

Larry's Tax Law

Inadvertent S Election Termination

By Larry Brant on 10.29.13 | Posted in Corporate Tax

The Service Continues its Warm Approach to Taxpayers with S Corporation Inadvertent Terminations (PLR 201340001)

As we know, in accordance with Code Section 1362(f) and the corresponding Treasury Regulations, a corporation will continue to be treated as a Subchapter S corporation during a period of termination, if:

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 1. The election was terminated, either because the corporation was disqualified as an electing small business corporation, or as a result of running afoul of the passive investment income rule;
 2. The Service determines the termination as inadvertent;
 3. The corporation promptly takes steps to correct the defect after discovery; and
 4. The corporation and its shareholders acted as if the election was continuously in effect.

Continuation of an S election following an inadvertent termination is ultimately within the Secretary's sole discretion. Unfortunately, taxpayers must request a ruling to obtain relief. Treas. Reg. Section 1.1362-4(c). The good news, however, is that the Service routinely issues affirmative rulings in this area.

Private Letter Ruling 201340001 (October 18, 2013) is an example of the Service issuing inadvertent termination relief. In this private letter ruling, shares of the taxpayer were transferred to a trust which was an ineligible shareholder. The next day, the taxpayer discovered the problem and immediately caused the shares to be transferred to an eligible shareholder. The Service, in its ruling, emphasized that the taxpayer represented that:

- Its shareholders at all times since the effective date of the S election treated the corporation as an S corporation;

- The termination was not motivated by tax avoidance or retroactive tax planning;

- The eligible shareholder who ultimately received the shares reported all items of the taxpayer's income, loss, deduction and credit that would have been allocated to the ineligible trust shareholder, and the eligible shareholder paid all taxes associated therewith; and
- The taxpayer's shareholders agreed to make any adjustments required by the Secretary.

Based upon these representations, the Service granted relief to the taxpayer. While a private letter ruling is only binding on the Service and the taxpayer who obtains it, this ruling is a good reminder to practitioners that relief may be granted under Code Section 1362(f) for inadvertent S corporation terminations. The keys to obtaining an affirmative ruling in the inadvertent termination area appear to be fourfold: **(i)** the termination was inadvertent; **(ii)** prompt curative action was taken after discovery of the error; **(iii)** the shareholders acted consistently with the election being in continuous effect; and **(iv)** the absence of any tax avoidance motives.

If you are faced with an inadvertent S corporation termination because the corporation no longer qualifies as an electing small business corporation or due to violating Code Section 1362(d)(3) (excessive passive investment income), you may be able to obtain relief under Section 1362(f). A ruling request, however, will be required.

Tags: Code Section 1362(f), Inadvertent Terminations, S corporation