

NEWS & INSIGHTS

Pitfalls of an S election: Hurdles for an LLC

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In recent years, more of our limited liability company (LLC) clients are electing S corporation status to take advantage of certain favorable features such as the ease of formation, less stringent corporate formalities, and potential payroll tax savings. While there are compelling reasons for electing S corporation status, there are many hazards that come along with the election that LLC owners must understand before they forge ahead. LLC owners should fully understand some of the drawbacks of converting to S status before making such an election.

What is an S corporation?

An S corporation is a federal tax classification elected by some corporations and LLCs. This tax classification allows an S corporation to passthrough to its owners, income, losses, deductions and credits for federal tax purposes. As a result, there is only one level of tax.

To qualify as an S corporation, the entity must meet the following requirements:

- Be a domestic corporation or an LLC that is otherwise eligible to be an S corporation status for federal income tax purposes
- Owners must be individuals or certain trusts and estates
- Limited to 100 owners
- Have only one class of stock where all outstanding shares (or ownership interests) have identical rights to distribution and liquidation proceeds but different voting rights are permitted
- Not be an ineligible corporation such as certain financial institutions, insurance companies and domestic international sales corporations

To become an S corporation, an entity must timely submit Form 2553, Election by a Small Business Corporation, to the IRS. An LLC that elects S corporation status is deemed to be both a corporation and an S corporation.

Potential hazards and pitfalls of an S election

Election Form 2553 Hazards. One of the hazards of electing to be an S corporation is the preparation and filing of Form 2553. Form 2553 must be signed by all the owners of the entity and in community property states, the owners' spouses also need to sign. Further, for an S election to be effective as of the beginning of a tax year, such election must be filed with the IRS no later than 2 months and 15 days after the beginning of that tax year.

When filing Form 2553, written evidence of filing needs to be obtained. The signed Form 2553 should be mailed to the IRS with certified mail receipt or its equivalent. The IRS is required to accept these receipts as evidence of filing. According to IRS procedures, the IRS is required to send a notification confirming the S-election within 60 days after receiving Form 2553. If IRS confirmation is not timely received, we recommend following up until confirmation is provided. The written evidence of filing and IRS confirmation will be critical documents if the entity undergoes an IRS audit or wishes to engage in a merger or acquisition because the buyer will want proof of a timely and accurate S-election.

LLC Operating Agreement Traps. If an operating LLC elects S corporation status, its operating agreement may contain language that results in an inadvertent termination of the S corporation status.

Operating agreements are generally drafted to conform with partnership tax law. Under partnership tax law,

liquidating distributions may be made in accordance with positive capital accounts, which results in a second class of stock and violates the single class of stock requirement applicable to S corporations. The single class of stock requirement specifically requires that all outstanding shares of stock (or ownership interests) have identical rights to distribution and liquidation proceeds.

Other provisions frequently found in a traditional LLC operating agreement may also cause distributions, income and deductions to be made or allocated disproportionately to the members' ownership interests. For example, some of the more complex operating agreements may allow priority distributions to certain members and return of capital to others (i.e., distribution waterfalls). These provisions could result in a second class of stock in violation of the S corporation rules.

Before an S-election is made, an LLC's operating agreement should be reviewed and revised to comply with all the S corporation requirements. Having a properly drafted operating agreement will make future acquisition due diligence proceed more smoothly and may provide some protection if disproportionate distributions are inadvertently made to the owners of the S corporation.

S election challenges and drawbacks

No Flexibility with Distributions. An S corporation is permitted one class of stock, which means that all the outstanding shares of stock (or ownership interests) must have identical rights to distribution and liquidation proceeds in proportion to each owner's interest. For example, a 50% owner must receive 50% of the liquidation proceeds upon the entity's dissolution.

This inflexibility makes it difficult for S corporation owners to offer equity as an incentive to its employees and owners because awarding profits interests would cause disproportionate distributions. Whereas an LLC taxed as a partnership is permitted to award profits interests as part of its compensation package to retain and motivate its executives.

Disproportionate distributions can also occur inadvertently. For example, some closely held businesses directly pay some personal expenses of its owners. Once an S-election is made, this kind of practice will likely result in disproportionate distributions.

Loans to an owner of an S corporation may, in certain instances, be treated as distributions to that owner and require the owner to recognize a taxable gain. More importantly, classifying a loan as a distribution could result in a disproportionate distribution and a second class of stock. To avoid the reclassification of a loan as a distribution, loans to an owner of an S corporation should be properly documented in its books and records along with a loan agreement and/or a promissory note setting forth the stated interest, payment terms and conditions, and maturity date. The owner-debtor and S corporation-lender must also respect the loan terms.

The good news is all is not lost if disproportionate distributions are inadvertently made to S corporation owners so long as the entity's governing documents provide for distribution and liquidation rights in accordance with an owner's interest. See Rev. Proc. 2022-19.

Hurdles to Attracting New Investors. The inflexibility in distributions can also affect an S corporation's ability to attract new investors. Traditional LLCs taxed as partnerships may be structured with different membership classes

to attract investors that have different investment needs and requirements. The varying membership classes can offer different members priorities as to distribution and/or a rate of return which would not be permitted with an S corporation.

The investors of an S corporation are also restricted to individuals, certain trusts, and estates. In fact, corporations and traditional multi-member LLCs are not permitted to hold S corporation stock. This restriction dramatically reduces the pool of potential investors.

Additionally, new S corporation investors are likely to recognize taxable gain when investing in a S corporation unless the new investor owns at least 80% of the S corporation interests post-investment. The 80% ownership control requirement necessary to defer any gain on the investment presents a fairly steep hurdle for potential investors. Alternatively, traditional LLCs permit new investors to invest in the LLC on a tax-deferred basis without an ownership control requirement.

Challenges With Mergers and Acquisitions. As an S corporation grows it may attract potential buyers. The process of selling or acquiring an S corporation is more difficult than the sale or acquisition of a traditional LLC. The due diligence process is more complex as the buyers will investigate the S corporation's tax status by confirming the validity and timing of the Selection, reviewing all governing documents, and reviewing entity operations to ensure that the entity has met the S corporation requirements in form and operation as of the date of election.

If the buyers have any doubts as to the validity of the entity's S corporation status it will likely require the entity to engage in an F reorganization before the acquisition. Even if the buyers are satisfied with the entity's S corporation status, the buyers may still require the entity to engage in an F reorganization if the buyers are not a permitted S corporation shareholder. The F reorganization is generally not difficult to complete but increases the cost of the transaction.

Conclusion

While there are advantages of an LLC making an S-election, such as payroll tax savings, there are many hazards business owners must consider before making an S election. Some of these hazards may affect certain business owners more than others because of the type of business involved and their business goals. Still, some of these hazards can be mitigated or avoided if a business takes the proper steps. Business owners should discuss with their tax attorneys the advantages and disadvantages of making an S election for their LLC before filing the election and after making the election, work with their tax attorneys on a regular basis to ensure operational compliance with the S corporation rules.

If you have questions about your business choosing to go the S corporation route, please reach out to [Pauline Markey](#).

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