

#7 EXTEND THE TIME FOR SMALL BUSINESSES TO MAKE SUBCHAPTER S ELECTIONS

Present Law

IRC § 1362(b)(1) provides that small business corporations (“S corporations”) may elect to be treated as pass-through entities by submitting Form 2553, *Election by a Small Business Corporation*, at any time during the preceding taxable year or at any time on or before the 15th day of the third month of the current taxable year.

The due date for an S corporation to file Form 1120S, *U.S. Income Tax Return for an S Corporation*, is the 15th day of the third month after the end of its taxable year.

Reasons for Change

Many small business owners are not familiar with the rules governing S corporations, and they learn about the effects of S corporation status for the first time when they hire a tax professional to prepare the corporation’s tax return for its first year of operation. By that time, the deadline for electing S corporation status has passed. The failure to make a timely S corporation election can cause significant adverse tax consequences for businesses, such as taxation at the corporate level and the inability to deduct operating losses on shareholders’ individual income tax returns.³⁴ For context, more than 4.8 million S corporation returns were filed in FY 2017, which accounted for about 70 percent of all corporate returns.

Taxpayers may seek permission from the IRS to make a late S corporation election under the provisions of Revenue Procedure 2013-30 or through a private letter ruling (PLR) request. Under the revenue procedure, a corporation that failed to timely file Form 2553 may request relief by filing Form 2553 within three years and 75 days of the date the election is intended to be effective. In addition, the corporation must attach a statement explaining its reasonable cause for failing to timely file the election and its diligent actions to correct the mistake upon its discovery.

Finally, each shareholder, during the period between the date the S corporation election was to have become effective and the date the completed election form is filed, must sign a statement affirming that 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. If an entity is unable to comply with the requirements of the revenue procedure, it may request relief through a PLR, for which the IRS charges a user fee ranging from \$5,800 to \$28,300 per request.

The current S corporation election deadline burdens small businesses by requiring them to pay tax professionals and often IRS user fees to request permission to make a late election. It also burdens shareholders, because when the IRS rejects an S corporation return due to the absence of a timely election, the status of the corporation is affected, and that, in turn, may result in changes on the shareholders’ personal tax returns. In addition, the current deadline and relief procedures require a commitment of significant resources on the part of the IRS to process late-election requests.

³⁴ The value of an S corporation election increased for many taxpayers with the passage of Pub. L. No. 115-97 (2017), which generally allows an individual taxpayer to deduct 20 percent of domestic “qualified business income” (QBI) from a pass-through business, including an S corporation, effectively reducing the individual income tax rate on such income by 20 percent. The deduction is subject to certain income thresholds (first \$315,000 of QBI for joint filers and \$157,500 for single returns), phase-outs for professional services, and limitations based on W-2 wages paid or capital invested by a business owner for larger pass-through entities. See Pub. L. No. 115-97, § 11011 (2017); H.R. REP. NO. 115-466, at 205-224 (2017) (Conf. Rep.). Some taxpayers will not realize they must make an S corporation election by March 15, 2018 to obtain the benefits of this provision for taxable year 2018.

Because small business owners often consider the S corporation election for the first time at the end of the taxable year in connection with the preparation of their company's first tax return, the burdens described above would be substantially eliminated if corporations could make an S election on their first timely filed tax return.

Recommendation

Amend IRC § 1362(b)(1) to allow a small business corporation to elect to be treated as an S corporation by checking a box on its first timely filed (including extensions) Form 1120S, *U.S. Income Tax Return for an S Corporation*.³⁵

³⁵ For legislative language generally consistent with this recommendation, see Protecting Taxpayers Act, S. 3278, 115th Cong. § 304 (2018); S Corporation Modernization Act of 2017, S. 711 and H.R. 1696, 115th. Cong. § 7 (2017).