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Inadvertent Termination of S Corporation Elections

Section 1363(a) of the Internal Revenue Code of 1986, as amended (the "Code"), provides the general rule that an S corporation ("S Corp") shall not be subject to tax. An S Corp is defined as a "small business corporation" for which an election is made under the Code. A "small business corporation" is defined as a domestic corporation that: (i) is not an ineligible corporation; (ii) does not have more than 100 shareholders; (iii) does not have shareholders other than individuals (except for an estate or certain trusts and tax-exempt organizations); (iv) has no non-resident alien shareholders; and (v) does not have more than one class of stock. The Code specifically provides that an S Corp does not have more than one class of stock solely because of differences in voting rights. As such, an S Corp can have both voting and nonvoting stock.

There may be business transactions after formation that involuntarily terminate an S Corp's S election. In addition, a single transaction by an individual shareholder could involuntarily terminate an S election for the S Corp. Both of these instances are referred to below as an inadvertent termination. The cost for such an inadvertent termination is that the S election terminates on the date the S Corp ceases to be a small business corporation and a new S election cannot be made for five years.

Accordingly, S Corp officers, directors and shareholders need to recognize actions that may cause an inadvertent termination and take the necessary precautions to prevent them. Two common areas in which an inadvertent termination may arise are when the S Corp takes on an ineligible shareholder or becomes treated as having more than one class of stock.

An S Corp cannot be owned by a non-resident alien, C corporation or partnership. This may occur when a shareholder sells or otherwise transfers his stock to one of these ineligible shareholders during the tax year. A properly drafted Shareholders Agreement should impose transfer restrictions that goes beyond prohibiting and actually voids any such transfers.

All outstanding shares of stock must confer identical rights to distribution and liquidation proceeds. As such, disproportionate distributions during the tax year could unintentionally terminate the S Corp's S election. This can be the case when an S Corp is in the growth mode and raising additional capital. A properly drafted Shareholders Agreement should contain provisions that prohibit the creation of a second class of stock.

In both these instances and others, even the best Shareholders Agreement may not prevent the occurrence of an inadvertent termination. Since the S Corp would no longer be a small business corporation it would be subject to tax as a C corporation.

All may not be lost upon the occurrence of an inadvertent termination. The IRS has the statutory authority to waive the termination of the S election in the event the S Corp ceases to be a small business corporation. This relief is available when the termination event is shown to be inadvertent, the S Corp corrects the event in a timely manner, and the S Corp and its shareholders agree to make such adjustments as may be required by the IRS. If these steps are satisfied, then the IRS will waive the termination and treat the S Corp as never having lost its S election and status as a small business corporation. The S Corp should attach to its return for the tax year in which the termination has occurred notification that a termination has occurred and the date of the termination.

The S Corp has the burden of establishing whether the termination was inadvertent based upon the facts and circumstances, and it should file a ruling request with the IRS. The Treasury regulations provide that the fact that the terminating event was not reasonably within the control of the S Corp and not part of a plan to terminate the S election, or the fact that the terminating event took place without the S Corp's knowledge, notwithstanding its due diligence to safeguard itself against such an event or circumstance, tends to establish that the termination was inadvertent. Any waiver granted by the IRS is not effective until the S Corp takes the necessary steps to correct the violation. In addition, the terminating event needs to be corrected in a reasonable period of time. A reasonable period of time begins on the earlier of the date the S Corp had actual knowledge of the event or the date a reasonable person would have had knowledge of the event.

Since due diligence in safeguarding against an inadvertent termination is a factor in obtaining a ruling from the IRS, year-end planning should include a review of the S Corp's operations and actions of its shareholders for compliance with its S election during the tax year. Don't let the clock start without your knowledge!

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This issue of the Tax Law Alert was written by Christopher J. Rixon, Chair of the Tax Group at Reid and Riege, P.C. The Group works with business lawyers on issues of choices of entities, formation and operation, as well as taxable and/or tax-free transactions. The Group is involved with decisions involving capitalization, working with commercial and transactional lawyers in structuring and determining levels of equity, debt and various hybrids. The Tax Group is also called upon to work outside the Business Law Practice Area with respect to issues of pensions and profit sharing arrangements, trusts and estates, personal wealth planning, real estate transactions and financing, litigation and settlement agreements, health care and nonprofit law.

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