S Corporation Corner

By Stuart J. Frentz

Practitioners Should Schedule Periodic Check-ups for Their S Corporation Clients

The number of inadvertent termination and inadvertent invalid S election rulings the IRS continues to issue each year[1] suggests there are opportunities for tax professionals to provide more and better services to their clients aimed at monitoring and maintaining their S elections. Several recent rulings point out that the inadvertent termination at issue was first discovered when a sale of the corporation was under negotiation.[2] Unfortunately, problems giving rise to requests for relief under Code Sec. 1362(f) are commonly detected during the due diligence preceding an acquisition.[3]

The unintentional loss of an S election is serious whenever it occurs, but discovering an inadvertent termination during the due diligence leading up to the sale of an S corporation can be disastrous.[4] When the validity of the target's S election is critical, as often is the case, the transaction may have to be delayed for four to six months or longer while the parties seek inadvertent termination relief from the IRS through the ruling process.[5] If the IRS refuses to issue an acceptable ruling, the terms of the deal may have to be re-negotiated, or the transaction may fall apart completely. The discovery of a defect in the S election while a transaction is pending is akin to having the family automobile break down during a vacation trip up the Alaska Highway. Preventive maintenance can go a long way toward avoiding both kinds of disappointment (or worse).

Indeed, S corporations need scheduled maintenance checks nearly as much as the automobiles we drive. The marketplace is replete with automobile parts suppliers and other vendors constantly reminding us that the cost of preventive maintenance is trivial

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compared with expenses for towing, rental cars, labor and parts for emergency repairs or replacements, not to mention the risk of highway accidents. The market for comparable maintenance services for S corporations appears to be relatively underserved.

Once a client decides to have the status of its S election examined periodically, the frequency of review must be determined. The appropriate timetable depends in large part on such factors as the number of shareholders, the nature of the corporation's operations, how often stock transfers take place, whether there is a comprehensive buy-sell agreement, likelihood of the business being sold and the degree of communication between the corporation and its shareholders with regard to maintaining the corporation's S status. If the business is relatively stable and has only a few shareholders who are generally knowledgeable of S corporation requirements, a review every three to five years may be sufficient. On the other hand, most S corporations would benefit from having their elections evaluated every year.

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When Should Reviews Be Conducted During the Year?

One's first thought might be to schedule S corporation reviews as part of the CPA firm's normal year-end review that typically takes place in January or February for calendar-year S corporations. This timetable is appealing because it enables the practitioner to review all transactions that took place during the previous year. However, conducting the review *before* the end of a corporation's tax year can yield an important advantage. If a terminating transaction is discovered during September, October or November for a calendar-year S corporation, it may be possible to rescind the transaction so that, for tax purposes, it is treated as though it never happened.[6] Typically, rescission will be greatly preferable to seeking inadvertent termination relief under Code Sec. 1362(f) after the tax year of the terminating event has closed.

Rev. Rul. 80-58[7] establishes two requirements for rescission: (1) the parties to the transaction must be restored to "the relative positions they would have occupied had no contract been made," and (2) this restoration must be achieved before the end of the tax year in which the original transaction took place. Although Rev. Rul. 80-58 dealt with the rescission of a sale of property, the IRS has cited it several times in approving the rescission of other types of transactions that cause S elections to terminate.

In LTR 200752035,[8] for example, the IRS ruled that the legal doctrine of rescission applied to a situation in which an S corporation rescinded the issuance of its stock to an IRA by voiding the stock certificate and refunding to the IRA the purchase price of the shares. Because the restoration and the original transaction took place within the same tax year, the IRS ruled that the rescission was effective to undo the corporation's issuance of stock to the IRA and prevent termination of its S election.

Similarly, in LTR 200533002[9] the IRS recognized a rescission of a corporation's sale of newly issued convertible preferred stock to three limited partnerships when the sale was rescinded within the same tax year. The sale would have terminated the corporation's S election for two reasons: (1) the preferred stock was an impermissible second class of stock, and (2) the limited partnerships were not qualified S corporation shareholders. The IRS held that the rescission doctrine of Rev. Rul. 80-58 applied, and the corporation's S election continued in effect without interruption during the tax year of the sale and rescission.

On the other hand, a terminating transaction that is discovered during a subsequent tax year cannot be rescinded for federal income tax purposes.[10] In order to restore an S election in those circumstances, the corporation and its shareholders generally must seek inadvertent termination relief under Code Sec. 1362(f)—a process that can be expensive,[11] as well as time-consuming. However, even if rescission is not available, it should still be worthwhile to uncover and correct any problems through a program of regularly scheduled check-ups well before a sale transaction is imminent.

The Initial Review[12]

Certain factors relating to a corporation's S election need not be re-checked on every review; once these elements have been verified during the first review, they are unlikely to change, and the time and costs of revisiting them on subsequent reviews are unlikely to be justified. The following items and considerations might be included in this category:

- Form 2553, the S election itself.
  - Was the federal election[13] filed during the tax year prior to the effective date, or by the 15th day of the third month following the effective date?[14]
  - Was the election effective as of the first day of the corporation's existence, or as of the first day of its tax year?[15]
  - If a retroactive election was made, was the corporation eligible to make an S election as of the effective date and at all times during the period between the effective date and the filing date?[16]
  - Was the corporation a successor corporation to a corporation whose election under Code Sec. 1362 was terminated within five tax years prior to the effective date of the S election?[17]
  - Did all persons who were shareholders at the time of the election properly consent?[18]
  - Did the appropriate persons sign on behalf of each consenting shareholder?[19]
- Determine whether an acceptable proof of filing is available, including at least one of the following: (i) certified or registered mail receipt (timely postmarked), or its equivalent from an acceptable private delivery service; (ii) the Form 2553 with an "accepted" stamp or stamped "IRS received" date; or (iii) an IRS letter stating that the Form 2553 was accepted.[20]
- Was the electing corporation a domestic corporation that was not ineligible to make an S election?[21]

Initial and Subsequent Reviews

Additional items should be checked both on the initial review ***and*** on each subsequent review. The following is a summary of the documents and information that the reviewer should obtain and analyze for their potential impact on the client's S election.[22]

- ***Shareholder Eligibility and Number of Shareholders***—Obtain originals or verified copies of the following documents:
  - stock ownership records, including a list of the shareholders;
  - a list of the outstanding shares of stock owned by each S corporation shareholder;
  - a list of outstanding options or warrants to acquire stock and their terms;
  - the stock-transfer ledger;
  - any stock powers or other stock-transfer documents;
  - the corporation's stock certificates (outstanding stock certificates and cancelled stock certificates);
  - any investor rights or "buy-sell" agreements;
  - any voting trust, proxy agreement or similar arrangement;
  - any trust documents with respect to any shareholders of the S corporation that are trusts;
  - any qualified Subchapter S trust (QSST) election made by any shareholder of the corporation that purports to be a QSST;
  - the confirmation notice received by the S corporation from the IRS stating that the trust's QSST election has been accepted;
  - any electing small business trust (ESBT) election filed by any shareholder of the corporation that purports to be an ESBT;
  - the confirmation notice received by the S corporation from the IRS stating that the trust's ESBT election has been accepted; and
  - affirmation of citizenship status or U.S. resident status of the individual shareholders.
- Confirm that the corporation has no more than 100 shareholders,[23] counting husband and wife as one shareholder and counting the members of a family (*i.e.*, within six generations of a common ancestor[24]) as one shareholder.
- Confirm that none of the following entities is a shareholder:
  - a partnership or LLC (other than a single-member LLC owned by an individual or other qualified shareholder);
  - a corporation;
  - an individual retirement account (IRA)[25] or retirement plan;[26]
  - a nonresident alien;[27]
  - a trust other than: (i) a QSST;[28] (ii) an ESBT;[29] (iii) a grantor trust; (iv) a Code Sec. 678 trust, all of which is treated as owned by an individual citizen or resident of the U.S.; (v) a voting trust; (vi) certain trusts that receive stock under a will; (vii) an employee stock

ownership plan (ESOP); or (viii) certain exempt organizations;[30]
- a decedent's estate undergoing an unduly prolonged administration period.[31]

- ***Single Class of Stock***—Confirm that the corporation has only one class of stock[32] issued and outstanding by obtaining and reviewing the following documents:
  - a list of any outstanding indebtedness (including convertible debt) of the S corporation, including the terms and conditions and identity of the holders of the indebtedness;[33]
  - any agreements or plans concerning outstanding or proposed stock options, warrants or rights, including any employee stock purchase plan,[34] and a list of any outstanding options, warrants or other rights with respect to stock of the S corporation[35];
  - the original articles of incorporation and all amendments approved since the last review;
  - the original bylaws and all amendments approved since the last review;
  - minutes of meetings and reports issue by the shareholders (since the effective date of the S election or since the date of last review);
  - minutes of meetings and reports issued by the corporation's board of directors (since the effective date or since the date of the last review);
  - minutes of meetings and reports issued by any executive, audit or other committee (since the effective date or since the date of the most recent review);
  - a schedule of distributions made by the S corporation to or on behalf of each of its shareholders since the date of the last review;
  - any shareholder agreements, investor rights agreements, voting trusts, proxy agreements or similar arrangements;
  - any stock purchase agreements with, between or among any of the shareholders;
  - any agreements relating to preemptive rights or other preferential rights of shareholders;
  - any agreements restricting the sale or other disposition of stock; and
  - any phantom stock, stock appreciation rights or similar deferred-benefit plan.
- ***QSubs***—Determine whether any subsidiary corporations are properly treated as qualified Subchapter S subsidiaries (QSubs)[36] by obtaining and reviewing originals or verified copies of the following documents:
  - a list of all subsidiaries of the S corporation and the amounts and classes of stock or other equity interests held by the S corporation in those subsidiaries;
  - any QSub election filed for any subsidiary of the S corporation; and
  - confirmation received by the S corporation or any QSub from the IRS stating that the QSub election has been accepted and the effective date of the election.
- ***Excess Passive Investment Income***—Determine whether the corporation may have terminated its S election by having C earnings and profits and excess passive investment income for three consecutive tax years,[37] and, if so, obtain and review originals or verified copies of the following documents:
  - workpapers computing the corporation's accumulated adjustments account ("AAA");[38]
  - workpapers computing C earnings and profits[39] from the tax years prior to the S election or acquired from C corporations or other S corporations;
  - workpapers computing passive investment income as a percentage of gross receipts[40] for each year of the corporation's existence since the effective date of its S election;
  - any election under Code Sec. 1368(e)(3) to "flush out" C earnings and profits through prior distributions.
- ***Built-in Gains Tax***—Determine whether the corporation is subject to the built-in gains tax under Code Sec. 1374, as interpreted by Reg. §§1.1374-1 through 1.1374-10:[41]
  - Was the S election made within the previous 10-year period?[42]
  - Has the corporation acquired assets from a C corporation in a carryover basis transaction within the previous 10-year period?[43]
  - If the answer to either of the foregoing questions is yes, was an appraisal obtained to try to fix the amount of built-in gain?
  - Obtain and analyze the following documents:
    - the appraisal report (or other basis for valuation);
    - workpapers computing the tax basis of the corporation's assets as of the effective date of the S election; and
    - reports of recognized built-in gain on federal income tax returns filed for prior tax years during the recognition period.

Conclusion

S corporation advisors should not wait until the eve of sale to review the status of their client's S election. Rather, they should offer their S corporation clients periodic maintenance checks comparable to those offered to automobile buyers by dealers, independent garages and national retail chains. The costs of reviewing a corporation's S election on an annual, biennial or triennial basis pale in comparison with the costs of deferring the closing of an advantageous sale due to newly discovered problems with the corporation's S election or, worse yet, losing out entirely on a favorable sale opportunity.

Endnotes

[1] Approximately 435 rulings were issued under Code Sec. 1362(f) during the four-year period from January 1, 2008, through December 31, 2011.

[2] *See, e.g.*, LTRs 201123008, 201123009, 201123010 and 201123011 (all dated June 10, 2011), a sequence of near-identical rulings in which the principal shareholder discovered "… during subsequent sale negotiations …" that a prior transfer of ownership interests to a trust "… may have caused an inadvertent termination of X's S election." *See also* LTR 201035010 (Sept. 23, 2010) (an ESBT transferred all of its stock in an S corporation to an ineligible shareholder; in a subsequent taxable year, "Z acquired all the stock of X pursuant to a stock purchase agreement that required Z and the shareholders of X to make an election under §338(h)(10)"); LTR 200952015 (Dec. 24, 2009) (a shareholder of an S corporation transferred all of her shares to a nonqualifying trust; in a subsequent taxable year, "Y acquired all of the stock of X pursuant to a stock purchase agreement that obligates Y and [all of the shareholders] to make an election under §338(h)(10) to treat the sale of X's stock as an asset sale and liquidation of X"); and LTR 200945012 (Nov. 6, 2009) ("In [month], X consulted new legal counsel in preparation of an anticipated stock transaction and X was advised that X may be treated as having two classes of stock for purposes of §1361(b)(1)(D)").

[3] The author is aware of one ruling in which the terminating event was discovered during the due diligence for a pending acquisition, but that fact is not mentioned in the published ruling. *See* LTR 200802008 (Jan. 11, 2008).

[4] This is especially true where the purchaser of stock wishes to make a Code Sec. 338(h)(10) election, and the deal has been priced on that basis.

[5] In some cases it may also be necessary to seek state-level rulings.

[6] *See* Sheldon I. Banoff, *New IRS Rulings Approve Rescission Transactions that Change an Entity's Tax Status*, 105 J. Tax'n, July 2006, at 5; Rev. Rul. 80-58, 1980-1 CB 181 (establishes standards for tax rescission). Note, however, that the IRS recently announced that it has decided to stop issuing private letter rulings in rescission transactions, and that general area was added to the IRS no-rule list in Rev. Proc. 2012-3, 2012-1 IRB 113 (Section 5.02).

[7] Rev. Rul. 80-58, 1980-1 CB 181.

[8] LTR 200752035 (Dec. 28, 2007).

[9] LTR 200533002 (Aug. 19, 2005).

[10] *See* LTR 8304134 (Oct. 28, 1982), in which the IRS ruled that a court-ordered rescission of a sale of an S corporation's stock to another corporation that had terminated the S election did not salvage the election since the sale took place in 1980, but the rescission was not ordered until 1982. The ruling implies that a rescission prior to the end of the 1980 tax year would have been effective. State law rules are beyond the scope of this column, but when an S corporation is organized in or is doing business in one of the handful of states that do not automatically accept the federal S election, *e.g.*, by requiring a separate state election, the impact of such laws should be considered during a periodic review of S status.

[11] The user fee may be as much as $18,000; *see* Rev. Proc. 2012-1, 2012-1 IRB 1.

[12] For a checklist and in-depth discussion of the many due-diligence items that should be addressed in an acquisition of S corporation stock, *see* Stephen R. Looney and Ronald A. Levitt, *Due Diligence Issues Arising in Connection With the Acquisition of an S Corporation*, J. Tax'n, July 2011, at 4.

[13] Also consider any state-specific election.

[14] Code Sec. 1362(b); Reg. §1.1362-6(a).

[15] Code Sec. 1362(b)(1); Reg. §1.1362-1(b).

[16] Code Sec. 1362(b)(2); Reg. §1.1362-6(a)(2)(ii).

[17] Reg. §1.1362-5(b).

[18] Code Sec. 1362(a)(2); Reg. §1.1362-6(b).

[19] Reg. §1.1362-6(b)(2).

[20] IRS Instructions for Form 2553 (Rev. Dec. 2007): "The service center will notify the corporation if its election is accepted and when it will take effect. The corporation will also be notified if its election is not accepted. The corporation should generally receive a determination on its election within 60 days after it has filed Form 2553."

[21] The corporation cannot be a financial institution using the reserve method of accounting for bad debts under Code Sec. 585, an insurance company, a possessions corporation, or a DISC or former DISC. Code Sec. 1361(b)(2).

[22] For ease of reference, the discussion throughout this column is couched exclusively in corporate terms—shareholders, stock, etc. Suitable adjustments should be made for limited liability companies and other forms of business entities that elect to be taxed as S corporations. See Reg. §301.7701-3(c)(1)(v)(C) (an eligible entity that makes a timely and valid election to be an S corporation under Code Sec. 1362(a)(1) will also be treated as having made an election to be classified as an association).

[23] Code Sec. 1361(b)(1)(A).

[24] Code Sec. 1361(c)(1); Reg. §1.1361-1(e)(3).

[25] *But see* Code Sec. 1361(c)(2)(A)(vi), which permits an IRA that on October 22, 2004, held stock of an S corporation that was a bank or depositary institution holding company to continue holding that stock without terminating the corporation's S election.

[26] Rev. Rul. 92-73, 1992-2 CB 224. There is a steady stream of rulings granting relief from inadvertent terminations caused by shareholders transferring S corporation stock to IRAs or by S corporations issuing stock to IRAs. As discussed in two previous S Corporation Corner columns, however, several of these rulings have limited the retroactivity of the relief to tax years that remain open as of the date the ruling is issued. *See* Stuart J. Frentz, S Corporation Corner, *Developments in IRS Policy on Inadvertent Termination Relief*, J. Passthrough Entities, Nov.-Dec. 2008, at 29, and Stuart J. Frentz, S Corporation Corner, *The IRS Will Extend Inadvertent Termination Relief to Closed Years—For a Price*, J. Passthrough Entities, Mar.-Apr. 2010, at 39. Another such ruling was issued within the past year; *see* LTR 201119022.

[27] Code Sec. 1361(b)(1)(C).

[28] Code Sec. 1361(d).

[29] Code Sec. 1361(e).

[30] Code Secs. 1361(b)(1)(B) and 1361(c)(6).

[31] *Old Virginia Brick Co., Inc.*, CA-4, 66-2 USTC ¶ 9708, 367 F2d 276, *aff'g*, 44 TC 724, Dec. 27,532 (the estate of a decedent who died in 1941 consented to an S election in 1959; the S election was invalid because under Reg. §1.641(b)-3(a) the estate had terminated and had become a trust for federal income tax purposes).

[32] Code Sec. 1361(b)(1)(D), Code Sec. 1361(c)(4) and (c)(5); Reg. §1.1361-1(l).

[33] Determine whether any such indebtedness

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constitutes a second class of stock under Reg. §1.1361-1(l).

[34] Code Sec. 423.

[35] Determine whether any such option, warrant or other stock right may constitute a second class of stock under Reg. §1.1361-1(l).

[36] Code Sec. 1361(b)(3); Regs. §§1.1361-2 through 1.1361-6.

[37] Code Sec. 1362(d)(3); Reg. §1.1362-2(c).

[38] Code Sec. 1368(e)(1).

[39] Code Secs. 1371(c) and 312.

[40] Code Sec. 1362(d)(3).

[41] Exposure to the built-in gains tax may reduce or eliminate the benefits of the target S corporation's shareholders joining in an election under Code Sec. 338(h)(10) and Reg. §1.338(h)(10)-1. Accordingly, an assessment of the corporation's preparedness to limit the impact of the built-in gains tax should be reviewed for any S corporation that either made a mid-stream election after a prior history as a C corporation or acquired appreciated assets from a C corporation in a carry-over basis transaction. *See* Code Sec. 1374(d)(8) and Reg. §1.1374-8.

[42] *I.e.*, the applicable "recognition period" under Code Sec. 1374(d)(7).

[43] Code Sec. 1374(d)(8); Reg. §1.1374-8.