

Insights

Failed S Election – Fatal Flaw or Fixable Mistake?

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No one wants an unwelcomed surprise of discovering that the subchapter S election or qualified subchapter S subsidiary (QSub) election made on behalf of your corporation either inadvertently failed at the time of filing or was later inadvertently terminated. This discovery will often come at especially problematic times, such as during the sale of the business.

The consequences of a failed election or inadvertent termination of the subchapter S election or QSub election can be severe. The universal negative consequence comes from the entity being taxed as a C corporation subject to the dreaded “double taxation”, rather than as a pass-through entity. This will almost always give rise to a significant adverse tax impact on both the corporation and its shareholders. As a result, the corporation and its principals may also face problems with breaches of duties to the other shareholders and breaches of representations in contracts, such as loan agreements.

The good news is all is not lost. The Internal Revenue Service (IRS) provides some relief to taxpayers to address a few of the common inadvertent errors so the corporation may still be treated as an S corporation or a QSub (as the case may be).

Common Failures

Failures leading to loss of S corporation or QSub status come most frequently from a handful of causes. Taxpayers fail to make the required filings on a timely basis. Shareholders may be or become ineligible S corporation shareholders. The corporation may have made disproportionate distributions or made other financial arrangements through loans and incentive packages that run counter to the single class of stock requirement.

Those launching the corporation must engage in careful planning at the outset if they want to assure compliance and to benefit from the policy objectives embedded in the S corporation regime. Some of these common failures can be avoided by appropriate structuring, by adopting and following an action plan, by appropriate shareholder undertakings and by educating the owners, directors and officers of the corporation about following protocols that avoid the failure triggers.

Regulatory Relief

The IRS has accommodated inadvertent failures on a case-by-case basis for many years and on a more

general basis since at least 2013. That year, the IRS adopted Revenue Procedure 2013-30 which provides guidance on a simplified method for requesting relief for late filings of the subchapter S election or the QSub election. To obtain relief for a late filing, the taxpayer must submit a completed election form, along with supporting documentation and a statement made by the taxpayer explaining a reasonable cause for the late filing and the actions the taxpayer took to correct the mistake. So long as the applicable requirements are met, relief for a late election will be granted automatically. Note that these filing errors must generally be corrected within three years and 75 days from the start of the year for which the election takes effect.

Last year, the IRS provided additional relief to correct common inadvertent filing errors and terminations associated with S corporations or QSubs and expanded the opportunities under which taxpayers may obtain automatic relief without the need for a private letter ruling (PLR) from the IRS. Under Revenue Procedure 2022-19, automatic relief for a failed filing or termination will be available to the corporation and its shareholders if the following three requirements are met: the circumstances that resulted in the ineffective filing or termination of the election must be inadvertent; within a reasonable time after discovering the error, the taxpayer must take steps to rectify the issue; and lastly, every shareholder who was a shareholder of the corporation at any time during the periods at issue must agree to make the necessary tax adjustments as may be required by the IRS.

If all three requirements are met, automatic relief may be granted to address any of the following circumstances: (1) one class of stock requirement in governing provisions; (2) disproportionate distributions; (3) certain inadvertent errors or omissions on Form 2553 (Election by a Small Business Corporation) or Form 8869 (Qualified Subchapter S Subsidiary Election); (4) missing acceptance letters for subchapter S election or QSub election; and (5) inconsistent filings of federal income tax returns. Additionally, Revenue Procedure 2022-19 provides a procedural process for addressing non-identical governing provisions which would otherwise result in the corporation having more than one class of stock, making it ineligible to be classified as an S corporation.

Let's take a closer look at the specific requirements for relief under Revenue Procedure 2022-19:

“One Class of Stock” Requirement. An S corporation may have only one class of stock. Treasury Regulations indicate that a corporation will be treated as having only one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. While the governing documents of the corporation may provide for identical distributions, other agreements (e.g., buy-sell agreements, agreements restricting transferability, and redemption agreements) could be interpreted as creating a second class of stock. Revenue Procedure 2022-19 indicates that such agreements will not be treated as creating a second class of stock so long as the principal purpose of such agreements is not to circumvent the “one class of stock” requirement, or otherwise modify shareholders’ rights to distribution and liquidation proceeds.

Disproportionate Distributions. A “disproportionate distribution” means a distribution which differs in timing or amount from the distribution with respect to any other share of a corporation’s stock. Revenue Procedure 2022-19 clarifies that if the governing provisions of an S corporation provide for identical distribution and liquidation rights, the IRS will not treat disproportionate distributions that the corporation makes as violating the “one class of stock” requirement.

Inadvertent Filing Errors. An inadvertent error or omission on Form 2553 or Form 8869 does not invalidate the election unless the error or omission relates to shareholder consent, selection of a permitted year, or an officer’s signature. Revenue Procedure 2022-19 provides an opportunity for the taxpayer to fix the election form by submitting a letter to the IRS explaining the error or omission and providing the corrected information.

Similar to late election relief, these filing errors must generally be corrected within three years and 75 days after the effective date. The Revenue Procedure also lays out previous IRS guidance to correct the errors related to shareholder consent, the permitted year, or an officer's signature, including directing the taxpayer to request a PLR once all other avenues of automatic relief have been exhausted.

Missing Acceptance Letters. When a Form 2553 or Form 8869 is filed, the IRS provides a letter acknowledging and accepting the election which should be retained in the taxpayer's records. In the event the letter is missing, Revenue Procedures 2022-19 provides taxpayers with an IRS hotline to obtain a duplicate.

Inconsistent Tax Return Filings. Filing an incorrect federal tax return for a year that is inconsistent with the entity's S corporation or QSub status does not necessarily terminate the subchapter S election or QSub election. For example, filing a Form 1120 instead of a Form 1120-S will not terminate the election and the taxpayer should simply file the appropriate federal income tax return for open tax years which is consistent with its status.

Non-identical Governing Provisions. If an S corporation and its shareholders meet the requirements set forth in the Revenue Procedure, a subchapter S election that is invalid or terminated due to one or more non-identical governing provisions will be treated for Federal income tax purposes as continuing from the date on which the first non-identical governing provision was adopted. The taxpayer must provide a statement describing all relevant facts regarding each non-identical governing provision, how the provision was discovered, and each action taken to correct the provision before discovery is made by the IRS. The corporation and each person who was a shareholder during the relevant timeframe must represent that they acted reasonably and in good faith upon discovery to demonstrate reasonable cause for relief.

Conclusion

Maintaining S corporation status can drive significant value to the corporation and its shareholders, making it a very attractive business structure. However, achieving that favorable status can be challenging, given the multitude of potential pitfalls at inception and throughout the lifecycle of the entity. Fortunately, over the years, the guidance released by the IRS in recognition of the various unintentional errors may provide some relief.

If you have questions about your corporation's eligibility for S corporation status or want to learn more about structuring your entity to achieve your objectives, please contact **Maria M. Vladimirova** or any member of our **Business, Acquisitions, & Securities Practice**.

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