

Section 2

S Corporations Restrictions on Ownership (Updated)

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S Corporations Restrictions on Ownership

- Qualifying Types of Shareholders. I.R.C. § 1361(b)(1)(B), (C).
 - Eligible Shareholders of an S Corporation Include:
 - U.S. Citizen/Resident Individuals;
 - An Estate of an Eligible Shareholder;
 - A Bankruptcy Estate of an Eligible Shareholder;
 - Certain Trusts (discussed *infra*); and
 - Certain Exempt Organizations.

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S Corporations Restrictions on Ownership

- Qualifying Types of Shareholders. I.R.C. § 1361(b)(1)(B), (C).
 - Qualifying Trusts Include: I.R.C. § 1361(c)(2)(A).
 - Grantor Trusts.
 - Testamentary Trusts (for 2 years).
 - Voting Trusts.
 - Qualified Subchapter S Trusts (discussed *infra*).
 - Electing Small Business Trusts (discussed *infra*).

S Corporations Restrictions on Ownership

- Qualified Subchapter S Trust ("QSST") Requirements. I.R.C. § 1361(d)(3).
 - The terms of the QSST must require the following:
 - Only one income beneficiary during the life of the current income beneficiary;
 - Corpus distributions only to current income beneficiary during that beneficiary's life;
 - Current income beneficiary's income interest must terminate on earlier of: (i) that beneficiary's death; or (ii) termination of the trust; and
 - If the trust terminates during the current beneficiary's life, all trust assets are distributed to that beneficiary.
 - All income of the QSST must be either distributed or required to be distributed currently to only one individual who is a U.S. citizen/resident.

S Corporations Restrictions on Ownership

- Qualified Subchapter S Trust (“QSST”) Requirements.
 - QSST Election. I.R.C. § 1361(d)(2).
 - Made by current income beneficiary or their legal representative.
 - Filed with the IRS Service Center where the S corporation return is filed.
 - Must be filed within 2 ½ months of effective date.
 - Income Beneficiary is the deemed owner of the stock for purposes of counting shareholders.

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S Corporations Restrictions on Ownership

- Electing Small Business Trust (“ESBT”) Requirements. I.R.C. § 1361(e).
 - No interest in the ESBT was acquired by purchase;
 - All of the ESBT’s beneficiaries are individuals, estates or charitable organizations, including nonresident aliens; and
 - The trust elects to be treated as an ESBT.
- Certain trusts cannot be ESBTs. I.R.C. § 1361(e)(1)(B).
 - Any QSST;
 - Any trust that is exempt from federal income tax; and
 - Any CRAT or CRUT.

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S Corporations Restrictions on Ownership

- Electing Small Business Trust (“ESBT”)
 - Each Potential Current Beneficiary is treated as a shareholder. I.R.C. § 1361(c)(2) (b) (v).

S Corporations Restrictions on Ownership

- ESBT Election. I.R.C. § 1361(e)(3); Treas. Reg. § 1.1361-1(m)(2).
 - Made by the Trustee.
 - Filed with the IRS Service Center where the S corporation return is filed.
 - Filed within 2 ½ months of effective date.
 - Must (i) name each potential current beneficiary, (ii) contain representations that: (a) all potential current beneficiaries are eligible Subchapter S shareholders; and (b) the trust is eligible for ESBT treatment.

Estate of U.S. Resident or Citizen

- Estate is qualified shareholder for period of reasonable administration.
- Treas. Reg. Section 1.641(b)-3(a) that period actually required by the administrator to perform the ordinary duties of administration. Such administration may not be unduly prolonged.
- No election is necessary for Estate.
- Estate is the deemed shareholder of the stock

Estate of U.S. Resident or Citizen

- Estate will cease to be qualified shareholder if the stock is transferred from the estate.
 - If transferred to a qualified individual no election or notice is required.
 - If transferred to a Trust, such Trust must independently qualify as a shareholder under another rule (e.g. grantor trust, QSST, or ESBT) with any required election being filed timely.

Estate of U.S. Resident or Citizen

- If transferred to multiple individuals and/or trusts, each transferee must independently qualify as a shareholder.
- If transferred to a Trust that has already made a ESBT election for the same or another corporation, a new ESBT election is not required.
- If transferred to a QSST that has made an election for another S-Corporation, but not for the corporation of the stock being transferred, then a separate QSST election is necessary for each new corporation.

Testamentary Trust

- A trust that was a grantor trust immediately before the death of the grantor is a qualified shareholder, but only for the two year period following death.
- A trust with respect to stock transferred to it pursuant to the terms of a will be a qualified shareholder for the 2 year period following the date the stock is transferred to it.
 - Note that the period is only 2 years as opposed to the undefined period of administration for an estate.

Testamentary Trust

- Also note that the 2 year period runs from the time the stock is transferred. (e.g. an individual dies owning stock and the stock is held in the estate for 3 years during administration. The stock is then transferred to a trust pursuant to the terms of a will. The trust will qualify as a shareholder for the two year period following the transfer.)
- Special rule for revocable trust that becomes irrevocable upon death of grantor. General rule is that such trust may hold stock for two year period following death or transfer, but if such trust and the estate make a Section 645 election to treat a “qualified revocable trust” as part of the estate, then such trust may hold the stock for the period of administration of the estate.

Grantor Trust

- A trust all of which is treated under Sections 671-679 of the Code (subchapter J) as owned by an individual who is resident or citizen of U.S. is a qualified shareholder.
- Includes revocable and irrevocable grantor trusts.
- Important to note that must be wholly owned by the grantor. It is possible for a trust to be a grantor trust as to a portion of the trust or as to the income or principal only.
- No election is necessary for Grantor Trust.

Termination of Grantor Trust

- On the death of the grantor of a grantor trust causing the trust not to be owned wholly by the grantor, such trust will qualify as a shareholder for the two year period following death.
- If however, such stock is transferred to another trust during such period, such new trust would have to independently qualify as a shareholder.

Termination of Grantor Trust

- If a Grantor Trust is terminated by something other than the grantor's death, the trust will cease to be qualified shareholder and the corporations S election will terminate.
- Examples
 - Grantor intentionally terminates status by disclaiming or giving up rights that make the trust a grantor trust.
 - Change in Trustee that changes whether the Trustee is an adverse party under the grantor trust rules.

Other Trusts

- The following trusts and entities are also qualified shareholder.
 - Trust created primarily to exercise voting power of stock.
 - Estate of an individual in bankruptcy.
 - Exempt organization described in Section 401(a) or 501(c)(2) and exempt from taxation under 501(a).

Inadvertent Termination

- Recurring problems with many S corporations include the untimely discovery of a failure to timely file an S election, filing of an inadvertently invalid election, or inadvertent termination of a previously valid S election.

Inadvertent Termination

- Absent relief, the termination of an S election can have severe consequences, particularly where the corporation has been making regular distributions.
 - An S Corporation with a terminated election is taxed as a C corporation and therefore owes C corporation taxes; if those taxes are for past years, then interest and potential penalties will apply.
 - An entity with a terminated S election is ineligible to make another S election before the fifth taxable year beginning after the first taxable year for which the election was terminated.

Inadvertent Termination

- IRS has the power under § 1362(f) to waive invalid or inadvertently terminated S elections provided that certain requirements are satisfied:

Inadvertent Termination

- Conditions for Inadvertent Termination Relief:
 - IRS determines the termination invalidity was inadvertent;
 - Within a reasonable period of time after discovery of such problem, steps are taken to qualify the corporation for an S election, or as a QSUB, as the case may be;
 - The corporation and shareholders agree to adjustments that the Commissioner may require for the period of such invalid or inadvertent termination of the election; and
 - Except where automatic relief is available under Rev. Proc. 2013-30, § 1362(f) relief is sought through the filing of a private letter ruling request with the IRS national office and payment of the required user fee.

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Inadvertent Termination - Automatic

- Automatic relief is available under Rev. Proc. 2013-30.
- In the case of a late or no S election, QSST election, ESBT election, or QSUB election, automatic relief may be available under Rev. Proc. 2013-30, so long as:
 - The corporation intended to be an S corporation as of a certain date;
 - Relief is requested within 3 years and 75 days after the intended effective date;

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Inadvertent Termination - Automatic

- Rev. Proc. 2013-30 conditions (cont):
 - The failure to qualify as an S corporation was solely because an S election, QSST election or ESBT election was not timely filed or a QSUB election was not timely filed;
 - The corporation had reasonable cause for the failure to make a timely election; and
 - All of the applicable procedural requirements of Rev. Proc. 2013-30 are satisfied.

Inadvertent Termination - Automatic

- Section 5.04 of Rev. Proc. 2013-30 provides that the 3 year and 75 day limitation on granting relief will not apply if certain enumerated requirements are satisfied:

Inadvertent Termination - PLR

- If automatic relief is unavailable because steps were not timely taken to qualify for relief under Rev. Proc. 2013-30, or the facts do not satisfy other requirements of the Rev. Proc, relief is only available through the filing of a private letter ruling request with the IRS national office.

Inadvertent Termination - PLR

- Common invalid election or inadvertent termination S corporation scenarios for which relief has been granted under §1362(f) by private letter rulings include the following:
 - A QSST or ESBT election was not timely filed (by the beneficiary, in the case of a QSST, or by the trustee, in the case of an ESBT) [PLR 201528028];
 - The S election terminated because stock ownership passed to a nonqualified shareholder, such as a partnership or LLC treated as a partnership for tax purposes [PLR 201813012; PLR 201706001];

Inadvertent Termination - PLR

- Various rulings have addressed situations in which an entity was either formed as a state law limited partnership or LLC, or later converted to a limited partnership or LLC, coupled with an election to be taxed as a corporation and an S election. However, the partnership or LLC agreement provided for maintenance of capital accounts and allocations and distributions that were inconsistent with the single class of stock requirements that distributions be in accordance with stock ownership. Thus, the election was either invalid or terminated on the subsequent conversion. [PLR 201840004; PLR 201706001];

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Inadvertent Termination - PLR

- The grantor trust status of a trust shareholder was terminated other than by death of the grantor and either a QSST election, if available, or ESBT election was not made within the sixteen day and two month period beginning on the date of termination of grantor trust status (Reg. §§ 1.1361-1(j)(6)(iii) and 1.1361-1(m)(2)(iii)) [PLR 201636013];
- The grantor trust status of a trust shareholder was terminated by death of the grantor and an ESBT election was not made within two years from the date of death of the grantor (§ 1361(c)(2)(A)(ii)) [PLR 201544006; PLR 201613004];

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Inadvertent Termination - PLR

- Failure to make a QSST or ESBT election within two years from the date on which stock was transferred to a trust pursuant to the terms of the will (§ 1361(c)(2)(A)(iii)) [PLR 201527008];
- Consent to the S election by a QSST was erroneously made by the trustee, rather than by the income beneficiary, as required [PLR 201729016];
- Failure of the S election to contain signatures of spouses who held a community property interest in the stock [PLR 201531008];

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Inadvertent Termination - PLR

- Shareholder consent by a grantor trust was erroneously signed by the trustee rather than the deemed owner [PLR 201537001];
- A QSST became an ineligible shareholder when it failed to satisfy the QSST income distribution requirements [PLR 201716004];
- An S corporation with prior C corporation E&P had passive investment income in excess of 25% of gross receipts for three consecutive years, resulting in a termination of the S election [PLR 201629001];

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Inadvertent Termination - PLR

- S corporation stock was owned by an LLC which was, in turn, owned by an individual and his grantor trust and therefore disregarded. On the individual's death, the trust ceased to be a grantor trust and the LLC automatically became a partnership between the estate and the trust, for tax purposes, thereby terminating the S election. The corporation redeemed the shares held by the estate in order to qualify for the ruling [PLR 201730002];

Inadvertent Termination - PLR

- In each of these rulings the ruling was conditioned upon restructuring, as applicable, such that the corporation qualified to be an S corporation. In the case of ownership by an ineligible shareholder, that restructuring generally took the form of a divestiture of such stock to an eligible owner.

Inadvertent Termination - PLR

The IRS typically will require that the corporation and shareholders make adjustments; for example:

- In the case of a failure to file a timely ESBT, the IRS will typically require that amended tax returns be filed for open years and any tax difference and accrued interest be paid within 120 days of the ruling;
- In the event that the statute of limitations on assessment has lapsed on any of such interim years, the IRS typically will still require that the tax difference and accrued interest for such barred years nevertheless be paid as a condition of the ruling;

Inadvertent Termination - PLR

- In the case of a failure of a QSST to make an income distribution, the IRS usually requires that such distributions be made;
- In the case of three consecutive years of excess passive income by an S corporation with C corporation E&P, the IRS will generally require that the E&P be distributed.

Inadvertent Termination - PLR

- The current user fee for a private letter ruling seeking relief under § 1362(f) is \$30,000.
- The typical time for receipt of the letter ruling is six months from the time of submission of the ruling request.