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## **INADVERTENT TERMINATIONS OF AN LLC'S S ELECTION**

This notice applies to LLCs that are taxed as S corporations.

Two recent Private Letter Rulings (“PLRs”) demonstrate that an LLC may terminate its S election inadvertently if it has the wrong provisions in its operating agreement. When an S election is terminated, the IRS will treat the LLC as a C corporation which may result in significant unfavorable income tax consequences to the entity.

Most recently, in PLR 201930023 the IRS ruled that an LLC terminated its S election because an amendment to its operating agreement did not provide members with the same rights to distribution proceeds. The amendment stated that distributions would be paid to members with positive capital accounts in accordance with their respective positive capital account balances.

The facts and circumstances in PLR 201822003 were similar. Like in PLR 201930023, the IRS ruled that the LLC terminated its S election because a new operating agreement was implemented that included common partnership tax provisions that address qualified income offsets, special allocations, and contributions of built-in gain property and built-in loss property. The new operating agreement also provided for liquidating distributions to be made in accordance with the positive balances of each member’s capital account.

In both cases, the IRS ruled that the entities violated the “one class of stock” requirement because their equity interests provided for different rights to distribution and liquidation proceeds. These cases demonstrate how easy it is to violate the S corporation requirements. There is no reason the operating agreement of an LLC taxed as an S corporation should reference Subchapter K provisions of the Internal Revenue Code (i.e. IRC §§ 700-799).

Ultimately, the IRS decided the S election terminations were not made in bad faith and were inadvertent, so the LLCs were permitted to retain their S election. Even though the IRS decided to allow the LLCs to retain their S elections (and avoid characterization as a C corporation), the entities likely spent significant time and money to rectify their tax dilemmas.

If you or your clients have an LLC that is taxed as an S corporation for purposes of federal income tax, we strongly encourage you to review the operating agreement for these issues. We would be happy to assist you in your review. We would also be happy to assist you if you are considering forming another LLC or amending an existing LLC's operating agreement. Please contact our office to discuss how to best avoid unintended tax consequences.

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