## 4.0 S CORPORATION ELECTIONS & TERMINATIONS

- 4.1 Requirements to be a California S Corporation (Revenue and Taxation Code (R&TC) Section 23800)
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# 4.1 REQUIREMENTS TO BE A CALIFORNIA S CORPORATION (R&TC SECTION 23800)

Prior to January 1, 2002, California allowed corporations that were S corporations for federal purposes, to make an election to be treated as a C corporation for state purposes. ( R&TC Section 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 purposes are treated as an S corporation for state tax purposes. (R&TC Section 23800 and R&TC Section 23801)

However, unlike the federal rules, California S corporations must pay either the minimum tax or the regular income at a rate of 1.5 percent (3.5 percent for Bank & Financials) on their California source income. (R&TC Section 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 meets all of the following criteria:

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

An ineligible corporation means any corporation that meets any of the following criteria:

- A financial institution to which IRC Section 585 applies.
- An insurance company subject to tax under subchapter L.
- · A corporation to which IRC Section 936 applies.
- A domestic international sales corporation (DISC) or former DISC. (IRC Section 1361(b)(2).

## 4.3 MAKING A FEDERAL S ELECTION (IRC SECTION 1362)

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

#### 1. All shareholders must consent to the election (IRC Section 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 Section 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  $16^{th}$  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 Section1361(c)(2)(B)) at any time during the portion of the year that occurs prior to the time the election is made, even if such person is not a shareholder at the time the election is made.

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

For example, if the corporation wants to become an S corporation beginning in its taxable year ending December 31, 1997 (meaning effective January 1, 1997), Federal Form 2553 must be postmarked anytime during the period covering January 1, 1996, to March 15, 1997.

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 timeframe for that taxable year, and (3) the corporation meets the requirements of a small business corporation as provided in IRC Section 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 Section 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 Section 1378(b)(2), IRC Section 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 SECTION 23801)

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

- 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 Section 1362(d), that is not an inadvertent termination pursuant to IRC Section 1362(f), shall simultaneously terminate the "S corporation" election for California purposes. (R&TC Section 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 Section 1362(d). (R&TC Section 23801(e)(2))

#### 4.4.2 Election Not Filed Timely

The provisions of IRC Section 1362(b)(5) 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 IRC Section 1362(a) for taxable years beginning on or after January 1, 1997. (R&TC Section 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 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. (R&TC Section 23801(h)(2))

The provisions of IRC Section 1362(f), 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 IRC Section 1362(a) for taxable years beginning on or after January 1, 1997.

## 4.5 FEDERAL TERMINATIONS (IRC SECTION 1362(d))

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

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

- 4.5.1 Revocation (IRC Section 1362(d)(1))
- 4.5.2 Corporations Ceasing to be Small Business Corporations (IRC Section 1362(d)(2))

- 4.5.3 Passive Investment Income Exceeds 25 Percent of Gross Receipts for Three Consecutive Taxable Years and the Corporation has Subchapter C Earnings and Profits (IRC Section 1362(d)(3))
- 4.5.4 Inadvertent Terminations (IRC Section 1362(f))

#### 4.5.1 Revocation (IRC Section 1362(d)(1))

A revocation is effective when more than 50 percent of the shares consent to the revocation. It is effective for that income year if made within 2½ 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 Secton §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 Section 1361(b)(1).

# 4.5.3 Passive Investment Income Exceeds 25 Percent of Gross Receipts for Three Consecutive Taxable Years and the Corporation has Subchapter C Earnings and Profits (IRC Section 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 three consecutive taxable years and (2) has gross receipts for each of such taxable years more than 25 percent of which are passive investment income.

#### 4.5.4 Inadvertent Terminations (IRC Section 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 percent of gross receipts for three 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.
- · Each shareholder agrees to make such adjustments.

Examples of terminating events in which corporations have requested to be reinstated include:

- 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). Private Letter Ruling (PLR) 8822046.
- The corporation, unaware of its subchapter C earnings and profits upon S election, reported passive investment income in excess of 25 percent of its gross receipts for three 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. PLR 9335052

# 4.6 CALIFORNIA TERMINATIONS (R&TC SECTION 23801(e) (1)-(2))

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

If the federal termination was by revocation (more than 50 percent of the shares consented to the revocation), the corporation is required to notify the Franchise Tax Board (FTB) by filing FTB Form 3560 within the timeframe for reporting its federal revocation (R&TC Section 23801(e)(2)). However, failure to notify FTB 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 & PROFITS AND PASSIVE INVESTMENT INCOME IN EXCESS OF 25 PERCENT OF GROSS RECEIPTS OF THREE 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 Section 1375 Tax imposed when passive investment income of a corporation

having subchapter C earnings and profits exceeds 25 percent of gross

receipts.

IRC Section 1375(b)(3) The terms "gross receipts," and "passive investment income"

shall have the same meanings as used in IRC Section 1362(d)

(3)(B)-(C), respectively.

R&TC Section 23811 Tax on passive investment income.

#### Termination of S Election:

IRC Section 1362(d)(3) Termination where passive investment income exceeds 25 percent of

gross receipts for three consecutive taxable years and the corporation

has subchapter C earnings and profits.

R&TC Section 23811(d) The term "subchapter C earnings and profits" or "accumulated

earnings and profits" as used in IRC Section 1375 shall mean the subchapter C earnings and profits of the corporation attributable to California sources determined under this part, modified as provided in

subdivision (e).

R&TC Section 23811(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 Section 1362(d)(3) provides that if an S corporation has subchapter C earnings and profits at the close of each of three consecutive years, and more than 25 percent 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 purposes R&TC) Section 23801(g) provides that; IRC Section 1362(d)(3), 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 Section 23811(d) and (e))

R&TC Section 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 Section 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 2007, made a valid federal S election for tax year 2012. Therefore, for CA purposes 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.

The information provided in this manual does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the last update.

On March 31, 2014, 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 December 31,2015, ABC distributes \$600,000: \$550,000 is treated as a consent dividend for California purposes per R&TC Section 23811(e)(1) and \$50,000 is treated as a consent dividend for federal (and California) purposes per IRC Section 1368(e)(3).

## 4.8 ELECTION AFTER TERMINATION (IRC SECTION 1362(g))

IRC Section 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. (R&TC Section 23801)

#### 4.9 EXHIBIT

Exhibit 4.9.1 Federal Tax Form 2553

Revised Date: December 2018