

Want to Convert to an S Corporation? Watch Out for These Common Mistakes

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At some point, many proprietors weigh the benefits of switching to an S corporation. In truth, an S corporation entity structure does offer a variety of tax advantages. The basic process of converting to an S corporation is fairly simple.^[1] However, tax law always has its hidden caveats.

When dealing with the IRS, they *always* know their rules. Unfortunately, taxpayers are not always so fortunate. That's why you need to make sure you understand the tax ramifications before you start paperwork and other steps to switch your company over to an S corporation. For one thing, you want to make sure that the IRS views your S corporation as exactly that, and not a C corporation, which works completely differently when it comes to taxes. Also, you'll want to understand all those tax advantages available to you. If you're not aware of them, you can't use them.

Functioning as an S Corporation

So, just because you have an S corporation on paper doesn't necessarily mean that's what you're operating as. In order to be work under this entity structure, you have to meet these basic requirements:^[2]

- The company must be a domestic corporation;
- It must have fewer than 100 shareholders;
- Only people, estates, and certain kinds of trusts can be shareholders;
- Only US residents can be shareholders; and
- The corporation can have stock only in one class.

These rules should be fairly easy for the typical business owner to meet. However, the rules have a few hidden elements, and if you miss one of them, the S corporation will revert to a C corporation, possibly with disastrous results to your business. In fact, the IRS can revert your entity to a C corporation for up to three years back.^[3]

Tricky Rules

Here's one of the implied rules that don't get listed about S corporation—community property laws. If you live in a state with community property laws, your spouse may be an owner in your corporation, even if he or she doesn't actually have in stock by name.^[4] This means your spouse also has to meet all of the requirements. In community property

situations:

- Your S corporation is invalid if your spouse is a nonresident alien.^[5]
- Your S corporation is invalid if your spouse fails to consent to the S corporation election on IRS Form 2553.^{[6][7]}

In fact, entity structures are a lot more fluid than you may think. LLCs can easily become an S corporation for tax purposes by taking only two steps. It's called "Check and Elect"^[8].

1. File Form 8832 and check the box to convert your LLC to a C corporation.^[9]
2. Then, file Form 2553, which allows the IRS to tax your C corporation as an S corporation.^[10]

Here's another tip about implied rules that sneak into those requirements. Certain types of loans paid by you to your company can be treated by the IRS as a second class of stock for your corporation. Look at the rules above—more than one class of stock and your company is disqualified from filing taxes as an S corporation.

Usually, loans under \$10,000 are okay, as long as your corporation has a plan in place to pay back the loan relatively quickly.^[11] Larger loans, however, are a bit of a stickier situation. You can still avoid them being classified as a second class of stock if:

1. You have the loan in writing;
2. Your corporation has a firm deadline for repaying the loan;
3. The loan cannot be converted into stock; and
4. The instrument for repayment uses a fixed interest rate, keeping the rate out of your control.^[12]

So, loans may be viewed as stock and cancel out your S corporation benefits. But, it turns out you actually can *safely* have two different classes of stock, as long as the two kinds of stock have no differences except voting rights (a hidden benefit!).^[13] This means you could create a class of voting stock and a class of nonvoting stock. You just have to keep all other aspects of the stock the same. Nonvoting stock can be a big advantage when you want to allow certain people to have distributions but no ability to make business decisions.

What Else You Need to Know

As with any tax requirement, filing to create an S corporation must be completed at the right time. Your business typically has to meet all S corporation requirements *on the*

day you file the election.^[14] Here's an example of how the deadlines work. If you file in 2014 to be an S corporation with an effective date of January 1, 2015, then you must meet the requirements on the day you filed—in 2014.^[15]

What this means is you should not file unless and until your business meets the requirements. Luckily, if you forget to file before the end of the previous year, you're able to file up to two months and 15 days after the first of the year (March 15 for a business that uses the calendar year as the taxable year), and your S corporation will still be effective as of the first of the year. Keep in mind, however, that this only works if your business met all the S corporation requirements from the beginning of the year and you had the consent of all shareholders for that year.^[16]

Remember the community property state laws? They could come into play here. If you live in a community property state and get divorced on in February, you would need your ex-spouse's consent for the S corporation election because they were a shareholder during January, while you were still married.

Additionally, C corporations wanting to convert to an S corporation may face their own unique challenges. Here's a quick overview of concerns that may cost you extra in taxes:

- **Built-in Gains Tax**—To convert, you'll sell your C corporations assets upon conversion. This means you could be subject to the built-in gains tax if the assets are now worth more than their basis.^[17]
- **Passive Investment Income**—Higher taxes are an issue when more than 25 percent of your S corporation's income is passive investment income, such as rents, interest, dividends, royalties, or annuities, and the previous C corporation had accumulated profits and earnings.^[18]
- **LIFO Recapture**—This is a recapture tax that you may owe if the LIFO (Last-In First-Out) accounting method was used for your C corporation's inventories.^[19]
- **Loss of Tax Attributes**—Generally you lose out on the ability to claim C corporation losses or take minimum tax credits when you switch over to an S corporation.^[20]

As you can see, it's easy to think you followed all the rules and still get caught in a tax trap. Fortunately, now that you're aware of the additional hidden rules, you'll see them coming and be able to plan ahead so that you don't find yourself in a tax disaster. S corporations can generate significant tax benefits, but make sure the change is worth it and you follow the rules.

1. The "S" in S corporation refers to its location in the tax code: Subchapter S of

Chapter 1. [^](#)

2. IRC Section 1361; you can find a thorough checklist of how to qualify in the Instructions for Form 2553. [^](#)
3. The statute of limitations typically prevents assessments for periods more than three years in the past. See *Barnes Motor & Parts Co. v U.S.*, 309 F. Supp. 298 (EDNC 1970) [^](#)
4. Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin are community property states. Also, Alaska allows married couples to opt-in to community property. [^](#)
5. IRC Section 1361(b)(1)(C). [^](#)
6. IRS Form 2553, Election by a Small Business Corporation [^](#)
7. Reg. Section 1.1362-6(b)(2)(i). [^](#)
8. The choice to be a C corporation is called “checking the box.” The choice to be an S corporation is called an election. [^](#)
9. See Rev. Rul. 2009-15 and IRS Form 8832, Entity Classification Election (Rev. January 2012). [^](#)
10. IRS Form 2553, Election by a Small Business Corporation [^](#)
11. Reg. Section 1.1361-1(l)(4)(ii)(B)(1). [^](#)
12. IRC Section 1361(c)(5)(B). [^](#)
13. IRC Section 1361(c)(4). [^](#)
14. See Rev. Rul. 86-141 and IRS Form 2553, Election by a Small Business Corporation. [^](#)
15. Assuming your taxable year matches up with the calendar year. [^](#)
16. IRC Section 1362(b). [^](#)
17. IRC Section 1374. [^](#)
18. IRC Section 1375; see definition of “passive investment income” in IRC Section 1362(d)(3)(C). [^](#)
19. IRC Section 1363(d). [^](#)
20. IRC Section 1371(b). [^](#)