



SEATA Presentation

S Corporations

Formation and

Termination



IRC §1361(a)(1)

Defines an “**S corporation**”, with respect to any taxable year, as a **small business corporation** for which an **election** under IRC §1362(a) is in effect.

ELIGIBILITY

Small Business Corporation

**IRC §1361(b)(1) defines a
Small Business Corporation
as –**

- **a domestic corporation ,**
- **which is not an ineligible corporation,**

AND

ELIGIBILITY

Small Business Corporation

Does **not** have:

- as a shareholder a person who is not an individual (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)),
- a nonresident alien as a shareholder,
- more than 100 shareholders,
- more than 1 class of stock.



S Corporation Requirements

- **Domestic Corporation**
- **Allowable Shareholders**
- **No More Than 100 Shareholders**
- **One Class of Stock**
- **Not an Ineligible Corporation**



Allowable Shareholders

- **Individuals who are U.S. citizens or resident aliens,**
- **Estates,**
- **Certain domestic trusts,**
- **Pension plans under IRC §401(a) (including ESOPs), or**
- **IRC §501(c)(3) charitable organizations.**

S Corporation Election, Form 2553



During the preceding year or the current year - within 2 months and 15 days after tax year begins.

A new corporation's tax year begins the earliest of when the corporation:

- **Issues shares,**
- **Acquires property, or**
- **Commences business.**



S Corporation Election

Election to be effective:

- Corporation must meet **ALL** eligibility requirements on **each day** of the election year, including the pre-election period,
- Corporation must meet eligibility requirements on the **day the election is filed** if filed in the year preceding the election year, and
- **ALL** shareholders must consent.



Elections in Addition to Form 2553

- **QSST** – Beneficiary files election statement. IRC §1361(d)(2) and Treas. Reg. §1.1361-1(j)(6)(iii).
- **ESBT** – Trustee files election statement. Treas. Reg. §1.1361-1(m)(2)(iii).
- **QSub** – Corporation files Qualified Subchapter S Subsidiary Election, Form 8869. Treas. Reg. §1.1361-3.
- **LLC** – Files Form 8832 , Entity Classification Election, to be taxed as a corporation.



Calendar Year Exceptions

Small Business Corporation, must have election in effect and a permitted tax year.

Calendar Year Unless

- **> 50% of shareholders have the same fiscal year as the corporation,**
- **Natural business year exception,**
- **Business purpose exception, or**
- **Tax deposit is made with IRC §444 Election (Year ending September, October or November).**



Relief for Late Elections

- **Revenue Procedure 2003-43**
 - **Entity fails to file the appropriate election timely**
 - **Attach statement to Form 2553 to request relief**
 - **Must be filed within 24 months of the due date of the election**

S Corp return filed – No valid election



- **If no valid election on file, the service center cannot process the Form 1120S**
- **Service Center sends letter to taxpayer**
 - **Taxpayer can respond and ratify the election via Rev. Proc 2007-62 (if within 6 months of due date of return)**
 - **If no response, service center converts return to C Corp and assesses tax at corporate level; but no adjustments are made by service center at the shareholder level**



Relief for Late Elections

- **Revenue Procedure 2007-62**
 - **Allows election to be made on the first filed Form 1120S**
 - **Must be filed within 6 months of due date of tax return (i.e. 9/15 for 3/15 due date)**
 - **Request relief on Form 2553 (Part 1, Line H)**



Inadvertent Invalid S Elections

- **IRC 1362(f)**
 - **Granted by National Office (service center cannot grant this relief)**
 - **Request Private Ruling for relief (procedures in Rev. Proc 2009-1)**
 - **Too many shareholders**
 - **Invalid shareholder, etc.**



Terminations

Election terminated when the corporation:

- 1. Voluntarily revokes the election, or**
- 2. Involuntarily by the corporation ceasing to be a small business corporation, or**
- 3. When passive investment income exceeds 25% of gross receipt for 3 consecutive years **AND** the corporation has accumulated earnings and profits.**



Effect of Mid-Year Termination

- **Corporation files 2 short period returns,**
 - **Short S Year and Short C Year**
- **All income and deductions are split:**
 - **Pro-rata allocation method, or**
 - **Interim closing method (IRC 1377(a)(2))**
- **Both (S corporation and C corporation) returns are due on the “corporate” due date, and**
- **C corporation tax determined on an annualized basis.**



Allocation of Items

- **No change in ownership:**
 - **Based on percentage of ownership.**
- **Change in ownership:**
 - **Per-share per-day allocation method, or**
 - **Interim closing of the books method (if elected).**



Per Day Allocation

- **Equal amount of items to each day.**

- determine all amounts (income, loss, deduction, or credit) for entire year then allocate throughout the year on a daily basis

- Termination on February 22; then allocation to short S Year is

- 52 days/365 days X Total income for entire year; remainder is reported on short C Year return.

- **Change in ownership – pro rata share.**

- $\% \text{ shares owned} \times \% \text{ year owned} = \text{Overall \% Owned} \times \text{Taxable Income/Loss Item} = \text{Amount Reported}$



Interim Closing of the Books

- **Election must be filed with return,**
- **All affected parties must consent,**
- **Divide year into two short taxable years (both returns due on 3/15)**
 - **S Termination short year ends on day prior to termination event**
 - **C Corporation short year begins day of termination event and ends 12/31**