



Understanding S Elections for LLCs

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More and more accountants are making S elections for their client's limited liability companies with some significant consequences that may not be understood.

Background: By default, an LLC is classified as either a partnership for tax purposes or it is disregarded if it is a single member or husband and wife who own the interest as community property. That classification can be changed by making an election.

There are two forms that can be filed to elect to be treated like a corporation for tax purposes.

Tax Elections:

Form 2553 is filed to elect S corporation treatment, but can still result in C corporation treatment if your corporation is not eligible for S election status.

Form 8832 is filed to be treated like a C corporation. S status can be elected by also filing form 2553 at the same time, if eligible.

Making sure your accountant and attorney are communicating on tax elections that are being made for a limited liability company is important. Here are five reasons why:

1. If any non-resident aliens own an interest in your LLC and you make an S election, the S election will be disregarded and your entity may be treated like a C corporation for tax purposes. If this mistake is not recognized, it could mean years of back taxes and penalties, or even cause a hiccup when you are trying to sell your business if discovered during due diligence, since this is the kind of liability that can be imposed on a successor even in an asset transfer.
2. If one of the shareholders of your LLC is an S corporation, the S election will be disregarded. Of course, if this mistake is never discovered, you could go on for years without recognizing the issue. The fix is complex, unless the accountant filed only form 2553 (and not also form 8832). If your accountant filed both forms, your entity will be treated as a C corporation if it is not eligible for S status (once the IRS discovers the mistake

– but retroactively). If your accountant filed only form 2553, your entity will be treated as a partnership for tax purposes, or disregarded, depending on whether it is a single member LLC (or treated as such) or not, if it is not eligible for S status.

3. If, before making the S election, you had an operating agreement for your LLC (or other LLC agreement), it will need to be revised when you make the S election, otherwise its provisions may blow your S election, potentially subjecting you to C corporation tax. Two common provisions that can blow the S election are 1) having distributions tied to capital accounts on liquidation, or 2) allowing disproportionate distributions. An S corporation can only make distributions in proportion to stock ownership. Once an LLC makes an S election, it loses the flexibility to make disproportionate distributions. Almost all of the tax provisions of the agreement will need to be deleted or changed.
4. If you have more than one class of ownership, you cannot make a valid S election. Your attorney will need to check the provisions of your operating agreement regarding distribution of losses as well as income and other rights that may differ among owners to make sure you are eligible to make (and keep!) an S election.
5. If you make a valid S election and then violate any of the S corporation tax rules, you may lose the pass through status of your entity and the result is a double tax, like a C corporation, once on corporate income at the corporate tax rates and again on distributions, which will be treated as dividends and generally will be taxed at the capital gains rates.

If you made a mistake, recognizing it and fixing it before you are audited may be costly, but far less costly than waiting until the IRS recognizes it and charges you years of back taxes, and interest and penalties as if you were a C corporation all along.

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