

Current Developments in S Corporations (Part II)

By: **Hughlene Burton, Ph.D., CPA**
Stewart S. Karlinsky, Ph.D., CPA

Part I of this two-part article, in the October issue, examined recent S corporation operational tax issues. Part II discusses S corporation eligibility, elections, and termination issues. It covers significant topics related to a second class of stock, trusts owning S corporation stock, and an interesting ruling on the reelection of S status. In addition, numerous letter rulings on corporate and shareholder eligibility are discussed. This S corporation tax update covers the period July 9, 2008–July 9, 2009.



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 the rulings discussed below show clearly 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. 2003-43,¹ which grants S corporations, qualified subchapter S subsidiaries (QSubs), electing small business trusts (ESBTs), and qualified subchapter S trusts (QSSTs) a 24-month extension to file Form 2553, Election by a Small Business Corporation (Under Sec. 1362), Form 8869, Qualified Subchapter S

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

EXECUTIVE SUMMARY

- The IRS issued letter rulings granting taxpayers relief for the late filing of an S corporation election in over 100 cases during the past year.
- The IRS continued its policy of liberally granting relief through the letter ruling process for inadvertent terminations due to corporations having more than one class of stock or having ineligible shareholders.
- In the *Dansby* case, the Tax Court held that a corporation did not qualify as an S corporation where the taxpayer did not introduce credible proof showing that a Form 2553 had been timely filed for the corporation.
- The Fifth Circuit in *Minton* held that Regs. Sec. 1.1361-1(l)(7) permits retroactive application of Regs. Sec. 1.1361-1(l), which contains the one-class-of-stock rules, only to prior tax years and not to prior transactions.

Subsidiary Election, or a trust election without obtaining a letter ruling, and Rev. Proc. 2007-62,² 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 also be included on the Form 2553.

It appears that the intent of the revenue procedures is working. Even though the IRS continues to receive late-filing requests,³ it issued fewer than 120 rulings this year regarding the late filing of Form 2553 compared with over 300 letter rulings per year issued on the topic before the procedure's issuance. In all the rulings during the period covered here, the IRS allowed S status under Sec. 1362(b)(5) as long as the taxpayer filed a valid Form 2553 within 60 days of the ruling.⁴ Most of the rulings dealt with a corporation requesting S corporation status from inception. However, several rulings⁵ requested relief from a late filing for a date subsequent to the inception of the company. In each of the cases, the IRS granted the taxpayer's request.

In several other situations,⁶ 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 some issues to resolve to make sure the S election was valid. Preparers should be aware that FIN 48⁷ is now effective for all corporations, including S corporations. Under this standard, all S corporations should check to make sure they have a valid S election in place.

In an interesting situation⁸ after a husband and wife formed a company, they

created grantor trusts A and B. Both of them then transferred their shares in the company to their respective trusts. The husband died, terminating A's grantor trust status. The company then elected S corporation status. However, neither the wife, as B's deemed owner, nor the husband's estate, as A's deemed owner, filed Form 2553, and the husband's estate never made an ESBT election for A, rendering it an ineligible shareholder. Thus, the company's S corporation election was ineffective. In this situation the IRS held that the various failures were inadvertent and that the company was entitled to S corporation status from the period beginning with the date on which it originally was made.

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 have 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 instances⁹ 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 in which the entity failed to file either of the elections, the IRS granted these entities relief and allowed S status from inception as long as

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

3 See, e.g., IRS Letter Rulings 200932013 (8/7/09), 200923009 (6/5/09), 200915021 (4/10/09), and 200903074 (1/16/08).

4 See, e.g., IRS Letter Rulings 200928012 (7/10/09), 200919021 (5/8/09), 200906038 (2/6/09), and 200845033 (11/7/08).

5 See IRS Letter Rulings 200928002 (7/10/09), 200927001 (7/2/09), and 200914016 (4/13/09).

6 See IRS Letter Rulings 200931035 (7/31/09), 200916019 (4/17/09), and

200906005 (2/6/09).

7 Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. Note that FASB has codified its accounting standards; FIN 48 is now mostly codified in Accounting Standards Codification Subtopic 740-10.

8 IRS Letter Ruling 200908008 (2/20/09).

9 IRS Letter Rulings 200917017 (4/24/09), 200910022 (3/6/09), 200908010 (2/20/09), 200906029 (2/6/09), and 200849010 (12/5/08).

both forms were filed within 60 days of the ruling. The change in the regulations omitted the requirement to file Form 8832, not Form 2553, but in two situations in 2008 a company filed Form 8832 but not Form 2553.¹⁰ In both situations, the IRS granted the company S status if it filed Form 2553 within 60 days. With the change in the regulations, there should be far fewer instances of this type of ruling in the future.

In another ruling,¹¹ a company was required to file both Form 8832 and Form 2553 and a QSub election for its wholly owned subsidiary. It did not file any of the elections; nevertheless, the IRS granted relief. Specifically, it concluded that the S corporation had satisfied the requirements with respect to the late entity classification and the late QSub election. The IRS also concluded that, provided the parent otherwise qualified as an S corporation (a subject on which the IRS did not opine), that parent had met the criteria for relief from its untimely S corporation election.

To qualify as an S corporation, the corporation and all its shareholders on the date of the election (as well as other affected shareholders) must timely file a valid Form 2553. This election should be sent by certified mail (return receipt requested), registered mail, or a preapproved private delivery service (e.g., FedEx, DHL, or UPS).

In a 2008 ruling,¹² the shareholders did not file a timely S election. During the time between inception and the request for this ruling, the respective interests of the shareholders had changed, and there was a possibility that the corporation had made disproportionate distributions during certain periods. However, the S corporation advised the IRS that it had taken steps to address that issue, and it sought a ruling that the IRS would recognize it as an S corporation from the date of formation. The IRS granted relief, ruling that the corporation had reasonable cause for its failure to timely elect S corporation

status and that its belated S corporation election would be treated as timely filed. The IRS also determined that if a second class of stock was created, thus terminating the election, such termination was inadvertent and would be disregarded. The IRS conditioned the ruling on the company's election otherwise being valid and on the S corporation and the shareholders making adjustments required by the Service.

In past years the IRS has granted S status from date of incorporation even though it did not have any record of receiving Form 2553 and there was no proof of the taxpayer's mailing it. However, when the taxpayer raised this issue in court,¹³ the judge ruled that the corporation did not qualify as an S corporation. In this case, IRS records showed no evidence that a Form 2553 on behalf of the corporation was ever received or processed. There was also nothing in the taxpayer's attorney's file that proved the taxpayer had ever mailed a Form 2553 to the IRS on behalf of the corporation. The taxpayer alleged that he filed the corporation's 2000 and 2001 federal income tax returns as though the corporation were a C corporation only because the corporation had not yet received an answer to its application for S corporation status. The taxpayer offered as evidence two documents he said had been attached to the corporation's federal income tax returns that purportedly stated that the corporation was awaiting a determination regarding its S status and was filing as a C corporation because it had not received an S determination. However, the IRS had no record of having received such documents with the corporation's 2000 and 2001 tax returns. Because the taxpayer did not offer any persuasive or credible proof of timely mailing a Form 2553, the judge denied the claim.

Who Signs Form 2553

When a corporation files Form 2553, all shareholders must consent to the election.

In Letter Ruling 200909027,¹⁴ a company elected to be an S corporation, and its stockholders were an individual and three trusts. The beneficiaries of the trusts did not consent to the Form 2553 for the trusts. Consequently, the trusts did not properly consent to the entity's election to be an S corporation. The failure of the trusts' beneficiaries to properly consent to the election made the election invalid. The IRS concluded that the S corporation election was ineffective because of the failure of the trust beneficiaries to consent but that the ineffectiveness of the election was inadvertent. Thus, the entity would be treated as an S corporation provided that the election was otherwise valid.

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 on 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). Under the facts of Letter Ruling 200849003,¹⁵ a domestic corporation elected S status. Thereafter, however, the company made disproportionate distributions to shareholders to defray income taxes attributable to the company's income. When the S corporation discovered the error, it rectified the matter for year 3 but had not yet done so for years 1 and 2. The corporation reported that it would do so if the IRS ruled that any termination that occurred because the company had a second class of stock was inadvertent, which it did.

In Letter Ruling 200924019,¹⁶ an S corporation entered into an informal unwritten employment agreement with two

10 IRS Letter Rulings 200903071 (1/16/09) and 200843028 (10/24/08).

11 IRS Letter Ruling 200927026 (7/2/09).

12 IRS Letter Ruling 200842033 (10/17/08).

13 *Dansby*, T.C. Memo. 2009-70.

14 IRS Letter Ruling 200909027 (2/27/09).

15 IRS Letter Ruling 200849003 (12/5/08).

16 IRS Letter Ruling 200924019 (6/12/09).

individuals as officers and employees. It represented that all its outstanding shares conferred identical rights to distribution and liquidation proceeds and that it made distributions to its shareholders only in proportion to the shareholders' stock ownership. It further represented that the circumvention of the one-class-of-stock requirement was not a principal purpose of the employment agreement. Finally, it represented that the corporation and each of its shareholders had filed all returns consistent with the S election remaining in effect. The IRS concluded that the employment agreement was not a governing provision and therefore did not cause the S corporation to have more than one class of stock.

In another ruling,¹⁷ an S corporation amended its articles of incorporation to include both voting and nonvoting shares, and its shareholders exchanged some of their voting shares for nonvoting shares. Following the exchange, the shareholders' legal counsel and accountants advised them that the amended articles could be interpreted to provide differing rights to voting shares

and nonvoting shares upon the occurrence of certain hypothetical events. In order to eliminate any potential inconsistencies, amendments to the amended articles were filed with the secretary of state. The IRS concluded that the S corporation election might have terminated because the entity might have had more than one class of stock. However, if the S election was terminated, such a termination was inadvertent.

In Letter Ruling 200914005,¹⁸ the taxpayer asked the IRS to rule on whether an S corporation could revoke its status as an S corporation. However, the IRS also ruled on whether a second class of stock may have terminated the company's S election earlier. In this situation, as part of a stock incentive compensation program, the entity granted shares of restricted class B common stock to certain key employees in two years. The restricted stock was subject to vesting in equal increments over a number of years. The S corporation did not treat the unvested restricted stock as outstanding stock even though the shareholders had made Sec. 83(b) elections. The IRS concluded that if the erroneous

failure to treat the restricted stock as outstanding stock caused the entity's S election to terminate, the termination was inadvertent; the company would be treated as continuing to be an S corporation from its election to its revocation date, provided that the subchapter S election was not otherwise terminated.

In another situation,¹⁹ the company was a state corporation formed under a plan of reorganization to acquire Y stock. Subsequently, the company elected to be treated as an S corporation and Y elected to be a QSub. The

company also adopted a restricted stock plan benefiting certain individuals who made Sec. 83(b) elections. The company did not treat unvested restricted shares as outstanding shares. It did not know that all those shares were required to be treated as outstanding as of the date of the awards. When the company discovered the error, it asked for IRS relief from any termination of either entity's subchapter S status due to the company's improper treatment of restricted shares. The IRS held that any resulting termination of either entity's S status was inadvertent; the company was entitled to be treated as continuing to be an S corporation, and Y would continue to be treated as a QSub.

A similar situation occurred in Letter Ruling 200917006,²⁰ where a company elected S corporation status when its current owners were an individual and two trusts. The company then executed a stock subscription agreement with another entity. This agreement may have been an event that terminated the company's S status. However, while the subscriber transferred funds to the company in order to acquire the stock, no stock certificate was issued, and its name was not entered on the company's books as a shareholder. The company's tax advisers later informed it that the subscriber was an ineligible shareholder. The company then retroactively amended the subscription agreement to provide for issuance of the shares directly to trusts 1 and 2. The company sought a ruling that it continued to be an S corporation notwithstanding the terminating event, on the grounds that the termination was inadvertent and was not motivated by either tax avoidance or retroactive tax planning. The IRS agreed.

In Letter Ruling 200914019,²¹ a holding company that elected S corporation treatment became the parent of a common parent through a redemption transaction that restructured the common parent. To ensure that the terms of the redemption were fair to an employee stock ownership plan (ESOP) and two other stock plans, the plans adopted a floor price agreement



17 IRS Letter Ruling 200921001 (5/22/09).

18 IRS Letter Ruling 200914005 (4/3/09).

19 IRS Letter Ruling 200901011 (1/2/09).

20 IRS Letter Ruling 200917006 (4/24/09).

21 IRS Letter Ruling 200914019 (4/3/09).

and a valuation methodology. The common parent entered into split-dollar life insurance agreements with the CEO and a trust, both of which were shareholders of the company. The IRS concluded that the provisions would be disregarded in determining whether the outstanding shares of company stock conferred identical rights. Therefore, the company would not be considered as having more than one class of stock as a result of the floor price agreement and the valuation methodology. In addition, the IRS determined that the common parent did not enter into the insurance agreements to circumvent the one-class-of-stock requirement. Therefore, the company would not be considered as having more than one class of stock as a result of the split-dollar life insurance agreements.

Usually companies try to prove that they did not have a second class of stock. The opposite problem occurred in *Minton*,²² 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 Tax 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. The taxpayer appealed the court's decision. The Fifth Circuit²³ concurred with the Tax Court's decision even though the judge determined that the lower court erred in applying an election under Regs. Sec. 1.1361-1(l)(7) in that the provision permits retroactive application only to prior tax years and not to prior transactions. The judge ruled that the

error was harmless because the evidence was not convincing that the transaction created a second class of stock.

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

an employee exercised an option and received QSub shares, the QSub canceled all outstanding options and repurchased the stock. In requesting a ruling, the S corporation stated that neither it nor its shareholders nor its subsidiary understood that the issuance of the options could cause the QSub to have an owner other than the S corporation and that the conduct was not

If an S corporation violates any of the restrictions on shareholders, its S status automatically terminates.

election should be filed on Form 8869 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 that occur after 2004 if the conditions of Sec. 1362(f) are met. This is consistent with Rev. Proc. 2004-49,²⁴ 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 rulings²⁵ seeking relief for the late filing of a QSub election. In each of these, the IRS determined that the taxpayer had shown good cause for the delay and granted an extension of 60 days from the ruling date to make the election.

Two rulings dealt with whether a company qualified to make a QSub election. In Letter Ruling 200916010,²⁶ an S corporation acquired all the stock of another corporation. It intended to treat the subsidiary as a QSub but failed to file the required election. The QSub thereafter issued stock options to employees, the fair market value of which exceeded the exercise price ("in the money options"). After

motivated by tax avoidance or retroactive tax planning. They asked the IRS to rule that neither entity's status had been affected adversely by such errors, which the IRS did. Therefore, the corporations were allowed to keep their S and QSub status.

In another situation,²⁷ a domestic corporation that was an S corporation acquired the stock of another corporation. The S corporation intended to treat the stock acquisition as an acquisition of assets by making a Sec. 338(h)(10) election and also intended to elect to treat the company as a disregarded entity (DE). Though the S corporation made the first election, its tax professional erroneously advised that it was not required to make a QSub election in order to treat the subsidiary as a DE. When the S corporation later discovered that this advice was incorrect, it asked for an extension of the deadline to make the election and for relief from the inadvertent termination of its S status because of the missing QSub election. The IRS held that the S corporation was allowed to make a late QSub election on behalf of the subsidiary and that the termination of the S status was inadvertent.

Earnings and Profits

If an S corporation has subchapter C accumulated earnings and profits (AE&P),

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

23 *Minton*, 562 F.3d 730 (5th Cir. 2009).

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

25 See, e.g., IRS Letter Rulings 200928026 (7/10/09), 200909018 (2/27/09),

200910016 (3/6/09), and 200845016 (11/17/08).

26 IRS Letter Ruling 200916010 (4/17/09).

27 IRS Letter Ruling 200903062 (1/16/09).

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 IRS has been lenient in its definition of passive income; as a result, the number of ruling requests is down significantly. In the period covered, income from commercial and residential rentals was deemed to be active income.²⁸ 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, collecting rent, finding new tenants, and negotiating leases. In one of the rulings,²⁹ the IRS stated that whether the S corporation was performing significant services was based on facts and circumstances, such as the number of people employed to provide the services or the types and amounts of costs incurred.

In Letter Ruling 200841004,³⁰ an S corporation engaged in leasing tangible property. The S corporation's employees provided services that included equipment pickup and delivery; equipment maintenance, replacement, and repair; and customer training and demonstration. As with real estate rentals, the IRS found that the rents were not passive investment income under Sec. 1362(d)(3)(C)(i).

Sec. 1362(d)(3) Terminations

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

In one situation,³¹ the taxpayer was a domestic corporation that elected S corporation status. At the start of year 1, it had AE&P due to its prior existence as a C corporation. For each of the next three consecutive years, the taxpayer had passive investment income exceeding 25% of its yearly gross receipts, triggering the termination of its S election. The company sought relief from the IRS, advising that it did not realize that excessive passive investment income could trigger termination. It also stated that it had taken corrective actions to assure that it would not have excessive passive investment income in the future. The IRS held that the S corporation had satisfied the requirements for relief from an inadvertent termination and would be treated as an S corporation for the desired period, notwithstanding the termination. However, the IRS conditioned relief on the S corporation's filing amended returns and paying the Sec. 1375 tax on excess net passive income.

In Letter Ruling 200927028,³² a company that elected to be an S corporation had subchapter C earnings and profits at the close of each of three consecutive tax years and had gross receipts for each of those years, more than 25% of which were passive investment income. As a result, its S election terminated, but it represented that this termination was inadvertent, unintended, and not the result of tax avoidance or retroactive tax planning. The corporation distributed all its subchapter C earnings and profits to its shareholders and, along with its shareholders, agreed to make any required adjustments consistent with its treatment as an S corporation. The IRS concluded that the termination was inadvertent and that it would treat the entity as continuing to be an S corporation. The IRS made

the same ruling in another situation with similar facts.³³

In Letter Ruling 200928024,³⁴ an S corporation intended to invest in publicly traded limited partnerships (PTPs) that purchased, transported, stored, and/or marketed oil and gas. It identified to the IRS three specific PTPs that were actively engaged in such pursuits, stating that each met the qualifying income exception of Sec. 7704(c), that none was an electing large partnership, and that normal flowthrough provisions in governing law applied. Finally, the S corporation advised that it intended to invest in other similar PTPs and asked for rulings relative to how the IRS would treat income from the proposed investments. The IRS held that the taxpayer's distributive shares of the gross receipts of the identified PTPs were includible in its gross receipts for purposes of Secs. 1362 and 1375 and that its distributive shares of gross receipts attributable to the exploration, development, mining, production, processing, refining, transportation, or marketing of any mineral or natural resources did not constitute passive investment income. This would seem to open up the planning possibility of using certain PTPs to avoid the passive investment income from exceeding 25% of gross receipts.

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 Letter Ruling 200917008,³⁵ a corporation made an S election when all its shareholders were eligible shareholders that had consented to the S election. The S corporation agreed to enter into a transaction with an unrelated third party involving the creation of a partnership between the S corporation and the third party.

In connection with this transaction, investors that were not permissible S corporation shareholders purchased some of the S corporation stock. The S corporation

28 See, e.g., IRS Letter Rulings 200923007 (6/5/09), 200905012 (1/30/08), and 200845006 (11/7/08).

29 IRS Letter Ruling 200932010 (8/8/09).

30 IRS Letter Ruling 200841004 (10/10/08).

31 IRS Letter Ruling 200930027 (7/24/09).

32 IRS Letter Ruling 200927028 (7/12/09).

33 IRS Letter Ruling 200906019 (2/6/09).

34 IRS Letter Ruling 200928024 (7/10/09).

35 IRS Letter Ruling 200917008 (4/24/09).

represented that it was unaware that the purchase of its stock by the impermissible shareholders would cause a termination of its S election. Furthermore, it relied on a CPA firm to prepare its income tax returns and for tax advice, but the firm never advised that the ownership of stock by the impermissible shareholders would result in the termination of the S election. All the stock held by the ineligible shareholders was redeemed. The IRS concluded that although the S corporation election had terminated, the termination was inadvertent.

In one instance,³⁶ a corporation elected to be treated as an S corporation, but one of its owners was another S corporation, an ineligible shareholder. When the company discovered that the ownership by another S corporation made the S election ineffective, the shareholder distributed its shares in the taxpayer in the first corporation to its sole shareholder, an individual. The IRS held that the ineffectiveness of the taxpayer's S corporation election was inadvertent. However, the IRS disclaimed any ruling as to whether the corporation otherwise qualified as an S corporation and did not address whether the distribution to the individual would be a taxable event. If the stock had appreciated in value or was worth more than the shareholder's basis, Sec. 311(b) would apply to create a recognized gain at the corporate level that would pass through and be taxable to the shareholder.

In another instance,³⁷ on the date of its formation as a state limited partnership, a company made an S election. Its owners included another S corporation, an ineligible shareholder. The company did not know that an S corporation was ineligible and that the company's S election might be ineffective. It was also unclear whether the company, at the time of formation, had a second class of stock, the existence of which would have meant that the company

was ineligible for S corporation status. After the company's counsel advised it of such defects, the S corporation shareholder merged into the company. The IRS held that the company's election was ineffective due to the presence of an ineligible shareholder and also due to the circumstances involving a second class of stock. However, because those defects and circumstances were inadvertent and had been remedied, relief under Sec. 1362 was granted.

In Letter Ruling 200926028,³⁸ an entity elected to be an S corporation and intended to treat Y, another corporation, as a QSub. However, the QSub election was ineffective due to procedural defects.

In an unusual ruling, the IRS did not allow an S corporation to reelect S status within five years even though ownership had changed more than 50%.

It was also ineffective because an ineligible entity was a shareholder of Y at the time of the election. After the company discovered that the QSub had an ineligible shareholder, all parties involved took corrective action to restore Y's status as an eligible QSub. The IRS ruled that Y would be treated as a QSub provided that its election was not otherwise terminated and that the company could keep its S status.

Partnerships

A partnership is an ineligible S corporation shareholder. In one situation,³⁹ S corporation stock was transferred to a partnership—an ineligible shareholder—and then transferred to a second partnership, also ineligible. Thereafter, both partnerships transferred their stock to eligible shareholders. The IRS found that the termination was inadvertent. The S corporation never treated the partnerships as shareholders; instead, the eligible

shareholders were treated as the owners for the entire time.

In one instance,⁴⁰ a state corporation with six wholly owned subsidiaries and two shareholders elected to be an S corporation. One shareholder transferred its shares to a state limited partnership, an ineligible shareholder, triggering the termination of the S corporation election. Other events, including an unauthorized filing of an S corporation revocation and the issuance of shares to an IRA, also an ineligible shareholder, occurred thereafter. Once they knew the extent of the irregularities, the S corporation and its shareholders took corrective action and asked

the IRS to treat the termination as inadvertent, which it did.

In another situation,⁴¹ at the time an entity elected S status, its shareholders were individuals. It converted to a state limited partnership upon the creation of LLC1, with the individuals as limited partners and LLC1, which the individuals owned, as the general partner. After the entity became aware that as a result of its conversion its S election terminated, it effectuated a series of transactions that created additional LLCs such that a single member owned each of the new LLCs and they could qualify as disregarded entities. To further remedy the terminating event, the entity represented that it would convert to a corporation under state laws if necessary. The IRS concluded that the entity's S corporation election terminated when LLC1 became the general partner and that it might have terminated if the conversion of the entity to a state limited partnership

36 IRS Letter Ruling 200921027 (5/22/09).

37 IRS Letter Ruling 200907012 (2/13/09).

38 IRS Letter Ruling 200926028 (6/26/09).

39 IRS Letter Ruling 200847013 (11/21/08).

40 IRS Letter Ruling 200906015 (2/6/09).

41 IRS Letter Ruling 200908009 (2/20/09).

created a second class of stock. However, the IRS concluded that the termination was inadvertent.

In yet another situation,⁴² an entity was incorporated under state law and later elected S corporation status. In the period between formation and election, the company's stock was held through limited partnership arrangements adopted by groups of family members. With the intent of meeting subchapter S criteria, those family groups collectively formed four grantor trusts to hold the S corporation stock. However, because individuals did not wholly own the grantor trusts, they were ineligible to hold S corporation shares, and the transfer of the stock to the trusts terminated the S election. The S corporation proposed to amend and restate three of the trusts in the manner required to address their ineligibility and to terminate the fourth. The IRS held that while the S corporation was invalid by reason of the presence of ineligible shareholders, that invalidity was inadvertent and the company would be treated as an S corporation from the election, assuming that the described steps were taken.

LLCs

Like a partnership, an LLC is an ineligible shareholder. However, in Letter Ruling 200927014,⁴³ the IRS was asked whether an LLC could be an eligible S corporation shareholder if the LLC was a disregarded single-member LLC (SMLLC). The answer was that the SMLLC could be an eligible shareholder because the LLC's owner (assuming he or she is an eligible shareholder) would be treated as the owner of the S corporation. Many tax professionals and the IRS have used this concept to establish or continue a valid S corporation as discussed below.

In one instance,⁴⁴ X was formed as a single-member LLC treated as a disregarded entity for federal tax purposes. X acquired Y, an S corporation. As part of the acquisition, the sole shareholder of Y

became a member of X. As a result, X had more than one member. X became a partnership for federal tax purposes and was therefore an ineligible shareholder of Y. Consequently, Y's S corporation election terminated. The IRS concluded that Y's S corporation election terminated inadvertently and granted X an extension of time to make the appropriate elections.

In another situation,⁴⁵ an S corporation issued shares of its stock to an LLC, an ineligible corporation shareholder. The members of the LLC were two individuals. The S corporation redeemed all of the shares of the S corporation stock held by the LLC. The IRS concluded that the termination of the S corporation election was inadvertent. Thus, it would continue to treat the entity as an S corporation, provided that its election was otherwise valid. During the termination period, the individuals would be treated as the owners of the S corporation stock in proportion to their ownership interests in the LLC. The LLC could not be treated as a shareholder for any period it held an interest in the entity.

IRAs

The general rule is that an IRA cannot be an S shareholder. There have been several rulings in which S corporation stock was transferred to an IRA.⁴⁶ In these situations, either the S corporation 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 IRAs. 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 200915020, the IRA, not the IRA's beneficiary, was treated as the shareholder for the time the stock was held by the IRA when the S corporation had a loss; the rest of the time the beneficiary was considered the shareholder. Treating the IRA as the shareholder is a

relatively new concept, but for the past few years the IRS has ruled that if an S corporation had a loss while an IRA held the stock, the IRA would be considered the shareholder, whereas if the S corporation had income, the beneficiary would be considered the shareholder. By treating the IRA as the owner when the S corporation has a loss, no one gets the benefit of this loss in the current year, especially because no special allocation provision is permitted for an S corporation.

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. The Service has ruled on several situations involving trusts as S shareholders.

In the first ruling,⁴⁷ S stock was transferred to a trust, an ineligible shareholder, with the result that the S election terminated. Only later, in connection with the S corporation's proposed sale, did the company and its shareholders discover that a terminating event had occurred. In seeking relief, the S corporation and its shareholders stated that they were unaware of the terminating event and had not intended that the corporation's S election terminate. The IRS granted the relief and held that the termination was inadvertent. The Service also ruled that the corporation would be treated as continuing to be an S corporation provided that, within 60 days, the trustee of the trust filed an election to be treated as an ESBT and that payment of the amount determined to be the required adjustment under Sec. 1362(f)(4) was made.

Testamentary Trusts

In a 2009 ruling,⁴⁸ S stock was used to fund two revocable trusts. When the

42 IRS Letter Ruling 200927006 (7/2/09).

43 IRS Letter Ruling 200927014 (7/2/09).

44 IRS Letter Ruling 200914008 (4/3/09).

45 IRS Letter Ruling 200851008 (12/19/08).

46 IRS Letter Rulings 200931039 (7/31/09) and 200915020 (4/10/09).

47 IRS Letter Ruling 200924009 (6/12/09).

48 IRS Letter Ruling 200932031 (8/7/09).

grantor 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. Both trusts had the same three beneficiaries, and both were divided into and merged into three different trusts. The resulting trusts did not qualify as QSSTs and did not elect to be treated as ESBTs. When termination of the taxpayer's S status was discovered, the governing trust agreements were amended to satisfy the QSST criteria. The IRS concluded that the termination was inadvertent but conditioned the ruling on the shareholders' adjusting their interests as appropriate and the trusts' filing the appropriate elections within 60 days of the ruling.

In a similar situation,⁴⁹ stock was transferred to a trust on the death of the shareholder. The trust was eligible to be a QSST so that it could hold the stock more than two years, but the beneficiary failed to make the QSST election. The IRS ruled that the termination was inadvertent contingent upon certain enumerated conditions being met, including an adjustment under Sec. 1362(f)(4), a specified payment, and the beneficiary's filing of a valid QSST election within 60 days of the ruling. A similar ruling can be found in three other letter rulings.⁵⁰

In a very common situation,⁵¹ an S corporation transferred stock to a grantor trust that was an eligible shareholder. On the death of the grantor, the assets of the grantor trust transferred to another trust that was eligible to be either a QSST or an ESBT. In each of the situations, either the beneficiaries or the trustee of the recipient trusts failed to file the appropriate election. In all the situations, 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 con-

tinue to treat the entity as an S corporation, contingent on the recipient trusts making the appropriate election within 60 days of the ruling.

In Letter Ruling 200928020,⁵² S corporation stock was transferred to a grantor trust and was later transferred to a second grantor trust. When the grantor died, the stock was allocated between a trust described under Sec. 1361(c)(2)(A)(i) and a trust that was intended to be a QSST. However, not only did the trust's beneficiary fail to make a timely QSST election, but the trust was not eligible for QSST status. Later the trustee won a court order modifying the trust to qualify for QSST status. The IRS ruled that the termination of the corporation's S status was inadvertent and it would be treated as continuing to be an S corporation from the date of termination, provided that a completed QSST election was filed within 60 days of the ruling.

In another situation,⁵³ a grantor trust owned S stock. When its grantor died, the grantor trust became irrevocable. Its terms provided for transfer of its S stock to a family trust, but that transfer did not occur. When the grantor trust became an ineligible shareholder, the S election terminated. Later the grantor trust transferred its shares to the family trust, but its income beneficiary failed to make a timely QSST election. The IRS ruled that the termination was inadvertent and allowed the corporation to retain its S status as long as the income beneficiary filed a valid QSST election and any affected shareholders filed amended returns made necessary by the ruling.

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. During the period covered, there were numerous instances⁵⁴ in which a trust was intended to be treated as either a QSST or an ESBT and met all the requirements, but the trustee or 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's 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, the corporation and its shareholders were required to file amended tax returns.

In Letter Ruling 200927027,⁵⁵ S stock was transferred to a trust that was represented as a permissible S shareholder. That stock was subsequently transferred to two other trusts, both of which were supposed to be ESBTs, but no elections were made. In addition, because the beneficiaries of two trusts had withdrawal powers, both trusts were ineligible shareholders, and the transfer of the stock terminated the S election. The corporation took steps to ensure that the trusts were eligible shareholders. The IRS held that the termination was inadvertent and that the corporation would be treated as continuing to be an S corporation. It also held that the two trusts would be treated as ESBTs for the relevant period.

One issue that trusts must be careful of is who signs the trust election. The proper individuals to make the election are the beneficiary of a QSST and the trustee of an ESBT. In one instance,⁵⁶ the trustee of a QSST, instead of the minor beneficiary or her legal representative, signed both the Form 2553 and the QSST election. In another situation,⁵⁷ the beneficiary of an ESBT, not the trustee, signed the Form

49 IRS Letter Ruling 200932001 (8/7/09).

50 See IRS Letter Rulings 200929002 (7/17/09), 200932022 (8/7/09), and 200927029 (3/31/09).

51 See, e.g., IRS Letter Rulings 200908007 (2/20/09), 200906037 (2/6/09), and 200843007 (10/24/08).

52 IRS Letter Ruling 200928020 (7/10/09).

53 IRS Letter Ruling 200931036 (7/31/09).

54 See, e.g., IRS Letter Rulings 200925027 (6/19/09), 200917024 (4/24/09), 200902001 (1/9/09), and 200845036 (11/7/08).

55 IRS Letter Ruling 200927027 (7/2/09).

56 IRS Letter Ruling 200909017 (2/27/09).

57 IRS Letter Ruling 200909003 (2/27/09).

2553. The Service determined in both instances that the S election was inadvertently invalid and allowed the company to retain its S status.

It is important to make sure that the trusts meet all the proper requirements and that all the beneficiaries are qualified beneficiaries. In one instance,⁵⁸ a trust was eligible to make an ESBT election. The trust was the sole owner of the S corporation. Beneficiaries of the trust were an individual and two trusts. One of those trusts (T3) was a tax-exempt organization. The other trust (T2) had several beneficiaries; when they all died the remainder would go to T3. Because T2 was not a charitable remainder trust, all the beneficiaries qualified for ESBT purposes.

Letter Ruling 200921022⁵⁹ deals with a case in which a trust was funded with the stock of an S corporation and elected to be a QSST. However, the trust did not meet the qualifications of a valid QSST. It was eligible to be an ESBT but did not make the required election. Therefore, the trust was an ineligible shareholder, which caused the S corporation election to be invalid. The trust was split into two trusts for the benefit of two separate beneficiaries, and S corporation stock was transferred. Neither of the new trusts made any elections to be treated as either QSSTs or ESBTs. The IRS ruled that the S corporation election was ineffective because the first trust was an ineligible shareholder but that the ineffectiveness was inadvertent. Likewise, to the extent the S corporation election would have terminated when the first trust transferred stock to the other two trusts, such termination was also inadvertent.

Income distribution: One condition for qualifying as a QSST is that the trustee must distribute all the income each year. In Letter Ruling 200928025,⁶⁰ S corporation stock was transferred to trusts intended to be QSSTs. Although the trust instruments did not require the trustees to distribute all the income to each of the trust's current income beneficiaries, the S corpora-

tion represented that it and the grantors, trustees, and beneficiaries intended that trustees would actually distribute all such income. Due to an oversight, the beneficiaries of the trusts failed to make QSST elections. In addition, some of the trusts failed to distribute to their respective beneficiaries an immaterial amount of income. The IRS concluded that the S corporation termination was inadvertent and that it would continue to treat the entity as an S corporation, provided the election was valid, and the trusts would be treated as QSSTs if the beneficiaries filed appropriately completed QSST elections. Likewise, in Letter Ruling 200925031,⁶¹ even though the trust agreement required that all the income be distributed, the trusts did not comply. Even so, the IRS determined that the termination of the S status was inadvertent.

One income beneficiary: Another requirement for a QSST is that it have only one current income beneficiary. In one situation in 2009,⁶² a QSST had only one income beneficiary; however, when that beneficiary died, his children became the trust's beneficiaries. Because the trust had more than one income beneficiary, it no longer qualified as a QSST. However, the trust qualified to be an ESBT. Because no ESBT election was made, the trust was an ineligible shareholder and its ownership triggered the termination of the corporation's S election. The IRS determined that the taxpayer's S election terminated when the trust ceased to qualify as a QSST and failed to timely file an ESBT election. Given the facts, the IRS ruled the termination was inadvertent.

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,⁶³ an entity terminated its S corporation election by recapitalizing its common stock into common stock and an ESOP convertible preferred stock. The entity's four shareholders sold

the ESOP convertible stock to the entity's ESOP, and two shareholders elected Sec. 1042 treatment on the sale of their stock. The entity then redeemed all its common stock, causing the ESOP to become its sole shareholder.

The IRS denied the entity's request for permission to reelect S corporation status before the expiration of the five-year statutory waiting period. The entity terminated its S corporation status by creating two classes of stock. The shareholders compounded the error by selling their stock to the ESOP because only C corporation shareholders may sell their stock to an ESOP and defer the gain under Sec. 1042 by reinvesting the proceeds in publicly traded stocks and bonds. The election of Sec. 1042 treatment by the two shareholders precluded Sec. 1362(g) relief without regard to the redemption of the entity's stock, causing a more than 50% ownership change as described in Regs. Sec. 1.1362-5(a).

TTA

EditorNotes

Hughlene Burton is an associate professor in the Department of Accounting at the University of North Carolina–Charlotte in Charlotte, NC, and is chair of the AICPA Tax Division's Partnership Taxation Technical Resource Panel. Stewart Karlinsky is a professor emeritus at San Jose State University in San Jose, CA, and a member of the AICPA Tax Division's S Corporation Taxation Technical Resource Panel. For more information about this article, contact Dr. Burton at haburton@uncc.edu or Dr. Karlinsky at karlin_s@cob.sjsu.edu.

58 IRS Letter Ruling 200912005 (3/20/09).

59 IRS Letter Ruling 200921022 (5/22/09).

60 IRS Letter Ruling 200928025 (7/10/09).

61 IRS Letter Ruling 200925031 (6/19/09).

62 IRS Letter Ruling 200927012 (7/2/09).

63 IRS Letter Ruling 200851003 (12/19/08).