1997

S Corporations

Samuel P. Starr

Repository Citation
http://scholarship.law.wm.edu/tax/340

Copyright c 1997 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.
http://scholarship.law.wm.edu/tax
S Corporation Planning for 1997:
Practical Application of the New Rules

Samuel P. Starr

Coopers & Lybrand L.L.P.

William and Mary Tax Conference
Williamsburg, VA
December 5, 1997
# Table of Contents

<table>
<thead>
<tr>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualified Subchapter S Subsidiaries (QSSSs)</td>
<td>1</td>
</tr>
<tr>
<td>Electing Small Business Trusts (ESBTs)</td>
<td>9</td>
</tr>
<tr>
<td>Banks as S Corporations</td>
<td>13</td>
</tr>
<tr>
<td>Exempt Organization Shareholders</td>
<td>17</td>
</tr>
<tr>
<td>Late or Invalid S Corporation Elections</td>
<td>21</td>
</tr>
<tr>
<td>S Corporation Acquisitions</td>
<td>25</td>
</tr>
</tbody>
</table>
S Corporation Planning for 1997: Practical Application of the New Rules

Samuel P. Starr
Coopers & Lybrand L.L.P.
Washington, DC

I. QUALIFIED SUBCHAPTER S SUBSIDIARIES (QSSSs)

A. In General

1. Elections. Wholly owned domestic subsidiaries of S corporations can make a special election to be treated as a qualified subchapter S subsidiary. See IRC §1361(b)(3)(B). Under this special election, the subsidiary is deemed to liquidate under Section 332 into the parent S corporation. The IRS issued specific instruction for making this election in Notice 97-4, 1997-2 I.R.B. 24. The temporary instructions indicate that Form 966 is to be used, but with some modifications.

Caution should be used in advising or making QSSS elections in conjunction with other reorganizational transactions. The IRS has promised guidance to clear up uncertainties, but as yet it has not been issued.

2. Segregation of Business Liability. S Corporations with lines of business distinguishable by type or region can now segregate the liability of each line using a corporate subsidiary, while getting favorable flow-through treatment for tax purposes. Subsidiaries that have made a QSSS election will be treated as a division of the parent.

B. Existing Consolidated Groups Electing S Status

1. Terminating Consolidated Group. Normally under the consolidated return rules, the termination of a consolidated group is a triggering event for deferred intercompany gains or losses as well as excess loss accounts. Treasury Regulations ("Reg.") §§1.1502-13(d); 1.1502-19(c). Reg. §1.1502-13(j)(6) states however, that if the group terminates because the common parent is the only remaining member, the common parent succeeds to the treatment of the terminating group for purposes of the intercompany transaction rules so long as it neither becomes a member of an affiliated group filing separate returns nor becomes a corporation
described in Section 1504(b). For taxable years beginning after December 31, 1996, Section 1504(b)(8) now excludes S corporations from the definition of an includible corporation eligible to join in the filing of a consolidated return. An S election by the parent will cause a deconsolidation of the group. A potential problem arises due to the timing of events in the QSSS election.

2. QSSS Deemed Liquidation. A QSSS election causes a deemed Section 332 liquidation to occur. This liquidation is deemed to occur immediately before the election is to be effective. The QSSS election is made by the S corporation parent. The S election and subsequent QSSS elections are presumably effective at the same time. A question with respect to the timing of the deemed liquidation creates the following debate. Does the S election cause a deconsolidation before the deemed liquidation; or is the liquidation of the subsidiary deemed to occur immediately before the S election?

Electing S Status for Consolidated Groups

Example: Parent makes an S election and elects to treat S1, S2 and S3 as QSSSs. S1 has deferred gains from prior property sales to S2 (one in 1995, one in 1996) and S2 has an excess loss account in its stock in S3. (All subsidiaries are solvent.)

Question: What happens to deferred intercompany gains and excess loss accounts on electing S/QSSS status?

3. Deferred Intercompany Transactions (DITs). Old Reg. §1.1502-13 provides that a collapsing of a consolidated group into the parent will not trigger the recognition of DITs. In general, old Reg. §1.1502-13 is applicable to pre-1996 DITs. Post-1995 DITS are governed under new
Reg. §1.1502-13. New §1.1502-13 basically follow the old rules except Reg. §1.1502-13(j)(6) was added which provides that DITS are preserved only if the surviving parent does not become a corporation described in Section 1504(b), which now (post 12/31/96) includes an S corporation. Thus under new Reg. §1.1502-13, the conversion of the parent to S status triggers the post-1995 DITS.

It is questionable whether Treasury had contemplated the addition of S corporations to the list of nonincludible corporations under Section 1504 at the time Reg. §1.1502-13(j)(6) was promulgated. If the liquidation of a QSSS is deemed to occur immediately before the S election is effective then the above analysis should apply. (This general explanation applies with respect to DITs arising from intercompany asset transactions. DITs which arise with respect to intercompany stock transactions will always be triggered upon liquidation.)

**Electing S Status for Consolidated Groups with DITs**

- **Pre-July 12, 1995 tax years:** DITs not triggered if subs actually liquidated prior to deconsolidation. Former Treas. Reg. Sec. 1.1502-13(c)(6), (f)(1)(iii) and (f)(2)(ii)(b).
- Former parent can track gains and take them into account when otherwise triggered.
- **Post-July 12, 1995 tax years:** Need to modify Treas. Reg. Sec. 1.1502-13(d)(1) and (j)(1) to provide similar treatment of "new" DITs.
- Other issues
  - exit strategies
  - insolvent subs

4. Excess Loss Accounts (ELAs). Reg. § 1.1502-19 governs the triggering of ELAs. Again, if the liquidation for a QSSS election is deemed to occur immediately before the S election, then the ELAs disappear.
Electing S Status for Consolidated Groups with ELAs

- Will consolidated group's ELAs be triggered into income upon electing S status?
  - Answer not clear; administrative guidance pending
- Are QSSSs deemed liquidated before S election?
  - ELAs are not triggered if subs actually liquidated before deconsolidation. Reg. Sec 1.1502-19(b)(2)(i)
  - Upon deconsolidation, basis in sub stock no longer relevant
  - Gains recognized when sub stock sold

5. Pending Guidance. Treasury however, has the ability to take a technical reading of the current statutes and regulations and treat the common parent's S election as being effective before the deemed liquidation. Subsequently, the consolidated group shall have terminated, thus causing all DITs and ELAs to be triggered as mentioned above. See generally, PLRs 9625024, 9421034, 933022.

This result seems contrary to tax policy since all the assets still remain in a successor corporation (albeit one excluded under Section 1504(b)). In addition, in the "Blue Book" on the Small Business Job Protection Act, the Joint Committee on Taxation appears to indicate, in a footnote to their explanation of the QSSS provisions, that the triggering may not be the desired result.

In the 1997 Tax Relief Act, a technical correction was made to Section 1361(b)(3) by granting Treasury authority to prescribe regulatory exceptions to the general rule. The general rule is that a QSSS election is treated as a liquidation of the subsidiary into the parent for all purposes of the Code.

The Treasury has determined that this is a significant issue and guidance must be issued shortly. Unfortunately, many corporations have already made their S and QSSS elections before guidance has been issued.
At this point in time, it is unclear as to the proper treatment. However S corporations should be advised of the possible triggering. They must then weigh the potential adverse consequences against the benefits they anticipate under S status.

C. Brother/Sister Consolidations

1. Transaction. Many S corporations have appropriately avoided terminating S status under prior law by owning less than 80 percent of another corporation. The other 21 percent of these 79 percent owned subsidiaries is often owned by the shareholders. Under new law, if the S corporation owns 100 percent of a domestic subsidiary, a QSSS election can be made and the subsidiary is generally liquidated tax free under Section 332. What many companies will want to do is to have the shareholders contribute the 21 percent to the S corporation achieving the 100 percent ownership requirement, and then elect QSSS status for the subsidiary. Ideally, the contribution would be governed by Section 351 and the liquidation by Section 332, thus resulting in tax free treatment. Alternatively, a shareholder may wish to contribute the stock of a sister corporation into an S corporation and make an election for the S corporation subsidiary.

Scope of Deemed Consequences of QSSS Election

Step 1:
Stock for Stock

Step 2:
Elect QSSS

Issue:
How far will the application of Secs. 332 and 351 be carried when a QSSS election is made or terminated?

2. "D" Reorganizations. Although not completely clear, the above transactions could be collapsed into one integrated transaction.
According to Rev. Rul. 67-274, 1967-2 CB 141, the acquisition of stock combined with the liquidation of the subsidiary whose stock was acquired will convert the transaction into a direct acquisition of the subsidiary's assets. In the Rev. Rul. 67-274, the transaction resulted in a reorganization under Section 368(a)(1)(C). However, because of the relationship of the corporations through the shareholders in the above fact pattern, the C reorganization is also an acquisitive D reorganization under Section 368(a)(1)(D).

3. Liabilities Exceed Basis. When the liabilities of the target corporation exceed the tax basis of its assets, Section 357(c) requires that gain be recognized in a D reorganization. The gain is equal to the amount that target liabilities assumed by the S corporation exceed the tax basis of target's assets. Although the intended result was a tax-free restructuring under current S corporation rules, an unintended recognition of gain may be the consequence.

### Scope of Deemed Consequences of QSSS Election Analysis

- Rev. Rul. 67-274,
  - "B" with a liquidation is a "C" or "D", and Sec. 357(c) applies
- General Rule: Liquidation treatment for all purposes of Title 26
- Treasury now has authority to carve out exceptions
- Basis for treating it differently
- Guidance or clarification applied prospectively?

The above result for the described transaction is not entirely certain, and guidance regarding the use of QSSSs and transactions involving them has not been issued by the IRS. The analysis is made under the assumption that a QSSS election is literally equivalent to a Section 332 liquidation and that the IRS will integrate a QSSS election with other steps of an overall restructuring.
D. Acquisitions

With the change in the rules which allows an S corporation to own 80 percent or more in another corporation, qualified stock purchases under Section 338(d) do not have to be followed by a liquidation of the target corporation. The S corporation Acquirer can choose between three alternatives after such a transaction:

1. The subsidiary could continue to be treated as a C corporation with a separate tax return filing requirement,
2. The parent could make a QSSS election to treat the subsidiary as liquidated, or
3. The parent could formally liquidate the subsidiary as it would have under the old rules.

Option number (2) will likely provide a very favorable result, as the tax treatment of the acquired business will flow-through to the S corporation shareholders, while the assets and contracts in the acquired company are not transferred for legal purposes.

E. Other Issues

1. Employment Taxes. The IRS has already issued notices to taxpayers filing employment tax returns under a QSSS's TIN, that such filing is inappropriate. The IRS apparently intends to apply the full interpretation of the deemed liquidation to all aspects of the Internal Revenue Code. This means that they will be expecting the employment taxes of the QSSS employees to be reported with the employees of the Parent S corporation.

2. Transfer Taxes. It is uncertain whether some states will attempt to impose a transfer tax on the deemed liquidation of a QSSS. In general, any consideration on the matter should apply the rules associated with the treatment of a deemed asset acquisition under Section 338(h)(10).

3. Expansion of IRS Authority to Deal with QSSS Elections.
   a. Revocation of QSSS Election -- Section 1361(b)(3)(C) provides that a QSSS election will terminate when the corporation no longer meets the requirements to be treated as such. Taxpayers could cause a termination by issuing a nominal percentage interest in the subsidiary to another person. However, the statute and legislative history do not
indicate that a termination could be proactively made by the shareholder through a revocation.

This area is under consideration for separate entity treatment under Treasury regulations.

b. *Waiver or Relief* -- Section 1362(b)(5) grants the IRS authority to treat late S elections as timely when no such election has been made and where the IRS determines there was reasonable cause for the failure to timely file. The IRS has provided guidance and will likely issue regulations to facilitate the application of this authority. (See Ann. 97-4, Rev. Proc. 97-1, Rev. Proc. 97-40, and Rev. Proc. 97-48).

Section 1362(f) grants the IRS authority to treat certain inadvertent invalid S elections and terminations as valid, and to treat such corporation's S election as still in effect. Regulations and procedures for such relief are in effect and are granted on a regular basis.

An S election and a QSSS election share many similar attributes for purposes of eligibility and termination. A QSSS election is also likely to suffer from the pitfalls that Congress intended the above provisions to remedy. A technical correction may be needed to allow the IRS to treat late QSSS elections as timely; to validate inadvertent invalid QSSS elections; and to waive inadvertent terminations of QSSS status. Such a correction could be implemented by incorporating QSSS election relief in the provisions already in place for relief for subchapter S elections.

The IRS has informally indicated that late QSSS elections may receive relief under Section 9100. This does not provide comfort with respect to inadvertent terminations of QSSS status.

c. *Application of At Risk Rules at the QSSS Level* -- The QSSS legislative history indicates that the Treasury Secretary may prescribe guidance on the application of the at-risk rules with respect to QSSSs when a shareholder has loaned money both to the parent and the subsidiary. It is unclear as to what this rule would accomplish. For federal purposes, all the activities of the subsidiary are considered those of the parent, therefore, to the extent a shareholder is at risk with respect to the parent S corporation (including QSSS liabilities), the shareholder should be at risk with respect to the subsidiary's activity. Until Treasury issues any guidance on this matter, this could be the approach taken.
II. ELECTING SMALL BUSINESS TRUST (ESBTs)

A. In General

1. Eligibility. The new law expands the eligible shareholder rules to include "electing small business trusts." The new rules would tax the trust directly but would allow for accumulations and sprinkling of income. The beneficiaries of the trust must themselves be individuals, estates, or public charities. Each beneficiary of the trust is counted as a separate shareholder for purposes of the 75 shareholder limit. In addition, interest in the trust may not be acquired through a purchase. Interests in the trust can be acquired via gift or bequest. Section 1361(e).

The IRS issued guidance on Electing Small Business Trusts (ESBT) in Notice 97-12 and Notice 97-49. The Notices provide guidance for taxpayers making the election prior to the issuance of Regulations under Section 1361(e).

2. Factors on Choosing Which Trust Election to Use.

Choosing between an ESBT and QSST

- **ESBT**
  - Accumulation Features
  - Sprinkle Features
  - Control over distributions
  - Tax born by trust
  - Highest marginal tax rates

- **QSST**
  - Income splitting
  - Mandatory distributions
  - One income beneficiary
  - Tax born by beneficiary
Estate planners are now faced with another alternative for using a trust to facilitate the transfer of S corporation stock to another generation of shareholders. The primary considerations for each alternative are outlined as follows.

a. **ESBT** -- This trust finally allows the grantor to convey S corporation stock through a trust that has accumulation features and sprinkle features. It can be an open ended trust that will include future progeny or generations. While this form of conveyance allows restrictions and control of distributions, it results in a current tax on earnings equal to the highest marginal income tax rate.

b. **QSST** -- This trust is familiar for many S corporation shareholders and provides for a conveyance through trust, limiting control on the stock and with required income distributions. This trust is an effective income splitting trust. However, all trust accounting income must be distributed at least annually to the sole income beneficiary.

B. **Making the ESBT Election**

1. **Format.** Section 1362(e)(3) specifies that the trustee must make the ESBT election by signing and filing with the service center with which the corporation files its income tax return. According to Notice 97-12, the election is made by filing a statement that:

   a. Contains the name, address, and taxpayer identification number of all potential current income beneficiaries, the trust, and the corporation;

   b. Identifies the election as an election made under Section 1361(e)(3);

   c. Specifies the effective date (not more than 2 1/2 months before filing);

   d. Specifies the date that stock was transferred to the trust;

   e. Provides information and representations necessary to show that; A) all potential current beneficiaries meet the shareholder requirements of Section 1361(b)(1); and B) the trust meets the definitional requirements of an ESBT under Section 1361(e).

   **Comment:** This form of election is significantly more complex than originally discussed informally by the IRS. However, the IRS indicates in
the notice that this information is required to assure compliance with the new 1996 provisions.

2. Timing. Similar to QSST elections, the trustee has a 16-day-and-two-month period from the time that S corporation stock is transferred to the trust to file an ESBT election. The election can also be attached to Form 2553 in the case of a newly electing S corporation.

3. Consent to S election. Although Section 1362(a) requires that all shareholders must consent to an S election, Notice 97-12 indicates that only the trustee must sign the consent for an S election with Form 2553. An ESBT trustee's signed consent to the S election is not necessary for existing S corporations.

4. Taxation of the ESBT. Even though only one trust exists for legal purposes, an ESBT will be treated as two separate trusts, i.e., one trust holding S corporation stock (ESBT) and the other trust holding all other assets (remainder trust). The remainder trust will be subject to the normal rules of Subchapter J. An ESBT will be taxed currently, at the highest individual rate, on its share of S corporation income. Gain or loss on the sale of S corporation stock will also be taxed at the trust level. No exemption is allowable against the ESBT's share of S corporation income nor will that income qualify as distributable net income of the trust.

ESBT Beneficiary Analysis

- Statutory language allows only three ESBT beneficiaries:
  - Individuals
  - Estates, and
  - Certain tax-exempt entities

- IRS Notice 97-49 clarified that the definition of a beneficiary does not include a "distributee trust" but rather includes the persons holding such a beneficial interest in the distributee trust.

- Allocations between S and non-S portions of the ESBT
Since an ESBT is taxed at the highest individual rate, the flexibility it affords may not be as advantageous in the case of a beneficiary in a lower tax bracket. The use of a QSST may be more prudent in this situation.

The ordering rules for distributions from an ESBT were clarified in Notice 97-49. The Notice provides that distributions from an ESBT first will be from the trust's distributable net income (which is determined without regard to S corporation items), and then from the fiduciary income from the S portion of the trust. The beneficiary should not be taxed on distributions with respect to ESBT income. Distributions from the remainder trust income would follow the normal Subchapter J rules.

C. Eligible Current Income Beneficiary Issues

1. Trust Beneficiaries.

The language of Section 1361(e)(1)(A) states that the only eligible current income beneficiaries of an ESBT are individuals, estates and certain charitable organizations. Prior to the Service issuing Notice 97-49 there was a valid concern that many estate planning trusts would not meet this requirement because the potential income beneficiaries were other trusts. For example, an intended ESBT's governing instrument provides for discretionary distributions of income or principal to A for life, and upon A's death the division of the remainder into separate trusts for the benefit of A's children.

Notice 97-49 clarified that the term "beneficiary" does not include a distributee trust but does include those persons who have a beneficial interest in the property held by the distributee trust. Therefore, in the example above, A's children (and not the distributee trusts) would be considered the beneficiaries with respect to the eligibility tests of Section 1361(e)(1)(A).

2. Charitable Remainder Trusts.

In the 1997 Tax Relief Act, a technical correction was made to Section 1361(e)(1)(B) which clarifies that a charitable remainder trust defined under Section 644(d) is not eligible for an ESBT election. This resolves any uncertainty raised by practitioners.
III. BANKS AS S CORPORATIONS

A bank (as defined in Section 581) is an eligible small business corporation unless such institution uses a reserve method of accounting for bad debts. Thus a large bank that meets all the subchapter S eligibility requirements and a small bank using the specific charge of method (and also meeting S eligibility requirements) may elect to be treated as an S corporation. Any bank using the bad debt reserve method may consider a change in accounting method to become eligible.

A. S Status is Bank's Only Option for Pass-Through Tax Treatment

The IRS has long protected what it has considered standing intent by Congress: Any entity engaged in banking activities will be taxed as a corporation. Period!

Recent evidence of this practice of preventing pass-through tax treatment to banking businesses includes the following examples:

In PLR 9551032, the IRS determined that the new statutory entity called a Texas Limited Banking Association would not be treated as a partnership, even under the corporate characteristic tests, because it was engaged in banking activities.

Under the "check-the-box" regulations, any federally insured entity carrying on the business of banking is a corporation by default. Reg. §301.7701-2(b)(5).

B. Changing Accounting Method

1. Specific Change Required. One caveat remaining is that an electing institution cannot use a reserve method of accounting for bad debts as defined under Section 585(a). Under Section 585(c), large banks cannot use the reserve method of accounting for bad debts. Thus, large closely held banks, and small banks using the specific charge-off method, that meet all of the subchapter S eligibility requirements may elect to be treated as S corporations.

Observation: Banks using the reserve method desiring to elect S status will need to request permission to change their accounting method to the specific charge-off method.

2. Automatic change in Accounting Method. Revenue Procedure 97-18 1997-10 I.R.B.53, provides guidance on how a bank can seek an automatic method change. The revenue procedure requires that the entity making the method change makes an S election for its first year
beginning after December 31, 1996. Some banks have a holding company which is making an S election as of January 1, 1997 and a qualified subchapter S election for the bank subsidiary. Technically the entity requesting the change in this situation is not making an S election. Informal conversations with the drafter of the rev. proc. have indicated that this was not the intent. One author of the Rev. Proc. has explained that the rev. proc. focuses on single entity banks making an S election and did not intend on excluding the bank subsidiary of a holding company from using the rev. proc. so long as the holding company's S election and the QSSS election will be effective for the first tax year starting after December 31, 1996. In this instance it appears that the bank sub may use the rev. proc. to change its method.

The other requirement is that the method change must be effective for the first tax year beginning after December 31, 1996. The S election (and QSSS election) must also be effective at the same time. In some instances, a subsidiary may not be eligible for a QSSS election to be effective as of January 1, 1997. For example, 100% of the stock may not be owned by the parent S corporation until later in the year. QSSS elections can be retroactive (up to 75 days) however, the sub must have been eligible for all retroactive periods. In this case, there would be a short C year (1/1/97 to the time that all the stock was owned by the parent) and an S year (starting with the effective date of the QSSS election). The method change and tax status conversion must be effective for the first year after December 31, 1996 and therefore, the rev. proc. will not apply in this instance. For the same reason, the rev. proc. will also not apply if an existing S corporation acquires 100% of the stock of an existing bank mid year.

If a company cannot change its method under Rev. Proc. 97-18, then the company can apply to change from the reserve method to the specific charge off method under Rev. Proc. 92-20, 1992-1 CB 685. In general, a Form 3115 must be filed by the company within the first 180 days of the "year of change." If the tax year is a short year, the Form 3115 must be filed not later than last day of the short year, if the short year is less than 180 days. Under certain circumstances, the IRS may (at its discretion) extend these deadlines. The change to the specific charge off method is effective for the first day of the "year of change" (assuming the IRS grants the request). Thus, there is a position that the S election and/or QSSS election could be made for the "year of change." However, the Service could deny an S or QSSS election in this situation, since, at the time the election was made, it was uncertain whether the method change would be granted. Of course, if the method change were not granted, the entity would have been ineligible to make the election.
An existing bank S corporation can acquire 100% of another bank midyear and make a QSSS election for the newly acquired bank provided the S corp bank's method (specific charge off) is the principal method under Section 381 (this would presumably require the S corp bank to be larger than the bank acquired). Under Section 332 and Section 381, the liquidation would cause the method of the sub to change automatically. However, the reserve of the subsidiary would need to be included in income in the year of the liquidation as opposed to the spread available under Rev. Proc. 97-18.

3. Coordination with QSSS Issues. Bank charters generally are entity specific. If the bank is a subsidiary of a bank holding company, the QSSS election will cause all the assets and liabilities of the bank to become those of the holding company. This presumably includes the federal bank charter. Since the entity to which the charter was originally granted is no longer in existence for federal tax purposes, the ability of the holding company to perform banking activities may be in question since the holding company is not explicitly chartered.

S Corporation Banks

- Bank Holding Company
- Separate Recognition of Bank QSSS - Guidance Needed
- Change of Accounting Method
- Thrift Distributions, Sec. 593(e)
- Executive Preferred Shares
In the 1997 Tax Relief Act, a technical correction was made to Section 1361(b)(3) by granting Treasury authority to prescribe regulatory exceptions to the general rule. The general rule is that a QSSS election is treated as a liquidation of the subsidiary into the parent for all purposes of the Code.

The technical correction allows the IRS to create exceptions to the single entity treatment of QSSS and parent S corporations. The IRS has promised that guidance is forthcoming.

4. Thrift Distributions. Section 593(e) imposes an ordering rule for distributions from thrifts which maintain "applicable excess reserves" as defined in Section 593(g)(2)(A)(ii). Distributions of property will be first taken out of accumulated earnings and profits accumulated in taxable years beginning after December 31, 1951. It is unclear if this provision will override the normal ordering rules for S corporation distributions which provide that distributions are made from the Accumulated Adjustment Account and then from earnings and profits.

5. Director Shares. Many state statutes require bank directors to own an interest in the bank. These interests are usually nominal in cases where the director is not a majority owner of the bank or bank holding company. These holding requirements may be satisfied several ways. For example, the director may own stock directly in the bank, own stock in a bank holding company, or even through profit sharing or individual retirement plans. These director shares raise several issues. An S corporation may not have more than one class of stock therefore these shares must be identical to shares owned by other stockholders. If the director owns stock in a bank subsidiary, a QSSS election will not be possible since a QSSS election requires the parent S corporation to own 100% of the outstanding stock of the subsidiary. If a director holds shares in an IRA, an ineligible shareholder issue arises. Finally, a family-owned bank may not want non-family member directors to share in the profits and distributions of a bank upon the election of S corporation status.
IV. EXEMPT ORGANIZATION SHAREHOLDERS

A. General Rules

Those entities described in Section 401(a) and Section 501(c)(3) will be allowed to be shareholders in S corporations. IRC §1361(c)(7). For purposes of determining the shareholder limit, each qualified tax exempt entity will be considered one shareholder. Items of income which flow through to the entities will be considered unrelated business taxable income (UBTI). In addition, gain or loss on the disposition of the S corporation stock will generate UBTI.

Certain special tax rules relating to ESOPs will not apply with respect to S corporation stock held by the ESOP. These rules include rules relating to certain contributions (Section 404(a)(9)), deductions for dividends paid on employer securities (Section 404(k)), and rollover of gain on the sale of stock to an ESOP (Section 1042). However, additional changes to the law in 1997, make an ESOP a much more viable shareholder and exit vehicle for S corporations.

Several reasons exist for the changes. By allowing pension plans to be S corporation shareholders, the S corporation is able to raise capital more freely. With a current limit of 75 shareholders, employee stock ownership plans (ESOPs) will provide for more employee ownership since an ESOP will only be considered as one shareholder. Allowing charitable organizations to own S corporation stock should increase charitable giving. Estate planning may also be facilitated via the ability to transfer ownership to others through these tax exempt entities.

B. ESOP as Shareholders

Major modifications in 1996, and additional changes in 1997, make an ESOP a possible alternative to transfer part or all of the ownership in an S corporation to employees.

1. No UBIT for S Corporation ESOPs

Tax law changes made in 1996, allow Employee Stock Option Plans ("ESOPs") along with other tax-exempt organizations to own S corporation stock for tax years beginning after December 31, 1997, without terminating the S corporation's status. At that time, the law also directed that all income allocated to the ESOP from the S corporation would be taxable as unrelated business taxable income ("UBTI"), common for other tax-exempt shareholders.
Observation: The effect of this however put a double tax on the S corporation earnings attributable to the ESOP because, participants in the ESOP are again taxed when distributions are made. The fact that the S corporation may or may not distribute all of the taxable income creates further problems for ESOPs when distributions must be made to plan participants.

Example: An ESOP owns 100 shares of an S corporation and is allocated $100,000 of taxable income over several years. The S corporation distributes to the ESOP only $50,000 (50% of the taxable income) for that period, and the ESOP pays a tax on its UBTI of $40,000 (40% combined federal and state marginal tax rate). To distribute the remaining $60,000 of increased value to plan participants, the ESOP must liquidate some of its holdings. Furthermore, the plan participants are then taxed on the $60,000 as ordinary income subject to the individual income tax rates which can be as high as 39.6% for federal taxes. Plan participants would ultimately receive less than 50% of the S corporation earnings.

Although the effective date for this 1996 tax law change has not yet arrived, new law repeals the UBIT on ESOP S corporation shareholders. Under the new law, an ESOP will not pay income tax on S corporation earnings allocated to them through stock ownership.

Observation: This provision does not change the rules for other tax exempt shareholders in S corporations. For those shareholders, S corporation income will continue to be UBTI.

Effective Date: The new law would take effect at the same time that ESOPs will become eligible shareholders, which is tax years beginning after December 31, 1997.

2. Other Issues with ESOPs

New law also makes some specific changes for S corporation ESOPs that allow them to distribute cash to shareholders, and remove some restrictions on the prohibited transactions. Both of these changes were required in order to make ESOPs practical for S corporations.

Section 404(a)(9) increases the deduction limit for contributions to pay down principle on stock acquisition loans from 15% to 25% and allows for unlimited deduction of contributions used to pay interest on these loans. The new provisions would disallow these added deductions to S corporation ESOPs. In effect, the amount of debt an ESOP could incur would need to be scaled back in order to allow for the limited
contributions (15% of compensation paid to eligible employees) to service the principal and interest.

*Observation:* As an alternative, S corporation distributions could be made to *all* shareholders, with the ESOP using its distributions to finance the loan. This could put a cash flow constraint on the organization.

Under certain circumstances, Section 1042 allows individuals to postpone realized gain from the sale of stock to an ESOP if the proceeds received are used to purchase qualified replacement property within required time constraints. This provision will not apply to S corporations. S corporation shareholders will be required to recognize currently any gain realized upon the sale of their shares to the S corporation's ESOP.

C. *Tax Treatment to Contributor*

In the case of a contribution of S corporation stock to a public charity, the contributor would currently be allowed a charitable deduction for the full fair market value of the stock. For contributions to other types of tax exempt charitable organizations, such as private foundations, the rules associated with the contribution of non-publicly traded securities would apply.

---

**Exempt Shareholders in S Corporations**

- Larger Tax Deduction for Shareholder
- Charity Taxed on Income
- Charity Taxed on Redemption or Disposition
D. **Tax Treatment to Exempt Organization**

1. **Distributable Income.** Exempt organizations will become eligible S corporation shareholders for tax years beginning after December 31, 1997. They will be required to report any income or loss which flows through to them, including interest and dividends, as unrelated business income (UBTI).

2. **Disposition of Stock.** Any gain on the disposition of the S corporation stock would be treated as unrelated business income. As originally proposed, the qualified tax exempt entity would be required to recognize UBTI on the redemption/disposition of C corporation stock which was an S corporation at any time the organization held the stock. The gain however, would be limited to the gain which would have been recognized had the organization sold the stock on the last day that the corporation was an S corporation.

This section was omitted from the final version of the bill. Although a qualified tax exempt entity will still be required to recognize UBTI on the redemption/disposition of S corporation stock, UBTI will not be recognized on the redemption/disposition of C corporation stock which previously was S corporation stock in the hands of the entity.

E. **Example**

*Example:* S corporation shareholder B is in the top marginal tax bracket (rounded to 40%). B wishes to contribute to a qualified public charity. There are two methods to achieve this. B can have the S corporation redeem shares with a fair market value of $1,000. This transaction will likely qualify as an ordinary distribution causing B to pay $280 of tax (assuming zero basis in the stock). B will then contribute the remaining $720 to the qualified charity. This deduction will cause a reduction in B's tax of $288 with a net tax benefit of $8 to B. On the other hand, B could contribute $1,000 of S corporation stock to the qualified charity. B will recognize a tax savings of $400 ($1,000*40%). The S corporation will subsequently redeem the stock from the qualified charity. The proposed changes will cause the qualified charitable organization to recognize the redemption as UBTI. Assuming other UBTI exists and the qualified organization is in the 35% tax bracket, their will be $350 of tax imposed. From the donor's perspective, the new legislation would give him a far greater deduction. On the other hand, the charity will end up with less after tax dollars.

Charities will likely welcome a charitable contribution of S corporation stock. They typically will be looking at keeping approximately 60% of the fair market value of the S corporation stock contributed. The other 40%
would be paid in income taxes. Sixty percent of something is better than 100% of nothing in everyone's perspective.

F. IRAs Are Still Not Eligible Shareholders

Although the changes which allow other tax exempt organizations to own S corporation stock are relatively broad, individual retirement accounts are still not eligible shareholders. Transferring stock to an IRA will cause a termination of S status for the corporation and can have other significant ramifications on the IRA.

G. Other Issues

Tax exempt entities may be interested in investing in S corporations if the return after taxes on the UBTI is high enough to justify the investment. Private foundations may face problems if related parties are involved, causing self dealing problems. Otherwise, such organizations will likely look elsewhere for investment opportunities.

V. LATE OR INVALID S CORPORATION ELECTIONS

A. General Rules

The IRS is now authorized to waive the effect of invalid elections. Previously, the IRS could only waive inadvertent terminations. The new law also allows the IRS to treat late S elections as timely filed where it determines reasonable cause existed for the failure to timely file.

This change is effective for tax years after December 31, 1982.

B. Scope of Provision

Announcement 97-4 states that taxpayers may seek relief through the ordinary means of a private letter ruling. In the case of inadvertent invalid elections, rules similar to Reg. Section 1.1362-4(c) through (f) must be followed when seeking a private letter ruling request. Such relief will provide such corporations with more security in their S status and allow for more certainty when selling, merging or making acquisitions.

Comment: To obtain relief, reasonable cause must be demonstrated. However, consistent with the legislative history, the "reasonable cause" standard is intended to be somewhat lenient, and consistent with the Services' standard in granting relief for inadvertent termination.
Waivers for Late or Invalid Elections

- Limited Late Election Relief under Rev. Proc. 97-40
- Additional Late Election Relief under Rev. Proc. 97-48 for:
  - Filed Form 1120S, no IRS Notice
  - Filed Form 1120 due to IRS Notice
- Other Relief under Private Letter Ruling Request
- Certainty of S Status is Crucial
  - Initial Public Offerings
  - S Corporation Acquisitions
  - Bank or Venture Financing
- Reasonable Cause Required
  - PLR 9652016 where taxpayer did not know S election was required

C. Late Election Relief - Rev. Proc. 97-40

The Service has issued Revenue Procedure 97-40, 1997-33 I.R.B. 50, which indicates how certain corporations which have inadvertently failed to file Form 2553 on time may receive automatic late filing relief.

In order to obtain relief under Rev. Proc. 97-40, corporation must have failed to file the Form 2553 on time. All other requirements to elect S status must have been met. Relief must be requested within 6 months of the original due date for filing Form 2553. In addition, the due date (determined without regard to extensions) for the first S taxable year must not have passed prior to requesting relief.

Observation: There is no relief for invalid QSSS or ESBT elections under this revenue procedure.

1. Relief may be obtained if the corporation files (within the six months of original due date) a completed Form 2553, including signatures of an
officer and all shareholders (deemed and actual) since the first day of the taxable year for which the election is to be in effect.

2. The Form 2553 should be filed with the applicable service center.

3. "FILED PURSUANT TO REV. PROC. 97-40" should be stated at the top of the Form 2553.

4. A statement explaining the reason for the failure to timely file must be attached to the Form 2553.

5. The IRS will notify each request if it is determined to be reasonable.

6. There is no user fee for relief obtained under this rev. proc. If the corporation is ineligible to use this rev proc it must request relief via a private letter ruling following Rev Proc 97-1

D. Late Election Relief - Rev. Proc. 97-48

The Service has also issued Revenue Procedure 97-48, 1997-43 I.R.B. 19, which indicates how certain other corporations which have inadvertently failed to file Form 2553 on time may receive automatic late filing relief.

Rev. Proc. 97-48 provides special procedures to obtain relief for certain late S corporation elections under the following two situations:

1. A corporation intends (and is eligible) to be an S corporation, the corporation and its shareholders reported their income consistent with S corporation status for the taxable year the S corporation election should have been made and for every subsequent year, and the S corporation did not receive an IRS notice regarding any problem with the S corporation's status within 6 months of the date on which the Form 1120S for the first year was timely filed; and

2. For periods prior to January 1, 1997, a corporation intends (and is eligible) to be an S corporation: however, due to a late S corporation election, the corporation was not permitted to be an S corporation (and therefore, filed as a C corporation) for the first taxable year specified in the election (because late S corporation relief was not available during that period), the corporation and its shareholders treated the corporation as an S corporation for all succeeding years, and all relevant taxable years for both the corporation and all of its shareholders are open (with respect to the statute of limitations).
It appears that the first situation is for newly created corporations where a late election was filed and the second situation is a converting C corporation to an S corporation where a late election was filed. The procedure allows automatic relief by the IRS. Therefore, no user fees apply.

In order to receive automatic relief under Rev. Proc. 97-48, the corporation must file with the applicable service center (or district director if under examination) a completed Form 2553, signed by an officer of the corporation authorized to sign and all persons who were shareholders at any time during the period that the corporation intended to be an S corporation. The words "FILED PURSUANT TO REV. PROC. 97-48" should be stated at the top of Form 2553. A special declaration signed by an officer of the corporation and all persons who were shareholders at any time during the period that the corporation intended to be an S corporation must be attached to Form 2553. The declaration's required information varies with the two situations listed above.

In the latter situation, the corporation and its shareholders must file amended tax returns to reflect S corporation status. This may generate refunds for shareholders of a corporation that sustained a tax loss for the affected period.

E. Initial Guidance

According to PLR 9652016, the sole shareholder of X did not know that an affirmative election to be treated as an S corporation was required. However, X filed a Form 1120S for its first tax year. After filing the first return, the state where X operates sent a notice that the state had never received an S corporation election (apparently that state requires an affirmative election also). At that time, X filed a protective S election to be effective with both the federal and state revenue service centers. Under new Section 1362(b)(5), the Secretary may treat an S election as timely made if, 1) no election is made for any taxable year, and 2) the Secretary determines that there was reasonable cause for the failure to timely make such election. Corporation X represented the following facts which were likely important considerations taken into account by the IRS in making this ruling. X was a qualified small business corporation from inception to the present time and distributed all of its profits during this period. Additionally, X filed S corporation tax returns on Form 1120S, from inception to the present time.

1. It is notable that the IRS considered the fact that the sole shareholder was unaware of the need to file an affirmative S election as reasonable cause. This is a lesser standard than a Section 1.9100 ruling, but this lesser standard is consistent with the legislative history behind the enactment of Section 1362(b)(5).
2. Although the statute requires that no S election be filed, the taxpayer had filed a protective S election with an effective date subsequent to the one requested in the private letter ruling. It is unclear if such filing was disregarded for purposes of the letter ruling or deemed made to be effective from Corporation X's inception.

3. It is not clear how much weight was given to the fact that X had filed S corporation tax returns for each year, rather than C corporation returns in response to the realization that they had failed to timely file. This raises the question of whether a company that missed filing its S election in its first year and filed a C corporation return, could seek remedy through a private letter ruling to amend that year as an S corporation. Such a result could eliminate both built-in gain issues and C corporation E&P.

F. Planning Observations

It is important to clear up problems and seek relief as soon as the taxpayer recognizes a problem exists. Often these issues are raised when performing due diligence for an impending transaction.

- Underwriters will want a clean bill of health for the S corporation before taking it public.
- A closely held corporation must be an S corporation to participate as a Target corporation in a Section 338(h)(10) acquisition.
- Banks or venture capitalists will require that S status is valid to support the financial assumptions on which their lending decisions are based.

VI. S CORPORATION ACQUISITIONS

A. General Rules and Congressional Intent

S corporations will no longer be treated as individuals in their capacity as shareholders of another corporation. Thus, liquidations of C subsidiaries will be governed by the generally applicable subchapter C rules. These include Section 332 and Section 337 allowing tax free liquidations into a parent corporation, and Section 338 elections. S corporation shareholders would still be prohibited from receiving a dividend received deduction.
S Corp Acquisitions

- Subchapter C applies to Subchapter S Unless Inconsistent. Section 1371(a)
- Section 332/337 Liquidations
- Section 338(a)(10)
- Type A, C, D and F Reorganizations
- Momentary Affiliation is no longer relevant
- Transitory Ownership is still applicable

B. Prior Rulings

The IRS has provided scarce but direct guidance on this previously unclear area of S corporation tax law. In TAM 9245004, the IRS suggested that an S corporation should be subject to the corporate rules under Sections 332 and 337. Additionally, if an S corporation wanted to have a step up in basis in acquired assets it needed to effectuate the transaction through an asset purchase or by way of a Section 338 or 338(h)(10) election. It is curious that the IRS elaborated on these options in this TAM where the purpose was to merely deny the taxpayer a step up in basis of the assets through a stock purchase and immediate liquidation.

In PLR 9630005, the IRS ruled directly on the fact that a newly formed S corporation could be the acquirer in a Section 338(h)(10) acquisition of a subsidiary from a consolidated group.

C. What Types of Transactions?

The new rules provide statutory authority for the long followed guidance provided by the IRS. Under that guidance an S corporation was able to use an "A" reorganization (statutory merger), "C", acquisitive or divisive "D" or "F" reorganization under IRC Section 368(a). GCM 39768. An S corporation may also acquire assets in an IRC Section 351 transaction. However, in all these cases the general eligibility rules of S status must be observed.
D. Concept of Momentary Affiliation No Longer Applicable

The IRS created the transitory subsidiary as an administrative exception to the old no-affiliated-group requirement. Under prior law, an S corporation could purchase all the stock of another corporation and liquidate it shortly thereafter without terminating S status due to affiliation. In Haley Bros. Construction Co., 87 T.C. 26 (1986), the Tax Court criticized Rev. Rul. 73-496, 1973-2 C.B. 312, which provided 30 days to complete the liquidation. Although the IRS has stopped citing Rev. Rul. 73-496, it continued to rely on Rev. Rul. 72-320, 1972-1 C.B. 320, which permitted an S corporation to have a "momentary" subsidiary.

The new law allows an S corporation to own any percentage of another corporation. This is a significant change in the focus of transitory or momentary subsidiary. The question of momentary affiliation for an S corporation is now solely a concept of "prior law."

E. Concept of Transitory Ownership is still applicable

In various private letter rulings the IRS cited its revenue rulings supporting the transitory subsidiary rule and expanded it to ignore momentary ineligible shareholders so that S corporation status would not terminate. LTRs 9514010, 9512020, and 9509030. In these rulings, the IRS held that in spite of the fact that a new corporation formed as part of a divisive D reorganization was owned by an ineligible shareholder for a moment in time, the shareholders could make an S election for the corporation.

In LTRs 8948015, 9421022, and 9422055, the IRS extended the transitory ownership rules to a partnership incorporation followed by an S election by the newly formed corporation. Under Rev. Rule 84-111, the taxpayers had formed the corporation with the partnership assets. Upon forming the corporation, the partnership distributed the stock to its partners in complete liquidation. Although the partnership owned the corporation's stock for a brief instant, the IRS applied the transitory ownership concept and ruled that the corporation was eligible to make an S election.

This concept will likely have significant relevance in the future in light of the ability for S corporations to have QSSSs and the increase in use of partnerships such as LLCs.

* END *