## What’s New

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page No.</th>
<th>Source</th>
<th>Update</th>
</tr>
</thead>
<tbody>
<tr>
<td>14</td>
<td>263</td>
<td>CCA 201446021</td>
<td>AAA did not survive on a corporation that elected, terminated and then re-elected S status.</td>
</tr>
</tbody>
</table>
I. Terminating an S Election Overview

- Revoke the Election
- Fail to meet requirements of election
- Excess Passive Income for Three Consecutive Years
I. Terminating an S Election Overview

When does the termination take effect?

B. Depends on what the event is and how made.

- Election – on the election date or after unless made within the first 2 ½ months of the tax year then taxpayer can decide
- Failure – Two short tax years, prior to and post the failure
- Excess Passive Income – In the third year of the event
I. Terminating an S Election Overview

The Traps

Tax Traps—Changing from S Corporation to C Corporation

- The 5-year rule that requires an entity to remain a C corporation for 5 years before electing back to S corporation status.

- Potential double tax on assets owned by a corporation with high fair market value and low basis (built-in gain).

- Potential for C corporation penalty taxes, such as Personal Holding Company (PHC) tax, Qualified Personal Service Corporation (QPSC) tax, and Accumulated Earnings (AET) tax.
I. Terminating S Election Overview

FILING TIP: If an S election is terminated or revoked during the year, the box at line H(5) “S election termination or revocation” on page 1 of Form 1120S and the “Final K-1” box on Schedule K-1 should be checked to notify the IRS that this will be the final S corporation return. If the S election was involuntarily terminated, a statement should be attached to the tax return.

NOTE: The “Final Return” Box at Line H(1) on Page 1 of Form 1120S is only checked when the corporation is liquidated during the year and NO corporation filing requirement of any type will apply for future years.
I. Terminating S Election Overview

Final 1120-S NO
Final K-1 Yes
II. Revoking Election Voluntarily

Voluntary Termination

If filed by 15th day of 3rd month of tax year effective day 1 of tax year

Effective Date
01/01/2017

Election made
03/15/2017
II. Revoking Election Voluntarily

Election made after the 15th day of the third month of the tax year effective on date of election or any date there-after as designated.

- Election made on 03/16/2017
  - Effective 03/16/2017
- Effective 08/01/2017
- Effective 01/01/2018
IV. Waiver of Inadvertent Termination

E. There is a long history of IRS waiving inadvertent terminations through the PLR process. While expensive it does show the IRS frequently offers relief to taxpayer mistakes in this arena.

Practice Hint – Try the begging letter first, it is less expensive and may obtain the desired result without the expense.
VI. Waiting Period

- **PLR -New Majority Ownership – Only by IRS consent**
- **PLR-Termination beyond control of shareholders**

**Post Term of Election can not re-elect until 5\textsuperscript{th} year unless**

- **D. Election revoked before if became effective**
- **D. Corp failed eligibility tests by the first effective day**
VII. Post-Termination Transition Period (PTTP)

Suspended Losses – For a period of one year (PTTP) may be accessed by shareholders BUT

C. Definition – Starts on the last day of the S-Corps qualifying period and ends on the latest of:
   1. One year after that day
   2. Due date of final S-Corp Return
   3. 120 days after the determination that the S Corp has been terminated or
   4. 120 days after an IRS determination of adjustment to items of S-Corp, income, loss or deduction
VII. Post-Termination Transition Period (PTTP)

F. Some other benefits during the PTTP

1. Monetary distributions can be made from AAA
2. Basis can be restored to allow deduction of suspended losses
3. At-risk failure can be cured
5. Basis can be restored through additional stock purchases – FSA 200207015
VII. Post-Termination Transition Period (PTTP)

Taxpayer asked IRS what was status of the AAA account when a former S-Corp made a new S election but had failed to empty the AAA during the prior PTTP. – It was not good news

The IRS determined that the AAA of a corporation that elected, terminated, then re-elected S corporation status was zero. IRC Sec. 1368(e)(2) defines the S period during which the AAA is adjusted as the most recent continuous period during which the corporation has been an S corporation.

The taxpayer argued that the AAA balance from the initial S period survived the break in S status. The chief counsel applied the plain language of IRC Sec. 1368(e)(2), which requires the corporations' AAA be “reset” at the end of the post-termination transition period. Consequently, the AAA of the re-elected S corporation was zero after the intervening C corporation period. CCA 201446021.
VIII. Short Year Allocations

When corp has S and C status in a single tax year – two returns are filed and net income is allocated in one of two ways.
VIII. Short Year Allocations

Allocations

D. Actual Method

1. Close books on date of termination
   - Required if 50% or more ownership change
2. Elected with consent of all shareholders who own S-Corp at anytime and day one of C-Corp
3. File election with C-Corp return
   - Attach statement of consent by each required shareholder
VIII. Short Year Allocations

Allocations - Books and records

EXAMPLE: A calendar year S corporation terminated its S corporation election on May 31, 2017. It allocated income to two short years based on books and records as follows:

- S corporation short year: $20,000
- C corporation short year: $60,000

Total: $80,000

Tax Calculation is annualized for both methods.

The tax on the C corporation short year will be computed as follows:

\[
\text{Gross up short year } \left( \frac{365}{214} \times 60,000 \right) = \$102,336
\]

\[
\text{Tax on } \$102,336 \left( \$23,411 \times \frac{214}{365} \right) = \$23,411
\]

\[
\text{Tax for short year} = \$13,726
\]
X. Disposition of Stock

Note that the sale of stock of an electing S-Corp is subject to reporting based on the basis of the stock in the same manner as a C-Corp

A. Basis is first adjusted for all predisposition flow through activity.

B. In the event that stock basis has been reduced to ZERO the gain will equal the sale proceeds.

C. Suspended losses do not affect sale gain they simply disappear.
X. Disposition of Stock

**EXAMPLE:** Louise is a 50% stockholder in Teaching Golf. As of December 31, 2016, she had **zero basis in her stock and a suspended loss of $100,000**. On July 1, 2017, Louise sells her stock to Gary for $120,000. The company shows a loss of $40,000 for 2017.

Louise's suspended loss at disposition is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Suspended loss balance—12/31/2016</td>
<td>$100,000</td>
</tr>
<tr>
<td>Pro rata share of 2017 loss:</td>
<td></td>
</tr>
<tr>
<td>($40,000 × ½ yr. × 50%)</td>
<td>10,000</td>
</tr>
<tr>
<td>Suspended loss balance—6/30/2017</td>
<td>$110,000</td>
</tr>
</tbody>
</table>

Her gain on sale of stock is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$120,000</td>
</tr>
<tr>
<td>Basis</td>
<td>0</td>
</tr>
<tr>
<td>Gain</td>
<td>$120,000</td>
</tr>
</tbody>
</table>

The suspended loss disappears. OUCH!
IX. Disposition of Stock

E. The new consideration – Sale of S Corporation Stock may be subjected to the NIIT for non-material stock holders.

Example – Fred and Paula retired from their very successful S-Corporation, a manufacturing company, retaining their ownership, but no longer participating in management of the company that they have given to their decedents which they have now sold 15 years later.
## S Corporation Election Guide

<table>
<thead>
<tr>
<th>Election</th>
<th>How to Make Election</th>
<th>Date for Making Election</th>
<th>Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electing S corporation status</td>
<td>Form 2553 signed by a corporate officer and consented to by each shareholder</td>
<td>Any time during preceding tax year or by the 15th day of the 3rd month of the current tax year</td>
<td>IRC Sec. 1362(a)</td>
</tr>
<tr>
<td>QSub election</td>
<td>Form 8869, signed by an officer of the corporation</td>
<td>Any time within the 12-month period before desired effective date or within 2 months and 15 days after desired effective date</td>
<td>IRC Sec. 1361(b)(3)</td>
</tr>
<tr>
<td>ESBT-election to treat a trust as an electing small business trust</td>
<td>Separate election statement made by trustee</td>
<td>Within 2 months and 15 days after the 1st day on which the trust must qualify as an ESBT</td>
<td>IRC Sec. 1361(e)(3)</td>
</tr>
<tr>
<td>Revocation of S election</td>
<td>Separate election statement signed by a corporate officer, and with signed consent of shareholders owning more than 50% of outstanding stock</td>
<td>Any time before the desired effective date or by the 15th day of the 3rd month of the tax year to be retroactive to the beginning of the year</td>
<td>IRC Sec. 1362(d)(1)</td>
</tr>
<tr>
<td>Rescission of revocation of S election</td>
<td>Separate election statement signed by each person who consented to the original revocation, and by each person who became a shareholder after the revocation</td>
<td>Any time before the revocation becomes effective</td>
<td>Reg. 1.1362-2(a)(4)</td>
</tr>
<tr>
<td>Election to allocate income during S termination year using other than pro rata allocation</td>
<td>Separate election statement signed by corporate officer and each shareholder</td>
<td>Attach to tax return for the C short year</td>
<td>IRC Sec. 1362(e)(3)</td>
</tr>
</tbody>
</table>

## S Corporation Election Guide

<table>
<thead>
<tr>
<th>Election</th>
<th>How to Make Election</th>
<th>Date for Making Election</th>
<th>Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Elective ordering rule for basis adjustments</td>
<td>Separate election statement by the electing shareholder</td>
<td>Any time within the 12-month period before the desired effective date or within 2 months and 15 days after desired effective date</td>
<td>Reg. 1.1361-3(b)</td>
</tr>
<tr>
<td>Election to distribute E&amp;P first</td>
<td>Separate election statement signed by a corporate officer. All affected shareholders must consent</td>
<td>Attach to timely filed original or amended S return</td>
<td>IRC Sec. 1368(e)(3)</td>
</tr>
<tr>
<td>Election to terminate year for purposes of allocating S income on the complete termination of a shareholder’s interest</td>
<td>Separate election statement signed by a corporate officer and consented to by all affected shareholders</td>
<td>Attach to timely filed original or amended S return for the year in which the shareholder’s interest terminated</td>
<td>IRC Sec. 1377(a)(2)</td>
</tr>
<tr>
<td>Election under Sec. 444 to use a year other than a required year</td>
<td>Form 8716</td>
<td>File by the earliest of the 15th day of the 5th month following the month that includes the 1st day of the tax year the election will first become effective, or the un-extended due date of the return for the tax year resulting from the election</td>
<td>IRC Sec. 444</td>
</tr>
<tr>
<td>Termination of Sec. 444 election</td>
<td>Statement with return for the short period resulting from the termination of the election</td>
<td>Due date of timely filed return for the short period</td>
<td>Temp Reg. 1.1444-1T</td>
</tr>
</tbody>
</table>