company requested a ruling that any termination created by this situation was inadvertent.

The IRS ruled that to the extent the S election terminated because of the excess bonus, the termination would be treated as inadvertent as long as the company took steps to correct the problem. The ruling required the shareholder to make a partial repayment of the bonus, and the company had to make a corrective pro-rata distribution to the other shareholders. In addition, the company and the shareholder had to amend their tax returns to correct for the deductions taken for the amount of the bonus repayment.

In two other instances,⁶⁸ a company twice issued convertible notes to shareholders in order to raise capital. When the notes became due, they were converted to company stock. The IRS found that if the issuance of the notes created a second class of stock that would terminate the company's S election, the termination would be deemed inadvertent. The shareholders had to amend their tax returns and adjust the basis in their stock to treat the notes as stock from the issuance date. In addition to the second class of stock problem, the corporation also issued stock to an LLC,

an ineligible shareholder. When the company realized an LLC was an ineligible shareholder, the stock was transferred to the LLC's owner. The IRS determined that this termination was also inadvertent.

In Letter Ruling 200827008,⁶⁹ a company adopted an employee stock ownership plan (ESOP) while it was a C corporation. At the time, the company had only one class of stock. The company later elected to be treated as an S corporation, after which the ESOP became the sole shareholder. The company loaned money to the ESOP so that it could buy all the remaining outstanding stock. After the ESOP purchased the stock, there was a sharp decline in the stock's value (mainly because of the loan).

To protect the ESOP participants from this decline, the company adopted a floor purchase agreement that set a minimum price for which the company would repurchase shares. The company said the agreement was to protect the pre-transaction ESOP shares that had already been allocated to employee accounts from a steep decline in value. The IRS ruled that the purchase agreement would be disregarded when determining if the company had a second class of stock.

In another situation,⁷⁰ the shareholders approved the creation of a class of non-voting stock that would be issued through stock dividends. However, the articles of incorporation were not changed to reflect this class of stock until a later date. Because the stock was unauthorized, the company thought it might be treated as a second class of stock. The IRS found that if any rights conferred by state law to unauthorized stock created different rights to liquidation proceeds or distributions, the S election would terminate but the termination would be inadvertent.

In yet another instance,⁷¹ an S corporation had a sole shareholder. The company paid the shareholder's estimated tax payments for him. Later the company sold stock to additional shareholders. The company continued to make estimated

64 IRS Letter Ruling 200820021 (5/16/08).

65 IRS Letter Ruling 200752013 (12/25/07).

66 IRS Letter Ruling 200802002 (1/11/07).

67 IRS Letter Ruling 200807004 (2/15/08).

68 IRS Letter Rulings 200813012 and 200813011 (3/28/08).

69 IRS Letter Ruling 200827008 (7/4/08).

70 IRS Letter Ruling 200826003 (6/27/08).

71 IRS Letter Ruling 200824007 (6/13/08).

tax payments for the original shareholder but not for any of the other shareholders, which created disproportionate distributions. The company later made remedial distributions to the other owners to correct the effect of the payments made on behalf of the original owner. The IRS determined that any termination that may have occurred because of a potential second class of stock was inadvertent.

In Letter Ruling 200824017,⁷² when a corporation converted to S status it had two classes of stock. The company's tax advisers were not aware of the second class of stock. When they discovered this fact, they had the company take corrective action by converting all preferred stock to common (hopefully by means of an E reorganization rather than a corporate redemption). The IRS ruled that the S election was invalid because of the two classes of stock but that the ineffectiveness was inadvertent and allowed the company to be treated as an S corporation from the original date of the election.

Finally, in a simple transaction,⁷³ an S corporation purchased 100% of another corporation and made a QSub election. The S corporation then amended its articles of incorporation and issued preferred stock. When the company became aware that a second class of stock had been created, it took the corrective action of issuing additional common stock and canceling the preferred. As with the other rulings, the termination was determined to be inadvertent.

Usually companies try to prove that they did not have a second class of stock. The opposite problem occurred in *Minton*,⁷⁴ in which the taxpayer tried to prove that the S corporation had a second class of stock so that she would not have to report her share of the S corporation's income. The shareholders of the S corporation orally agreed to make a monthly distribution to the company's founder, who was semi-retired. Accordingly, the taxpayer's attorney advised her that this agreement created a second class of stock

and thus terminated the S election. However, the corporation continued to file 1120S returns and the other shareholders treated it as such.

The court held that the agreement did not create a second class of stock because the taxpayer could not prove that there was a "binding agreement" to make the payments. In fact, the taxpayer herself testified that the agreement was only an informal oral understanding between the shareholders. However, the company never took any formal corporate action to implement the understanding. Thus, the corporation's S election was not terminated and the taxpayer was liable for the tax on her share of the corporation's income.

QSub election: A subsidiary that wants to be treated as an S corporation must be wholly owned by a parent S corporation, and a QSub election must be properly filed. The election should be filed on Form 8869, Qualified Subchapter S Subsidiary Election, by the fifteenth day of the third month after the effective date. In the past, numerous ruling requests involved a late filing of this election.

The IRS can now waive inadvertently invalid QSub elections and terminations if the conditions of Sec. 1362(f) are met. This is consistent with Rev. Proc. 2004-49,⁷⁵ which simplifies the procedure to request relief for a late QSub election by allowing the S corporation to attach a completed Form 8869 to a timely filed tax return for the tax year the QSub was created.

Despite this, there were still requests for rulings⁷⁶ seeking relief for the late filing of a QSub election. In each of these, the Service determined that good cause had been shown for the delay and granted an extension of 60 days from the ruling date to make the election. In one situation,⁷⁷ the taxpayer maintained that the QSub election had been filed, but the IRS had no record of the election. The taxpayer was allowed to file another Form 8869 electing to treat the subsidiary as a QSub without penalty.

Earnings and Profits

If an S corporation has subchapter C accumulated earnings and profits (AE&P), it will be subject to a tax under Sec. 1375 on its excess net passive investment income if its total passive investment income exceeds 25% of its gross receipts. Most of the rulings in this area have dealt with whether rental real estate activities were active or passive in nature for purposes of the tax. Under Regs. Sec. 1.1362-2(c)(5)(ii)(B), rents received by a corporation are treated as from an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business.

Since the issuance of the regulations, the Service has been lenient in its definition of passive income; as a result, the number of ruling requests is down significantly. This year, income from commercial and residential rentals was deemed to be active income.⁷⁸ In these rulings, the S corporation provided various services to the tenants, including utilities and maintenance for common areas, landscaping, garbage removal, and security. In addition, the S corporation handled leasing and administrative functions, including billing, rent collection, finding new tenants, and negotiating leases. The income was nonpassive whether the investment in the rental property was directly owned by the S corporation or indirectly owned through ownership of a partnership or an LLC interest.⁷⁹

In Letter Ruling 200808016,⁸⁰ a qualified QSub engaged in equipment-leasing operations, which involved qualification and bidding for new leases, credit underwriting, rent collection, payment reconciliation, and other administrative activities. As with real estate rentals, the IRS found that the rents were not passive investment income under Sec. 1362(d)(3)(C)(i).

A corporation may also have its S status terminated if it has AE&P and its passive investment income exceeds 25% of its gross receipts for three consecutive years under

72 IRS Letter Ruling 200824017 (6/13/08).

73 IRS Letter Ruling 200817034 (4/5/08).

74 *Minton*, T.C. Memo. 2007-372.

75 Rev. Proc. 2004-49, 2004-33 I.R.B. 210.

76 IRS Letter Rulings 200827010 (7/4/08) and 200804006 (1/25/08).

77 IRS Letter Ruling 200815012 (4/11/08).

78 IRS Letter Rulings 200826023 (6/27/08), 200825023 (6/20/08), 200817023 (4/25/08), and 200752030 (12/28/07).

79 IRS Letter Rulings 200815019 (4/11/08) and 200801037 (1/4/08).

80 IRS Letter Ruling 200808016 (2/22/08).

Sec. 1362(d)(3). The Service has issued several rulings on termination of S status for this reason.

In one situation,⁸¹ an S corporation with AE&P received more than 25% of its receipts from passive investment income for three consecutive years. On the first day of year 4, the company's S election terminated. The company did not discover the problem until year 5. At that point the company distributed all of its AE&P and then requested a ruling. The IRS ruled that the termination was inadvertent and allowed the company to retain its S status; however, the company had to make a tax payment under Sec. 1362(f)(4) within 30 days of the ruling.

In another ruling,⁸² a company elected S status. The company had AE&P and received more than 25% of its receipts from passive investment income for the three years after the election. One reason the company may not have corrected this problem was that subsequent to the S election, the company's president and principal operating officer became permanently disabled. The IRS ruled that the company's S election terminated on the first day of the fourth year but that the termination was inadvertent. The company was allowed to retain its S status if it distributed its AE&P pro rata to its shareholders. The shareholders had to report the distribution as a dividend on their individual tax returns, and the S corporation had to pay the excess passive investment income tax within 30 days.

In a departure from the other rulings,⁸³ an S corporation leased commercial property. In connection with the sale of a business, the company leased the real property used by the business to the new buyers. The only cost to the S corporation was the real estate taxes. Because the company did not provide significant services or incur substantial costs related to this lease, the rental

income was deemed to be passive investment income. Since the income exceeded 25% of the company's gross receipts for three years, the S election was terminated. However, the termination was inadvertent. To keep its S status, the company was required to file an amended tax return electing under Sec. 1.1368-1(f)(3) to make a deemed dividend distribution and to make the appropriate tax payment within 60 days of the ruling. The shareholders had to amend their tax returns to reflect the dividend and pay the additional taxes as well.



Shareholder Eligibility

Sec. 1361(b) restricts ownership in an S corporation to U.S. citizens, resident individuals, estates, certain trusts, and certain tax-exempt organizations. In one instance,⁸⁴ two shareholders of an S corporation transferred stock to a C corporation. When the S corporation learned that the C corporation was an ineligible shareholder, which terminated the S election, the stock issued to the C corporation was cancelled and reissued to an individual. The IRS determined that the termination was inadvertent. The individual to whom the stock was reissued would be treated as the shareholder during the termination period and required to include her share of the S corporation's income on her tax return. If necessary, amended returns were required to be filed.

Likewise, in Letter Ruling 200817005,⁸⁵ a corporation elected S status and also elected to treat its subsidiary as a QSub. One of the S corporation's shareholders was another S corporation, an ineligible shareholder. When the accountant brought this problem to the S corporation's attention, the stock was distributed to the individual owners of the second S corporation. In addition, one of the S corporation's eligible shareholders from a community property state failed to obtain the required consent to the S election from his spouse. The Service

found that the election was invalid but allowed the corporation S status as long as a valid election was filed with all the required signatures within 60 days.

In another situation,⁸⁶ an S corporation issued stock to three individuals, but the terms were not documented in writing and stock certificates were not issued. One of the individual's wholly owned S corporations actually purchased the stock and was treated as the shareholder on the S corporation's tax return for three years. The IRS determined that the S corporation election termination was inadvertent and allowed the company to be treated as an S corporation for the first three years. The individual who owned the second S corporation would be treated as the shareholder and required to include his share of income on his tax return and must make any necessary adjustments to his basis in the stock. Presumably, since the company was an S corporation, the individual had already reported this income and would not have to file amended tax returns.

In Letter Ruling 200751010,⁸⁷ under a stock purchase agreement, shares of an S corporation were issued to a resident alien (an eligible shareholder). However, he informed the corporation that he planned to spend most of his time in his home country and would probably lose his residency

81 IRS Letter Ruling 200802027 (1/11/08).

82 IRS Letter Ruling 200815017 (4/11/07).

83 IRS Letter Ruling 200808004 (2/22/07).

84 IRS Letter Ruling 200827028 (7/4/08).

85 IRS Letter Ruling 200817005 (4/25/08).

86 IRS Letter Ruling 200750003 (12/14/07).

87 IRS Letter Ruling 200751010 (12/21/07).

status. The shareholder entered into an agreement with two other shareholders in which they transferred their interests in an LLC in exchange for the resident alien's S corporation stock. The IRS determined that the transfer of the shares to the resident alien terminated the S election but that the termination was inadvertent. The ruling did not address the taxability of the transfer of the LLC interest for the S corporation stock. Presumably the transaction would be taxable because Sec. 1031 does not apply to the exchange of stock or partnership interests.

Partnerships: A partnership is also an ineligible S corporation shareholder. In one situation,⁸⁸ a portion of an S corporation's stock was transferred first to a partnership and then to three eligible shareholders. The IRS found that the termination was inadvertent. The partnership was never treated as a shareholder; the three individuals were instead treated as the owners for the entire time.

In another instance,⁸⁹ shares of an S corporation were issued to a state limited partnership (LP) whose owners were individuals, which terminated the S election. To remedy the problem, the LP was dissolved and the stock transferred to the individual owners. The IRS ruled that the S election's termination on the stock issuance to the partnership was inadvertent and that the partnership's owners would be treated as owning the share of the S corporation directly from the time the stock was first transferred to the LP.

In yet another situation,⁹⁰ a corporation made an S election. Based on counsel's advice, the stock was transferred to an LP. When the LP changed accountants, the new accountants notified the company that the stock transfer had terminated the S election. At this time the LP distributed the stock to its owners, all individuals who were eligible shareholders. The Service found that the S election terminated but that the termination was inadvertent,

and it allowed the corporation to keep its S status. A similar situation and result can be found in Letter Ruling 200813014.⁹¹

In a relatively common transaction,⁹² an S corporation converted to a state LP that was intended to be taxed as an association but did not file a Form 8832. In addition, the general partner was an ineligible shareholder. However, no income was allocated and no distributions had been made to the general partner. The corporation had two problems: (1) the limited partnership could create a second class of stock, and (2) the general partner was an ineligible shareholder. To remedy the problem, the company converted back to a state corporation and the ineligible shareholder divested itself of the S stock. Both conditions would ordinarily terminate the S election, but the IRS decided that both terminations were inadvertent.

In Letter Rulings 200813011 and 200813010,⁹³ an S corporation converted to a state LP that elected to be taxed as a corporation. The S corporation owners formed a new entity (an LLC) to act as the LP's general partner (GP). After finding out that the GP was an ineligible shareholder, the S corporation shareholders liquidated the GP and transferred the stock to the individual owners. Again the Service found the termination inadvertent, and the corporation was deemed an S corporation the entire time, as long as the shareholders were treated as the owners of the stock during the entire period in question.

An entity⁹⁴ that elected to be an S corporation converted to a state LP, believing that the conversion would be treated as a tax-free F reorganization. Thus, no new Form 2553 was filed. The entity's S election was terminated when an ineligible shareholder became the LP's GP. The entity took two remedial actions: It converted back to a state corporation, and the corporate partner divested itself of all interest in the taxpayer. The IRS

concluded that the termination of the S election by either stock acquisition by an ineligible shareholder or the potential creation of a second class of stock by conversion to a state LP was inadvertent. Thus, the IRS would continue to treat it as an S corporation.

In a similar situation,⁹⁵ an S corporation became a state LP that elected to be taxed as a corporation. The GP was an LLC (an ineligible shareholder). When the S corporation became aware of the problem, it converted to a state LLC that elected to be taxed as a corporation. The IRS found that the termination was inadvertent, but the ruling was conditioned on the LLC's not being treated as a shareholder for any period of time. Thus, the LLC's individual shareholders were treated as the owners the entire time.

LLCs: Like a partnership, an LLC is also an ineligible shareholder. In several instances,⁹⁶ S stock was sold to an LLC, which terminated the S election. Upon discovering the terminating event, the LLC distributed the S stock to its owners. The IRS determined that the stock transfer to the first LLC inadvertently terminated its S election, but it ruled that it would allow the company to retain its S status if the LLC was never treated as a shareholder and instead its members were treated as the owners.

In Letter Ruling 200816002,⁹⁷ the Service was asked whether an LLC could be an eligible S corporation shareholder if the LLC was a disregarded entity. The answer was that the LLC could be an eligible shareholder because the LLC's owner would continue to be treated as the owner of the S corporation.

Note: This ruling will only apply if the LLC's owner is an eligible shareholder.

IRAs: The general rule is that an IRA cannot be an S shareholder. This year there were several rulings in which S corporation stock was transferred to an IRA.⁹⁸ In these situations, either the S cor-

88 IRS Letter Ruling 200750012 (12/14/07).

89 IRS Letter Ruling 200812008 (3/21/08).

90 IRS Letter Ruling 200823013 (6/6/08).

91 IRS Letter Ruling 200813014 (3/28/08).

92 IRS Letter Ruling 200816015 (4/18/08).

93 IRS Letter Rulings 200813011 and 200813010 (3/28/08).

94 IRS Letter Ruling 200817015 (4/25/08).

95 IRS Letter Ruling 200822014 (5/30/08).

96 IRS Letter Rulings 200827029 (7/4/08), 200752015 (12/28/07), and 200744009 (11/2/07).

97 IRS Letter Ruling 200816002 (4/18/08).

98 IRS Letter Rulings 200817013 (4/25/08), 200807002 (2/15/08), 200802008 (1/11/07), and 200752034 (12/28/07).

poration or the S shareholder transferred the stock to an IRA. When the company discovered the problem, the shares were transferred to the beneficiaries of the IRA. The IRS determined that the termination of the S election was inadvertent. The only difference in the rulings was who would be treated as the shareholder during the period the IRA held the stock. In Letter Ruling 200817013, the IRA's beneficiary was treated as the shareholders for the period the stock was held by the IRA, whereas in the other rulings the IRA was treated as the shareholder. Treating the IRA as the shareholder is a new concept, but the distinction may be that in this situation the S corporation had a loss while the IRA held the stock. By treating the IRA as the owner, no one would get the benefit of the loss. In related Letter Ruling 200825029, an S corporation shareholder transferred S stock to an IRA for the benefit of another person. When the corporation realized the IRA was an ineligible shareholder the stock was transferred back to the original shareholder. As with other rulings, the corporation was allowed to retain its S status.

Trusts

Certain trusts are allowed to own S stock. However, there are strict rules that the trusts must follow to continue as eligible shareholders. Therefore, an S corporation and its tax advisers must constantly monitor trust shareholders' elections, trust agreements, and their subsequent modifications for compliance with S eligibility rules. This year the Service ruled in several situations on trusts as S shareholders.

In the first ruling,⁹⁹ the sole shareholder of an S corporation was a grantor trust. The trust created an entity (an ineligible shareholder) and transferred some of the stock to the entity. After the company realized the entity was an ineligible shareholder, the trust liquidated the entity and distributed the stock back to the trust. The IRS ruled that the transfer terminated

the S election but that it was inadvertent, and it allowed the corporation to retain its S status as long as the shareholders agreed to make whatever adjustments were required.

Letter Ruling 200747001¹⁰⁰ deals with a charitable lead trust established by a husband and wife in which S corporation stock is the contributed property. The ruling holds that even though the couple will get a charitable contribution for the net value of the stock and will not have to include the value of the stock in their estate, the trust is considered a grantor trust and under Sec. 1361(c)(2)(A)(i) the charitable lead trust is a qualified S shareholder. This ruling might be useful as a blueprint of what is allowed with the charitable lead trust rules and how they coexist with the S corporation requirements.

Testamentary Trusts

In another ruling,¹⁰¹ the taxpayer elected S status on formation. The stock was owned by a trust that was an eligible shareholder. When the owner died, the trust remained a permissible S shareholder for two years under Sec. 1361(c)(2)(A)(iii). However, the trustee did not distribute the assets within the two-year period, making the trust an ineligible shareholder. The stock was distributed to individual shareholders after the two-year period. The IRS ruled that the S election did terminate two years after the owner's death but that the termination was inadvertent.

In a similar situation,¹⁰² the stock was transferred to a trust on the death of the shareholder. The trust was eligible to be an ESBT so that it could hold the stock more than two years, but the trustee failed to make the ESBT election. After the two-year period, the stock was transferred to three other trusts that also failed to make ESBT elections. The IRS ruled that the termination was inadvertent contingent upon the trusts filing ESBT elections and amended returns.

In an unusual situation,¹⁰³ S stock was transferred to an eligible trust that was owned by a husband and wife. When the husband died, his share of the trust was not an eligible shareholder. The assets were then transferred to a second trust and a survivor's trust (an eligible shareholder). The second trust was eligible to make an ESBT election but no election was made. The S election's termination was deemed to be inadvertent.

In several other recent rulings,¹⁰⁴ stock held in a revocable trust was transferred to a trust that was set up on the death of an S shareholder. The trust qualified as a qualified subchapter S trust (QSST), but the beneficiary failed to file the QSST election. The Service held that the failure to make the QSST election terminated the company's S election but that the termination was inadvertent, and it allowed the company to retain its S status as long as the beneficiary filed a valid QSST election within 60 days of the rulings and amended returns. A similar situation can be found in Letter Ruling 200818004;¹⁰⁵ however, in this instance the problem was two separate trusts (for two different shareholders), one that qualified as a QSST and one that qualified as an ESBT. Neither election was made, but the results were the same.

In another instance,¹⁰⁶ an S corporation transferred stock to a grantor trust that was an eligible shareholder. On the death of the grantor, the trust was an eligible shareholder for two years. However, the trust did not distribute the S stock until more than two years after the grantor died; thus, the trust ceased to be an eligible shareholder. In addition, the beneficiaries of the recipient trusts failed to file ESBT elections. The IRS determined that the S election was terminated when the trust became an ineligible shareholder but that the termination was inadvertent. Consequently, the IRS ruled that it would continue to treat the entity as an S corporation, contingent on the recipient trusts making ESBT elections within 60 days of the ruling.

99 IRS Letter Ruling 200802004 (1/11/08).

100 IRS Letter Ruling 200747001 (11/23/07)

101 IRS Letter Ruling 200825001 (6/20/08).

102 IRS Letter Ruling 200826007 (6/27/08).

103 IRS Letter Ruling 200824011 (6/13/08).

104 See, e.g., IRS Letter Rulings 200820014 (5/16/08), 200817006 (4/25/08), 200814007 (4/4/08), 200806005 (2/8/2008), and 200804018 (1/25/08).

105 IRS Letter Ruling 200818004 (5/2/08).

106 IRS Letter Ruling 200744008 (11/2/07).

Other Trust Issues

Election requirements: Another problem encountered by trusts is that for both a QSST and an ESBT, a separate election must be made for the trust to qualify as an eligible S shareholder. Often this election is filed incorrectly or not timely filed, and an inadvertent termination ruling is needed. This year, there were numerous instances¹⁰⁷ in which a trust was intended to be treated as either a QSST or an ESBT and met all the requirements, but the beneficiary failed to file the election. The IRS determined in each case that there was good cause for the failure to make the election and granted a 60-day extension from the ruling date to make the election. In each of these cases, the ruling was contingent on the corporation being treated as an S corporation from the time the trust received the stock until the present. Therefore, all shareholders had to include their pro-rata share of the corporation's income, make any needed adjustments to basis, and take into account any distributions made by the S corporation. If necessary, amended tax returns for the corporation and its shareholders were required to be filed.

One issue that trusts must be careful of is who signs the trust election. The proper person to make the election is the beneficiary of a QSST and the trustee of an ESBT. In one instance,¹⁰⁸ the trustee of two QSSTs made the election instead of the beneficiary. In addition, one QSST election was executed by the mother of the beneficiary instead of the beneficiary, who was not a minor at the time. The Service determined that the S election was inadvertently invalid and allowed the company to retain its S status.

In a slightly different situation,¹⁰⁹ a grantor established a trust that qualified to make either an ESBT or a QSST election. After the trust had been funded, four separate QSSTs were created for the benefit of the grantor's children. The QSSTs were later converted to ESBTs. The IRS ruled that the QSSTs could revoke their election and convert to ESBTs. It concluded that the

conversion of the trusts would result in a transfer of property but would not result in a material difference in the kind or extent of the legal entitlements enjoyed by the beneficiaries, so the proposed conversion would not constitute a gain or a loss.

In one ruling,¹¹⁰ when a corporation made an S election it believed the trusts that owned its stock were eligible shareholders and filed valid QSST elections. When the company later discovered that the trusts were not eligible shareholders, it transferred the shares to eligible shareholders. On two additional occasions, shareholders transferred stock to trusts that did not file QSST elections. In one of the instances, a court modified the trusts to render them eligible to be shareholders, while in the second situation stock was transferred to eligible shareholders. Because all the stock was now owned by eligible shareholders, the IRS determined that the terminating events were inadvertent and the company remained an S corporation.

In Letter Ruling 200822009,¹¹¹ three trusts became shareholders of an S corporation and the trustee made ESBT elections. However, the company was informed by its attorney that a provision in the trust agreement allowed distributions to ineligible potential current beneficiaries, which could cause the trusts to be ineligible shareholders. A state court approved an amendment to the trust to eliminate the trustees' ability to make payment to any ineligible shareholders. The IRS ruled that the S election terminated when the stock was transferred to the trust but that the termination was inadvertent.

Finally, in Letter Ruling 200827002,¹¹² S stock was held by a trust. The trust was supposed to divide its assets into three additional trusts. The trustee made an ESBT election for the original trust. The three other trusts were eligible to be ESBTs, but no election was made. Thus, the three additional trusts were ineligible shareholders. The IRS held that the termination was inadvertent and granted relief.

Terminations

Under Sec. 1362(g), if an S corporation's election is terminated, it is not eligible to reelect S status for five tax years. S and C short years are treated as two separate tax years. In one instance,¹¹³ Company 1 was an LLC taxed as a partnership and Company 2 was an S corporation. Company 1 acquired all the stock of Company 2. At this time Company 2's S status terminated because Company 1 was an ineligible shareholder. After Company 1 acquired Company 2, it elected to be treated as an S corporation and sought IRS consent to file a QSub election for Company 2, even though the five-year period under Sec. 1362(g) had not expired. The IRS granted the request. The Service concluded that the entity met its burden of establishing just cause and allowed the corporation to reelect S status, because there had been a more-than-50% change in ownership.

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EditorNotes

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¹⁰⁷ See, e.g., IRS Letter Rulings 20082408 (6/13/08), 200812015 (3/21/08), 200809003 (2/27/08), and 200801004 (1/4/08).

¹⁰⁸ IRS Letter Ruling 200823023 (6/6/08).

¹⁰⁹ IRS Letter Ruling 200802028 (1/11/08).

¹¹⁰ IRS Letter Ruling 200825013 (6/20/08).

¹¹¹ IRS Letter Ruling 200822009 (5/30/08).

¹¹² IRS Letter Ruling 200827002 (7/4/08).

¹¹³ IRS Letter Ruling 200817002 (4/25/08).