

What is an inadvertent termination of an S election? How does an S corporation and its shareholders rectify an inadvertent termination? What could happen if a company fails to rectify the termination?

An inadvertent termination of an S corporation is the accidental end of an S election. An accidental termination could happen because the company has failed the passive investment income test for 3 consecutive years or if there are more than 100 shareholders.

To rectify inadvertent termination the company would need to make adjustments to reverse the issue (or make the required changes required by the IRS) to comply with S election rules. The adjustments would depend on what caused the S election to terminate. If it is because of not meeting the less than 100 shareholders step, steps can be taken to buy out shareholders to eliminate their interest. A company can also take steps before hand to ensure that they remain at 100 shareholders or below by requiring current shareholders get prior approval before selling their stock or have a standing first option with the shareholders to buy back the stock. This will ensure that inadvertent termination does not happen because a shareholder sells their stock to more than one person. If a company does not correct the inadvertent termination they cannot re-apply for an S election for five years and the company is taxed as a corporation.

Response 2

An inadvertent termination of an S election is when a company loses its S-corporation election unintentionally or by accident. This can happen when a company is not paying close enough attention or simply make a mistake. Action should be taken to ensure that this doesn't happen. To rectify an inadvertent termination the S-corporation or the shareholders have to respond in a timely manner and "if the IRS determines that the termination was inadvertent, the corporation and all persons owning stock during the termination period must agree to make the adjustments necessary to report the income for this period as if the S election had been in effect continuously" (p. 11-11). I think this process would be challenging and from what I have seen in other posts from people in the business it seems to be something that should be avoided! If the termination isn't rectified the IRS as some measures to reduce the consequences but they are time consuming n expensive.