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SC TECHNICAL ADVICE MEMORANDUM #89-24

TO: Mr. Marvin N. Davant, Director
Field Services Division

FROM: John Swearingen, Manager
Tax Policy and Procedures Department

DATE: October 18, 1989

SUBJECT: Subchapter S Corporations
(Income Tax)

REFERENCE: S.C. Code Section 12-7-235(b)
S.C. Code Section 12-7-455(u) (Law. Co-op. 1988).
IRC Section 1362 (1988)

AUTHORITY: S.C. Code Ann. Section 12-3-170 (1976)
S.C. Revenue Procedure #87-3

SCOPE: A Technical Advice Memorandum is a temporary document issued to an individual within the Commission, upon request, and it applies only to the specific facts or circumstances related in the request. Technical Advice Memoranda have no precedential value and are not intended for general distribution.

Questions:

1. Are corporations that made S corporation elections for federal purposes prior to January 1, 1985 required to comply with the timing of election provision of Internal Revenue Code (IRC) Section 1362 when making the S corporation election for state purposes?
2. Can the S corporation election for state purposes be made on a delinquent return?
3. If the corporation filed on an SC1120 instead of an SC1120S and all of the shareholders deducted the S corporation's losses, is a valid S election in effect for state purposes?

Facts:

The Field Services Division has requested advice on the requirements for making an S election for state purposes. Prior to 1984, South Carolina did not recognize S Corporations. Section 12-7-235 was passed in June, 1984 and allowed S-corporations for state purposes for tax years beginning after December 31, 1983. The South Carolina Income Tax Federal Conforming Amendments of 1985 amended Section 12-7-235 and added Section 12-7-455(u) for tax years beginning after December 31, 1984. The above questions have arisen as a result of several audits of S corporations and shareholders of S corporations. In each case, a valid S election was in effect prior to January 1, 1985 for Federal purposes.

Discussion:

Section 12-7-235(b) provides that if a small business corporation makes a valid S election to be exempt from income taxes for federal purposes, it is similarly exempt for state purposes.

Section 12-7-455(u) provides transitional rules for corporations that elected S status for federal purposes prior to January 1, 1985.

The pertinent parts of Section 12-7-455(u) provide:

Except as hereinafter provided, all elections made under the provisions of Internal Revenue Code Sections 1361 through 1378 automatically apply for South Carolina purposes. If a taxpayer had a valid "S" election in effect for federal tax purposes prior to January 1, 1985, but has not elected that treatment for South Carolina income tax purposes, the taxpayer may at its option continue to be subject to the tax provided in Section 12-7-230 or it may affirmatively elect in the manner described in Internal Revenue Code Section 1362 to be exempt from the South Carolina tax...A taxpayer shall give the Commission notice of its intent to be an "S" corporation by filing with the Commission a copy of the election it files with the Internal Revenue Service although, the failure to file the notice does not void the corporation's "S" election for South Carolina tax purposes. (emphasis added)

As stated above, Sections 12-7-235(b) and 12-7-455(u) provide that for tax years beginning after December 31, 1984 a federal S election automatically applies for state purposes with one exception. The exception is when the federal S election was made prior to January 1, 1985 and no S election has been made for state purposes, then the taxpayer has an option to continue as a C corporation for state purposes or elect S status for state purposes.

The wording of the exception states the taxpayer "may affirmatively elect in the manner prescribed in Internal Revenue Code Section 1362 to be exempt from the South Carolina tax." The question arises whether strict compliance with the provisions of IRC Section 1362 are required. The timing of election provision of IRC Section 1362 requires the election to be made prior to or before the sixteenth day of the third month of the first taxable year for which the election is made. For example, for a calendar year corporation an election for 1988 must be made before March 16, 1988. Further, the election under 1362 cannot be made on a delinquent return.

The intention of adoption of the Federal Conforming Act of 1985, was to conform South Carolina income to federal income. Strict compliance to the requirements of IRC Section 1362 in the application of 12-7-455(u) would be contrary to this intention. The fact that Section 12-7-455(u) was not approved until May 15, 1985, but was effective for the tax year beginning January 1, 1985 supports this position. If strict compliance to IRC Section 1362 were required, the election for 1985 could not be made as it would have been required before March 16, 1985. The last sentence of Section 12-7-455(u) provides that the taxpayer shall give notice to the Commission of its intent to be an S corporation, but the failure to file the notice does not void the S election for State purposes. Therefore, strict compliance with the S election provisions of IRC Section 1362 is not required for state purposes. A corporation that was an S corporation for federal purposes prior to January 1, 1985 could make the state election after the sixteenth day of the third month of the first taxable year for which the election is made or on a delinquent return.

When Section 12-7-235 was first passed allowing the S election, corporations were advised in 1984 to file on an SC1120, make a Schedule A adjustment for S earnings distributed or deemed distributed and file an election (federal form 2553) with the return if the election had not been made separately. In 1985, the SC1120 provided a deduction for subchapter S distributions on line 6. The SC1120S was not available until 1986. Thus, for the first two years an S corporation filed on a regular SC1120 for state purposes. Administratively, an S election was accepted with the return as long as a federal election was in effect and all shareholders consented to the election. A determination of whether all shareholders consented can be made by two methods. A form 2553 could be filed with all the shareholders consenting to the state election or all shareholders indicate their consent by reporting the S corporation loss on their individual returns. If a determination that all shareholders consent is made under either of the two methods described above, a valid S election will be considered in effect for state purposes. If form 2553 has not been filed and not all of the shareholders reported the S corporation loss on their returns, the S election will be considered invalid for state purposes.

Conclusion:

1. Corporations that made S corporation elections for federal purposes prior to January 1, 1985 are not required to comply with the timing of election provision of IRC section 1362 when making the election for state purposes.
2. The S corporation election for state purposes can be made on a delinquent return.
3. If the corporation filed an SC1120 instead of an SC1120S and all of the shareholders deducted the S corporation's losses, a valid S election is in effect for state purposes provided all the shareholders consented.