

Legislative Recommendation #5**Extend the Time for Small Businesses to Make Subchapter S Elections****SUMMARY**

- *Problem:* Individuals who incorporate their sole proprietorships or small businesses often miss the deadline for electing to be treated as an “S” corporation because the election deadline generally precedes the filing deadline for the corporation’s first income tax return. Taxpayers routinely obtain permission to make late elections but at considerable cost and hassle for the business and the IRS alike.
- *Solution:* Allow taxpayers to elect “S” status on their first timely filed corporation income tax return.

PRESENT LAW

IRC § 1362(b)(1) provides that a small business corporation (S corporation) may elect to be treated as a passthrough entity by making an election 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 prescribed form for making this election is Form 2553, Election by a Small Business Corporation.

IRC § 6072(b) provides that income tax returns of S corporations made on a calendar-year basis must be filed on or before March 15 following the close of the calendar year, and income tax returns of S corporations made on a fiscal year basis must be filed on or before the 15th day of the third month following the close of the fiscal year.

REASONS FOR CHANGE

Many small business owners are not familiar with the rules governing S corporations, and they learn about the ramifications of S corporation status for the first time when they hire a tax professional to prepare their corporation’s income tax return for its first year of operation. By that time, the deadline for electing S corporation status has passed. Failure to make a timely S corporation election can cause significant adverse tax consequences for businesses, such as incurring taxation at the corporate level and rendering shareholders ineligible to deduct operating losses on their individual income tax returns.¹ For context, over five and a half million S corporation returns were filed in FY 2022, which accounted for 71 percent of all corporate returns.²

Taxpayers may seek permission from the IRS to make a late S corporation election under 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.

1 The value of an S corporation election increased for many taxpayers with the passage of the Tax Cuts and Jobs Act, which generally allows individual taxpayers to deduct 20 percent of domestic “qualified business income” (QBI) from a passthrough 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 IRC § 199A; Pub. L. No. 115-97, § 11011, 131 Stat. 2054, 2063 (2017); H.R. REP. NO. 115-466, at 205-224 (2017) (Conf. Rep.).

2 IRS, Pub. 55-B, IRS Data Book FY 2022, <https://www.irs.gov/pub/irs-pdf/p55b.pdf> (Table 2, Number of Returns and Other Forms Filed, by Type, Fiscal Years 2021 and 2022).

Finally, all shareholders must sign a statement affirming they have reported their income on all affected returns as if the S corporation election had been timely filed (*i.e.*, during the period between the date the S corporation election would have become effective if timely filed and the date the completed election form is filed). If an entity cannot comply with the revenue procedure, it may request relief through a PLR. In 2023, the IRS generally charged a user fee for a late-election relief PLR of \$12,600.³

The 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 may cause changes on the shareholders' personal income tax returns. In addition, the deadline and relief procedures require a commitment of significant resources by the IRS to process late-election requests.

Because small business owners often consider the S corporation election for the first time when they prepare their company's first income tax return, the burdens described above would be substantially eliminated if corporations could make an S corporation election on their first timely filed income 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 Form 1120-S, U.S. Income Tax Return for an S Corporation.⁴

3 User fees for PLRs are set forth in the first revenue procedure of each year. For 2023 user fees, see Rev. Proc. 2023-1, 2023-1 I.R.B. 1, App'x A, *Schedule of User Fees*. Treas. Reg. § 301.9100-3 prescribes the procedures and requirements for requesting late-election relief.

4 For legislative language generally consistent with this recommendation, see Protecting Taxpayers Act, S. 3278, 115th Cong. § 304 (2018).