Avoiding inadvertent S corp termination

S corporation structure provides most of the tax benefits of a partnership plus the liability protection of a corporation. But because of the strict requirements that apply to these entities, preserving S corporation status requires due diligence.

Reap the benefits

Like a traditional C corporation, an S corporation shields its shareholders from personal liability for the corporation's debts. Like a partnership, an S corporation is a "pass-through" entity, which means that all of its profits and losses are passed through to the owners, who report their allocable shares on their personal income tax returns. This allows S corporations to avoid the double taxation of C corporations, whose income is taxed at the corporate level and again when distributed to shareholders.

To qualify as an S corporation, all of a corporation's shareholders must file an election with the IRS on Form 2553, *Election by a Small Business Corporation*. In addition, the corporation must:

- Be a domestic (U.S.) corporation,
- Have no more than 100 shareholders (certain family members are treated as a single shareholder for this purpose),
- Have only "allowable" shareholders (see below),

- Have only one class of stock (generally, that means that all stock confers identical rights to distributions and liquidation proceeds; differences in voting rights are permissible), and
- Not be an "ineligible" corporation, such as an insurance company, a domestic international sales corporation (DISC) or a certain type of financial institution.

Allowable shareholders include individuals, estates and certain trusts, such as a qualified Subchapter S trust (QSST) and an electing small business trust (ESBT). Partnerships, corporations and nonresident aliens are ineligible.

Preserve and protect

To avoid inadvertent termination of S corporation status, among other things, you should:

- Continually monitor the number and type of shareholders, scrutinize the terms of any trusts that hold shares, and ensure that QSSTs or ESBTs have filed timely elections,
- Include provisions in buy-sell agreements that prevent transfers to ineligible shareholders,
- Make sure that if shares are transferred to an ESBT, all potential current beneficiaries are eligible shareholders, and
- Be aware that if shares are held by grantor or testamentary trusts, these types of trusts are eligible shareholders for only two years after the grantor dies or the trust receives the stock. So track the two-year eligibility period and make sure trusts convert into QSSTs or ESBTs or transfer their shares to an eligible shareholder before the period expires.

Also, avoid actions that may be deemed to create a second class of stock, such as making disproportionate distributions.

Stay focused

Avoiding inadvertent termination of your company's S corporation status is critical. Termination generally will result in the loss of substantial tax benefits. You may be able to get the IRS to retroactively restore your S status, but it can be an expensive, time-consuming process. So stay focused on maintaining compliance with all S corporation requirements. Contact us if you have questions.