S Corporations: 10 Traps for the Unwary

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This article discusses the S corporation rules, several common S corporation traps for the unwary, how to prevent a violation of a rule, and how to rectify an inadvertent termination of S corporation status.

S corporation tax treatment appears to be the best of both worlds; S corporations avoid double taxation (as compared to C corporations), and S corporation treatment can reduce the amount of employment taxes paid by employee-shareholders (as compared to partners in a partnership). However, the benefits of S corporation status come with rigid rules that may be overlooked, putting S corporation status in jeopardy.

> Shareholders must make a one-time election for S corporation treatment. To qualify to make the election, the shareholders and entity must satisfy several (sometimes burdensome) requirements.

In cases where the S corporation rules have been broken, an entity instead may be treated as a C corporation for U.S. federal income tax purposes, which can have devastating consequences to the entity and the shareholders in terms of substantive income tax, penalties, and interest. Further, the longer the rules have been broken, the more tax exposure to the entity and its shareholders.

Below, we describe generally the S corporation rules and then outline ten traps for the unwary. Additionally, we describe ways to prevent a violation of a rule or how to rectify an inadvertent termination of S corporation status. We will refer to S corporation "shares" herein; however, both a state law corporation and a state law limited liability company may be treated as an S corporation for U.S. federal income tax purposes.

Ten common traps for the unwary involving S corporations include the following, as discussed below:

1. Invalid S Corporation Election
2. Defective Organizational Documents
3. Ineligible Shareholder: A Disregarded Entity Converts into a Partnership
4. Ineligible Shareholder: Failure to Transfer or File QSST and ESBT Elections
5. Ineligible Shareholder: Transfer Pursuant to Bankruptcy Administration
6. Second Class of Stock: Unreasonable Compensation
7. Second Class of Stock: Disproportionate Distributions
8. Second Class of Stock: Recharacterized Shareholder Loans
9. Second Class of Stock: Incentive Compensation
10. Special Concerns with Constructive Partnerships

S CORPORATIONS GENERALLY

An entity, including a corporation or a limited liability company, that satisfies the requirements under Section 1361 of the Internal Revenue Code of 1986, as amended (the "Code") may elect to be treated as an "S corporation" for U.S. federal income tax purposes. An S corporation generally does not pay U.S. federal corporate income tax like a C corporation.[1] Instead, income, loss, deductions, and credits pass through to the S corporation's shareholders for U.S. federal income tax purposes, similar to the taxation of entities treated as partnerships for U.S. federal income tax purposes. Unlike partners in a partnership, however, the owners of an S corporation can be employees of the S corporation. This allows such owners of S corporations to pay employment taxes on a reasonable salary only and avoid payment of employment taxes on the S corporation's net income.

Shareholders must make a one-time election for S corporation treatment.[2] To qualify to make the election, the shareholders and entity must satisfy several (sometimes burdensome) requirements. Specifically, Section 1361(b)(1) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation[3] and which does not (1) have more than 100 shareholders, (2) have as a shareholder a person (other than an estate, a trust described in Section 1361(c)(2), or an organization described in Section 1361(c)(6)) who is not an individual, (3) have a nonresident alien as a shareholder, and (4) have more than one class of stock. Because Section 1361(b)(1)(B) requires every shareholder of an S corporation to be an individual, an estate, or a certain type of trust, this means that Section 1361(b)(1)(B) prohibits corporations and partnerships from owning S corporations. Below, we look at certain of these rules in more depth.

Eligible Shareholders. As described above, every shareholder of an S corporation must be a U.S. resident individual, an estate, or a certain type of trust. Section 1361(c)(2)(A) provides that the following trusts will be treated as eligible shareholders of an S corporation:

1. A trust which is treated as owned by an individual who is a citizen of the United States under Sections 671 through 679 (a "Grantor Trust");
2. A trust that was a Grantor Trust immediately before the death of the deemed owner and which continues to exist for the two-year period following the deemed owner's death;
3. A trust to which stock has been transferred by a will, but only for the two-year period beginning on the day on which such stock is transferred to it (*i.e.*, a testamentary trust);
4. A trust created primarily to exercise the voting power of stock transferred

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to it and meeting certain other requirements (*i.e.*, a voting trust);

5. An electing small business trust (an "ESBT"); and
6. Certain types of individual retirement accounts holding stock of a bank or a depository holding company.

Additionally, Section 1361(d) provides that a qualified subchapter S trust (a "**QSST**") may qualify as an eligible S corporation shareholder. ESBTs and QSSTs are discussed in further depth below.

The deemed owner of a Grantor Trust, and not the trust itself, is treated as the shareholder for purposes of the S corporation rules. As a result, the grantor of a Grantor Trust holding S corporation stock must be a U.S. citizen or resident.

As described above, a Grantor Trust remains an eligible S corporation shareholder under Section 1361 for two years after the deemed owner's death. At the expiration of the two-year period and to continue the S corporation status, the trust must (1) transfer the S corporation stock to an eligible S corporation shareholder or (2) make an election to be treated as an ESBT or a QSST. In certain circumstances, a trust may make an election under Section 645 to treat the trust as part of the estate, which would provide an extended period of time for the trust to hold the S corporation stock beyond two years, but only for a "reasonable" period of estate administration.[4]

Certain Treasury Regulations and IRS authorities contemplate the qualification of a disregarded entity as an eligible S corporation shareholder under Section 1361(b)(1)(B) if the regarded owner of the disregarded entity qualifies as an S corporation shareholder under Section 1361(b)(1)(B).[5] The use of disregarded entities as S corporation shareholders creates several traps for the unwary that we discuss in detail below.

S Corporation Economics. As described above, an S corporation may have only one class of stock. Reg. 1.1361-1(l)(1) provides, in part, that a corporation is generally treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Notably, Section 1361(c)(4) provides that "a corporation shall not be treated as having more than 1 class of stock solely because there are differences in voting rights." Reg. 1.1361-1(l)(2)(i) provides that a determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state laws, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, Reg. 1.1361-1(l)(2)(i) provides that any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Every shareholder of an S corporation must be a U.S. resident individual, an estate, or a certain type of trust.

Reg. 1.1361-1(l)(2)(vi), Example 2, describes an S corporation ("S") with two equal shareholders, A and B, who are entitled to equal distributions under S's bylaws. S distributes $50,000 to A in the current year but does not distribute $50,000 to B until one year later. The circumstances indicate that the difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds. As such, Example 2 concludes that the difference in timing of the distributions to A and B does not cause S to be treated as having more than one class of stock. This example shows that a violation of the single-class-of-stock requirement may be remedied with a true-up distribution and is consistent with the relief provided by the IRS for the treatment of disproportionate distributions under Revenue Procedure 2022-19, as discussed in more detail below.

IRS RELIEF

Section 1362(f) provides that the Secretary of the Treasury may provide relief to taxpayers who have "inadvertently" violated the S corporation rules (and therefore terminated their S corporation status). Under Reg. 1.1362-4(b), the "fact that the terminating event or invalidity of the election was not reasonably within the control of the corporation . . . or the fact that the terminating event or circumstance took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event or circumstance, tends to establish that the termination or invalidity of the election was inadvertent." Treasury and the IRS have issued certain procedures to streamline the relief process for S corporations under Revenue Procedure 2013-30 and Revenue Procedure 2022-19.[6] We discuss when these relief procedures may be useful below.

Where taxpayers do not qualify for streamlined relief under the revenue procedures, taxpayers may file a private letter ruling ("**PLR**") request with the IRS to ask to be treated as an S corporation. In addition to the professional fees incurred to prepare the PLR request and collateral documents (such as shareholder consents) and to interact with the IRS in connection with any questions and supplementary requests the IRS may have, the current cost to submit a PLR request is generally $38,000, subject to relief for certain small businesses. The IRS has issued several favorable private letter rulings with respect to corporations that have filed invalid S corporation elections[7] and terminated an S corporation election inadvertently by adopting erroneous language in governing documents.[8]

TRAPS FOR THE UNWARY: HOW S CORPORATIONS GO AWRY

Below, we describe several common S corporation traps for the unwary. We also discuss mechanisms taxpayers may use to avoid inadvertently violating the S corporation rules and ways to otherwise remedy a violation of the rules.

DEFECTIVE S CORPORATION ELECTION

There are several ways an entity may fail to qualify as an S corporation on the intended effective date of its S corporation election. For example, an S corporation election may be defective for the following reasons:

- The election is filed with the IRS before the entity has been legally formed;[9]
- The election is filed late;
- The election contains an administrative error; or

- The entity does not qualify as an S corporation on the intended effective date.

The S corporation election is made on Form 2553 and must be filed with the IRS within two months and 15 days after the beginning of the tax year the election is to take effect.[10] The election must contain the signature of every shareholder as well as the signature of any spouse of a shareholder who has a community property interest in the shares.[11]

If the entity does not meet all the S corporation requirements on the intended effective date, the entity cannot be treated as an S corporation as of that date. For example, if an entity files Form 2553 on 1/1/2024, and as of that date, the entity has more than 100 shareholders, the entity could not be treated as an S corporation as of 1/1/2024.

How to Avoid: Taxpayers should work with advisors who understand the S corporation rules, and advisors should thoroughly consider the S corporation requirements prior to suggesting that an entity become an S corporation. To avoid the cost of remedying any problems in connection with making the elections, it is important to identify the person responsible for preparing and filing the S corporation election and any related trust election(s) and ensuring that they are properly executed and timely filed.

How to Remedy: Some violations of the S corporation rules may simply bar an entity from electing S corporation status, such as having more than 100 shareholders, having foreign or other ineligible shareholders, or having more than one class of stock outstanding. But for procedural missteps, taxpayers may be able to obtain relief from the IRS. Additionally, in lieu of submitting a costly PLR request to the IRS, taxpayers that qualify may remedy an invalid S corporation election by following Revenue Procedure 2013-30 and Revenue Procedure 2022-19.[12]

Generally, to qualify for relief under Section 1362(f) and either of Revenue Procedure 2013-30 or Revenue Procedure 2022-19, the following conditions must be met:

- The ineffective S corporation election was ineffective by reason of either a failure to meet the definition of a "small business corporation" or a failure to obtain shareholder consents;
- The IRS determines that the circumstances that kept the election from taking effect were inadvertent;
- Within a reasonable time after the discovery of the circumstances resulting in the ineffectiveness of the election, steps are taken to make the corporation a "small business corporation" or to get the required shareholders consents;[13] and
- The corporation and all persons who owned stock during the period for which relief is granted agree to make certain adjustments required by the IRS, and those adjustments must be consistent with the treatment of the corporation as an S corporation.

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Under Rev. Proc. 2013-30, an entity and its shareholders may request relief for late elections and must request relief within three years and 75 days of the intended effective date of the S corporation election. However, an entity and its shareholders may request relief beyond this period in some circumstances if the following conditions are met;

- The corporation is not seeking late corporate classification election relief concurrently with a late S corporation election;
- The corporation fails to qualify as an S corporation solely because the Form 2553 was not timely filed;
- The corporation and all of its shareholders 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 (if any);
- At least six months have elapsed since the date on which the corporation filed its tax return for the first year the corporation intended to be an S corporation;
- 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 on which the Form 1120-S for the first year was timely filed; and
- The completed Form 2553 includes statements signed under penalties of perjury from all shareholders during the period between the date the S corporation election was to have become effective and the date the completed Form 2553 is 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 filed and for all subsequent years.

Under Rev. Proc. 2022-19, an inadvertent error or omission on Form 2553 that does not involve a shareholder consent, a selection of a permitted year, or an officer's signature may be eligible for streamlined relief. To perfect the Form 2553 for other errors or omissions, the taxpayer should write to the IRS service center identified in Rev. Proc. 2022-19 explaining the error or omission and making the necessary correction. Rev. Proc. 2022-19 provides specific guidance regarding how to remedy errors related to shareholder consents, the selection of a permitted year, or an officer's signature.

DEFECTIVE ORGANIZATIONAL DOCUMENTS

As described above, an S corporation may have only one class of stock outstanding. Whether the single-class-of-stock requirement is satisfied is based on the entity's governing documents.[14] Accordingly, governing documents that allow for disproportionate allocations of flow-through income, gain, loss, or deduction, or disproportionate distributions of cash may violate the single-class-of-stock requirement even if a company never makes a disproportionate allocation or distribution.

For example, shareholders of an S corporation may adopt an LLC agreement that contains customary partnership taxation language providing for capital accounts, allocations in accordance with Section 704(b), and liquidating distributions in accordance with the positive capital accounts of the owners. This situation may occur if the LLC agreement is drafted by counsel that is not familiar with S corporation requirements. In our experience, this is a common trap for the unwary, and many S corporations operate with these provisions in place in their charters and/or LLC agreements and only discover the issue years into operation or possibly at the time of a sale of the company.

How to Avoid: Taxpayers should consult with an advisor familiar with the S corporation rules before forming an entity or making any changes to an S corporation's governing documents. Advisors could suggest that an S corporation place a restriction on multiple classes of stock in its charter or other formation document. Additionally, advisors should confirm that S corporation-specific language is included in any LLC agreement or stockholders' agreements and that no partnership tax language is included.

How to Remedy: Once organizational documents violating the S corporation rules have been adopted, the S corporation election will be in jeopardy. If such defect is present on the intended effective date of an S corporation election, such adoption may result in an ineffective election. If such defect arises at a later date, the S corporation's status may terminate. In those cases, the S corporation may seek IRS relief pursuant to Section 1362(f) if the shareholders want to avoid C corporation treatment.

Alternatively, taxpayers that have violated the S corporation rules through their governing documents may be eligible for relief under Revenue Procedure 2022-19. Specifically, Revenue Procedure 2022-19 provides that if an S corporation and its shareholders meet certain requirements, an S corporation election that is invalid or terminated solely as the result of one or more "non-identical governing provisions" may receive retroactive relief. To qualify, the taxpayer must meet the following requirements:

- The corporation has or had one or more non-identical governing provisions;
- The corporation has not made, and for U.S. federal income tax purposes is not deemed to have made, a disproportionate distribution to a shareholder;
- The corporation timely filed a return on Form 1120-S for each taxable year of the corporation beginning with the taxable year in which the first non-identical governing provision was adopted and through the taxable year immediately preceding the taxable year in which the corporation made a request for corrective relief under Revenue Procedure 2022-19; and
- Before any non-identical governing provision is discovered by the IRS, all of the requirements described in Revenue Procedure 2022-19 are satisfied.

An S corporation may have only one class of stock outstanding. Whether the single-class-of-stock requirement is satisfied is based on the entity's governing documents.

Taxpayers who qualify under Revenue Procedure 2022-19 must take action to correct or remove the non-identical governing provisions and follow certain other administrative requirements. In short, the administrative requirements resemble the documentation a taxpayer typically must assemble to submit a PLR request to the IRS; however, the corporation need only retain the documentation in its corporate records. Taxpayers do not need to notify the IRS of the inadvertent termination or the changes made pursuant to Revenue Procedure 2022-19 unless the S corporation is audited.

INELIGIBLE SHAREHOLDER: A DISREGARDED ENTITY CONVERTS INTO A PARTNERSHIP

As described above, certain Treasury Regulations and IRS authorities contemplate the qualification of a disregarded entity as an eligible S corporation shareholder if the regarded owner of the disregarded entity qualifies as an S corporation shareholder. Under that authority, individual taxpayers may hold their S corporation shares through a wholly owned LLC or a grantor trust, in each case, where the direct holder of shares is disregarded for U.S. federal income tax purposes. Although the use of an LLC or grantor trust may have non-tax benefits (*e.g.*, preventing the indirect shareholder's name from disclosure on certain filings), such investment vehicles can be a trap for the unwary.

S corporations with disregarded entities as direct shareholders find themselves in trouble when a change occurs at the level of the disregarded entity that causes the entity to become regarded for U.S. federal income tax purposes. For example, a married individual may hold interests in an S corporation through a wholly owned LLC; however, a judge may order the married individual to transfer a 50% interest in the LLC to the individual's spouse as part of a divorce settlement. In that case, the LLC would convert into a partnership for U.S. federal income tax purposes on the date of the transfer. Because a partnership is not an eligible shareholder of an S corporation, the S corporation election would terminate upon the transfer, possibly unbeknownst to the S corporation until after the transfer.

A similar result can occur when an individual holding an interest in an S corporation through a wholly owned LLC transfers an LLC interest in other contexts, such as upon death, as payment for services (*e.g.*, the issuance of a profits interest), or in connection with estate planning or other intra-family transfers without realizing the effects on the S corporation. Like in the instance of divorce, these types of transfers may cause an LLC to have multiple members and convert into a partnership for U.S. federal income tax purposes, terminating the S corporation election.

How to Avoid: S corporations should consider adding transfer and other restrictions to their governing documents to protect against having an ineligible shareholder, such as the following restrictions: (1) no shareholder will transfer shares of the S corporation to an ineligible shareholder or take any action to cause an eligible shareholder to become an ineligible shareholder; (2) if a shareholder purports to make a transfer of an interest in the S corporation to an ineligible shareholder or take any action that would cause an eligible shareholder to be an ineligible shareholder, such transfer or action will be void and have no effect, and (3) no shareholder will take or fail to take any action of any nature whatsoever that could directly or indirectly cause the termination of the company's S corporation election. Additionally, the S corporation could require its shareholders to indemnify the company and the other shareholders from any U.S. federal, state, or local income tax consequences resulting from a terminated S corporation election caused by a shareholder.

How to Remedy: Once an ineligible shareholder holds S corporation shares, the S corporation election is terminated. In that situation, the S corporation may seek IRS relief pursuant to Section 1362(f) if the shareholders want to avoid C corporation treatment. In this instance, taxpayers would need to submit a PLR request to the IRS for relief and would not qualify for relief under any of the available IRS Revenue Procedures.

INELIGIBLE SHAREHOLDER: FAILURE TO TRANSFER OR FILE QSST AND ESBT ELECTIONS

As described above, certain trusts are eligible S corporation shareholders. Of these trusts, a Grantor Trust that holds S corporation shares remains an eligible S corporation shareholder for the two-year period following the death of the grantor. Additionally, a testamentary trust that receives S corporation shares pursuant to a will remains an eligible S corporation shareholder for the two-year period following the death of a shareholder. In each of these cases, the S corporation shares must be transferred to an eligible S corporation shareholder by the end of a two-year period; however, taxpayers sometimes lose track of this requirement over the two-year period or a probate administration may extend beyond a reasonable period. As a result, taxpayers either fail to transfer the shares or make a timely QSST or ESBT election, causing the trust shareholder to become an ineligible shareholder.

How to Avoid: Advisors should review the trust agreements of any trust shareholders to (1) determine whether the trusts are eligible S corporation shareholders, (2) determine what trust level elections are required, if any, and (3) make the advisor aware of any steps that would need to be taken in the event of a change at the level of the trust — for example, upon the death of the settlor. Additionally, as previously discussed, S corporations should consider adding transfer and other restrictions to their governing documents to protect against having an ineligible shareholder. S corporations should also require shareholder trusts to provide copies of trust agreements and notify the S corporation of any proposed amendments to trust agreements before they are implemented.

The LLC agreement or shareholders agreement for an S corporation may contain the restrictions discussed above as well as require that the shareholders execute all documents required for the company to maintain its S corporation election, including that shareholders be required to provide the S corporation with copies of all timely filed QSST and ESBT elections.

> Treasury and the IRS have issued certain procedures to streamline the relief process for S corporations under Revenue Procedure 2013-30 and Revenue Procedure 2022-19.

How to Remedy: When an S corporation terminates due to the failure of a shareholder to elect to be treated as an ESBT or a QSST, relief under Section 1362(f) may be available if the requirements of Revenue Procedure 2013-30 described above are satisfied. The trustee of an ESBT or current income beneficiary of a QSST must sign the election form and include certain statements certifying its qualification for ESBT and QSST status. If the requirements for relief under Revenue Procedure 2013-30 are not met, a taxpayer may seek relief by requesting a PLR.

INELIGIBLE SHAREHOLDER: TRANSFER PURSUANT TO BANKRUPTCY ADMINISTRATION

As described above, an estate of an individual in bankruptcy is a permissible S corporation shareholder; however, as part of the bankruptcy administration, the S corporation shares could be transferred to an ineligible S corporation shareholder, such as a creditor of the individual in bankruptcy. In this case, the bankruptcy of an individual shareholder could also cause the termination of an S corporation election.

How to Avoid: As previously discussed, S corporations should consider adding transfer and other restrictions to their governing documents to protect against having an ineligible shareholder. We recommend that the LLC agreement or shareholders agreement for an S corporation contain the restrictions discussed above as well as require that the shareholders execute all documents required for the company to maintain its S corporation election.

How to Remedy: Once an ineligible shareholder holds S corporation shares, the S corporation election is terminated. In that situation, the S corporation will have to seek IRS relief pursuant to Section 1362(f) if the shareholders want to avoid C corporation treatment. In this instance, taxpayers would need to submit a PLR request to the IRS for relief and would not qualify for relief under any of the available IRS Revenue Procedures.

SECOND CLASS OF STOCK: UNREASONABLE COMPENSATION

An attractive feature of S corporation status for a small business is the ability for employee-shareholders to potentially limit their annual employment tax liability. As described above, employee-shareholders generally do not owe self-employment tax on distributions from S corporations (as compared to partnerships).[15] As a result, an employee-shareholder may be tempted to provide themselves a modest salary, which would be subject to employment taxes, and take a large distribution, which would not be subject to self-employment tax.

The IRS has asserted that S corporations may not underpay employee-shareholders to avoid employment taxes and has recharacterized wages as a disguised dividend.[16] For example, if a third-party would pay an employee a salary of $130,000, but such person's S corporation pays the employee a salary of $10,000, the IRS could recharacterize the $120,000 payment as salary. Section 1366(e) specifically allows the IRS to reallocate income between family members who are all shareholders of the same S corporation.

A recharacterization of distributions as wages may then cause the distributions that were made to shareholders to become disproportionate. It may be especially difficult for taxpayers to defend a low salary in cases where the employee-shareholder performs the bulk of the services that generate income and the company is engaged in service activities. The regulations provide that certain "commercial contractual agreements," including employment agreements, are not treated as binding agreements relating to distribution and liquidation proceeds for purposes of determining whether the single-class-of-stock requirement is met, unless such agreements are entered into with a principal purpose of circumventing such requirement.[17]

In contrast, an employee-shareholder may be tempted to inflate their salary and take a small distribution to avoid providing larger, proportionate distributions to all shareholders. However, like in cases of unreasonably low salaries, the IRS could recharacterize a portion of the salary as a distribution. A recharacterization may then cause the distributions that were made to shareholders to become disproportionate. If the IRS were to find that the excessive compensation was purposely used to circumvent the single-class-of-stock requirement, the IRS could find that the S corporation status terminated due to a second class of stock.[18]

How to Avoid: In order to rebut any presumption that compensation is being used to circumvent the single-class-of-stock requirement, it is advisable to make a good faith determination of reasonable compensation payable to employee-shareholders, taking into account the relevant facts and circumstances, which may include the following: (1) compensation paid to non-owner employees; (2) compensation levels, if known, paid in the industry or by competitors; (3) the amount of capital required to be contributed by the shareholder to the corporation;[19] and (4) the amount of leverage in the business (*i.e.*, the ability of the business to profit from the services provided by non-owner employees). Further, it is advisable that all compensation arrangements with employee-shareholders be memorialized in contemporaneous written agreements.

Advisors should inform their clients about the risks of underpaying or overpaying employee-shareholders. Tax return preparers should flag this issue for clients when preparing tax returns and noticing the underpayment of employee-shareholders.

How to Remedy: While the underpayment of wages alone should not cause the termination of an S corporation election, a recharacterization of distributions as wages could cause aggregate distributions to be treated as disproportionate. In this case, if the recharacterization occurs as part of an audit, the S corporation may be able to work with the IRS to obtain relief for the termination of S corporation status. Alternatively, the S corporation may need to seek relief pursuant to Section 1362(f), which may require the S corporation to submit a PLR request. If an advisor catches this issue close in time, the S corporation may be able to true-up the wages and distributions paid.

SECOND CLASS OF STOCK: DISPROPORTIONATE DISTRIBUTIONS

In our experience, this is an issue that frequently causes taxpayers to be at risk of inadvertently terminating their S corporation election. As described above, S corporations must have a single class of stock, meaning all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Often, taxpayers desire to distribute different amounts to the shareholders. For example, taxpayers may desire to provide a preferred return to certain shareholders or provide certain family members in a family business more than others (*e.g.*, the parents want to pay the child-shareholder that is involved in the business a larger distribution than the child-shareholder who is not involved in the business). An S corporation can compensate employee-shareholders with different, reasonable salaries, but if an S corporation makes disproportionate distributions to its shareholders, such distributions will terminate the S corporation election.

How to Avoid: S corporations should include a single-class-of-stock restriction in the S corporation's charter where possible under state law. Additionally, advisors should educate their clients as to the single-class-of-stock requirement. Tax return preparers should recommend that S corporations make distributions to shareholders at the same time and in a proportionate manner. Tax return preparers who learn of disproportionate distributions should recommend that the S corporation true-up any under-distributed shareholders as quickly as possible. As described above, a true-up that occurs in the following tax year may correct disproportionate distributions made in the preceding year without terminating the S corporation election.

How to Remedy: Once the S corporation makes disproportionate distributions, the S corporation election may be terminated. The S corporation may seek IRS relief pursuant to Section 1362(f) if the shareholders want to avoid C corporation treatment. In this instance, taxpayers would need to submit a PLR request to the IRS for relief and would not qualify for relief under any of the available IRS Revenue Procedures. However, as discussed above, Revenue Procedure 2022-19 provides that the IRS will not provide a PLR in instances where true-up distributions are made, and the taxpayer seeks a ruling in which the IRS must determine whether the true-up distributions remedy an inadvertent termination.

SECOND CLASS OF STOCK: SHAREHOLDER LOANS

It is common for business owners to capitalize a company in part through shareholder loans to the company. If a shareholder loan to an S corporation were recharacterized as equity for U.S. federal income tax purposes, the S corporation could be treated as having an impermissible second class of stock. For that reason, it is critical for an S corporation that any such loan be properly documented. The applicable Treasury regulations also provide for a safe harbor under which certain loan agreements will not be recharacterized as a second class of stock, even if such loan agreements would be treated as equity under general tax principles.[20]

To qualify for the "straight-debt" safe harbor, the debt must satisfy the following four conditions: (1) there is a written unconditional promise to pay a sum certain in money; (2) the interest rate and interest payment dates are not contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock, or similar factors; (3) the debt is not convertible into stock; and (4) the debt is held by an eligible S corporation shareholder. While the straight-debt safe harbor protects from violations of the single-class-of-stock requirement, the IRS may recharacterize purported debt for other purposes of the Code.

How to Avoid: Any loans to an S corporation should either (1) qualify for the straight-debt safe harbor described above or (2) satisfy all requirements under general tax principles to be respected as debt.

How to Remedy: If debt issued by an S corporation is recharacterized as equity (and if the straight-debt safe harbor does not otherwise apply), the S corporation election is likely to be terminated. The S corporation may seek IRS relief pursuant to Section 1362(f) if the shareholders want to avoid C corporation treatment. In this instance, taxpayers would need to submit a PLR request to the IRS for relief and would not qualify for relief under any of the available IRS Revenue Procedures.

SECOND CLASS OF STOCK: INCENTIVE COMPENSATION

The single-class-of-stock requirement presents a significant obstacle to issuing incentive compensation from an S corporation to employees. However, phantom stock, stock appreciation rights ("**SARs**") and performance bonuses can be used to reward employees of S corporations if structured properly. These programs compensate employees based upon the S corporation's performance without giving the employee actual ownership, which could run afoul of the S corporation rules if incentive compensation is deemed to be a second class of stock. Regs. 1.1361-1(b)(3) and (4) provide safe harbors for restricted stock and deferred compensation plans that meet specific requirements.

How to Avoid: Advisors should make themselves aware of the various incentive equity options available for S corporations to assist clients in implementing plans to retain valuable employees. Advisors should be keenly aware of types of incentive equity that are not available to S corporations, such as the issuance of profits interests (which are commonly used with entities treated as partnerships for U.S. federal income tax purposes), to avoid the implementation of plans that will terminate the S corporation election. As with employee-shareholder compensation, taxpayers should document the reasonableness of incentive compensation and document such compensation in writing.[21]

How to Remedy: Once the S corporation is treated as having a second class of stock, the S corporation election may be terminated. The S corporation may seek IRS relief pursuant to Section 1362(f) if the shareholders want to avoid C corporation treatment. In this instance, taxpayers would need to submit a PLR request to the IRS for relief and would not qualify for relief under any of the available IRS Revenue Procedures.

SPECIAL CONCERNS WITH CONSTRUCTIVE PARTNERSHIPS

Shareholders of S corporations should be cautious when making agreements regarding the S corporation business through side agreements outside of the S corporation. Such a side agreement can be treated as a constructive partnership. In that case, a litany of negative consequences can result, such as treatment of the constructive partnership as an S corporation shareholder (*i.e.*, an ineligible shareholder) and/or an aggregation of distributions that result in disproportionate distributions. In either case, the existence of a constructure partnership may terminate the S corporation election.

How to Avoid: Advisors to S corporations should ask for all documents pertaining to a business structure, including side letter agreements, and should review all documentation for the possibility of constructive partnerships. Where the flexibility of a partnership structure is warranted, the Treasury Regulations specifically allow for an S corporation to become a partner in a bona fide partnership without treating the S corporation's partner as an S corporation shareholder.[22] In that case, we recommend that the S corporation enter into a formal partnership agreement with its partners to document the arrangement.

How to Remedy: Once the S corporation is treated as having an ineligible shareholder or as having made disproportionate distributions, the S corporation election may be terminated. The S corporation may seek IRS relief pursuant to Section 1362(f) if the shareholders want to avoid C corporation treatment. In this instance, taxpayers would need to submit a PLR request to the IRS for relief and would not qualify for relief under any of the available IRS Revenue Procedures.

CONCLUSION

The benefits of S corporation status come with rigid rules that may be overlooked, putting S corporation status in jeopardy. However, there are ways to prevent a violation of an S corporation rule or to rectify an inadvertent termination of S corporation status.

End Notes

1 Exceptions apply, including in the following circumstances: (1) S corporations that previously were taxed as C corporations and sell assets that were appreciated on the effective date of their S corporation elections within the five-year period following such effective date (*see* Section 1374), and (2) S corporations that have both C corporation earnings and profits and for which more than 25% of their gross receipts consist of passive investment income (*see* Section 1375).

2 Section 1361(a)(1), Section 1362.

3 Generally, an "ineligible corporation" means a financial institution, an insurance company, or a domestic international sales corporation.

4 Regs. 1.641(b)-3(a), 1.645-1(e)(2)(i), and 1.645-1(e)(3)(i).

5 Reg. 301.7701-3(b); Reg. 1.1361-1(e); Reg. 1.1361-1(e)(3)(ii)(F).

6 Rev. Proc. 2013-30 modified and superseded Rev. Proc. 2003-43, Rev. Proc. 2004-48, and Rev. Proc. 2007-62; superseded the relief provided in Situation 1 of Rev. Proc. 97-48; obsoleted the relief provided in Situation 2 of Rev. Proc. 97-48; modified and superseded the relief of Rev. Proc. 2004-49, § 4.01 and § 4.02; and obsoleted the relief provided in Rev. Proc. 2004-49, § 4.03.

7 *See, e.g.*, P.L.R. 201936005 (5/22/2019) (treating an S corporation election as valid on Date 4 even though (1) as of Date 4, E was a shareholder, failed to sign and submit Form 2553, and was an ineligible shareholder under Section 1361(b)(1)(B) and (2) even if the S election was valid, the election would have terminated when the partnership agreement was amended to contain terms creating a second class of stock); P.L.R. 201815003 (12/29/2017) (treating the corporation as an S corporation as of Date 3 even though B was an ineligible shareholder under Section 1361(b)(1)(B) on Date 3).

8 *See, e.g.*, P.L.R. 202021007 (2/20/2019) (waiving a termination as inadvertent when the corporation's members entered into an operating agreement containing partnership provisions that created a second class of stock, which issues were perpetuated in an amendment to the operating agreement); P.L.R. 201908019 (11/13/2018) (waiving a termination as inadvertent when an S corporation acquired three other S corporations, terminating the latter's elections, even though remedial actions were not taken immediately upon discovery of the terminations because the corporations expected their tax and legal advisors to correct the problem, but the advisors did not do so, and were taken when a new tax advisor pointed out the continuing issues and sought relief from the Service); P.L.R. 201905002 (10/23/2018) (waiving a termination as inadvertent where a corporation's operating agreement contained provisions calling for liquidating distributions to be made according to members' capital accounts, which termination was triggered when the corporation, originally owned by one member, acquired additional members); P.L.R. 201519008 (12/19/2014) (waiving a termination as inadvertent where the corporation relied on its in-house accountant and made disproportionate distributions with respect to its stock).

9 *See* Reg. 1.1362-6(a)(2)(iii), *Example 1*.

10 *See* Instructions for Form 2553 (Rev. December 2020).

11 *Id.*; *see* Rev. Proc. 2004-35 (providing automatic relief for certain taxpayers requesting relief for late shareholder consents for S elections in community property states).

12 Pursuant to Rev. Proc. 2022-19, the following topics are not eligible for P.L.R. requests: (1) potential violations of the single-class-of-stock requirement where the IRS must determine whether a taxpayer entered into an agreement (*e.g.*, a buy-sell agreement, an agreement restricting the transferability of stock, or a redemption agreement) the principal purpose of which was to circumvent the single-class-of-

stock requirement; (2) whether disproportionate distributions have "an appropriate tax effect in accordance with the facts and circumstances;" (3) inadvertent errors or omissions on Form 2553; (4) a lack of written acknowledgement that the IRS has accepted the corporation's S corporation election (*e.g.*, because such letter was lost or never received); and (5) the filing of a U.S. federal income tax return that is inconsistent with an S corporation election (*e.g.*, filing a Form 1065, U.S. Return of a Partnership).

[13] These consents need to be received from all persons who were shareholders at any time included in the period for which retroactive relief is being sought, regardless of whether such persons happen to be shareholders at the time the relief is being requested. Locating former shareholders and securing their cooperation can sometimes be challenging.

[14] Reg. 1.1361-1(l)(2)(i).

[15] Rev. Rul. 59-221.

[16] Rev. Rul. 77-44; *see e.g., Joseph Radtke*, 712 F. Supp 143 (E.D. Wis. 1989), *aff'd per curiam*, 895 F.2d 1196 (7th Cir. 1990) (recharacterizing dividends as compensation where an attorney paid himself a salary of $0 and dividends of $18,225 in a year); *Watson*, 757 F. Supp.2d 877 (S.D. Iowa 2010), *aff'd*, 668 F.3d 1008 (8th Cir. 2012) (treating dividends paid to a shareholder-owner as additional compensation to the $24,000 salary paid to such shareholder-owner); *Sean McAlary Ltd., Inc.*, T.C. Sum. Op. 2013-62 (8/12/2013) (rejecting a compensation agreement and focusing on qualifications, hours, duties, and success to recharacterize a dividend as compensation); *Glass Blocks Unlimited*, TCM 2013-180 (recharacterizing purported loan repayments as compensation where the employee-shareholder did not receive a salary).

[17] Reg. 1.1361-1(l)(2)(i).

[18] Reg. 1.1361-1(l)(2)(vi), *Example 3*.

[19] The shareholders are entitled to a reasonable return on their capital contributions in the form of dividends.

[20] Reg. 1.1361-1(l)(5)(iv).

[21] As discussed above, the Treasury Regulations provide that certain "commercial contractual agreements" including employment agreements, are not treated as binding agreements relating to distribution and liquidation proceeds for purposes of determining whether the single-class-of-stock requirement is met, unless such agreements are entered into with a principal purpose of circumventing such requirement. Reg. 1.1361-1(l)(2)(i).

[22] Reg. 1.701-2(d), *Example 2*.