

S Corporations

Relief from Late Elections and Inadvertent Terminations

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Introduction

According to IRS statistics, about six million corporation returns are filed every year, and about 70 percent of these are Forms 1120S, showing that an S corporation is the preferred choice among corporations.¹

To qualify as an S corporation, a corporation must satisfy specific requirements and must file an election. It is not uncommon to find that a corporation has not filed its election. This was a common audit issue when I worked for the IRS many years ago. If a corporation hasn't filed its S election, there can be undesirable income tax consequences. The corporation is treated as a C corporation, which can result in double taxation of profits or disallowance of flow-through losses. In addition, corporations who do file the election sometimes become ineligible for the S corporation election, resulting in its termination.

This article discusses why an S corporation is a popular choice of entity, the requirements for filing an S corporation election, relief available when the election isn't filed timely, revoking or terminating the election, and relief from inadvertent terminations.

Why Choose an S Corporation?

When it comes to selecting an entity in which to operate a small business, an S corporation is the preferred choice because of its advantages over sole proprietorships, C corporations and partnerships. Sole proprietors must pay both income tax and self-employment tax on their entire profits. C corporations must pay tax on profits at the corporate level, and amounts distributed to shareholders are taxed again at the individual level as either dividends, capital gains or compensation. Losses sustained by a C corporation are usually trapped at the corporate level. Partners must pay tax at the individual level on income earned by the partnership, and often that income is subject to self-employment tax. A partner's share of losses of a partnership are limited to the partner's adjusted basis of the partner's interest in the partnership.

A shareholder of an S corporation must pay tax at the individual level on the S corporation's distributive items, but this income is not subject to self-employment tax. If the shareholder performs services for the S corporation, then a reasonable amount must be treated as compensation (which the S corporation can deduct as an expense); the S corporation's distributive share of income cannot substitute for this compensation.² A shareholder may deduct a distributive share of an S corporation's losses, but such deduction is limited to the shareholder's basis in stock and indebtedness of the S corporation.³

The S Corporation Election

A corporation may elect to be treated as an S corporation if it has 100 or fewer shareholders, all of whom are individuals (some estates and trusts qualify, too), none of whom are nonresident aliens, and the corporation must have only one class of stock.⁴

To make the election, the corporation must file Form 2553, *Election by a Small Business Corporation*.⁵ All of the corporation's shareholders must consent.⁶ Once a valid election is filed, new shareholders need not consent to the election.⁷

To be effective on the first day of the corporation's taxable year, the S election must be filed no later than the 15th day of the third month of that year.⁸ If the election is filed after this date, then it is considered to be effective for the next taxable year.⁹ The 15th day of the third month is not necessarily March 15. A corporation's year begins when the corporation has shareholders, acquires assets or begins doing business, whichever occurs first.¹⁰ This could be any day of the year.

A limited liability company may also file an S corporation election, and such election is treated both as an entity classification election (to be treated as an association taxable as a corporation), and as an S corporation election.¹¹

As mentioned above, certain trusts are permitted to be shareholders of an S corporation. These include a Qualified Subchapter S Trust (QSST) and an Electing Small Business Trust (ESBT).¹² To be a shareholder, the beneficiary of the QSST and the trustee of the ESBT must make an election.¹³ The election must be filed within two and a half months of the date that the stock is transferred to the trust.¹⁴

In addition, an S corporation may elect to treat a wholly-owned subsidiary as a Qualified Subchapter S Subsidiary (QSub).¹⁵ The S corporation parent may make the election at any time during the year.¹⁶ The election is made by filing Form 8869, *Qualified Subchapter S Subsidiary Election*.

Relief from Filing a Late S Corporation Election

Before 1996, the IRS had no authority to approve late-filed S corporation elections. If a corporation couldn't prove that it filed the election timely, IRS agents treated the corporation as a C corporation. In 1996, Congress authorized the IRS to approve late S corporation elections.¹⁷ This relief was retroactively effective to years after 1982.

Under this section, if a late election is filed for a particular year, or if no election has been filed for any year, then the IRS has the authority to treat a late election as timely if there was reasonable cause for the failure to file the election timely.¹⁸

continued on p. 13

continued from p. 12

In 1997, the IRS issued the first of many revenue procedures providing for relief if certain requirements were met.¹⁹ Corporations that did not satisfy the requirements of that revenue procedure could request a letter ruling to obtain relief.²⁰ In later years, the IRS issued additional revenue procedures that dealt with various permutations of late elections, including where the corporation hadn't filed the election at all, late elections by partnerships, limited liability companies, trusts and other entities.²¹

In 2013, the IRS decided to consolidate the various permutations into a single revenue procedure that covers most situations. Rev. Proc. 2013-30²² applies to a late election made by an "eligible entity." It includes any entity that wants to make a late S corporation election, QSST election, ESBT election, QSub election or late corporate classification election. This article focuses on late S corporation elections.

For late S corporation elections, the requirements for relief are:

1. The entity intended to be classified as an S corporation as of the intended effective date;
2. The entity is requesting relief within three years and 75 days of the date that the S corporation election was intended to take effect;
3. The failure to qualify as an S corporation is solely because the S election (Form 2553) was not timely filed; and
4. The S corporation has reasonable cause for failing to file the election timely and the corporation has acted diligently to correct the mistake upon its discovery.²³

The requirement that relief must be requested within three years and 75 days of the effective date is waived if:

1. The corporation is not seeking relief from a late corporate classification election;
2. The failure to qualify as an S corporation is solely because the S election (Form 2553) was not timely filed;
3. The corporation and its shareholders filed all returns as if the S election was in effect;
4. At least six months have elapsed since the corporation filed its return for the first year that the corporation intended to be an S corporation;
5. Neither the corporation nor its shareholders was notified by the IRS of any problem with the S corporation status within six months of the date that the first year's Form 1120S was filed; and
6. The election form (Form 2553) includes statements from all shareholders that during the period between the date the S corporation election was to have become effective and the date the completed election form is filed, they have reported their income on all affected returns consistent with the S corporation election for the year the election should have been filed and for all subsequent years.²⁴

As an example, if a corporation failed to file the S corporation election, and if the corporation and its shareholders have filed 10 years of returns as if the S election was in effect, and if there is reasonable cause for the failure to file the election timely, Rev. Proc. 2013-30 usually provides relief.

In addition, if a late corporate classification election (e.g., from LLC to corporation) is intended to take effect at the same time as the S election, the entity must satisfy additional requirements. Either:

1. the entity timely filed all required returns consistent with its requested classification as an S corporation and no inconsistent returns were filed; or
2. (a) the entity has not filed a return for the first year that the election is intended to take effect because the due date hasn't passed, and
(b) shareholders have filed their returns consistently as if the S corporation election was in effect.²⁵

To obtain the late election relief, the corporation may file Form 2553 (with supporting documents) either with the corporation's current year Form 1120S, with a late-filed prior year Form 1120S, or by itself.²⁶

If Form 2553 is filed with the corporation's current year or late-filed prior year Form 1120S, the statement "INCLUDES LATE ELECTION FILED PURSUANT TO REV. PROC. 2013-30" must be shown at the top of the first page of Form 1120S, and the return must be filed within three years and 75 days of the intended effective date of the election. If it is filed by itself, the statement "FILED PURSUANT TO REV. PROC. 2013-30" must be shown at the top of the first page of Form 2553.²⁷

In either case, a "Reasonable Cause/Inadvertence Statement" must also be included that describes the corporation's reasonable cause for failure to timely file the election and its diligent actions to correct the mistake upon its discovery, and this statement must be signed under penalties of perjury.²⁸

For California corporations, if the request for approval of the late election is filed by itself, it should be mailed to Department of the Treasury, Internal Revenue Service Center, Ogden, UT 84201, or faxed to 801-620-7116.

Not all situations result in Rev. Proc. 2013-30 relief. For example, suppose that an entity failed to file the S corporation election and it filed one or more returns as a sole proprietorship, partnership or C corporation. Suppose further that relief is not being requested within the three-year, 75-day period. No relief is available under Rev. Proc. 2013-30. Instead, the corporation might want to consider requesting a letter ruling from the IRS.²⁹ The IRS charges a user fee for such requests.³⁰

Revoking or Terminating the S Corporation Election

There are several ways that an S corporation's election may be terminated. It may be voluntarily revoked by consent of shareholders holding more than half of the corporation's stock, or it may be terminated if the corporation ceases to qualify as an S corporation (such as by having an ineligible shareholder), or it may be terminated when the corporation has accumulated earnings and profits for three consecutive years and more than 25 percent of its gross receipts for each of these years is passive investment income.³¹

An S corporation revokes its election by filing a statement with the IRS that it revokes its election. The statement must include

continued on p. 14

continued from p. 13

information specified in IRS regulations, and must be filed with the IRS service center where the S election was filed.³²

If the S election is revoked by consent of the shareholders, then the effective date of the revocation depends on when it is revoked. A revocation filed on or before March 15 is effective on the previous January 1. A revocation filed after March 15 is effective for the following year.³³

IRS regulations permit an S corporation to rescind a revocation of its S election, but the request to rescind must be filed before the effective date of the revocation.³⁴ If, for example, a corporation's S election was revoked on February 15, the revocation was effective on the previous January 1. It may not be rescinded because it's too late. On the other hand, if a corporation's S election is revoked on July 1, the revocation is effective for the following year, so a rescission filed on or before December 31 would rescind the revocation.

Inadvertent Ineffective S Election or Termination of the S Election

If a corporation's S election:

1. did not become effective due to the corporation's failure to qualify as an S corporation;
2. did not become effective due to failure to obtain shareholder consents;
3. was terminated because the corporation ceased to qualify as an S corporation; or
4. was terminated because the corporation received too much passive investment income,

and if the circumstances that resulted in the ineffective election or termination were inadvertent, then the IRS has the authority to grant relief and allow the corporation to continue to be treated as an S corporation.³⁵

To qualify for relief, within a reasonable period of time after the problem is discovered, the corporation must take steps to make sure that the S corporation qualifies as a small business corporation or to acquire the shareholder consents, as the case may be.³⁶ The IRS may also require the corporation or its shareholders to make appropriate adjustments to reflect the continuation of the S election.³⁷

A corporation that desires such relief must file a request for a letter ruling.³⁸ The IRS issues dozens of such letter rulings every year granting relief. A frequent situation is where a shareholder dies and the stock is transferred to a trust; the IRS grants relief by allowing the beneficiary additional time to file a late QSST election.

If an S corporation revoked or inadvertently terminated its S election, then why not simply file a new election? Because the Code precludes this. If the S corporation revoked or terminated its election, then it, and any successor corporation, is ineligible to make a new election for five years, unless the IRS consents.³⁹ The IRS will not waive the five-year waiting period unless the event causing termination was beyond the corporation's control.⁴⁰ The IRS will also not allow the corporation to simply transfer its assets to a new corporation and make a new S corporation election to avoid the five-year waiting period.⁴¹

Conclusion

As a tax practitioner, it is important for you to know the rules for qualifying as an S corporation and for filing a late S corporation election so that you can advise your clients on the proper course of action in the event that it is discovered that the election was not timely-filed, not filed at all, or was inadvertently terminated. I hope that this article has helped explain the rules and the relief available.

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¹ Source: IRS Selected Financial Data on Businesses, <http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data>.

² See, e.g., *David E. Watson, P.C. v. United States*, 757 F.Supp.2d 877 (S.D. Iowa 2010), *aff'd*, 668 F.3d 1008 (8th Cir. 2012), *cert. denied* 133 S.Ct. 364 (2012).

³ IRC § 1366(d)(1).

⁴ IRC § 1361(b)(1).

⁵ Treas. Reg. § 1.1362-6(a)(2).

⁶ IRC § 1362(a)(2). If the stock is community property, then both spouses must sign the consent. See Treas. Reg. § 1.1362-6(b)(2)(i).

⁷ Treas. Reg. § 1.1362-6(a)(2).

⁸ IRC § 1362(b)(1)(B).

⁹ IRC § 1362(b)(3).

¹⁰ Treas. Reg. § 1.1362-6(a)(2)(iii)(C).

¹¹ Treas. Reg. § 301.7701-3(c)(1)(v)(C).

¹² IRC §§ 1361(d) and (e).

¹³ IRC §§ 1361(d)(2) and (e)(3).

¹⁴ Treas. Reg. §§ 1.1361-1(j)(6)(iii)(A) and 1.1361-1(m)(2)(iii).

¹⁵ IRC § 1361(b)(3)(B).

¹⁶ Treas. Reg. § 1.1361-3(a)(3).

¹⁷ § 1305(b), Small Business Jobs Protection Act of 1996, P.L. 104-188.

¹⁸ IRC § 1362(b)(5).

¹⁹ Rev. Proc. 97-48, 1997-43 I.R.B. 19.

²⁰ *Id.*, Section 3.

²¹ Rev. Proc. 2002-59, 2002-39 I.R.B. 615; Rev. Proc. 2003-43, 2003-23 I.R.B. 998; Rev. Proc. 2004-48, 2004-32 I.R.B. 172; Rev. Proc. 2004-49, 2004-33 I.R.B. 210; and Rev. Proc. 2007-62, 2007-41 I.R.B. 786.

²² Rev. Proc. 2013-30, 2013-36 I.R.B. 173.

²³ *Id.*, Section 4.02.

²⁴ *Id.*, Section 5.04.

²⁵ *Id.*, Section 5.03.

²⁶ *Id.*, Sections 4.03(2)(a), (b) and (c).

²⁷ *Id.*, Section 4.03(1).

²⁸ *Id.*, Sections 4.03(1) and (3).

²⁹ See Rev. Proc. 2015-1, 2015-1 I.R.B. 1.

³⁰ *Id.*, Appendix A. For requests received after 2/1/2015, the user fee is \$9,800, but a reduced user fee of \$6,500 applies if the corporation's gross income on its most recently-filed return was less than \$1 million, \$2,200 if gross income was less than \$250,000.

³¹ IRC §§ 1362(d)(1), (2) and (3).

³² Treas. Reg. § 1.1362-6(a)(3).

³³ IRC § 1362(d)(1)(C).

³⁴ Treas. Reg. § 1.1362-6(a)(4).

³⁵ IRC § 1362(f).

³⁶ IRC § 1362(f)(3).

³⁷ IRC § 1362(f)(4); Treas. Reg. § 1.1362-4(d).

³⁸ Treas. Reg. § 1.1362-4(c).

³⁹ IRC § 1362(g).

⁴⁰ Treas. Reg. § 1.1362-5(a).

⁴¹ Treas. Reg. § 1.1362-5(b).