HUNTON & WILLIAMS

Client Alert

June 2014

The Increasing Problem of Inadvertent S Corporation Terminations and Six Ways to Protect Your Bank's S Election

S corporations have an obligation to police their shareholder base to see that all shareholders remain eligible. A common problem S corporations face is making sure that after the subchapter S election (the "S election") is made, it stays effective. When a bank is gearing up to make its S election, attorneys and accountants are typically reviewing shareholder documentation to confirm eligibility. But, after the S election is effective, most banks do not regularly review their shareholders' list to confirm eligibility. Actions beyond the bankers' control, such as the death or divorce of a shareholder, can result in an inadvertent termination of the S election. The tax consequences can be disastrous.

One critical component in preserving the bank's S election is confirming that all of the bank's shareholders are eligible shareholders of an S corporation. Generally, eligible shareholders include individuals, most trusts that make appropriate elections, and estates (please note that, while an estate is an eligible shareholder, an estate does terminate for tax purposes at some point, so as a general rule, shares cannot be held in an estate indefinitely). Corporations, limited liability companies, partnerships (including family limited partnerships), and eligible trusts that have not made the appropriate elections are ineligible shareholders.

Here is a common scenario. A bank has a shareholder who passes away. The executor, who is much more concerned with administering the estate than protecting the bank's S election, either transfers the bank shares to an ineligible shareholder or does nothing and leaves the shares in the estate. The executor fails to notify the bank that the shareholder has passed away for several years. Dividend checks continue to be cashed in the name of the decreased shareholder. All the while, the banker is not aware of what has happened.

Then, sometimes years later, something raises the issue. For example, the executor may finally contact the bank to effect the transfer of the shares, or a new review of the bank's shareholder list (for example, in connection with a potential sale of the bank) may raise questions about why an estate is still a shareholder. Only then does the banker realize that the shareholder's will transferred the shares to a corporation or that the shares have been sitting in the estate for many years. As a result, the S election has been compromised.

The good news is that the Internal Revenue Service (the "IRS") has a program in place for S corporations to request relief for inadvertent terminations. However, consent of 100% of the S corporation shareholders is required, along with a filing to the IRS and a substantial filing fee. If the issue is caught early enough, such expense may be avoided.

It can be time consuming to obtain the requested relief from the IRS, but going through the process is essential if there has been an inadvertent termination. However, bankers can avoid the inadvertent termination in the first place, which is obviously preferable. Below are some suggestions for protecting the bank's S election from an inadvertent termination:

1. Review the bank's shareholders' list frequently: The bank's internal audit program (or other ingrained system) should conduct a detailed review of the shareholders' list on at least an annual

basis to confirm all shareholders are eligible shareholders. In addition, every two years, the bank's accountants or attorneys should conduct a detailed review of the shareholders' list. It always helps to have a new set of eyes checking the bankers' homework to make sure nothing has been overlooked. If an issue is detected early, it is generally easier to fix.

2. Review the bank's shareholders' agreement: Most S corporations have a shareholders' agreement in place to protect the S election. A shareholders' agreement generally provides that certain transfers, such as transfers to ineligible shareholders, are not permissible. If the shareholders' agreement was drafted several years ago, an attorney should review it to confirm that the agreement is up to date with current law. In addition, the agreement should contain protections in the event the S election is inadvertently terminated, such as shareholder indemnification of the expenses incurred in connection with obtaining relief for the inadvertent termination and a covenant by the shareholders to take all steps necessary to remedy the inadvertent termination. There are other provisions that are useful as well.

3. Shareholder communication: On an annual basis, banks should send a certification to each shareholder to confirm the shareholder still qualifies as an eligible shareholder. This annual certification requirement can be built into the shareholders' agreement or something that the bank just sends out on its own each year. In our experience, shareholders have good intentions, but executors often times do not notify bankers when a shareholder passes away, and the executor may not understand the consequences of being a shareholder of an S corporation.

4. Remind shareholders of estate planning issues: Either in conjunction with the annual certification or separately, remind the bank's shareholders about the consequences if the shares pass upon the shareholder's death. For example, a shareholder should talk with the attorney who drafted his or her will to confirm that the shares pass under the will to an eligible shareholder.

5. Train the bank's corporate secretary: The bank's corporate secretary or whomever is in charge of maintaining the bank's shareholders' list should be mindful of S corporation qualifications and eligibility issues as well as common issues that could impact the S election. For example, if shares are transferred to an estate, the corporate secretary should be asking questions such as where do the shares pass under the will, when does the executor plan to transfer the shares out of the estate, etc. The corporate secretary can possibly help avoid an inadvertent termination by being proactive and asking the right questions. Our experience is that community bankers know when a death has occurred. After an appropriate and respectful delay, these questions should be respectfully asked.

6. Road map memos: Banks should consider requiring shareholders (for example, as part of the shareholders' agreement) to have their estate planning attorneys provide the bankers with a letter or memorandum detailing what happens to the shares upon the death of a shareholder, especially if the shares are already held in a trust.

By taking the steps above, a potential inadvertent termination of a bank's subchapter S election can be avoided. An ounce of prevention is worth a pound of cure.

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