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4.1 REQUIREMENTS TO BE A CALIFORNIA S CORPORATION (R&TC §23800)

Prior to 1/1/2002 California allowed corporations, who were S Corporations for federal purpose, to make an election to be treated as a C Corporation for state purpose. (CA R&TC §23801, before amendment by L. 2002 c.35) Then, beginning with tax year 2002 California generally conformed to federal law so that corporations electing to be treated as an S corporation for federal purpose are treated as an S Corporation for state tax purposes. (R&TC §23800 & §23801).

However, unlike the federal rules, California S corporations must pay either the minimum tax or the regular income or franchise tax at a rate of 1.5% (3.5 for Bank & Financials) on their California source income. (R&TC §23802)

4.2 REQUIREMENTS TO BE A FEDERAL S CORPORATION

Effective January 1, 1997, a corporation electing S corporation status must meet the federal requirements as a “small business corporation”.

The term “small business corporation” means a domestic corporation that is not an ineligible corporation and which —,

- Does not have more than 100 shareholders (a husband and his wife and their estates are treated as one shareholder (IRC §1361(c)(1))).
- The shareholder is an individual, a certain trust and estate (IRC §1361(c)(2), (3), and (e) for limitations on estates/trusts), a qualified Subchapter S trust (QSST) (IRC §1361(d), or a certain exempt organization (qualified retirement plan trusts and charitable organizations – see IRC §1361(c)(6) for limitations on tax exempt organizations),
- The shareholder is not a nonresident alien, and
- The corporation has only one class of stock.

An ineligible corporation means any corporation that is:

- A financial institution to which IRC §585 applies,
- An insurance company subject to tax under subchapter L,
- A corporation to which IRC §936 applies, or
- A DISC or former DISC.

4.3 MAKING A FEDERAL S ELECTION (IRC §1362)

Once the corporation meets the criteria for being an S corporation, it must file a valid S election with the IRS per Form 2553 (Exhibit 4.1). A valid election requires the following.

1. All shareholders must consent to the election (IRC §1362(a)(2)).

All persons who are shareholders in the corporation on the day on which the election is made must consent to such election. "Shareholders" also include persons having a community property interest in the corporation's stock -- as well as tenants in common, joint tenants, and tenants by the entirety -- on the date of election.

Pursuant to Treasury Regulation §1.1362-6(b)(3), additional signatures may be needed in circumstances in which the S corporation election is to be effective for the current tax year, and the election is made before the 16th day of the third month of the taxable year. The S corporation election form must also be signed by each person who was a shareholder (including any person who was treated as a shareholder under IRC §1361(c)(2)(B)) at any time during the portion of the year that occurs prior to the time the election is made and who is not a shareholder at the time the election is made.

The election would be invalid if consents were not obtained from all shareholders and their respective spouses. The courts strictly adhere to this requirement and oftentimes rule in favor of the IRS. Keep in mind, however, that there are instances in which the stock is not clearly distinguishable as either separate or community property. In a completed case example, the shareholders required their spouses to consent to the election as a precautionary measure and attached a statement specifying that the executions of the spouses' consents were not intended to create any implication as to the existence or nonexistence of an interest of the spouses in the stock. In another completed case example, the shareholder's spouse did not consent to the election; however, the election was determined to be valid based on litigation pursuant to divorce, which classified the stock as separate property at the time of the S election.

2. The election must be made during the preceding taxable year or within 2 ½ months of the taxable year (IRC §1362(b)(1)).

For example, if the corporation wants to become an S corporation beginning in its taxable year ending 12/31/97 (meaning effective 1/1/97), Federal Form 2553 must be postmarked anytime during the period covering 1/1/96 to 3/15/97.

Upon receipt of Federal Form 2553, the IRS verifies that (1) all required signatures are contained on the election, (2) the election is made within the required time frame for that taxable year, and (3) the corporation meets the requirements of a small business corporation as provided in IRC §1361(b).

In conjunction with making its federal S election, the corporation is generally required to use the calendar year period - a taxable year ending December 31 - (IRC §1378(b)(1)). An exception is allowed if the corporation establishes a business purpose for using any other accounting period, but not for the sole purpose of deferral of income to its shareholders (IRC §1378(b)(2), IRC §444).

The S corporation's federal S election can be verified by requesting a "BMF Transcript with MFTRA (E)" and Federal Form 2553 from the IRS, using FTB Form 6227, the IRS acceptance letter from the corporation, and/or a copy of Federal Form 2553 from the corporation.

4.4 MAKING A CALIFORNIA S ELECTION (R&TC §23801)

California no longer requires a corporation to make a separate election to be treated as an S Corporation for state purpose. The only requirement is that the corporation has to have in effect a valid federal election under Section 1362(a) of the Internal Revenue Code.

- 4.4.1 Termination of S Corporation Election
- 4.4.2 Election Not Filed Timely

4.4.1 Termination of S Corporation Election

A termination of a federal election pursuant to IRC §1362(d) of the Internal Revenue Code, that is not an inadvertent termination pursuant to IRC §1362(f) of the Internal Revenue Code, shall simultaneously terminate the "S corporation" election for California purposes. (CR&TC §23801(e)(1))

A federal termination by revocation shall be effective for purposes of this part and shall be reported to the Franchise Tax Board in the form and manner prescribed by the Franchise Tax Board no later than the last date allowed for filing federal termination for that year under IRC §1362(d) of the Internal Revenue Code. (CR&TC §23801(e)(2))

4.4.2 Election Not Filed Timely

The provisions of §1362(b)(5) of the Internal Revenue Code, relating to authority to treat late elections, etc., as timely, shall apply only for taxable years beginning on or after January 1, 1997, with respect to elections under §1362(a) of the Internal Revenue Code for taxable years beginning on or after January 1, 1997. (CR&TC §23801(h)(1))

Notwithstanding the provisions of the above paragraph, if for any taxable year beginning on or after January 1, 2003, a corporation fails to qualify as an "S corporation" for federal income tax purposes solely because the federal Form 2553 (Election by a Small Business Corporation) was not filed

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timely, the corporation shall be treated for purposes of this part as an "S corporation" for the taxable year the "S corporation" election should have been made, and for each subsequent year until terminated if, (a) the corporation and all its shareholders reported their income for California tax purposes on original returns consistent with "S Corporation" status for the year the "S Corporation" election should have been made and for each subsequent taxable year until terminated, (b) the corporation and its shareholders have filed with the Internal Revenue Service a federal Form 2553 requesting automatic relief with respect to the late "S corporation" election, in full compliance with the federal Revenue Procedure 1997-48, I.R.B. 1997-43, and have received notification of the acceptance of the untimely filed "S corporation" election from the Internal Revenue Service. A copy of the notification shall be provided to the Franchise Tax Board upon request. (CR&TC §23801(h)(2))

The provisions of §1362(f) of the Internal Revenue Code, relating to inadvertent invalid elections or terminations, shall apply only for taxable years beginning on or after January 1, 1997, with respect to elections under §1362(a) of the Internal Revenue Code for taxable years beginning on or after January 1, 1997.

4.5 FEDERAL TERMINATIONS (IRC §1362(d))

Federal rules specify three situations in which an S election can be terminated:

- Revocation (IRC §1362(d)(1)),
- Corporation ceases to be small business corporation (IRC §1362(d)(2)),
- Corporation's passive investment income exceeds 25% of gross receipts for 3 consecutive taxable years and the corporation has subchapter C earnings and profits (IRC §1362(d)(3)).

Termination by revocation is irrevocable. However, the corporation can request the S election not be terminated if it falls under either of situations #2 or #3 and establishes that the terminating event was inadvertent (IRC §1362(f)).

- 4.5.1 Revocation (IRC §1362(d)(1))
- 4.5.2 Corporations Ceasing to be Small Business Corporations (IRC §1362(d)(2))
- 4.5.3 Passive Investment Income Exceeds 25% of Gross Receipts for 3 Consecutive Taxable Years and the Corporation has Subchapter C Earnings and Profits (IRC §1362(d)(3))
- 4.5.4 Inadvertent Terminations (IRC §1362(f))

4.5.1 Revocation (IRC §1362(D)(1))

A revocation is effective when more than 50% of the shares consent to the revocation. It is effective for that income year if made within 2 ½ months of the beginning of the taxable year. If made after the 2½ months, it is effective for the beginning of the following taxable year. Federal revocations are made on Federal Form 2553.

4.5.2 Corporations Ceasing to be Small Business Corporations (IRC §1362(D)(2))

A federal S election ceases to be effective on and after the date it fails to qualify under the federal requirements to be a small business corporation as specified in IRC §1361(b)(1).

4.5.3 Passive Investment Income Exceeds 25% of Gross Receipts for 3 Consecutive Taxable Years and the Corporation has Subchapter C Earnings and Profits (IRC §1362(d)(3))

A federal S election ceases to be effective on the first day following the third consecutive taxable year in which the corporation (1) has subchapter C earnings and profits at the close of each of 3 consecutive taxable years and (2) has gross receipts for each of such taxable years more than 25% of which are passive investment income.

4.5.4 Inadvertent Terminations (IRC §1362(f))

An S corporation that meets the following terminating events will be treated as continuing to be an S corporation during the period specified by the Secretary:

- An election is terminated because of (a) failure to meet the requirements as a small business corporation or (b) where passive investment income exceeds 25% of gross receipts for 3 consecutive taxable years and has subchapter C earnings and profits,
- The Secretary determines that the termination was inadvertent,
- The corporation takes steps within a reasonable period of time after discovery of the terminating event to reinstate itself as a small business corporation, and
- Each shareholder agrees to make such adjustments.

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Examples of terminating events in which corporations have requested to be reinstated are as follows.

- The corporation was a family owned business with the mother and father owning 90% and their son owning 10%. The son announced his engagement to a nonresident alien. Upon hearing of the engagement, the CPA contacted the IRS to request that this event not terminate the corporation's S election. The IRS granted the request.
- Minor errors or changes made on Federal Form 2553 (changing facts contained on the form that are not relevant to the corporation's qualifications to make an election, or to the validity of the shareholders' consents, would not invalidate the S election).
- The corporation, unaware of its subchapter C earnings and profits upon S election, reported passive investment income in excess of 25% of its gross receipts for 3 consecutive years. In spite of the fact that this was a terminating event for the corporation, it requested to retain its S status by immediately distributing all subchapter C earnings and profits. The IRS granted the corporation's request.

4.6 CALIFORNIA TERMINATIONS (R&TC §23801(E) (1)(2))

Termination of a federal S election, which is not an inadvertent termination, simultaneously terminates the California S election (R&TC §23801(e)(1)).

If the federal termination was by revocation (more than 50% of the shares consented to the revocation), the corporation is required to notify the FTB by filing FTB Form 3560 within the time frame for reporting its federal revocation (R&TC §23801(e)(2)). Failure to notify the Board, however, has no impact on whether the corporation retains its California S election -- it is automatically terminated with or without such notification.

4.7 SPECIAL CONSIDERATION FOR TERMINATION OF S ELECTION WITH SUBCHAPTER C EARNINGS AND PROFITS AND PASSIVE INVESTMENT INCOME IN EXCESS OF 25% OF GROSS RECEIPTS FOR 3 CONSECUTIVE YEARS

- 4.7.1 Termination of S Election vs. Assessing the ENPI Tax
- 4.7.2 Applying the Federal/California Code Sections
- 4.7.3 California Subchapter C Earnings and Profits

4.7.1 Termination of S Election vs. Assessing the ENPI Tax

The events for assessing the excess net passive investment income (ENPI) tax are very similar to the events for terminating the S election. Do not confuse the two events and their respective code sections.

ENPI Tax:

- IRC §1375 Tax imposed when passive investment income of a corporation having subchapter C earnings and profits exceeds 25% of gross receipts.
- IRC §1375(b)(3) The terms "gross receipts," and "passive investment income" shall have the same meanings as used in IRC §1362(d)(3)(B)-(C), respectively.
- R&TC §23811 Tax on passive investment income.

Termination of S Election:

- IRC §1362(d)(3) Termination where passive investment income exceeds 25% of gross receipts for 3 consecutive taxable years and corporation has subchapter C earnings and profits.
- R&TC §23811(d) The term "subchapter C earnings and profits" or "accumulated earnings and profits" as used in IRC §1375 shall mean the subchapter C earnings and profits of the corporation attributable to California sources determined

R&TC §23811(e) under this part, modified as provided in subdivision (e). Distribution of a consent dividend to the shareholders is not to exceed the difference between the amount of federal subchapter C earnings and profits and California subchapter C earnings and profits.

4.7.2 Applying the Federal/California Code Sections

IRC §1362(d)(3) provides that if an S corporation has subchapter C earnings and profits at the close of each of 3 consecutive years, and more than 25% of gross receipts for each of the three taxable years are passive investment income, starting from the first date of the fourth year, the corporation's S election will be terminated.

However, for state purpose R&TC §23801(g) provides that, "Section 1362(d)(3) of the Internal Revenue Code, relating to circumstances where passive investment income exceeds 25 percent of gross receipts for three consecutive taxable years and the corporation has accumulated earnings and profits, does not apply unless the 'S' election is terminated for federal income tax purposes."

4.7.3 California Subchapter C Earnings and Profits

To determine whether the corporation has subchapter C earnings and profits, it must compute its subchapter C earnings and profits attributable to California sources as determined under the Bank & Corporation Tax Law, modified for consent dividends (R&TC §23811(d) and (e)).

R&TC §23811(e) - Consent Dividends:

(1) In the case of a corporation that is an "S corporation" for purposes of this part for its first taxable year for its first taxable year for which it has in effect a valid federal S election, there shall be allowed as a deduction in determining that corporation's "subchapter C earnings and profits" at the close of any taxable year the amount of any consent dividend (as provided in paragraph (2)) paid after the close of that taxable year.

(2) In the event there is a determination that a corporation has subchapter C earnings and profits at the close of any income year, that corporation shall be entitled to distribute a consent dividend to its shareholders. The amount of the consent dividend shall not exceed the difference between the California subchapter C earnings and profits on the date of determination and the federal subchapter C earnings and profits at the same date. A consent dividend must be paid within 90 days of the date of determination. The date of determination means the effective date of a closing agreement defined under R&TC §19441, the date an assessment of tax imposed by this section becomes final, or the date of execution by the corporation of an agreement with the FTB relating to liability for the tax imposed (excess net passive income tax) by this section.

Example A

ABC, Inc. incorporated in 1997, made a valid federal S election for tax year 2002. Therefore, for CA purpose they are also deemed an S-Corporation.

On this date, ABC has California subchapter C earnings and profits of \$1,000,000 and federal subchapter C earnings and profits of \$50,000. Assuming there are no future adjustments to either California or federal subchapter C earnings and profits, ABC is entitled to make a California consent dividend of up to \$950,000 (\$1,000,000 - \$50,000); a federal consent dividend of up to \$50,000.

On 3/31/2004, ABC makes a consent dividend of \$400,000. Its California subchapter C earnings and profits on this date is \$600,000 (\$1,000,000 - \$400,000). Its remaining allowable California consent dividend is \$550,000 (\$950,000 - \$400,000).

On 12/31/2005, ABC distributes \$600,000: \$550,000 is treated as a consent dividend for California purposes per R&TC §23811(e)(1) and \$50,000 is treated as a consent dividend for federal (and California) purposes per IRC §1368(e)(3).

4.8 ELECTION AFTER TERMINATION (IRC §1362(G))

IRC §1362(g) provides that if an S corporation terminates its S status by revocation, ceasing to be a small business corporation, or reporting three years of consecutive excess net passive income, the corporation must wait five years before making another S election, unless the Secretary consents to such election. California conforms to this code section.

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4.9 EXHIBITS

[Exhibit 4.1](#) Federal Tax Form 2553