

# Passthrough Partner

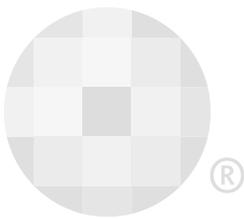
## S Corporation or Not? Transactions and Questionable S Corps

By *J. Leigh Griffith*

**E**ven though more closely held businesses are now created as limited liability companies (LLCs) taxable as partnerships each year than S corporations, the S corporation remains a very common and popular form of business entity. According to the latest IRS figures, there are almost twice as many S corporation returns filed as there are for LLCs taxable as partnerships.<sup>1</sup> Before LLCs, S corporations were the primary form of passthrough entity for closely held businesses. Today, in part because of the member/worker self-employment tax of service LLC income, S corporations are particularly popular with service professionals. As the life cycle of the S corporation moves to its conclusion, if a purchaser is purchasing the stock, there will be due diligence undertaken to verify that the S corporation status is valid and the risk of past taxes or, if applicable, a failure of the Code Sec. 338(h)(10) or 336(e) election failing is minimal.

In order for an entity taxable as a corporation to be classified as an S corporation, the entity must meet specific requirements and elect, properly and timely, to be classified as an S corporation. The failure either to meet the requirements at the time of the election or to properly elect will mean the entity will not be taxable as an S corporation from its inception. Unincorporated associations (hereinafter, for convenience, generally referred to as “LLCs”<sup>2</sup>) that are permitted to elect to be taxable either as corporations or as partnerships (or disregarded entities) historically would file a Form 8832 electing to be treated as an association taxable as a corporation and then file the Form 2553 to elect to be treated as an S corporation. The IRS found that a significantly high percentage of the S elections for such entities were defective. It provided that if only Form 2553 were filed, the LLC would be deemed to have elected to be classified as an association taxable as a corporation only if the S election were valid.<sup>3</sup> Therefore, by only filing a Form 2553, an LLC that failed to meet the S corporation requirements at the time of filing the Form 2553 or that did not make the proper election would not be treated as a C corporation for federal income tax purposes, but rather continue in its pre-election form as a passthrough entity (either as a partnership or as a disregarded entity).

The author’s practice over the past few years, particularly in the acquisition/disposition of service businesses such as medical practices, dental practices and veterinary practices across the country, indicates that a significant percentage of S corporations may have potential issues concerning the validity of their S



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status. This impression is reinforced by the need for the inadvertent ineffective elections or inadvertent termination provisions of Code Secs. 1362(b)(5) and 1362(f) with the myriad of private letter rulings in which the IRS determines the termination was inadvertent and permits the retention of the S status and the numerous late-election automatic consent provisions the IRS has provided to permit S status to be obtained or retained. Indeed, over the last 10 years alone, there have been at least 832 private letter rulings issued concerning inadvertent S election terminations, at least 92 of which address inadvertent invalid S elections.

*The one class of stock is generally the most troublesome area to evaluate even though the regulations are very pro-S corporation.*

In the context of an acquisition of an entity that purports to be taxable as an S corporation, the well-advised purchaser will perform due diligence and will require representations factually supporting the S status and a tax indemnity for the additional tax, interest and penalties the purchaser incurs in the event the IRS determines the S status is not valid at the acquisition date. The purchaser desires to become comfortable that (i) the target is in fact an S corporation and does not have latent prior-year C corporation income tax exposure, which would be acquired as a result of the transaction; or (ii) a Code Sec. 338(h)(10) or 336(e) election as part of the transaction will be valid and the purchaser will obtain the stepped-up basis of the corporate assets and not inherit any prior-year income tax exposure. Although the sellers may be obligated to indemnify the purchaser, the audit may arise long after any contingency escrow is released or such escrow may be insufficient and the future collection from the sellers may be difficult or impossible. Indeed, if a Code Sec. 338(e) or 338(h)(10) election is involved and the future amortization is the subject of an indemnity, the audit could occur over a decade later as the intangible amortization period is 15 years.<sup>4</sup> The corporate or passthrough entity purchaser whose financial reporting is in accordance with Generally Accepted Accounting Principles may be required to report under FIN 48<sup>5</sup> the tax benefits resulting from uncertain tax positions. Purchasers that file federal Form 1120, 1120L or 1120F and whose assets equal or exceed \$10 million<sup>6</sup> must file a schedule UTP with their returns.

The IRS can and will collect the tax from the assets of the target corporation.

In the context of a Code Sec. 336(e) or 338(h)(10) election transaction, a loss of stepped-up basis and the future depreciation and amortization of the assets may be very expensive and career-limiting for the persons involved for the large purchaser or crippling for the smaller purchaser. As will be discussed herein, it is often not perfectly clear whether the S status is valid at the time of the transaction in the absence of seeking a private letter ruling concerning potential inadvertent terminations and requesting a waiver of the particular actual or potential terminating events.

Even well-advised sellers will often make the representations and agree to indemnify for past taxes where compliance with the S requirements is a bit unclear, when seeking inadvertent termination relief is not feasible due to transaction time constraints or simply out of fear of approaching the IRS. In the absence of a Code Sec. 336(e) or 338(h)(10) election, the magnitude of this liability is often not a deal killer, and the exposure is generally to the current and past three tax years as the filing of an S corporation return starts the statute of limitations.<sup>7</sup> In the context of a Code Sec. 336(e) or 338(h)(10) election transaction, however, an indemnity for the future tax benefits of the purchaser from the loss of the stepped-up basis and its 15-year amortization for S corporation entities is another story. For professional service companies, for example, most of the consideration may be allocated to self-created goodwill with a zero basis in the hands of the target corporation.<sup>8</sup> The loss of S status voids the election, and the loss of the resulting step-up and amortization means the sellers could be liable for the present value of 40 plus percent of the purchase price above the historic inside tax basis. That would definitely take the economics out of a sale for the sellers.<sup>9</sup> Shareholders may be hesitant to take on such a risk, and well-advised purchasers are generally leery of a situation that might create a need to pursue the selling shareholders years later for such amounts. An indemnity claim does not necessarily mean the purchaser will actually be made whole. While the sellers are often “tax equalized” and perhaps even receive a relatively small amount of additional consideration as a result of agreeing to the election, the purchaser usually obtains the lion’s share of the present value of the future amortization and depreciation benefit. For acquiring corporations subject to the requirement to report uncertain tax positions,<sup>10</sup> the acquisition of a questionable S corporation target, particularly with a Code Sec. 338(h)(10) or 336(e) election, may lead to financial statement and tax return reporting of an uncertain tax position.

When there are questions about the validity of the S status, pricing may change, transactions may not occur or more complicated and expensive acquisition structures may be required. Generally, these more complicated structures expose the selling shareholders to a double-taxation risk if the S election is in fact not valid at the time of the sale. The sellers are theoretically free to seek an inadvertent termination private letter ruling, but the author has not participated in a transaction in which he is aware that the sellers undertook such an action once negotiations were underway. When it is not clear that the S status is invalid, it appears that sellers are often prone to simply go forward as they have in the past and rely on the running of the statute of limitations.

## 1. Election

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All of the shareholders of the corporation must timely and properly elect S corporation status on Form 2553. Not infrequently, S elections are not made timely, and there are relief provisions for late filing.<sup>11</sup> Indeed, not only can the IRS treat a late election as timely but the IRS can even approve an election to be effective in a prior year even if no election was actually filed if the IRS determines there is reasonable cause.<sup>12</sup>

Although the requirement that all shareholders at the time of the election must consent to the election seems simple, the regulations provide that when a husband and wife own the stock as community property (or the income of the stock is community property) or it is owned by tenants in common, joint tenants or tenants by the entirety, each person having a community interest in the stock or income therefrom and each tenant in common, joint tenant and tenant by the entirety must consent to the election.<sup>13</sup> It is not rare for an S corporation to have stock owned by one spouse in a community property state or for one or more shareholders to have another form of co-ownership described above and the spouse or co-owner fails to execute the Form 2553. This results in an inadvertent invalid election, and the corrective filing would be considered a late S election.

Rev. Proc. 2013-30 is a relief provision offered to simplify and streamline procedures for taxpayers to obtain relief from a late S election.<sup>14</sup> The revenue procedure provides that an entity may make a late S election dating back to the time the election was initially intended to be effective if the IRS determines the following requirements are met. First, the requesting entity must have actually intended to be an S corporation on the date of the failed election for which it seeks to be deemed as having made a valid election, and the entity must request relief in

accordance with the revenue procedure no later than three years and 75 days after such date it desires the election to be effective. Additionally, the defect preventing the S election must have only been the failure to timely file the election. For example, a failure to have a shareholder's spouse sign the election in a community property state is a correctable violation under the revenue ruling, but the existence of a disqualified shareholder is not. Further, the entity must have reasonable cause for its failure to file a timely S election and must show that it acted diligently to correct the failure once it has been discovered. Finally, the entity must follow procedural requirements set forth in the revenue procedure for requiring relief, such as filing a properly completed Form 2553<sup>15</sup> and submitting required supplemental materials, including representations relating the substantive requirements mentioned above. Significantly, taxpayers no longer have to request a costly private letter ruling process previously necessary to obtain relief from a late election if they qualify under Rev. Proc. 2013-30. Rather, a qualifying entity simply has to follow the procedural requirements to request relief, and the IRS will determine and notify the entity whether it will grant the entity additional time to file the defective S election. Private letter rulings are still necessary for any other type of inadvertent termination, however.

## 2. Four Requirements for an S Corporation

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The requirements for a domestic corporation or an LLC<sup>16</sup> that has elected to be an association taxable as a corporation and for which an election under Code Sec. 1362(a) is in effect for the year appear to be relatively simple and straightforward. Unfortunately, such appearance may be misleading. Under Code Sec. 1361(a) and (b), an S corporation is an eligible<sup>17</sup> domestic<sup>18</sup> corporation, which does not:

1. have more than 100 shareholders<sup>19</sup>;
2. have as a shareholder a person (other than an estate, a trust described in Code Sec. 1361(c)(2)), or certain exempt organizations described in Code Sec. 401(a) or 501(c)(3) and exempt from taxation under Code Sec. 501(a) who is not an individual<sup>20</sup>;
3. have a nonresident alien as a shareholder<sup>21</sup>; and
4. have more than one class of stock.<sup>22</sup>

An entity that elects to be an S corporation when it has C corporation accumulated earnings and profits will cease being a small business corporation when its passive investment income exceeds 25 percent of its gross receipts for three consecutive years.<sup>23</sup>

If an entity is formed as a corporation and the S election is not effective, the entity will be taxable as a C corporation. Historically, an LLC was required to make the election to be treated as an association taxable as a corporation and then in such “corporate” capacity make the S election. Under this construction, the subsequent failure of a valid S election would mean the LLC would be taxed as a C corporation. As a relief provision, the IRS now permits an LLC to file the S election on Form 2553 without filing an election to be taxable as a corporation. If such election is effective, the LLC will be treated as an association taxable as an S corporation,<sup>24</sup> and if such election is not effective (as a result of too many owners, a defective election, or having one or more ineligible shareholder/owners), it will be treated as a partnership or disregarded entity, as applicable. However, once a valid S election is made, the loss of S status will result in the entity being taxable as a C corporation. Without the permission of the IRS, if an election is revoked or lost, a new election cannot be made for five tax years.<sup>25</sup>

### 3. Number of Shareholders

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The number of shareholders is generally not a problem as it is clear that the S corporation has much fewer than 100 shareholders. If it appears there could be more than 100 shareholders, a careful analysis of the actual shareholders and their relationships should be undertaken. Under the applicable tax rules, for purposes of the 100-shareholder test, a husband and wife (and their estates) are treated as a single shareholder<sup>26</sup> and certain members of a family are treated as a single shareholder.<sup>27</sup> Conversely, it may appear that there are fewer than 100 shareholders, but if some of the shareholders are trusts, additional analysis is required, as some trusts are “looked through” and the beneficiaries counted as separate shareholders.<sup>28</sup>

### 4. Individual Shareholders (or Their Domestic Estates) and Certain Trusts

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All shareholders must be individuals holding the status of a U.S. citizen or resident alien, the domestic estate of an individual,<sup>29</sup> certain domestic trusts or certain tax-exempt organizations. Identifying shareholders as individuals is generally simple. Determining if all are citizens or resident aliens requires a little diligence, as it is not always obvious. Determining whether a trust is a permitted domestic trust is a bit more difficult. There are five kinds of domestic trusts that are permitted to be shareholders of an S corporation.<sup>30</sup>

These are (i) subchapter E “grantor” trusts<sup>31</sup>; (ii) testamentary trusts (for two years following death); (iii) voting trusts; (iv) qualified subchapter S trusts; and (v) electing small business trusts. Trusts referred to as grantor trusts are treated as wholly owned by one individual U.S. citizen or resident and may be a shareholder of an S corporation.<sup>32</sup> Examples include trusts in which (i) the grantor or a nonadverse party has the power to revoke the trust or return the corpus to the grantor<sup>33</sup>; (ii) the grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or grantor’s spouse<sup>34</sup>; (iii) the grantor retained a more-than-five-percent reversionary interest in the trust property or income valued on the date the trust is created<sup>35</sup>; (iv) the grantor or nonadverse party has power over the beneficial interests in the trust<sup>36</sup>; (v) the grantor has certain specified administrative powers<sup>37</sup>; (vi) a nongrantor has the power to independently vest the corpus or income in himself or a nongrantor has previously partially released or modified a power to vest corpus or income in herself and after the release retains control within the principles of Code Secs. 671 to 677 to make the grantor the owner of the trust.<sup>38</sup> Testamentary trusts are those that are created under a will of a decedent and are eligible shareholders only for the two-year period following death. Per Code Sec. 1361(d)(2) and (3), qualified subchapter S trusts require the current income beneficiary to elect such status, and the trust can have only one individual income beneficiary during the beneficiary’s lifetime; all income must be currently distributed to the individual; all corpus distributions during term of trust must be distributed to the current income beneficiary; and the current income beneficiary’s interest terminated on the earlier of death or the termination of the trust, and upon termination all corpus and income must go to the individual beneficiary. Electing small business trusts can have more than one current beneficiary, but each must be an individual, estate, charity or other trust that qualifies as an S corporation shareholder.<sup>39</sup> No interest in an electing small business trust may have been acquired by purchase, and the electing small business trust election must have been filed.<sup>40</sup>

### 5. All Shareholders Are U.S. Citizens or Resident Aliens

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While this requirement is easy to state, the verification is often delicate and requires diplomatic inquiry. The purchaser cannot safely assume that all shareholders are U.S. citizens or resident aliens. A resident alien that moves abroad and becomes a nonresident alien will inadvertently terminate the S election.

## 6. One Class of Stock

The Code requires that the S corporation have only one class of stock. Since the Subchapter S Revision Act of 1982, voting rights can vary. S corporations can now even have voting and nonvoting shares and the one class of stock requirement is not violated.<sup>41</sup> The shares in question must be outstanding. In order to be of the same class, each share of all outstanding shares must have identical rights to distributions and liquidation proceeds.<sup>42</sup> Stock issued in connection with the performance of services that is substantially nonvested is not treated as outstanding unless the holder makes a Code Sec. 83(b) election.<sup>43</sup> The initial inquiry is whether the corporate charter, articles of incorporation, bylaws, applicable state law and binding agreements relating to distribution and liquidation proceeds (collectively the governing provisions) provide for identical rights to distributions and liquidation proceeds.<sup>44</sup> Commercial contractual agreements, such as leases, employment agreements, loan agreements, *etc.*, are not binding agreements relating to distribution and liquidation proceeds and do not constitute governing provisions unless “a” principal purpose of the agreement is to circumvent the one class of stock requirement.<sup>45</sup>

The one class of stock is generally the most troublesome area to evaluate even though the regulations are very pro-S corporation.

Obligations or arrangements associated with stock may be broader than most anticipate. Since a redemption agreement is a binding obligation of the company, terms not within the parameters blessed by the regulations and discussed later below may create a second class of stock.<sup>46</sup> Conversion rights of nonvoting stock to convert into voting stock may have terms that create a second class of stock.<sup>47</sup> Terms in employee stock purchase agreements and bonus agreements may involve distribution and liquidation proceeds and also create a second class of stock.<sup>48</sup> One private letter ruling implies a tax indemnity agreement for unanticipated tax liabilities arising from a merger could additionally cause a second class of stock.<sup>49</sup>

Although, as discussed below, certain debt even if characterized as equity under general tax principles will not constitute a second class of stock, debt that is not described in these specific exceptions that would be classified as equity under general tax principles will be considered a second class of stock. Careful attention should be given to the terms of debt and convertible debt.<sup>50</sup>

The Code and/or regulations set forth the following situations that will not involve a second class of stock unless circumstances indicate there is an attempt to avoid the one class of stock requirement.

### (a) Debt

Generally debt is not treated as a second class of stock for purposes of S corporation classification. There are specific safe harbors in the regulations for certain debt that would otherwise be characterized as equity under generally applicable federal tax principles that will not create a second class of stock for purposes of S classification. These are:

- a. *Straight Debt.* Straight debt is not considered a second class of stock.<sup>51</sup> Straight debt is defined by the Code as a written unconditional promise to pay on demand or on a specified date a sum certain in money if (i) the interest rate (and interest payment dates) is not contingent on profits, the borrower’s discretion or similar factors; (ii) the promise of repayment is not directly or indirectly convertible into stock; and (iii) the creditor is an individual (other than a nonresident alien), an estate, a trust that is a permitted S corporation shareholder or a person who is actively and regularly engaged in the business of lending money.<sup>52</sup> A formal note is not required.<sup>53</sup> Such debt may be subordinated to other debt of the corporation.<sup>54</sup> If such debt is modified so it no longer meets the definition of straight debt or is transferred to a third party that is not an eligible shareholder and it is classified as equity under general principles of federal tax law, it will constitute a second class of stock.<sup>55</sup>
- b. *Certain Short-Term Unwritten Advances.* The regulations provide that unwritten advances that are (i) not in excess of \$10,000 in the aggregate; (ii) treated as debt by the parties; and (iii) expected to be repaid within a reasonable period of time do not constitute a second class of stock.<sup>56</sup>
- c. *Proportionately Held Obligations.* Obligations of the same class that are considered equity under general federal tax principles but that are held solely by shareholders in proportion to the shareholders’ stock are not considered a second class of stock.<sup>57</sup> Any shareholder debt of an S corporation with a single shareholder is definitionally a proportionately held obligation. However, the admission of a second shareholder would cause the obligation to become disproportionate.

### (b) Call Options

A call option (or similar instrument) is not treated as a second class of stock unless, taking into account all the facts and circumstances, the call option (i) is substantially certain to be exercised, and (ii) has a strike price substantially below the fair market value of the underlying stock

on the date that the call option is issued, transferred to a person who is not an eligible shareholder, or materially modified.<sup>58</sup> Under Reg. §1.1361-1(l)(4)(iii)(B), there are two exceptions. A call option that would otherwise be treated as a second class of stock is not treated as a second class of stock if it is issued to a person actively and regularly engaged in the business of lending and is issued in connection with a commercially reasonable loan.<sup>59</sup> Second, a call option issued to an individual employee or independent contractor in connection with the performance of services (and not excessive by reference to the services provided) is not a second class of stock if the call option is not transferable within the meaning of Reg. §1.83-3(d) and the call option does not have a readily ascertainable fair market value as defined in Reg. §1.83-7(b) at the time the option is issued. Reg. §1.1361-1(l)(4)(iii)(C) contains an additional exception. This exception provides that on the date the call option is (i) issued, (ii) transferred by an eligible shareholder to an ineligible shareholder, or (iii) materially modified, if the strike price is at least 90 percent of the fair market value of the underlying stock, it will not be treated as a second class of stock.<sup>60</sup> A good-faith determination will be respected unless substantial error and the determination were made without reasonable diligence. Failure of the option to meet this safe harbor does not necessarily result in the option being treated as a second class of stock.<sup>61</sup>

### (c) Deferred Compensation Plans

A deferred compensation obligation or arrangement is not a second class of outstanding stock for purposes of determining S corporation eligibility if it (i) does not convey the right to vote; (ii) is an unfunded and unsecured promise to pay money or property; (iii) is issued to an individual performing services as an employee or independent contractor and is not excessive by reference to the services provided<sup>62</sup>; and (iv) is issued pursuant to plan with respect to which the employee or independent contractor is not taxed currently on income.<sup>63</sup> This is true even if there is a current payment feature such as payment of dividend equivalent amounts that are taxed currently as compensation.<sup>64</sup>

### (d) Buy-Sell and Redemption Agreements

Buy-sell agreements among shareholders, agreements restricting the transferability of stock and redemption agreements are disregarded in determining if a corporation's outstanding shares of stock confer identical

distributions and liquidation rights unless (i) a principal purpose of the agreement is to circumvent the one class of stock requirement; and (ii) the agreement establishes a purchase price that, at the time entered into, is significantly in excess of or below the fair market value of the stock.<sup>65</sup> Under the regulations, a purchase or redemption price of stock (i) at book value determined under Generally Accepted Accounting Principles or used for any substantial nontax purpose<sup>66</sup>; or (ii) at a price between fair market value and such book value is not a price that is significantly in excess of or below fair market value.<sup>67</sup> A good-faith determination of fair market value will be respected unless the value is substantially in error and the determination was made without reasonable diligence.<sup>68</sup> Even though not constituting a second class of stock, the regulations note there may be income or transfer tax consequences as a result of such rights.<sup>69</sup> Put options are not specifically addressed by the regulations.<sup>70</sup> Despite the broad language concerning buy-sell agreements, in the context of inadvertent termination relief, the IRS has granted relief but required adjustments to the buy-sell agreements (which often had other provisions within them).<sup>71</sup>

*Bona fide* agreements to purchase or redeem upon the death, divorce, disability or termination of employment are disregarded in determining whether a corporation's shares confer identical rights.<sup>72</sup> Indeed, in one example, a shareholder who is an employee but who did not receive his shares as a result of the employment will be redeemed at a price significantly below their fair market value not only on the termination of employment but also if the sales fall below a specified level, provided a significant purpose of those portions of the agreement was not to circumvent the one class of stock requirement.<sup>73</sup>

*Bona fide* agreements outside the exceptions, however, can create a second class of stock. For example: An S corporation has voting and nonvoting shares. The shareholders have an agreement that if a purchaser desires to acquire the company and a majority vote of the shareholders holding voting shares accepts the offer, the nonvoting shareholders must sell their stock for a formula price yielding less per share than the price for the voting shares. On this fact pattern, the IRS determined that the shareholder agreement created a second class of stock.<sup>74</sup> In this situation, the IRS gave inadvertent termination relief, and the agreement was rescinded.

### (e) Unvested Stock on Which No 83(b) Election Has Been Made

In the absence of a Code Sec. 83(b) election, unvested stock (often referred to as restricted stock) is not considered

outstanding<sup>75</sup> and does not count in determining if there is more than one class for purposes of S corporation status. However, vested stock or stock that is subject to a Code Sec. 83(b) election is considered outstanding if a Code Sec. 83(b) election is made. As a result of the Code Sec. 83(b) election the forfeiture provisions that would otherwise cause the stock to be unvested are ignored.<sup>76</sup>

### **(f) Varying Interests**

A governing provision may provide that, as a result of changes in stock ownership, distributions in a tax year are to be made on the basis of the shareholders' varying interests in the S corporation's income in the current or immediately preceding tax year. Therefore, even though such distributions may in fact differ, a second class of stock does not exist.<sup>77</sup> However, if the distributions pursuant to this provision are not made within a reasonable time after the close of the tax year in which the varying interests occur, the distributions may be recharacterized for other tax purposes depending on the facts and circumstances but will not constitute a second class of stock.<sup>78</sup> A careful reading of the regulation reveals that in order not to be classified as a second class of stock under this provision, the distribution relating to a change in stock ownership must be made by the close of the tax year of the varying interest or the next year. Even if made within the following tax year, if it is not made within a reasonable time after the end of the year of the variance, it may be recharacterized for other purposes.<sup>79</sup>

### **(g) Special Rule for Code Sec. 338(h)(10) and Presumably Code Sec. 336(e) Elections**

The regulations provide a special rule for Code Sec. 338(h)(10) elections permitting shareholders to receive a varying amount per share, and such receipt will not cause the S corporation to have more than one class of stock if the varying amounts are determined in arm's-length negotiation with the purchaser.<sup>80</sup> Presumably, the principle of this regulation would also apply to Code Sec. 336(e) elections.<sup>81</sup> The author expects the rationale is that the shareholders have the ability to individually negotiate the sale of their stock and may well have different terms and prices. The election is a deemed transaction at the corporate level, not an actual transaction at the corporate level, and should not force the shareholders to sell their stock for a uniform price.<sup>82</sup> Note, instead of a deemed asset sale, if there was an actual asset sale followed by a disproportionate distribution of the proceeds in the liquidation of the corporation, there should be a second class of stock. It is difficult for the

author to see how there is not an agreement to distribute disproportionately when the distribution involves a liquidating distribution as there will never be an opportunity for a future distribution true up.

### **(h) Governing Provisions and Differences in Timing of Distributions**

The regulations *via* an example provide that if under the governing provisions all shareholders are entitled to equal distributions per share, but one shareholder actually receives a larger per-share distribution in one year and the other(s) receives a catch-up distribution one year later, such timing difference does not indicate a second class of stock if the difference in the timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds.<sup>83</sup> If the disproportionate distributions continue for a number of years and are not corrected, the author becomes nervous about whether there is a binding agreement to make such disproportionate distributions. A failure to correct or catch up the prior identified disproportionality of distributions in the context of a transaction would be more than troubling to the author. At some point, a binding agreement will be deemed to exist even if the parties say otherwise. Actions speak louder than words. Nevertheless, the IRS has granted Code Sec. 1362(f) inadvertent termination relief when disproportionate distributions, corrected at that time, had been made for several years.<sup>84</sup>

### **(i) Excessive Compensation to a Shareholder**

Compensation paid under an employment agreement to a shareholder that is found to be excessive will by itself not cause a second class of stock to exist if a principal purpose is not to circumvent the one class of stock requirement.<sup>85</sup> An employment agreement is not considered to be a binding agreement relating to distribution and liquidation proceeds and is not a "governing provision."<sup>86</sup> If the IRS determines that a principal purpose of the compensation is an avoidance of the one class of stock rule, then such employment agreement with its excess constitutes a second class of stock.<sup>87</sup>

### **(j) Below-Market Loan to a Shareholder**

The loan agreement is not a governing provision.<sup>88</sup> Unless the facts and circumstances indicate that a principal purpose of the loan agreement is to circumvent the one class of stock requirement, such loan to a shareholder will not be deemed to create a second class of stock.<sup>89</sup>

## (k) State Law Concerning Withholding or Composite Payments

Certain types of state laws are disregarded in determining if all of the company's outstanding shares have identical rights to distributions and liquidation proceeds. For example, laws that require a corporation to pay or withhold state income taxes on behalf of some or all of the shareholders are disregarded provided that the constructive distributions resulting from the payment or withholding of taxes by the corporation are required to be paid to the corporation by the shareholder(s) or are taken into account in determining future actual distributions. If such repayment or adjustment is required, the outstanding shares confer identical rights to distributions and liquidation proceeds. This is true whether such tax payments were treated as constructive dividends or advances that must be repaid or offset against distributions. However, the regulations provide that an agreement to adjust distributions for state tax burdens by making an upward adjustment of distributions to those shareholders who bear a heavier state tax burden such that all shareholders have equal after-tax distributions will create a second class of stock.<sup>90</sup> Such an agreement would constitute a governing provision that alters rights conferred by the stock in distributions and liquidation proceeds.

Beware of state laws that permit a composite payment of out-of-state shareholder state taxes. If there is an agreement for the corporation to file a composite return and pay such taxes, but not treat such amounts as a prepayment of distributions, a second class of stock will exist.<sup>91</sup> The IRS has given inadvertent termination relief to a situation whereby the S corporation had filed composite returns and in fact paid out-of-state shareholders' taxes for six years. The IRS found there was no oral or written agreement that the corporation would file composite returns and make such tax payment and found an inadvertent termination but required the corporation to make remedial distributions to the other shareholders.<sup>92</sup>

## 7. S Election Terminated as a Result of Excessive Passive Investment Income

As previously noted, a former C corporation with accumulated earnings and profits at the time it elects to become an S corporation will cease being a small business corporation and lose its S corporation status when it has both accumulated earnings and profits and passive income exceeding 25 percent of gross receipts for three

consecutive tax years.<sup>93</sup> Passive investment income includes income generated from royalties, rents, dividends, interest, annuities and gains from the sale or exchange of stock or securities.<sup>94</sup> Where an entity's S election is inadvertently terminated as a result of excessive passive investment income, it may qualify for relief under Code Sec. 1362(f).<sup>95</sup> A distribution or deemed distribution of all C corporation accumulated earnings and profits may be required for inadvertent termination relief.<sup>96</sup>

## 8. LLCs or Other Unincorporated Entities Taxable as an S Corporation

### (a) Election to Be an Association Taxable as a Corporation

A domestic LLC may elect to be treated as an LLC taxable as a corporation<sup>97</sup> and make an S election.<sup>98</sup> This can be done by the filing of a Form 8832 in which the LLC elects to be taxable as a corporation followed by the filing of a Form 2553 in which it elects to be taxable as an S corporation. As discussed earlier, an additional and the recommended alternative to filing both the Form 8832 and the Form 2553 is the filing of only a Form 2553 for the LLC. If the S election is otherwise valid, the LLC will be deemed to have elected S corporation status. If only the Form 2553 is filed and the election is defective for any reason, the LLC will be taxable as a partnership or, if there is only one member, a disregarded entity.

### (b) Governing Provisions

As discussed above in the context of a state law corporation, the regulations provide whether all outstanding shares of stock confer identical rights to distribution and liquidation are determined based on the corporate charter, articles of incorporation, bylaws, applicable state law and binding agreements relating to distribution and liquidation proceeds. If the governing provisions call for disproportionate distributions from operations or upon liquidation, it does not matter whether any have actually been made. The fact disproportionate distributions are authorized and stock with such rights is outstanding is sufficient.<sup>99</sup> Since LLCs do not have articles of incorporation or bylaws, the analogous documents that would constitute the governing provisions are the articles of organization,<sup>100</sup> the operating agreement, applicable state law and binding contracts. In addition, LLCs do not have shares. One should look at the agreements to see if the LLC has units of ownership interest, some other measure

of ownership or merely percentage interests in the LLC. Are all distributions required to be made in equal amounts per unit or other measure or in accordance with percentage interest? If capital accounts control the liquidating distributions, are book-ups under Reg. §1.704-1(b)(2)(iv)(f) and (g) required so that the units or percentage interest are entitled to equal rights to distribution and liquidation proceeds? Often the documents do not so provide. Special allocations and distributions, unless required by the allocation regulations, are likely to constitute a second class of stock. The IRS in these circumstances may provide relief if the following conditions are met<sup>101</sup>: (i) a ruling is requested within a reasonable time following discovery; (ii) appropriate representations can be made; and (iii) remedial action as required by the Commissioner is undertaken. Disproportionate allocations and distributions of operating income that have actually occurred as a result of the operating agreement or other legally binding agreement present a challenge. As part of the remediation for inadvertent termination relief, the “shareholders” will be required to make adjustments and file amended returns in a manner consistent with what should have been filed if all allocations were proportionate. If such actions have not been completed prior to the request for a ruling, the IRS will require the prompt completion as a condition of granting the relief. For example, corrective distributions from the S corporation will be required.<sup>102</sup>

On the other hand, if the disproportionate provisions existed at the date of the initial S corporation election and applied to outstanding membership interests, the election itself would be ineffective.<sup>103</sup> The LLC would be taxable either as a C corporation or as a partnership (or disregarded entity if only one member). If the articles and operating agreement had disqualifying provisions effective at the time and only a Form 2553 was filed (with no Form 8382 filed), the LLC will remain an association taxable as a partnership with passthrough treatment. In many, if not most, cases there would be minimal changes to the members’ income tax returns (unless the debt allocation and basis limitations caused losses to be reallocated or made them usable). A purchase of all of the membership interests would be deemed to be the purchase of assets, and the purchaser would not need to make a Code Sec. 336(e) or 338(h)(10) election. If treated as a partnership or disregarded entity, however, the members may be subject to self-employment taxes on operating income that they would not be subject to if the LLC was an S corporation. Under current IRS positions, the members cannot be employees of an LLC in which they are partners.<sup>104</sup> This means that various benefits of an individual as an employee are not available, and there may be adjustments at

the member level for everyone who had been a member during the period the statute of limitations is open. In addition, there may be some differences in state taxes. For the most part, however, the impact on the entity and its owners would be minimal and within the scope and tolerance of indemnifications and escrows for a purchaser that would permit an acquisition to go forward without the necessity of restructuring. From the author’s personal experience, the transaction would go forward under these circumstances as there would not be federal income tax exposure to the purchaser because the income passes through in either situation although there may be other collateral tax issues. Additionally, if a Code Sec. 336(e) or 338(h)(10) election is ineffective as a result, there would still be a step-up in basis equal to the purchase price and full depreciation and amortization. Generally, the purchaser’s potential exposure is very minimal, and the seller’s exposure is tolerable.

If capital accounts control liquidating distributions and the operating agreement gives (but does not require) the members or managers to book-up or book-down the book capital accounts in the event of acquisitions of additional membership interests by new or existing members, the book capital accounts may not be proportionate. Likewise if the distribution of more than a *de minimis* amount of assets and such adjustments are not made the book capital accounts may not be proportionate.<sup>105</sup> If the book capital accounts are disproportionate as are the Code Sec. 704(b) capital accounts, the result is liquidation proceeds will be required to be distributed disproportionately, does a second class of stock exist (i) *ab initio*; or (ii) only when the book-up or book-down does not occur? If *ab initio*, the LLC will never have been taxable as a corporation of any kind unless a Form 8832 was filed along with the Form 2553. If the second class of stock springs into existence only later on the failure to book-up or book-down, the failure will have occurred when the LLC is an S corporation and results in a loss of S status as opposed to an invalid S election from day one. In such case, without an IRS determination that the termination was inadvertent and a waiver of the terminating event, the LLC will be subject to taxation as a C corporation as its initial deemed corporate election will be valid and binding.

### **(c) State Law Distribution Default Rules Can Give Rise to Multiple Classes of “Stock”<sup>106</sup>**

In the absence of specific provisions in the articles of organization or operating agreement requiring equal distributions per unit or per percentage, does the law

of the state of formation save or doom the S status? Most states provide default rules for distributions if parties do not have an express agreement.<sup>107</sup> These default rules vary among the states. The state default rules will require distributions to be made either (i) *per capita*<sup>108</sup> (*i.e.*, per member); (ii) in accordance with capital contributed<sup>109</sup>; or (iii) by other methods,<sup>110</sup> such as percentage interest. In addition, for LLCs that distribute liquidation proceeds in accordance with positive capital account balances, it may well be that the capital account balance does not equate to the percentage interest or unit ownership of a member. This will be particularly true if the book-ups or book-downs are not required. It is far more likely for an LLC that desires to be treated as an S corporation to have a technical classification problem in its governing provisions than a true stock S corporation. Standard LLC operating agreements are not necessarily designed to require the distributions of equivalent amounts of per unit (*i.e.*, share equivalent) or even per percent of operating income and/or liquidation proceeds. If the operating agreement is silent and disproportionate distributions are made, unfavorable state law may well be the governing provision.

## 9. Inadvertent Termination Relief

Under Code Sec. 1362(f), the IRS can grant relief for both inadvertent invalid elections and inadvertent disqualification events if (i) the IRS views the disqualifying event as inadvertent; (ii) the corporation (or LLC that elected to be taxable as a corporation) corrects the event within a reasonable time period following discovery; and (iii) the corporation and its shareholders agree to make such adjustments as may be required by the IRS with respect to such period. Implicit in these requirements is the additional requirement that a request for inadvertent ineffective election or termination relief be made within a reasonable time period from the discovery. The corporation has the burden of proof to show the termination was inadvertent.<sup>111</sup> Inadvertence can be established when the terminating event was not within the reasonable control of the corporation and was not part of a plan to terminate the election or when the event occurred without the knowledge of the corporation and the corporation had taken reasonable steps to safeguard itself against such an event. In order to seek inadvertent ineffective election or termination relief, a private letter must be requested.<sup>112</sup> All shareholders during the period of the requested relief (not merely those who are shareholders at the time the relief is to be effective or at

the time relief is requested) must consent in writing to any adjustments that the IRS may require.<sup>113</sup> The IRS will want to know how and when the event was discovered and the steps taken to return the corporation to S status. Disproportionate distributions will be required to be “cured” in a short period of time if they have not already been made proportionate.<sup>114</sup>

A corporation is deemed to have discovered the event when it has actual knowledge of the event or when a reasonable person should have known of the event and understood its significance to the S status.<sup>115</sup> There does not appear to be a bright line as to what constitutes a reasonable time from discovering the disqualification event for correcting the disqualifying event. At least one commentator believes a 90-day period should be reasonable but noted that the IRS has privately ruled that, under the circumstances in the ruling, nine months was reasonable.<sup>116</sup> The IRS seems to accept a lack of understanding of the applicable law to the known facts does not constitute discovery.<sup>117</sup> The correction of potential problems should be undertaken prior to the submission of a ruling request for inadvertent relief. Under the regulation, the IRS may require shareholder adjustments for all periods for which the terminating event was effective and the company and all shareholders who were shareholders in the otherwise disqualification period must agree to the adjustments.<sup>118</sup>

Although the IRS appears quite generous with the Code Sec. 1362(f) inadvertent termination relief if the taxpayer acts promptly upon learning of the defect, the S corporation cure will change the nontax economics of the parties if disproportionate distributions are involved. In order to obtain the inadvertent termination “cure,” the corporation must submit a private letter request at a filing fee cost of \$9,000 plus professional fees for preparing the request as well as taxpayer anxiety. Generally, the S corporation will have taken corrective actions to rectify much if not all of the potential problems prior to the ruling request. Some private letter rulings indicate that the disproportionate distributions had not yet been cured and conditioned the favorable rulings on prompt curative distributions. In many, but not all transaction cases, the time to obtain a private letter ruling in advance of the transaction is prohibitive.<sup>119</sup> Acquisitions will not go on hold for months while a private letter ruling is pending. Typically, the purchaser does not wish to wait months to close nor assume the tax risk of purchasing the stock and having a defective Code Sec. 338(h)(10) or 336(e) election. Often a larger purchaser does not wish to be required to disclose as an uncertain tax position to the IRS nor have a FIN 48 disclosure of such on its financial statements.

## 10. Change of Ownership Transactions

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### (a) Potential Classification Issues Are Often First Discovered in the Due Diligence Process of a Transaction

The IRS audit coverage to verify whether a purported S corporation qualifies as an S corporation does not appear to be robust. There are also very few cases concerning inadvertent terminations. This may show a lack of audit inquiry or it may mean that the termination was sufficiently apparent and there was no reason to litigate.

The classification question frequently first arises when a third party is acquiring the stock of an S corporation (or the membership interests of an LLC that has made an S election). In the due diligence process, the purchaser will generally review the operating, income, compensation, loans and distribution history of the target as well as the ownership of the S corporation, shareholder agreements and its initial election to develop a degree of comfort concerning the validity of the S status. If in the due diligence process problems are found concerning the validity of the S corporation status, both the purchaser and the sellers are made aware of the problems or potential problems. The “reasonable time meter” will begin to run. Inadvertent ineffective election or termination relief may become unavailable in the future if corrective action and a ruling request are not undertaken at that time. Code Sec. 1362(f) (3) statutorily requires action within a reasonable period of time following discovery.

### (b) Second Class of Stock Potential Issue

From the author’s personal experience, generally (but not always) the election and the actual ownership requirements appear to be proper. For operating companies, which in the author’s personal experience are the primary acquisition targets, excessive passive investment income is generally not an issue. Unfortunately, all too frequently questions arise concerning the potential of a second class of stock. In the context of an actual corporation, it is unusual for the charter and bylaws to call for a second class of stock (unless there is a voting and nonvoting class) and many affirmatively prohibit a second class of stock. In an attempt to avoid self-employment taxes, however, many professional service S corporations are paying relatively small amounts of compensation and making large distributions. These distributions are not always in accordance with the stock or membership interest ownership.<sup>120</sup> The

governing provisions of an LLC’s articles and operating agreement are much more likely to create a second class of stock than the bylaws or charter of a true corporation and may be amended by attorneys unaware that the LLC has made an election to be taxable as an association taxable as an S corporation. Generally, questions arise due to past disproportionate distributions (often over a number of years) or arrangements involving debt conversion features, debt without maturity or interest payments or agreements (often found in the operating agreement) providing different amounts of consideration in the event of a sale or liquidation or other specified events. The disproportionate distributions may be actual or constructive. The granting of a profits interest, which is now a very common and powerful incentive for key service providers,<sup>121</sup> will, by definition, create a second class of stock. Such service provider cannot participate in capital transaction proceeds until the other members receive the liquidation value of the company.<sup>122</sup>

## 11. Transaction Restructuring

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If the transaction would otherwise be a purchase of the S corporation stock (with or without a Code Sec. 338(h)(10) or 336(e) election) but there are significant concerns in the mind of the purchaser as to the validity of the target’s S status and a private letter ruling seeking ineffective or inadvertent termination relief is not considered feasible prior to the consummation of the transaction, a restructuring may be required. Sellers should be aware, however, that a purchaser-instigated transaction restructuring will insulate the purchaser from the risk of an S status failure, but will leave some or all of the risk of a failed S status on the sellers or substantially reduce the purchase price. A restructuring of the transaction may be clear evidence that the sellers are aware of one or more potential problems with the S corporation status. The failure to seek a ruling for inadvertent ineffective election or termination contemporaneously appears to preclude Code Sec. 1362(f) relief. Since the transaction will likely be a large and unusual event for the shareholders, the likelihood of a shareholder audit may increase.

In the absence of an advance private letter ruling, potential restructurings include the following.

### (a) 1. Asset Purchase<sup>123</sup>

Assuming the target’s S election was made day one or has been outstanding for a period exceeding the recognition period required by Code Sec. 1374(d)(7),<sup>124</sup> to avoid the tax on built-in gain, the transaction alternative that often

appears simple to the sellers is an asset purchase. However, an asset purchase often involves obtaining consents from third-party licensors, landlords and others for the transfer of assets. This will take time and add expense. Some third parties may refuse to consent or attempt to “extort” a price for consenting even if under the applicable agreements consent cannot be unreasonably withheld or delayed. If the business is regulated or receiving government funds (particularly healthcare payments), a new federal identification number can mean time-consuming and expensive regulatory filings, new licenses, and in the context of Medicare and Medicaid payments, no payments being received for months while the various papers are processed. The purchaser will obtain a basis in the assets equal to the purchase price paid for such assets, including any debt the assets are subject to or the purchaser assumes.<sup>125</sup> From the seller’s perspective, an asset sale means if the S corporation status is not valid, there will be double taxation—taxation at the corporate level and taxation at the shareholder level when the corporation distributes the sale proceeds (either as a dividend or in liquidation).<sup>126</sup> From the purchaser’s perspective, the sellers are on their own.

### **(b) 2A. Formation of an LLC Taxable as a Passthrough Entity Wholly Owned by the S Corporation and a Sale of the LLC Membership Interest**

Although tax-wise this is substantially the same to the parties as a sale of assets, forming a new LLC and the S corporation selling its membership interests in the LLC may reduce or eliminate the third-party consents required. This alternative can be implemented by a transfer of assets and liabilities to a new LLC wholly owned by the S corporation. This transfer of assets may require some third-party consents, but there is often an exception for transfers to affiliates in the business documents, and a change of control is often not an event requiring the third party’s consent. For federal tax purposes, however, the purchaser’s acquisition of 100 percent of the membership interests is an asset purchase to the purchaser and a sale of membership interests by the seller.<sup>127</sup> The purchaser receives a basis equal to the purchase price (including assumed or subject to liabilities).<sup>128</sup> The purported S corporation is the seller of the membership interests. If the S corporation’s status is not valid and the proceeds are distributed, the owners of the S corporation bear the risk of the double taxation. In this scenario, when the membership interest is acquired by the purchaser, the LLC will be required to obtain a tax identification number different from that of the S corporation. This will either be a new taxpayer identification

number issued to the LLC once the LLC is owned by the purchaser or if there is a single purchaser and the LLC does not have its own employees, the federal identification number of the purchaser. Either requires using a new identification number for the LLC on a going-forward basis. For healthcare transactions where a change of tax identification numbers requires regulatory filings and a delay in payments until such paperwork is approved, this can be a problem. Sometimes there is a “work around” whereby the business continues to be operated and billed by the S corporation while managed by the purchaser for which the purchaser is handsomely compensated while the healthcare paperwork is processed. This, however, adds additional complexity for all concerned.

### **(c) 2B. Target Forms a Subsidiary and Makes a QSub Election**

Another possible method is to form a new corporation that owns 100 percent of the original S corporation *via* an F Reorganization<sup>129</sup> and the original S corporation then makes a QSub election.<sup>130</sup> Shortly thereafter, the QSub is converted into an LLC under a state law conversion provision.<sup>131</sup> The QSub F Reorganization can be accomplished by a contribution of the shares of the existing S corporation to a new holding company with the existing S corporation (now a subsidiary) electing QSub status.<sup>132</sup> This can also be achieved by a state law merger resulting in the existing S corporation becoming a subsidiary of a new S corporation<sup>133</sup> and the original S corporation making the QSub election.<sup>134</sup> Either of these methods requires a change of control review of the significant leases and contracts.

Under either the contribution of stock to the new holding company or a merger scenario, the formation of the new holding company and the original S corporation becoming a QSub is an F Reorganization.<sup>135</sup> The tax identification number of the existing S corporation that is then the QSub will remain with the QSub.<sup>136</sup> For this step, if the S corporation’s status is defective, the creation by contribution of property to a C corporation is nontaxable if the associated debts do not exceed the basis of the assets.<sup>137</sup> The liquidation of the corporate subsidiary as a result of the conversion shortly after the formation of the corporation is also nontaxable.<sup>138</sup> If the S status is valid, the new LLC retains the taxpayer identification number of the original S corporation by virtue of the F reorganization, QSub election and subsequent conversion of the QSub to an LLC. If the QSub’s election to be a QSub is ineffective because the parent does not qualify as an S corporation, the conversion into an LLC taxable as a single-member LLC would be a liquidation of the existing S corporation

into its corporate parent. Generally, the liquidation of a subsidiary into a corporate parent does not trigger taxable gain to the subsidiary<sup>139</sup> or to the corporate parent.<sup>140</sup> The corporate parent acquires the assets of the subsidiary with a carryover basis (*i.e.*, the same basis as the subsidiary had).<sup>141</sup> The subsequent sale of the LLC membership interests is a deemed sale of membership interests by the parent and a purchase of assets by the purchaser.<sup>142</sup> The parent corporation would recognize the taxable gain and be subject to tax. The tax result to the parties (with the exception of the purchaser obtaining the EIN) will be the same as Scenario 2A above. The distribution of the proceeds to the shareholders would engender the second taxable event if the corporate parent is a C corporation. The LLC would not be subject to tax and therefore the purchaser would not have an income tax exposure.

### **(d) 3. Sell the S Corporation Stock or Membership Interests for a Reduced Price**

If the risk that the S status is invalid is sufficiently high, and the owners do not wish to attempt to obtain inadvertent ineffective or termination relief under Code Sec. 1362(f) prior to or contemporaneously with the transaction, the final structural option is to simply sell the stock. The purchaser will not obtain a stepped-up basis, will have the risk of corporate income taxes for open years and will seek an indemnification for such exposure (tax, interest and penalty). Since many purchasers today are private equity sponsored funds that anticipate selling the business in three to seven years or so, the actual estimated cost of the loss of the amortization and depreciation may be the present value of three to seven years depending where in the cycle the acquisition takes place. There should be relatively little FIN 48 or UTP disclosure required to the purchaser. As discussed below, when and if appropriate, the sale of personal goodwill of the S corporation's owners may significantly reduce the "lost tax benefit" to the purchaser from not having a Code Sec. 336(e) or 338(h)(10) election.

If this is the route chosen, particularly in the absence of a large personal goodwill aspect to the transaction, there is often relatively little downside (current-year taxable income and generally the prior three years) to seeking a private letter ruling concerning the inadvertent ineffectiveness or termination of the S election even though the results of such ruling request will not be known until after the transaction is closed.<sup>143</sup> If a large amount of personal goodwill is involved and the amount of benefit is not too great, the equation may change as the IRS is rather hostile with respect to personal goodwill and its existence could

color the attitude of the IRS when determining if the error(s) is inadvertent. It is also possible that an audit recommendation may result from the ruling request review. A protective Code Sec. 338(h)(10) or 336(e) election can be made and if a favorable ruling is obtained, the sellers can receive an amount equal to the reduction in purchase price and the purchaser can have the stepped-up basis.

### **(e) 4. Sale of Personal Goodwill in Combination with the Above Scenarios**

In appropriate circumstances, a compliment to any of the alternatives above is the sale of personal goodwill as a possible option.<sup>144</sup> If the target is a service business or other business in which the personal relationships of the owners are the key economic drivers and such owners do not have long-term employment contracts or noncompete agreements, the purchase of personal goodwill may be viable.<sup>145</sup> In order to support the existence and value of the personal goodwill component, a qualified appraisal is more than highly recommended—it is virtually a requirement.<sup>146</sup> Since personal goodwill is definitionally outside the entity, whether or not the S corporation has a valid S status is irrelevant with respect to the consideration properly attributable to the personal goodwill. Such consideration will not flow through the entity. However, if the shareholder/members have a noncompete agreement or long-term employment agreement, the value of the personal goodwill will be significantly reduced if not totally eliminated.<sup>147</sup> The shareholder/members will also have to agree to take (and actually take) affirmative steps to transfer the personal goodwill to the acquired entity, as well as to not compete with the entity for a reasonable period of time.<sup>148</sup> Sellers wishing to "pack it up" and go to the beach need to postpone travel plans or return or otherwise take real actions to transfer their personal goodwill to the purchaser. In many situations, it is unlikely that the personal goodwill of each shareholder/member is proportionate to the shareholder's/member's percentage interest. In such case, either there will need to be different amounts paid to the various shareholders/members or the amount paid for such personal goodwill will need to be proportionately equal to the smallest proportionate amount to be paid to any shareholder/member for personal goodwill. With respect to medical and dental practice acquisitions in which Medicare and Medicaid funds are involved, there is reluctance by some purchasers to structure transactions with personal goodwill. In such cases where the purchaser is willing to purchase personal goodwill, the value of and the amount paid for the personal goodwill cannot reflect a payment for referrals. The appraisals must reflect that

fact. Nevertheless, some purchasers do not want to run the risk that the government takes the position there was a payment for referrals.

With the exception of the fourth alternative, each of the alternatives places the structural economic risk on the sellers. These alternatives are a bit more cumbersome, take additional time, add to the transaction costs and introduce their own set of risks. However, they are alternatives that may enable a transaction to occur. The author has seen situations that the transactions were unable to go forward and the shareholders were unwilling or unable to sell. In such a situation, the sellers should review their situation and perhaps attempt to obtain a private letter ruling of inadvertent invalid election or termination and with a definitive answer as to the S status, go back into the market.

## 12. Conclusion

There are many opportunities for an S corporation to have issues concerning the validity of the S status. The lack of aggressive IRS audit activity on S status may cause the tax preparer and other tax advisors not to be diligent with respect to ongoing corporate events and agreements that could lead to an inadvertent termination. The IRS is

incredibly liberal in its application of Code Sec. 1362(f). Owners of an S corporation contemplating the possibility of a sale should have the S status reviewed before the sales process is undertaken. If there are questions, seeking a private letter ruling for inadvertent ineffective election or termination of the S election will make sense in many situations. This is particularly true with respect to LLCs that have elected S status. Unless the articles and operating agreement were drafted with the election in mind, there is a reasonable possibility that the governing documents may create a second class of stock. Indeed, if the operating agreement was designed to meet the substantial economic effect safe harbor of Reg. §1.704-1(b)(2)(ii) substantial economic effect and have not made book-ups or book-downs on the admission of new members, it is almost certain that there is a potential second class of stock. Obtaining an inadvertent ineffective election or termination ruling if there is any uncertainty as to the status will place the sellers in a much better position to maximize the sales price of the business. A potential purchaser should carefully review the S status of the S corporation target, and if there are serious concerns with respect to the S status, restructure the transaction or otherwise factor the risk into the pricing, indemnities and escrows.

APPENDIX A <sup>1</sup>			
Statutory Default Basis for Distribution			
Per Capita		Pro Rata by Contribution	
Alabama <sup>2</sup>	Ala. Stat. § 10A-5A-4.05	Arizona	Ariz. Rev. Stat. Ann. § 29-709
Alaska	Alaska Stat. § 10.50.290	California	Cal. Corp. Code § 17704.04, subd. (a)
Arkansas	Ark. Code Ann. § 4-32-503	Colorado	Colo. Rev. Stat. § 7-80-503
District of Columbia	D.C. Code § 29-804.04	Connecticut	Conn. Gen. Stat. § 34-152
Georgia	Ga. Code Ann. § 14-11-403	Delaware	Del. Code Ann., Tit. 6, § 18-503
Hawaii	Haw. Rev. Stat. Ann. § 428-405	Florida	Fla. Stat. § 605.0404(1)
Iowa	Iowa Code § 489.404	Indiana	Ind. Code § 23-18-5-3
Idaho	Idaho Code § 30-6-404	Kansas	Kan. Stat. Ann. § 17-76,101; 17-76,102
Louisiana	La. Rev. Stat. Ann. § 12:1323	Kentucky	Ky. Rev. Stat. § 275.205; 210; 310
Michigan	Mich. Comp Laws § 450.4303	Massachusetts	Mass. Gen. Laws Ann. Ch. 156C, § 29(a); 30
Montana	Mont. Code Ann. § 35-8-601; -503	Maryland	Md. Code Ann., Corps. & Assn's. § 4A-503
Nebraska	Rev. Stat. NE § 21-133	Maine	Me. Rev. Stat. Ann. Tit. 31 § 1554
New Jersey	N.J. Rev. Stat. § 42:2C-34(a)	Minnesota <sup>3</sup>	Minn. Stat. § 322B.326; 322C.0404 Subd. 1
North Dakota	N.D. Cent. Code § 10-32.1-30; 1-54.	Mississippi	Miss. Code Ann. § 79-29-505; 507
Oregon	Or. Rev. Stat. § 63.195; 185	North Carolina	N.C. Gen. Stat. § 57D-4-03
South Carolina	S.C. Code Ann. § 33-44-405(a)	New Hampshire	N.H. Rev. Stat. Ann. § 304-C:90
South Dakota	S.D. Codified Laws Ann. § 47-34A-405(a)	New Mexico	N.M. Stat. Ann. § 53-19-22

**APPENDIX A<sup>1</sup>**

**Statutory Default Basis for Distribution**

Per Capita		Pro Rata by Contribution	
Tennessee	Tenn. Code Ann. § 48-220-101	New York	N.Y. Ltd. Liab. Co. Law § 503
Utah <sup>4</sup>	Utah Code Ann. § 48-3a-40	Ohio	Ohio Rev. Code Ann. § 1705.10
West Virginia	W. Va. Code § 31B-4-405(a)	Virginia	Va. Code Ann. § 13.1-1029; -1030
Wyoming	Wyo. Stat. § 17-29-404	Vermont	Vt. Stat. Ann. Tit. 11 § 3055
Pro Rata by Other Basis		Washington	Wash. Rev. Code § 25.15.200; 205
Oklahoma	Okla. Stat. Tit. 18, § 2025	Wisconsin	Wis. Stat. § 183.0503; 0602
Texas	Tex. Bus. Org. Ann. § 101.201	No Statutory Default Distribution Rule	
Illinois	805 ILCS § 180/25-1	Nevada	Nev. Rev. Stat. § 86.341
Missouri	Mo. Rev. Stat. § 347.111	Pennsylvania	N/A
Rhode Island	R.I. Gen. Laws § 7-16-26		

**ENDNOTES**

- <sup>1</sup> Adapted from RIBSTEN & KEATINGE, 1 RIBSTEIN AND KEATINGE ON LTD. LIAB. COS., Appendix 5-2, Default Allocation of Profits, Losses, and Distributions and Appendix 6-1, Charts.
- <sup>2</sup> Under the Alabama Limited Liability Company Law of 2014, the default distribution rule will be on a per capita basis beginning on January 1, 2017. The old default rule, distributions made *pro rata* by contribution, is currently being phased out. See Ala. Code § 10A-5-5.03 (*pro rata* by contribution default rule); Ala. Code 1975 § 10A-5A-12.01 (transition rules).
- <sup>3</sup> Minnesota recently adopted the Minnesota Revised Uniform Limited Liability Company Act. The Act is currently being phased in, but will not vary the prior default distribution rule (*pro rata* by contribution). See Minn. Stat. § 322C.1204.
- <sup>4</sup> The phase in of Chapter 3a will be complete January 1, 2016, at which time the Chapter will apply to all Utah LLCs. The phase in did not vary the prior default distribution rule (*per capita*). See Utah Code Ann. § 48-3a-1405.

**ENDNOTES**

- <sup>1</sup> There were 4,205,452 S corporation returns versus 2,211,353 LLC returns filed for tax year 2012. IRS, Statistics of Income (SOI) Tax Stats—Integrated Business Data, Table 1: Selected Financial Data on Businesses, available online at [www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data](http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data).
- <sup>2</sup> Since the predominant form of unincorporated association to which this discussion pertains is the LLC, for convenience purposes the column will discuss LLCs. However, most of the discussion would also apply to other forms of unincorporated associations doing business.
- <sup>3</sup> Reg. §301.7701-3(c)(1)(v)(C) (deemed entity classification election).
- <sup>4</sup> Code Sec. 197(a).
- <sup>5</sup> Financial Accounting Standards Board Interpretation No. 48 (Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109). Under FIN 48, uncertain tax positions that reduce an enterprise's current or future tax liabilities are reported in the enterprise's financial statements to the extent each benefit claimed on a return does exceed the more likely than not standard. This requires an exercise of judgment on the part of the auditors and an analysis of a range of possible outcomes and corresponding range of probabilities that could be realized upon a settlement using the available facts and circumstances.
- <sup>6</sup> Instructions to Form 1120, *Schedule UTP (2014)*, at 2.
- <sup>7</sup> Code Secs. 6037(a) and 6501(a).
- <sup>8</sup> See Code Sec. 197(c)(2).
- <sup>9</sup> Generally, the selling shareholders are "tax equalized" for the additional tax cost of the transaction ordinary income component and may obtain a modest additional amount, but usually this is a small percentage of the tax benefit the purchaser anticipates receiving as a result of the Code Sec. 336(e) or 338(h)(10) election.
- <sup>10</sup> See *supra* note 6.
- <sup>11</sup> Code Sec. 1362(b)(5); Reg. §1.1362-6(b)(3)(iii); Rev. Proc. 2013-30, IRB 2013-36, 173 (consolidating and extending S corporation late-election relief revenue procedures). The IRS also provides a direct link to late-election relief guidance from its S Corporation webpage, [www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Late-Election-Relief](http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Late-Election-Relief).
- <sup>12</sup> Code Sec. 1362(b)(5); see LTR 9839011 (June 23, 1998); LTR 9820014 (Feb. 9, 1998); LTR 9722021 (Feb. 26, 1997).
- <sup>13</sup> Reg. §1.1362-6(b)(2)(i).
- <sup>14</sup> Rev. Proc. 2013-30, IRB 2013-36, 173.
- <sup>15</sup> This Form 2553 must be signed by all persons who were shareholders at any time during the period that began on the first day of the taxable year for which the election is to be effective and ends on the day the completed application is filed.
- <sup>16</sup> Reg. §1.1361-1(c) defines corporation to include an unincorporated association taxable as a corporation.
- <sup>17</sup> Code Sec. 1361(b)(2) provides that the following corporations are ineligible to be an S corporation: (i) a financial institution using the reserve method of accounting for bad debts; (ii) an insurance company subject to tax under subchapter L; (iii) a corporation to which an election under Code Sec. 936 applies; or (iv) a DISC or former DISC.
- <sup>18</sup> Code Sec. 7701(a)(4) defines a domestic corporation as a corporation created or organized in the United States or under the law of the United States or of any state.
- <sup>19</sup> Code Sec. 1361(b)(1)(A).
- <sup>20</sup> Code Sec. 1361(b)(1)(B).
- <sup>21</sup> Code Sec. 1361(b)(1)(C).
- <sup>22</sup> Code Sec. 1361(b)(1)(D).
- <sup>23</sup> Code Sec. 1362(d)(3).
- <sup>24</sup> Reg. §301.7701-3(c)(1)(v)(C).
- <sup>25</sup> Code Sec. 1362(g).
- <sup>26</sup> Code Sec. 1361(c)(1)(A).
- <sup>27</sup> Code Sec. 1361(c)(1)(B). "Members of a family" is an expansive term. It covers individuals related through a "common ancestor" (an individual six or fewer generations removed from the youngest generation of shareholders who are otherwise members of the family); any lineal descendent of a common ancestor; as well as any current or former spouses of such individuals.
- <sup>28</sup> Code Sec. 1361(c)(2)(B)(iv) (providing each beneficiary of a trust created primarily to

exercise the voting power of stock transferred to it is treated as a shareholder) and Code Sec. 1361(c)(2)(B)(v) (providing that each potential current beneficiary of an electing small business trust is treated as a shareholder).

<sup>29</sup> See Reg. §1.1361-1(b)(ii); Reg. §1.1361-1(b)(iii); Reg. §1.1361-1(e)(2). Because an individual's estate may be a shareholder, but a shareholder may not be a nonresident alien, by implication, an estate qualified to be an S corporation shareholder must be a domestic individual estate. Indeed, Reg. §1.1361-1(e)(2) provides that where stock owned by husband and wife is treated as one shareholder, both the husband and wife must be U.S. citizens or residents, and a decedent spouse's estate must not be a foreign estate as defined in Code Sec. 7701(a)(31).

<sup>30</sup> Code Sec. 1361(c)(2)(A), see also Laura Howell-Smith, *What Types of Trusts Are Permitted Shareholders of an S Corporation?* ESTATE PLANNING, June 2007, at 26–34.

<sup>31</sup> As defined under subchapter J, Part I, subpart E. See Code Secs. 671 to 679.

<sup>32</sup> Code Sec. 1361(c)(2)(A)(i).

<sup>33</sup> Code Sec. 676. Revocable trusts.

<sup>34</sup> Code Sec. 677. Income benefit trusts.

<sup>35</sup> Code Sec. 673. Reversionary trusts.

<sup>36</sup> Code Sec. 674.

<sup>37</sup> Code Sec. 675.

<sup>38</sup> Code Sec. 678.

<sup>39</sup> Code Sec. 1361(e)(1)(A)(i).

<sup>40</sup> Code Sec. 1361(e)(1)(A)(ii) and (iii).

<sup>41</sup> Code Sec. 1361(c)(4).

<sup>42</sup> Reg. §1.1361-1(l)(1).

<sup>43</sup> Reg. §1.1361-1(b)(3), (l)(1) and (l)(3).

<sup>44</sup> Reg. §1.1361-1(l)(2)(i).

<sup>45</sup> Reg. §1.1361-1(l)(1) and (2).

<sup>46</sup> LTR 201308008 (Nov. 7, 2012) dealt with a redemption agreement in effect at the time of the S election. The IRS held that if the election was ineffective, the invalidity was inadvertent and the entity would be deemed to be an S corporation.

<sup>47</sup> See LTR 201240012 (May 9, 2012).

<sup>48</sup> See LTR 201424003 (Feb. 3, 2014).

<sup>49</sup> LTR 201217009 (Jan. 6, 2012).

<sup>50</sup> LTR 201434016 (Apr. 29, 2014) granted inadvertent termination relief for certain convertible debt. The terms of the convertible debt are not disclosed in the ruling.

<sup>51</sup> Code Sec. 1361(c)(5), see also Reg. §1.1361-1(l)(5).

<sup>52</sup> Reg. §1.1361-1(l)(5)(i).

<sup>53</sup> See Code Sec. 1361(c)(5).

<sup>54</sup> Reg. §1.1361-1(l)(5)(ii).

<sup>55</sup> Reg. §1.1361-1(l)(5)(iii).

<sup>56</sup> Reg. §1.1361-1(l)(4)(ii)(B)(1).

<sup>57</sup> Reg. §1.1361-1(l)(4)(ii)(B)(2).

<sup>58</sup> Reg. §1.1361-1(l)(4)(iii)(A).

<sup>59</sup> Pursuant to Reg. §1.1361-1(l)(4)(iii)(B)(1), a lender may transfer an option or the accompanying loan (or portion of the option and a corresponding portion of the accompanying loan) without causing such call option to be considered as a second class of stock. A transfer of such option without the accompanying loan will cause the option to be retested.

<sup>60</sup> If either of the two exceptions is met, the option will not be considered a second class of stock. See *Santa Clara Valley Housing Group*, DC-CA, 2012-1 *ustrc* ¶150,169.

<sup>61</sup> Reg. §1.1361-1(l)(4)(iii)(C).

<sup>62</sup> Whether the amount for the employee or independent contractor is excessive may be a subjective matter on which it is often hard to become comfortable.

<sup>63</sup> Reg. §1.1361-1(b)(4).

<sup>64</sup> Reg. §1.1361-1(b)(4) end flush.

<sup>65</sup> Reg. §1.1361-1(l)(2)(iii)(A).

<sup>66</sup> Reg. §1.1361-1(l)(2)(iii)(C).

<sup>67</sup> Reg. §1.1361-1(l)(2)(iii)(A) flush language.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> T.D. 8419, 1992-2 CB 217, May 29, 1992. It is the position of the IRS and the Treasury that "an agreement that effectively constitutes a buy-sell or redemption agreement should be treated as such regardless of its designation." *Id.*

<sup>71</sup> See LTR 200735022 (May 22, 2007) in which the majority shareholder of a bank sold shares to directors to meet regulatory rules that all directors must own stock, but as a condition of the sale, the majority shareholder would receive all dividends, and if the director ceased being a director, such director would resale the stock to the shareholder at the purchase price and the majority shareholder could repurchase the stock at that price at any time. Although the ruling did not definitively determine that a second class existed, as a condition of inadvertent termination relief, the shareholder agreement was revised for a repurchase at fair market value and the directors kept all dividends. The director had to report past dividends as income.

<sup>72</sup> Reg. §1.1361-1(l)(2)(iii)(B); see also Reg. §1.1361-1(l)(2)(vi), Examples 8 and 9.

<sup>73</sup> Reg. §1.1361-1(l)(2)(vi), Example 9.

<sup>74</sup> LTR 200831016 (Feb. 29, 2008).

<sup>75</sup> Reg. §1.1361-1(l)(2)(iii)(B).

<sup>76</sup> Reg. §1.1361-1(l)(2)(iii).

<sup>77</sup> Reg. §1.1361-1(l)(2)(iv).

<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

<sup>80</sup> Reg. §1.1361-1(l)(v).

<sup>81</sup> At the time these regulations were issued, Code Sec. 336(e) elections were not available but the principle should be the same. The author speculates that this regulation is simply acknowledging that shareholders and purchasers can negotiate their own deals for the sale of stock and the election that creates a deemed sale of assets and a deemed liquidation of the proceeds to the shareholders will not cause a second class of stock in *bona fide* third-party transactions.

<sup>82</sup> See T.D. 8940, 2001-1 CB 1016, Feb. 13, 2001. For example, shareholders may negotiate different share prices based on their respective federal and state tax liabilities, control premiums or other reasons. *Id.*

<sup>83</sup> Reg. §1.1361-1(l)(vi), Example 2.

<sup>84</sup> See LTR 201240012 (May 9, 2012).

<sup>85</sup> Reg. §1.1361-1(l)(vi), Example 3.

<sup>86</sup> Reg. §1.1361-1(l)(2)(i), see also Reg. §1.1361-

1(l)(2)(vi), Example 3.

<sup>87</sup> In LTR 200807004 (Nov. 9, 2007), the S corporation had loaned money to one shareholder employee to facilitate purchases of stock from another. The company then gave the shareholder bonuses (which were approved by the board of directors after the fact) to enable the employee shareholder to repay the loans. Although the S election was terminated as a result of another event on which inadvertent termination relief was granted, the IRS did not determine whether the bonus under the circumstances constituted a second class of stock, but to the extent it did, the IRS gave inadvertent termination relief but the recipient shareholder had to return the excessive amounts and other adjustments were required.

<sup>88</sup> Reg. §1.1361-1(l)(2)(vi), Example 5(ii).

<sup>89</sup> Reg. §1.1361-1(l)(2)(vi), Example 5(i).

<sup>90</sup> Reg. §1.1361-1(l)(2)(vi), Example 6.

<sup>91</sup> By negative inference, see Reg. §1.1361-1(l)(4)(vi), Example 7.

<sup>92</sup> In LTR 201240012 (May 9, 2012), there was no written or oral agreement for the corporation to file composite returns and make such payments, which were made over a six-year period of time. The corporation represented it will make remedial distributions to the other shareholders, and it did not intend to create a second class of stock. There was no motivation of tax avoidance or retroactive planning. The IRS granted that the termination was inadvertent within the meaning of Code Sec. 1362(f) and treated the corporation as an S corporation from its date of election.

<sup>93</sup> Code Sec. 1362(d)(3).

<sup>94</sup> Reg. §1.1362-2(c)(5).

<sup>95</sup> See e.g., LTR 201248001 (July 23, 2012) (providing relief from inadvertent termination of S election where the taxpayer had accumulated earnings and profits and excessive passive investment income for three consecutive years as a result of its tax advisor's failure to inform it of the passive investment rules); see also, LTR 201221008 (Feb. 24, 2012).

<sup>96</sup> See LTR 201221008 (Feb. 24, 2012).

<sup>97</sup> Reg. §301.7701-3.

<sup>98</sup> See LTR 200548021 (Aug. 23, 2005).

<sup>99</sup> See LTR 201132013 (May 3, 2011).

<sup>100</sup> In some states, the articles of organization may be referred to as the certificate of formation.

<sup>101</sup> See *infra* 9. Inadvertent Termination Relief.

<sup>102</sup> See LTR 201136004 (May 23, 2011).

<sup>103</sup> See LTR 201039005 (June 28, 2010).

<sup>104</sup> See generally, J. Leigh Griffith, *Passthrough Partner, Partners and W-2 Employee Status*, TAXES, Feb. 2015, at 19; J. Leigh Griffith, *W-2 Partner? Think Twice!* TENN. CPA J., Jan.–Feb. 2015, at 24 (providing a detailed discussion of this topic).

<sup>105</sup> Small discrepancies in capital account balances can create the second class of stock. See LTR 201351017 (Aug. 16, 2013).

<sup>106</sup> See *infra* Appendix A, State Law Distribution Default Rule Table, adapted from Ribstein & Keatinge, 1 RIBSTEIN AND KEATINGE ON LTD. LIAB. COS. Appendix 5-2, Default Allocation of Profits, Losses, and Distributions and Appendix 6-1, Charts.

<sup>107</sup> Nevada and Pennsylvania do not have a statutory default LLC distribution rule. *Id.*

<sup>108</sup> The following states have statutory default rules providing for *per capita* distributions where the operating agreement is silent: Alabama (applies to all LLCs beginning Jan. 1, 2017), Alaska, Arkansas, District of Columbia, Georgia, Hawaii, Iowa, Idaho, Kentucky, Louisiana, Michigan, Montana, Nebraska, New Jersey, North Dakota, Oregon, South Carolina, South Dakota, Tennessee, Utah, West Virginia and Wyoming. *Id.*

<sup>109</sup> The following states have statutory default rules providing for distributions *pro rata* by contribution where the operating agreement is silent: Alabama (current *pro rata* contribution default rule is being phased out and will be completely replaced by a *per capita* default rule starting Jan. 1, 2017), Arizona, California, Colorado, Connecticut, Delaware, Florida, Indiana, Kansas, Kentucky, Massachusetts, Maryland, Maine, Minnesota, Mississippi, North Carolina, New Hampshire, New Mexico, New York, Ohio, Virginia, Vermont, Washington, and Wisconsin. *Id.*

<sup>110</sup> Oklahoma, Texas, Illinois, Missouri and Rhode Island provide default statutory distribution rules on a *pro rata* basis other than contribution where the operating agreement is silent. *Id.*

<sup>111</sup> Reg. §1.1362-4(b).

<sup>112</sup> Reg. §1.1362-4(c).

<sup>113</sup> Reg. §1.1362-4(e). The Committee Reports accompanying the Subchapter S Revision Act of 1982 contemplate the shareholders will be treated as if the election was in effect for the entire period for which relief is granted. S. REP. NO. 97-640, at 12-13 (1982), 1982-2 CB 718, 723-24; H.R. REP. NO. 97-826, at 12 (1982), 1982-2 CB 730, 735.

<sup>114</sup> See LTR 201505008 (Oct. 14, 2014) and LTR 201102033 (Sept. 20, 2010) (each required catch-up distributions within 120 days from the date of the private letter ruling).

<sup>115</sup> STARR, SMITH AND SOBOL, S CORPORATIONS: FORMATION AND TERMINATION, 730-3rd T.M., at A-86.

<sup>116</sup> STARR, SMITH AND SOBOL, S CORPORATIONS: FORMATION AND TERMINATION, 730-3rd T.M., at A-87.

<sup>117</sup> For example, in LTR 201505008 (Oct. 14, 2014), the company represented that it was unaware that issuing new classes of stock to shareholders and issuing stock to ineligible shareholders could terminate the S election. Inadvertent termination relief was granted.

<sup>118</sup> Reg. §1.1362-4(d) and (e).

<sup>119</sup> See LTR 201351017 (Aug. 16, 2013) for an example of a transaction case in which the sellers obtained an inadvertent termination ruling. The purported S corporation was an LLC. The original operating agreement dated 1 was lost. A new operating agreement was entered into date 3, which had

distributions in proportion to the members' Profit Sharing Percentages unless all members otherwise consent, and liquidation was in accordance with positive capital account balances. The capital accounts were not in the exact proportion to Profit Sharing Percentages. The IRS concluded that the LLC's S election may have been ineffective or subsequently terminated because the LLC may have had more than one class of stock. The IRS made an inadvertent ineffectiveness or termination decision and gave retroactive relief. In this case, no distributions had actually been made based on hours worked and no liquidation distributions based on years of service had been made.

<sup>120</sup> See LTR 201132013 (May 3, 2011) where an LLC for which an S election had been made called for distributions based on a formula for hours worked and liquidation proceeds based on length of service and for which inadvertent termination relief was requested.

<sup>121</sup> See generally, J. Leigh Griffith, Passthrough Partner, *Transfer of Partnership Interest for Services Revisited—Part II, TAXES*, Feb. 2014, at 21; J. Leigh Griffith, Passthrough Partner, *Transfer of Partnership Interest for Services Revisited—Part I, TAXES*, Dec. 2013, at 21 (providing a detailed discussion on this topic).

<sup>122</sup> See Rev. Proc. 93-27, 1993-2 CB 343, as supplemented by Rev. Proc. 2001-43, 2001-2 CB 191.

<sup>123</sup> This can also be achieved through an actual liquidation of the S corporation followed by an asset sale. This would involve two transfers and the cooperation of all shareholders and generally would seem to be a cumbersome alternative to a sale of assets followed by a liquidation. It would be a most unusual situation in which this process would be cost efficient.

<sup>124</sup> The recognition period is currently 10 years. For tax years beginning in 2009 and 2010, the recognition period was seven years, and for 2011, 2012, 2013 or 2014, it was five years. It is possible that the period again will be shortened in an extenders bill for 2015 but that is unknown at this point in time.

<sup>125</sup> Code Sec. 1012.

<sup>126</sup> Although the federal tax rate is the same for capital gains and dividends, if the distribution is in liquidation, the outside basis will reduce the gain. However, if the S corporation election is invalid, the basis will have started off as only the amount originally paid for the stock plus any additional capital contributions.

<sup>127</sup> Rev. Rul. 99-6, 1999-1 CB 432.

<sup>128</sup> Code Sec. 1012.

<sup>129</sup> Code Sec. 368(a)(1)(F) (a reorganization resulting in "change in identity, form, or place of organization of one corporation, however effected ...").

<sup>130</sup> Reg. §1.1361-3; see also LTR 200701017 (Jan. 5, 2007).

<sup>131</sup> If the applicable state does not have a conversion statute, it can also be accomplished by a merger into an LLC owned by the new parent S corporation. Since the QSub and the single-member LLC are both disregarded entities for federal tax purposes, it should be a federal tax nothing.

<sup>132</sup> Code Sec. 368(a)(1)(F); Reg. §1.368-2(m); see LTR 200505010 (Oct. 14, 2004).

<sup>133</sup> *Id.*

<sup>134</sup> If the target is in fact an S corporation, the QSub election causes the new holding company to be an S corporation. Since there is a concern as to S corporation status, particularly if it is envisioned that the new holding company will continue in the future after the transaction, an "unnecessary" S corporation election could be made for the new holding company.

<sup>135</sup> See *supra* note 132 and 133.

<sup>136</sup> Rev. Rul. 2008-18, 2008-1 CB 674.

<sup>137</sup> Code Secs. 351 and 357(c).

<sup>138</sup> Code Sec. 332(a). Since the structural form is a transfer of assets from one form of disregarded entity to another form of disregarded entity owned by the same S corporation, this should not be a taxable event. If there is somehow a moment in time that the QSub again becomes a recognized corporate subsidiary in order to convert, Reg. §1.1361-5(b)(3), Example 2, wherein the merger of a QSub into an LLC wholly owned by the QSub parent, indicates that there would be no gain triggered under that construction.

<sup>139</sup> Code Sec. 337(a).

<sup>140</sup> Code Sec. 332(a).

<sup>141</sup> Code Sec. 334(b)(1).

<sup>142</sup> Rev. Rul. 99-6, 1999-1 CB 432.

<sup>143</sup> See LTR 201351017 (Aug. 16, 2013).

<sup>144</sup> In the context of a sale of stock, the personal goodwill option would provide the buyer with the potential for the amortization of the intangible and reduce the "haircut" the sellers are taking as a result of S corporation status problems. There is no tax advantage to the sellers but perhaps a significant advantage to the buyer.

<sup>145</sup> Personal goodwill transactions have their own risks, which are outside the scope of this column. Such transactions may invite IRS scrutiny and should not be undertaken without careful analysis and consideration.

<sup>146</sup> See *J.P. Kennedy*, 100 TCM 268, Dec. 58,339(M), TC Memo. 2010-206.

<sup>147</sup> See *Martin Ice Cream Co.*, 110 TC 189, Dec. 52,624 (1998); *W. Norwalk*, 76 TCM 208, Dec. 52,817(M), TC Memo. 1998-279.

<sup>148</sup> See *W. Norwalk*, 76 TCM 208, Dec. 52,817(M), TC Memo 1998-279; *I. Muskat*, DC-NH, 2008-1 ustrc ¶150,283.

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