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**ABA TAX SECTION
S CORPORATION COMMITTEE
2006 FALL MEETING**

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OOPS, THERE GOES MY S ELECTION

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I. S Elections

A. Timing of S elections

1. An election to be an S corporation for any taxable year may be made at any time during the preceding taxable year or at any time on or before the 15th day of the 3rd month of that taxable year. Code §1362(b)(1).
 - a. If the election is made late, it will be treated as an election for the following taxable year.
 - b. If the S corporation's first taxable year is 2 1/2 months or less, an election made not later than 2 months and 15 days after the first day of that year will be timely even if it is made in the following taxable year. Code §1361(b)(4).
2. Once made, the election is effective until it is revoked or terminated. Code §1362(c).

B. Newly Organized Corporations

1. Treas. Reg. §1.1362-6(a)(2)(C) provides that the first month of the first taxable year of a newly organized corporation begins when the corporation has shareholders, acquires assets, or begins doing business, whichever occurs first.
2. A month is a period commencing on the same numerical day of any calendar month as the day of the calendar month on which the taxable year began and ending on the day preceding the numerically corresponding day of the succeeding calendar month.
3. If there is no corresponding day, the month ends on the last day of the succeeding calendar month.
4. For example, if a corporation's first taxable year begins on January 7, each month begins on the seventh day of each calendar month and ends on the sixth day of the succeeding calendar month. An S election will be effective for the corporation's first taxable year only if it is filed within the period beginning on January 7 and ending on March 21.

C. Mechanics of the S election

1. The election is made using a Form 2553. Treas. Reg. §1.1362-6(a)(2).

2. Form 2553 must be filed with the service center where the corporation's annual return (Form 1120S) will be filed. It must be signed by a person who is authorized to sign Form 1120S on behalf of the corporation.
3. A minor error in completing Form 2553 will not invalidate the election.
 - a. In *Thompson v. Commissioner*, 66 T.C. 737 (1976), *acq.*, 1977-2 C.B. 2, the court held that a timely filed election was valid even though it showed an erroneous effective date.
 - b. If facts are set out on Form 2553 but are not relevant to the corporation's qualification to make the election or to the validity of the shareholders' consents, and the facts are subsequently changed, the change will not invalidate the election.
 - i. Thus, in Rev.Rul. 74-150, 1974-1 C.B. 241, an election was held valid even though the corporation issued fewer shares than shown on the Form 2553.
 - ii. Likewise, in *Leve v. Commissioner*, 49 T.C.M. (CCH) 1575 (1985), the court held that an election was valid even though boxes requesting the dates the corporation first had assets and shareholders and began doing business were not completed. The court reasoned that the purpose of that information is to determine if the election was timely filed. In light of the fact that the election form indicated the date of incorporation and that the sole shareholder acquired his stock on that date, the failure to complete the boxes did not hinder the determination of whether the election was timely filed.
 - iii. Similarly, in Rev.Rul. 66-68, 1966-1 C.B. 197, the IRS ruled that an election was not invalidated by the subsequent adoption of a fiscal year different from that specified on the Form 2553.
4. If the election is filed by mail and received by the IRS, it is deemed filed on the date of the postmark on the envelope. Code §7502(a). If the election is sent by registered mail, the registration is prima facie evidence that it was delivered to the IRS and the date of registration is deemed the postmark date. Code §7502(c)(1). If the election is sent by certified mail, the postmark on the receipt is deemed the postmark date on the envelope. Code §7502(c)(2).
5. Use of a private delivery service (PDS) designated by the IRS is treated the same as use of the U.S. Mail; the election is deemed filed on the date recorded electronically in the designated PDS's database or on the date on the cover in which the election is filed. Code §7502(f). In Notice 2004-83, 2002-2 C.B. 1030, the IRS designated the following PDSs, effective September 5, 2002:

- a. DHL Express: DHL Same Day Service, DHL Next Day 10:30 am, DHL Next Day 12:00 pm, DHL Next Day 3:00 pm, and DHL 2nd Day Service;
 - b. Federal Express: FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2 Day, FedEx International Priority, and FedEx International First; and
 - c. United Parcel Service: UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus and UPS Worldwide Express.
6. Use of any other delivery service by the above entities, or use of any other PDS, is not treated as use of the U.S. Mail.

D. Shareholder Consents

1. All shareholders must consent to the election. Code §1362(a)(2).
 - a. When stock is jointly owned, whether as community property or by tenants in common, joint tenants, or tenants by the entirety, each person having a community interest or each tenant must consent. This includes husbands and wives even though they are considered one shareholder for purposes of the 100-shareholder limitation.
 - b. Each beneficiary of a voting trust must consent, as must the beneficiary of a QSST or the deemed owner of a grantor-type trust.
 - c. Minors may consent on their own or by their legal guardian (or by their natural guardian).
 - d. The trustee of an ESBT consents on behalf of the ESBT, and an estate's consent is made by the executor or administrator. Treas. Reg. §1.1362-6(b)(2).
 - e. Although there is no specific authority addressing the issue, a tax-exempt organization should consent by an officer of that organization and a qualified retirement plan by a trustee of the trust established under such plan that holds the stock of the S corporation.
2. If the election is made after the first day of the taxable year but before the 15th day of the 3rd month, the election will not be effective for that year unless everyone who held stock during that period consents to the election. Code §1362(b)(2).
3. If the election is made before the first day of the corporation's taxable year for which the election is to be effective, consents of persons who become

shareholders after the election is filed are not required. Treas. Reg. §1.1362-6(b)(3).

4. The consent of all shareholders may be incorporated in one statement. Whenever possible, the shareholders should consent to the S election on Form 2553 rather than on a separate statement. This reduces the possibility of an inadvertent failure to obtain and file all of the necessary consents.

II. Late elections

A. IRS authority to accept late elections

1. The IRS can treat a late election as timely filed if it determines there was reasonable cause for failing to timely elect S status. Code §1362(b)(5). Although this authority was granted by the Small Business and Job Protection Act of 1996, it is effective retroactive to taxable years beginning after December 31, 1982.
2. The basic method to obtain this relief is to request a private letter ruling, which entails payment of a user fee. Rev.Proc. 97-40, 1997-2 C.B. 488.
3. However, the IRS has issued procedures under which relief can be requested from the appropriate service center, thereby avoiding the user fee. Rev.Proc. 2003-43, 2003-1 C.B. 998; Rev.Proc. 97-48, 1997-2 C.B. 521. Revenue Procedure 2003-43 also applies to late qualified Subchapter S trust (“QSST”), electing small business trust (“ESBT”), and qualified Subchapter S subsidiary (“QSub”) elections.

B. Revenue Procedure 2003-43

1. Under Rev.Proc. 2003-43, a corporation’s late election, or a late QSST, ESBT, or QSub election, will be accepted if the following requirements are met:
 - a. The entity fails to qualify for its intended status as an S corporation, ESBT, QSST, or QSub on the first day that status was desired solely because of the failure to timely file the appropriate election with the applicable service center;
 - b. Less than 24 months have passed since the original due date of the election;
 - c. Either -
 - i. The entity is seeking relief for a late S corporation or QSub election and the entity has reasonable cause for its failure to make the timely election; or

- a. If the entity seeking the election has not filed a tax return for the first taxable year of the intended election, the entity may request relief for the late election by filing with the applicable service center the properly completed election forms.
 - b. The election forms must be filed within 18 months of the original due date of the intended election (but in no event later than 6 months after the due date of the tax return (excluding extensions) of the entity (in the case of QSubs, the due date of the tax return of the parent) for the first year in which the election was intended) and must state at the top of the document “FILED PURSUANT TO REV.PROC. 2003-43.”
 - c. Attached to the election form must be a statement establishing either reasonable cause for the failure to file the election timely (in the case of S corporation or QSub elections) or a statement establishing that the failure to file the election was inadvertent (in the case of ESBT or QSST elections.)
4. Procedure if tax returns filed
- a. If the entity seeking the election has filed a tax return for the first taxable year of the intended election within 6 months of the due date of that tax return (excluding extensions), then the entity may request relief for the late election by filing with the applicable service center the properly completed election forms and the supporting documents described below.
 - b. The election forms must be filed within 24 months of the original due date for the election and must state at the top of the document “FILED PURSUANT TO REV.PROC. 2003-43.”
 - c. Attached to the election form must be a statement establishing either reasonable cause for the failure to file the election timely (in the case of S corporation or QSub elections) or a statement establishing that the failure to file the election timely was inadvertent (in the case of ESBT or QSST elections).
5. Additional Documents
- a. An entity seeking relief for a late S corporation election must file a completed Form 2553, signed by an authorized officer of the corporation and all persons who were shareholders at any time during the period that began on the first day of the taxable year for which the election is to be effective and ends on the day the election is made.
 - b. The completed election form must include the following material:

- i. Statements from all shareholders during the period between the date the S corporation election was to have become effective and the date the completed election was filed that they have reported their income (on all affected returns) consistent with the S corporation election for the year the election should have been made and for all subsequent years; and
 - ii. A dated declaration signed by an officer of the corporation authorized to sign that states, “Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete.”
- c. The trustee of an ESBT or the current income beneficiary of a QSST must sign and file the appropriate election with the applicable service center. The completed election form must include the following material:
- i. A statement from the trustee of the ESBT or the current income beneficiary of the QSST that includes the information required by Treas. Reg. §1.1361-1(m)(2)(ii) (in the case of ESBT elections) or §1.1361-1(j)(6)(ii) (in the case of QSST elections);
 - ii. In the case of a QSST, a statement from the trustee that the trust satisfies the QSST requirements of Code §1361(d)(3) and that the income distribution requirements have been and will continue to be met;
 - iii. In the case of an ESBT, a statement from the trustee that all potential current beneficiaries meet the shareholder requirements of Code §1361(b)(1) and that the trust satisfies the requirements of an ESBT under Code §1361(e)(1) other than the requirement to make an ESBT election;
 - iv. A statement from the trustee of the ESBT or the current income beneficiary of the QSST that the beneficiary or trustee acted diligently to correct the mistake upon its discovery;
 - v. Statements from all shareholders during the period between the date the S corporation election terminated or was to have become effective and the date the completed election was filed that they have reported their income (on all affected returns) consistent with the S corporation election for the year the election should have been made and for all subsequent years; and
 - vi. A dated declaration, signed by the trustee of the ESBT or the current income beneficiary of the QSST, that states, “Under penalties of perjury, I declare that, to the best of my knowledge and belief, the

facts presented in support of this election are true, correct, and complete.”

- d. An S corporation seeking relief for a late QSub election for a subsidiary must file a completed Form 8869, which is available in fillable and printable format at www.irs.gov. The completed election form must include the following material:
 - i. A statement that the corporation satisfies the QSub requirements of Code §1361(b)(3)(B) and that all assets, liabilities, and items of income, deduction, and credit of the QSub have been treated as assets, liabilities, and items of income, deduction, and credit of the S corporation (on all affected returns) consistent with the QSub election for the year the election was intended and for all subsequent years;
 - ii. A dated declaration signed by an officer of the S corporation authorized to sign that states, “Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete.”

C. Revenue Procedure 97-48

- 1. If relief is not granted under Rev. Proc. 2003-43 for a late S election, automatic relief under Rev.Proc. 97-48, 1997-2 Cum.Bull. 521, may be available. However, Rev.Proc. 97-48 applies only in two situations.
- 2. Situation 1
 - a. In the first situation, the following conditions must be met:
 - i. The corporation fails to qualify as an S corporation solely because the Form 2553 was not filed on time;
 - ii. The corporation and all of its shareholders reported their income consistent with S corporation status for the taxable year the S election should have been made and for every subsequent year;
 - iii. At least six months have elapsed since the date on which the corporation filed its tax return for the first taxable year it intended to be an S corporation; and
 - iv. Neither the corporation nor any of its shareholders was notified by the IRS of any problem regarding the S corporation status within six months of the date the Form 1120S for the first taxable year was timely filed.

- b. To obtain automatic relief, the corporation must file with the applicable service center a Form 2553 signed on behalf of the corporation and by all persons who were shareholders at any time during the period the corporation intended to be an S corporation.
- c. The Form 2553 must state at the top, "FILED PURSUANT TO REV.PROC. 97-48."
- d. Attached to the Form 2553 must be a dated declaration signed on behalf of the corporation and all persons who were shareholders at any time during the period that the corporation intended to be an S corporation, attesting (but, in the case of a shareholder, only with respect to that shareholder) that -
 - i. The corporation and the shareholder reported their income consistent with S corporation status for the year the S corporation election should have been made, and for every subsequent taxable year; and
 - ii. "Under penalties of perjury, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete."

3. Situation 2

- a. In the second situation, automatic relief is available if the following conditions are met:
 - i. The corporation fails to qualify as an S corporation solely because the Form 2553 was not filed on time for a taxable year that began prior to January 1, 1997;
 - ii. The corporation received notification from the IRS that the Form 2553 was not filed timely, that the corporation must file as a C corporation for the first taxable year the corporation intended to be an S corporation, and that the election would be treated as an S corporation election for the following taxable year;
 - iii. The corporation and all of its shareholders reported their income properly treating the corporation as a C corporation for the first taxable year the corporation intended to be an S corporation;
 - iv. The corporation and all of its shareholders reported their income consistent with S corporation status for all subsequent years;
 - v. The period of limitations on assessment has not lapsed for any of the taxable years of the corporation beginning on or after the date the corporation intended to be taxable as an S corporation; and

- vi. The period of limitations on assessment has not lapsed for any taxable year of any of the corporation's shareholders in which any taxable year described above ends.
- b. To obtain relief, the corporation must file with the applicable service center a completed Form 2553 signed on behalf of the corporation and all persons who were shareholders at any time during the period that the corporation intended to be an S corporation.
- c. The Form 2553 must state at the top, "FILED PURSUANT TO REV.PROC. 97-48."
- d. Attached to the Form 2553 must be a dated declaration signed on behalf of the corporation and all persons who were shareholders at any time during the period that the corporation intended to be an S corporation, attesting (but, in the case of a shareholder, only with respect to that shareholder) that -
 - i. The corporation and the shareholders reported their income (on all affected returns) consistent with the requirements for automatic relief under the revenue procedure;
 - ii. The corporation and the shareholders agree to amend their tax returns for the first year and any other affected returns to reflect S corporation status; and
 - iii. "Under penalties of perjury, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete."
- 4. A corporation qualifying under either of these situations will be deemed to have reasonable cause for the failure to file a timely S election and will automatically be granted relief to file the S election effective on the date that it intended to have the S election become effective.
- 5. The IRS will notify the corporation of the acceptance of its late S election under the Revenue Procedure or the denial of a request that fails to satisfy the requirements of the Revenue Procedure.

III. Extensions of Time To File Consents

- A. If an election is filed timely by the corporation but a shareholder fails to consent within the required time, an extension of time to file the consent will be granted if
 - 1. It is shown to the satisfaction of the district director or director of the service center that there was reasonable cause for failing to file the consent on time;

2. The request for the extension is made within a reasonable time under the circumstances; and
 3. The interests of the government will not be jeopardized. Treas. Reg. §1.1362-6(b)(3)(iii).
- B. If an extension of time is granted, proper consents must be filed within the extended period of time granted by the director by all persons who were shareholders at any time during the period beginning on the date of the invalid election and ending on the date on which the extension of time is granted and by all persons who did not previously consent to the election.

IV. Termination of S election

A. In general

1. Once an S election is made, it continues until either
 - a. It is revoked;
 - b. The S corporation ceases to be a small business corporation; or
 - c. The S corporation has Subchapter C earnings and profits and its passive investment income exceeds 25 percent of its gross receipts for three consecutive years. Code §1362(d).
2. Under prior law, the S election would terminate if a new shareholder, regardless of the number of shares owned, affirmatively refused to consent to the continuation of the S election. Code §1372(e)(1) (prior to its amendment by Subchapter S Revision Act of 1982). Under current law, a new shareholder cannot do so. Rather, if a new shareholder wants to terminate the S election, it must obtain the consent of a sufficient number of shareholders to revoke the election or transfer at least one share to a person or entity not qualifying to be an S corporation shareholder.
3. However, there is one situation in which an individual owning less than 50 percent of the stock can revoke the S election. When an individual becomes a successor beneficiary of a qualified Subchapter S trust, the QSST election continues unless the new beneficiary affirmatively refuses to consent to the QSST election. Treas. Reg. §1.1361-1(j)(9). Thus, if the trust does not otherwise qualify to be a shareholder of an S corporation, the refusal to consent to the QSST election will terminate the S election.

B. Revocation of the S election

1. An S corporation can revoke its S election.

2. Revocation also requires the consent of shareholders owning more than one half of the S corporation's stock on the day the revocation is made.
3. Effective date of revocation
 - a. A revocation made on or before the 15th day of the 3rd month of the taxable year is effective as of the first day of the taxable year.
 - b. A revocation made during the taxable year but after the 15th day of the 3rd month is effective on the first day of the following taxable year. Code §1362(d)(1).
 - c. However, an S corporation can specify an effective date for the revocation as long as it is after the date the revocation is filed. Treas. Reg. §1.1362-2(a)(2)(ii).
4. An S corporation may rescind a revocation at any time before the revocation becomes effective. A rescission may be made only with the consent of each person who consented to the revocation and each person who became a shareholder during the period beginning on the day after the date the revocation was made and ending on the date on which the rescission is made.

C. Termination by ceasing to be a small business corporation

1. An S election terminates whenever the S corporation ceases to be a small business corporation. Code §1362(d)(2). To qualify as a small business corporation, the corporation must:
 - a. Not be an ineligible corporation;
 - b. Be a domestic corporation;
 - c. Not have more than 100 shareholders;
 - d. Have as shareholders only individuals, estates, certain trusts, certain tax-exempt organizations, and certain qualified retirement plans;
 - e. Not have as a shareholder a nonresident alien; and
 - f. Have only one class or stock. Code §1361(b)(1).
2. Thus, an S election will terminate if only one share of stock is transferred to a non-qualifying shareholder, to a 101st shareholder, or to a nonresident alien; the S corporation issues a prohibited second class of stock; or it becomes an ineligible corporation.
3. Effective date of termination

- a. If an S election terminates because it ceases to be a small business corporation, the termination is effective as of the date on which the event causing the failure occurs. Treas. Reg. §1.1362-2(b)(2).
- b. If a corporation elects to be an S corporation effective beginning with the following taxable year and is not a small business corporation on the first day of that following taxable year, the election is treated as having terminated on that first day.
- c. If a corporation is a small business corporation on the first day of the taxable year for which its S election is effective, its election does not terminate even if it was not a small business corporation during all or part of the period beginning after the date the election was filed and ending before the first day of the taxable year for which the election is effective.
Id.

D. Termination due to excess passive income

- 1. An S election terminates if the S corporation has Subchapter C earnings and profits at the close of each of three consecutive taxable years and its passive investment income exceeds 25 percent of its gross receipts for each of those taxable years. Code §1362(d)(3).
- 2. A termination under this rule is effective on the first day of the first taxable year beginning after the third consecutive taxable year.
- 3. A prior taxable year is not taken into account unless it began after December 31, 1981, and the corporation was an S corporation for that taxable year. Code §1362(d)(3)(A)(iii).
- 4. Effective for taxable years beginnings after December 31, 2004, passive investment income of a bank (as defined in Code §581), a bank holding company (as defined in Section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a))), or a financial holding company (as defined in Section 2(p) of that Act) does not include (1) interest income or (2) dividends on assets required to be held by the bank or company. This includes stock in the Federal Reserve Bank, Federal Home Loan Bank or Federal Agricultural Mortgage Bank, or participation certificates issued by a Federal Intermediate Credit Bank. Code §1362(d)(3)(F), as amended by AJCA.

V. Inadvertent terminations

A. Authority to disregard an inadvertent termination

- 1. A corporation will continue as an S corporation during the period specified by the Commissioner if:

- a. The corporation made a valid S election and the election terminated;
 - b. The Commissioner determines that the termination was inadvertent;
 - c. Steps were taken by the corporation to return to small business corporation status within a reasonable period after discovery of the terminating event; and
 - d. The corporation and shareholders agree to adjustments the Commissioner may require for the period. Code §1362(f); Treas. Reg. §1.1362-4(a).
2. Although the determination of whether a termination was inadvertent is made by the Commissioner, the corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. Treas. Reg. §1.1362-4(b).
 3. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent. *Id.*
- B. Procedure to seek inadvertent termination relief
1. Inadvertent termination relief is requested in the form of a ruling request.
 2. The request should set forth all relevant facts, including but not limited to, the date of the corporation's S election, a detailed explanation of the event causing termination, when and how the event was discovered, and the steps taken to return the corporation to small business corporation status. Treas. Reg. §1.1362-4(c).
- C. Required adjustments
1. The Commissioner may require any adjustments that are appropriate. Treas. Reg. §1.1362-4(d).
 2. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified by the Commissioner.
 3. When stock was transferred to an ineligible shareholder, the Commissioner may require the ineligible shareholder to be treated as a shareholder of an S corporation during the period the ineligible shareholder actually held stock in the corporation.

4. Moreover, the Commissioner may require protective adjustments that prevent any loss of revenue due to a transfer of stock to an ineligible shareholder (as, for example, a transfer to a nonresident alien). *Id.*

D. Required consents

1. The corporation and all persons who were shareholders of the corporation at any time during the period specified by the Commissioner must consent to any adjustments that the Commissioner may require. Treas. Reg. §1.1362-4(e).
2. Each consent must be in the form of a statement agreeing to make the adjustments. The statement must be signed by the shareholder (in the case of shareholder consent) or a person authorized to sign the return required by Code §6037 (in the case of corporate consent).

E. Status during interim period

1. The status of the corporation after the terminating event and before the determination of inadvertence is determined by the Commissioner. Treas. Reg. §1.1362-4(f).
2. Inadvertent termination relief may be granted retroactive for all years for which the terminating event was effective, in which case the corporation is treated as if its election had not terminated.
3. Alternatively, relief may be granted only for the period in which the corporation again became eligible for S corporation treatment, in which case the corporation is treated as a C corporation during the period for which the corporation was not eligible to be an S corporation. *Id.*

VI. Rescission

A. In general

1. Another means of preserving an S election is to rescind the transaction which resulted in loss of the election. This could include:
 - a. Transfers of stock to ineligible shareholders.
 - b. Issuance of a prohibited second class of stock.
2. If a rescission qualifies, it is not necessary to convince the IRS that the event causing loss of the S election was inadvertent. In Ltr. Rul. 200533002 discussed below, the issuance of the preferred stock which resulted in the loss of the S election was intended by all of the parties, and the rescission transaction resulted from disagreements between the common and preferred shareholders, as opposed to a desire to reestablish the corporation's S status.

B. Revenue Ruling 80-58, 1980-1 C.B 181

1. In this Ruling the IRS ruled on whether a rescission would void an initial transfer in two situations.
 - a. Each situation involved a sale of real estate where the buyer had the right to rescind the contract if zoning changes were not obtained.
 - b. In both situations the zoning changes could not be obtained and the buyer rescinded the contract.
 - c. In both situations the purchaser received back all amount expended in connection with the transaction.
 - d. In situation 1 the rescission occurred in the same taxable year as the original sale.
 - e. In situation 2 the rescission occurred in the following year.
2. The IRS ruled that in situation 1 the rescission was effective since it occurred in the same taxable year as the original sale.
3. However, since the rescission in situation 2 occurred in the subsequent taxable year, under the annual accounting principle the rescission was not effective to result in disregarding the original sale.

C. Two requirements must be met for the rescission to result in disregarding the original transaction.

1. The rescission must occur in the same year in which the original transaction occurred.
2. The rescission must restore the parties to the positions they would have occupied had the original transaction not occurred.

D. Private Letter Ruling 200533002

1. Facts
 - a. An S corporation issued preferred stock to three partnerships to raise capital for use in the S corporation's business.
 - b. Following the issuance of the shares (and the loss of the S election), disputes arose between the common and preferred shareholders.
 - c. As a result, within the same taxable year that the preferred shares were authorized and issued, the shares were repurchased from the three partnerships.

- d. It was represented that during the time that the preferred shares were outstanding, no distributions were made to any of the shareholders.
2. The ruling concluded that since the rescission occurred in the same year in which the preferred shares were issued, and since no distributions were made to any of the shareholders during the time the preferred shares were outstanding, under the authority of Revenue Ruling 80-58, the rescission was effective to result in the complete disregard of the issuance of the preferred shares.
3. The ruling also note that all of the common shareholders would be treated as owners of 100% of the S corporation during the period that the preferred shares were actually outstanding and be required to report their allocable share of that income on their individual tax returns for that year.
4. Query: If distributions had been made to the preferred shareholders and the preferred shareholders returned the distributions to the S corporation, would the rescission still be effective? In Rev. Rul. 80-58 it was noted that the purchaser of the property received back all amounts expended in connection with the transaction.

VII. Election after termination

A. In general

1. If an S election is terminated, the corporation, or any successor corporation, cannot make a new S election until after the fifth taxable year after the termination.
2. However, an election can be made earlier with the consent of the Commissioner. Code §1362(g).
3. A corporation may, without requesting the Commissioner's consent, make a new S election before the five-year period expires if the termination occurred because the corporation revoked its election effective on the first day of the first taxable year for which its election was to be effective or failed to meet the definition of a small business corporation on the first day of the first taxable year for which its election was to be effective. Treas. Reg. §1.1362-5(c).

B. Authority of Commissioner

1. The corporation has the burden of establishing that, under the relevant facts and circumstances, the Commissioner should consent to a new election.

2. The fact that more than 50 percent of the stock in the corporation is owned by persons who did not own any stock in the corporation on the date of the termination tends to establish that consent should be granted.
 3. In the absence of this fact, consent ordinarily is denied unless the corporation shows that the event causing termination was not reasonably within the control of the corporation or shareholders having a substantial interest in the corporation and was not part of a plan on the part of the corporation or of such shareholders to terminate the election. Treas. Reg. §1.1362-5(a).
- C. To obtain the Commissioner's consent, a request for a private letter ruling must be submitted.

VIII. Other situations where the existence of the S election is important.

- A. There are a number of situations in which verification of the validity of an S election can be important. These generally relate to various corporate transactions, and can have an economic impact on both the seller and the buyer.
- B. Asset Sales
1. Where an S corporation will sell assets, the validity of the S election is critical to avoid the double tax otherwise inherent in a corporate sale of assets followed by a liquidation of the corporation.
 2. This is generally an issue that the shareholders of the S corporation face.
 3. However, if the loss of the S election becomes known prior to the seller prior to the closing of the sale, the seller may attempt to renegotiate the terms of the transaction to reduce the additional tax costs that may be incurred.
- C. Built-in gains tax
1. The built-in gains tax under Section 1374 applies to corporations that have converted from C to S status. However, the tax does not apply to an S corporation that has always been an S corporation.
 2. In general, if assets owned at the time of the S election are sold within ten years of the S election, a portion of the gain on the sale of those assets may be subject to tax at the corporate level.
 3. If a selling S corporation is relying on its election having been in effect for more than 10 years, it is critical for the seller to ensure that its S election has been effective for the entire 10-year period.
 4. As with an asset sale, this is generally an issue faced by the seller.

5. However, if the seller discovers it is subject to the built-in gains tax, it may attempt to renegotiate the purchase price to account for any additional taxes that will be incurred.

D. Section 338(h)(10) elections

1. Under Section 338(h)(10), where stock of an S corporation is purchased, the buyer and the seller can jointly elect to treat the transaction as if the S corporation had sold its assets to the buyer and then liquidated.
2. The advantage is that even though stock is being purchased, the inside basis of the assets of the S corporation will be stepped-up to the purchase price paid for the stock, while the seller will generally recognize only minimal additional tax as a result of the election.
 - a. This additional tax would result from the possible characterization of a portion of the gain on the deemed asset sale as depreciation recapture (taxable at ordinary income rates).
 - b. Generally, any additional tax cost may result in some renegotiation of the purchase price since the purchaser could obtain a significant tax advantage from obtaining increased tax basis in depreciable and amortizable assets (including goodwill amortizable over 15 years under Section 197).
3. For a 338(h)(10) election to be effective, the corporation must be an S corporation. Therefore, it is critical from the buyer's standpoint that the S election is valid. This will necessitate sufficient due diligence on its part to ensure that the S election is effective and valid.

E. Sale of stock

1. A buyer of stock in an S corporation may do so only with the intention that the S election will continue following his or her purchase of the stock. Further, the buyer may have arrived at the purchase price based on the fact that the corporation is an S corporation. Therefore, it is critical that the buyer ensure that the S election is effective.
2. The seller is also impacted by this issue. The basis for her stock will be determined based upon the flow-through of the income that has been allocated to her during the time that the S election is effective, as well as any distributions she received. If the S election has terminated, there may be less basis for the shares that are being sold, thereby resulting in increased tax liability to the seller. Therefore, the seller is similarly interested ensuring that the S election has not terminated.

- F. Attached as Exhibit A is a checklist that can be used in corporate transactions involving S corporations

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