TO "C" OR NOT TO "C"? A TRIUMPH OF S-ELECTION FORM OVER SUBSTANCE

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For shareholders of S corporations and their advisors, avoidance of the potentially catastrophic tax consequences resulting from a "blown" S election is always an issue of paramount importance. Due to superior asset protection, limited liability, tax savings and self-employment tax benefits, many Florida business owners have opted to operate their businesses utilizing an entity organized as a Florida limited liability company ("LLC") for state law purposes but which has elected for federal income tax purposes to be taxed as an S corporation. For business owners electing to use this type of "hybrid" entity, the purpose of this blog is to propose a technique that could significantly mitigate the potentially catastrophic tax consequences of a "blown" S election resulting from the failure of the entity to qualify as an S corporation as of the date the S election is made.

Prior to July 20, 2004, an LLC wishing to elect to be taxed as an S corporation was required to first file an Entity Classification Election (Form 8832) with the IRS electing to be treated for federal tax purposes as an association taxable as a corporation, followed by the timely filing of a Form 2553, Election By a Small Business Corporation, electing to be treated for federal tax purposes as an S corporation. In 2005, the IRS published Final Regulations, generally effective for all S elections made on or after July 20, 2004, which simplified these filing requirements by providing that the filing of a Form 8832 is not necessary if a Form 2553 is filed. Accordingly, the IRS now allows a single election to be filed (Form 2553) with respect to the LLC desiring to be taxed as an S corporation (the "Streamlined Procedure"), provided that the LLC meets all of the qualifications of an S corporation as of the date of such filing. Notwithstanding the ability to utilize the Streamlined Procedure, there are many tax practitioners who still insist on filing the entity classification election for the LLC in conjunction with the S election.

The key message of this blog is that filing *both* the entity classification election *and* the S election in a situation where the LLC does not qualify as an S corporation at the time of the S election could trigger a reversion to C corporation tax status, and subject the LLC members to the regime of double taxation resulting from such reversion.

If the Streamlined Procedure is utilized, and if the LLC fails to qualify to be taxed as an S corporation on the effective date of the election, then the filing of the S election will not be treated as a "deemed" election to be classified as an association taxable as a corporation and, thus, the "blown" S election will not result in the LLC being taxed as either an S corporation or a C corporation. Instead, in the absence of any other election, the LLC will be taxed in accordance with its default tax classification under the so-called "check-the-box" regulations (i.e., the default status would be a partnership if the LLC has two or more members, or a disregarded entity if it has only one owner). On the other hand, if the LLC first files an entity classification election (Form 8832), but does not qualify to be taxed as an S corporation upon its subsequent filing of the S election (Form 2553), the LLC will revert to C corporation status for federal tax purposes.

For example, an LLC that files both an entity classification election and an S election with the IRS, but fails to meet all other requirements to be an S corporation on the effective date of the election, will revert to C

corporation tax status and its attendant second level of taxation (a potentially catastrophic result). By contrast, if that LLC were to file only an S election (which is effective only if all qualifications for S corporation tax treatment are satisfied as of the date of such election) and not an entity classification election, the IRS would simply disregard the S election and would not treat it as a "deemed" election to be taxed as an association (*i.e.*, a corporation), in which case the LLC would not revert to a C corporation for federal tax purposes; rather, the LLC would revert to its "default" tax classification (i.e., either a partnership or a disregarded entity) which is certainly a better tax result than reversion to a C corporation.

In addition to determining the best method for electing S corporation status for the LLC (i.e., whether only an S election will be filed or whether an entity classification election will be filed in conjunction with an S election), an extra layer of protection against reversion to C corporation tax status is to ensure that the LLC will be eligible for taxation as an S corporation. In this regard, it is important to note that the operating agreement for the LLC must contain S corporation provisions (e.g., all distributions and allocations of taxable income and loss to the members must be made pro rata based on their ownership interests, etc.) and must not contain partnership tax provisions or any other provisions which could result in a second class of stock and, therefore, violate the S corporation tax rules (e.g., special tax allocations, non-prorata distributions, etc.). Otherwise, the S election may be in jeopardy. The operating agreement should also incorporate language typically found in S corporation shareholder agreements to prevent a termination of the S election, *e.g.*, restrictions against transfers to ineligible shareholders, requiring shareholders that are trusts to comply with the eligible shareholder requirement, and general language to the effect that the entity is to be taxed as an S corporation, and the members will at all times act in accordance with that intent.

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