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FREQUENTLY ENCOUNTERED S ELECTION PROBLEMS AND HOW TO FIX THEM

By

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Introduction

To be an S corporation for federal tax purposes is to live dangerously.

After all, there is no situation in which the tax law defaults a taxpayer into being treated as an S corporation, as is this case with C corporations,[1] disregarded entities,[2] and multi-member partnerships.[3] To the contrary, any taxpayer that wishes to be taxed as an S corporation must elect to do so, with the election only valid as long as the taxpayer meets and maintains strict eligibility requirements. One misstep – either with the procedural requirements of the election or the eligibility rules – and the S election terminates. [4]

But how often do S corporations really have problems with the validity of their S election? Quite often, it turns out. In an average year, more than 150 S corporations pay a substantial user fee[5] and request a Private Letter Ruling (PLR) from the IRS in the hopes that the Service will provide relief from an inadvertently invalid or terminated S election. In addition to the formal PLRs, each year the IRS processes another 30,000 relief requests from S corporations made under various revenue procedures that provide for automatic relief from a blown S election.[6]

All of this is to say that there is a *lot* that can go wrong with an S election. This article will examine four of the most likely reasons an S election will be inadvertently invalid or terminated, before then identifying how the S corporation can fix each fatal flaw without having to pay the considerable expense for a formal PLR.

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[1] Regs. Sec. 301.7701-2.
[2] Regs. Sec. 301.7701-3(b)(ii).
[3] Regs. Sec. 307.7701-3(b)(i).
[4] Whether the taxpayer reverts to a C corporation, multi-member partnership, or disregarded entity after the termination of its S election depends on the specific facts. For a state-law corporation or an entity that has filed a Form 8832, *Entity Classification Election*, to be taxed as a corporation for federal tax purposes, termination of an S election will cause the taxpayer to become a C corporation. However, the check-the-box regulations allow an unincorporated entity to elect to be treated as an S corporation without first filing a Form 8832 to be taxed as a corporation. If an unincorporated entity elects to be taxed as an S corporation without separately filing a Form 8832, the entity is *deemed* to have made a check-the-box election to be taxed as a corporation for federal tax purposes. Under Regs. Sec. 301.7701-3(c)(v)(B). This deemed entity classification election, however, is only valid if the entity was eligible to make the S election. Thus, if an unincorporated entity goes directly to making an S election without first fling a Form 8832 and the election is determined to be invalid when made because the entity was not eligible to be taxed as an S corporation, the entity should revert to being treated as a disregarded entity or multi-member partnership, depending on the number of owners.
[5] $38,000 in 2024. See Revenue Procedure 2024-1.
[6] See Robert S. Keller, David H. Kirk, and Tony Nitti, *Reflections on the 10th Anniversary of Rev. Proc. 2013-30*, 181 Tax Notes 69 (Oct. 2, 2023).

Problem #1: Nonidentical governing provisions in a state-law LLC-turned-S corporation

An S corporation is a "small business corporation" that has an S election in effect for the year at issue.[7] A small business corporation is a domestic corporation that does not (1) have more than 100 shareholders; (2) have as a shareholder a person (other than an estate, certain types of trusts,[8] or certain charitable organizations) who is not an individual; (3) a nonresident alien shareholder; or (4) more than one class of stock.[9]

If one were to poll a group of tax advisers, it's very likely that most would say that the statutory requirement that is *least* likely to cause a problem with an S election is the final one; the requirement that an S corporation may not have "more than one class of stock." Interestingly, however, because of the recent proliferation of state-law LLCs[10] electing to be taxed as S corporations for federal tax purposes, this single class of stock requirement has caused many of LLCs-turned-S corporations to discover that their S election was never valid. To understand why, however, one must first appreciate what the Code means when it limits an S corporation to a single class of stock.

An S corporation may have voting and nonvoting shares of stock;[11] what is critical, however, is that all outstanding shares of stock of the S corporation "confer identical rights to distribution and liquidation proceeds." [12]

In practice, this requirement is often misinterpreted as requiring that an S corporation make all distributions pro-rata, but that's not quite how the regulations work. Instead, the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the "governing provisions").[13]

Stated another way, the regulations generally determine whether an S corporation has a second class of stock by looking at what the corporation's governing provisions *say,* rather than by what the corporation *does* in terms of making proportionate distributions. This creates an interesting dichotomy: on the one hand, as the Service stated in Section 3.02 of Revenue Procedure 2022-19,[14] "the IRS will not treat any disproportionate distributions made by a corporation as violating the one class of stock requirement of Section 1361(b)(1)(D) so long as the governing provisions of the corporation provide for identical distribution and liquidation rights." On the other hand, as the IRS has determined in many PLRs, if a corporation's governing provisions do not confer equal rights to distribution and liquidation proceeds, the corporation's S election is not valid, regardless of whether it has made every distribution pro-rata to the penny.[15]

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[7] Sec.1361(a)(1).
[8] Discussed more fully later in this article.
[9] Sec. 1361(b)(1).
[10] Note, state-law LPs are generally avoid making an S election as the different state-law rights granted to a general partner and a limited partner inherently create different rights to distribution and liquidation proceeds. The IRS has stated that it will not rule on whether a state-law LLP may elect S status.
[11] Sec. 1361(c)(4).
[12] Regs. Sec. 1.1361-1(l)(1)
[13] Regs. Sec. 1.1361-1(l)(2)(i).
[14] Rev. Proc. 2022-19, Sec. 3.02; see also PLR 20122004, 201608006,
[15] See PLRs 201815003, 201819003, 201840004, 201904001, 202042001.

Example. *X Co., an S corporation, has two shareholders, A and B. On January 1, 2025, A and B enter into a shareholder agreement that provides that because A has moved to a state with a higher state income tax rate than B, A will get a larger distribution each year. The shareholder agreement is a binding agreement related to distribution and liquidation proceeds, and thus a governing provision of the S corporation. Because it does not confer equal rights to distributions to A and B, X Co. has a second class of stock and its S election terminates as of January 1, 2025.*

While these types of "non-identical governing provisions" are relatively rare in state-law corporations, consider the case of a state-law LLC that elects to be taxed as an S corporation. An LLC generally does not have articles of incorporation, bylaws or corporate charters. Rather, the governing provisions of a state-law LLC – those binding agreements relating to distribution and liquidation proceeds – are generally found in the LLC's operating agreement. And therein lies the problem.

Many LLC operating agreements were drafted in contemplation of the LLC being taxed as a partnership for federal tax purposes. As a result, those agreements often contain standard language that is required should the partnership desire to make special allocations of income, gain, loss or deduction. For example, in order to comply with the substantial economic effect safe harbor of Reg. Section 1.704-1(b)(2), the operating agreement must contain language requiring the partnership to maintain capital accounts in accordance with the rules of Section 704(b),[16] while also requiring that liquidating distributions be made in accordance with the positive balance of the partners' capital accounts.[17]

And while that language is certainly helpful should the LLC in fact operate as a partnership for federal tax purposes, as the IRS has ruled in a slew of PLRs over the past decade,[18] that same language is fatal the moment the LLC decides to file an S election, because requiring the LLC to make liquidating distributions in accordance with capital account balances that are maintained under the rules of Section 704(b) does not provide each shareholder equal rights to liquidating proceeds.

It cannot be overstated how prevalent this problem is; many LLC operating agreements will contain this offending language, creating nonidentical governing provisions. And assuming the agreement was in effect on the date of the S election, the S election will be invalid because the single class of stock requirement is not satisfied.[19]

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[16] Regs. Sec. 1.704-1(b)(2)(ii)(b)(1).

[17] Regs. Sec. 1.704-1(b)(2)(ii)(b)(2).

[18] See PLRs 201815003, 201819003, 201840004, 201904001, 202042001.

[19] As discussed previously in footnote 4, whether a state-law LLC that makes an invalid S election reverts to being taxed as a disregarded entity, partnership or C corporation for federal tax purposes depends entirely on whether the LLC filed a separate check-the-box election on Form 8832, Entity Classification Election, to be taxed as a corporation for federal tax purposes. If the LLC filed the Form 8832, the entity has become a corporation for federal tax purposes, and if the S election is invalid it will revert to being a corporation. A state-law LLC need not file a separate Form 8832 prior to making an S election, however. Regs. Sec. 301.7701-3(c) provides that a state-law LLC who elects to be taxed as an S corporation is deemed to have made a check-the-box election, but only if the LLC were eligible to make the S election. Because in the case of bad governing provisions in the operating agreement the election was never valid, in the absence of a separate check-the-box election to be taxed as a corporation, the entity should revert to being treated as a disregarded entity or partnership for federal tax purposes, depending on the number of owners.

Fix #1: Revenue Procedure 2022-19

If there's a silver lining to the "nonidentical governing provision" problem that plagues LLCs-turned-S corporations, it's that it's become so common that the IRS decided to offer a path for automatic relief.

In Revenue Procedure 2022-19,[20] the IRS permits S corporations and their shareholders to resolve certain "frequently encountered issues" without requesting a PLR. The guidance describes five issues that the IRS historically has identified as not affecting the validity or continuation of a corporation's S election. These five issues may now be addressed without the need to obtain a PLR, and they include:

1. Agreements or arrangements with no principal purpose to circumvent the one-class-of-stock requirement,
2. Disproportionate distributions when the corporation's governing provisions provide for identical distribution and liquidation rights,
3. Certain errors or omissions on Form 2553, *Election by a Small Business Corporation*, or Form 8869, *Qualified Subchapter S Subsidiary Election*, including missing shareholder consents, errors regarding a permitted year, or a missing officer's signature,
4. A lack of written acknowledgement that the IRS has accepted the corporation's S election or its subsidiary's QSub election, and
5. A federal income tax filing that is inconsistent with an S election or QSub election.

More germane to the problem of state-law LLCs with problematic operating agreements, Rev. Proc. 2022-19 provides procedures for allowing an S corporation to retroactively preserve S elections that are inadvertently invalid or have been terminated solely as the result of non-identical governing provisions.[21]

The Rev. Proc. provides that an S corporation with non-identical governing provisions will be treated as continuing from the adoption date of the first non-identical governing provision that invalidated or terminated the corporation's S election if the following four conditions are met:

1. The corporation has or had one or more non-identical governing provisions,
2. The corporation has not made and is not deemed to have made a "disproportionate distribution" to an "applicable shareholder,"
3. The corporation timely filed a Form 1120-S for each applicable tax year, beginning with the tax year in which the first non-identical governing provision was adopted and through the tax year immediately before the tax year in which the corporation sought corrective relief,
4. The S corporation obtains the Corporate Governing Provision Statement and the Shareholder Statement required by Section 3.06(2)(c) before the IRS discovers any non-identical governing provisions.

For purposes of this second condition, a "disproportionate distribution" is any distribution (including an actual distribution, a constructive distribution, or a deemed distribution) of property by a corporation with respect to shares of its stock that differs in timing or amount from the distribution with respect to any other shares of its stock.[22] An "applicable shareholder" is any current or former corporate shareholder who owns or owned corporation stock between the time that the non-identical governing

[20] Rev. Proc. 2022-19, 2022-41 I.R.B. 282.
[21] Rev. Proc. 2022-19, Sec. 3.06.
[22] Rev. Proc. 2022-19, Sec. 2.03(2).

provision was adopted and the date when that provision was removed or modified to ensure it complies with the one-class-of-stock requirement.[23]

This second condition greatly reduces the ability of an S corporation to utilize Proc. 2022-19, because even a single disproportionate distribution in an S corporation's past – whether actual or deemed – is enough to preclude the corporation from obtaining automatic relief; instead, the S corporation must pursue relief via the PLR process. This requirement – which has become known as the "double fault rule," applies even when the disproportionate distribution was not made in an attempt to comply with the S corporation's nonidentical governing provisions.

Example. *LLC elected to be taxed as an S corporation effective January 1, 2022. In 2024, LLC determined that at the time its S election was made, its operating agreement contained "substantial economic effect" language that resulted in nonidentical governing provisions. As a result, the S election was invalid when made on January 1, 2022. In addition, in 2023, LLC made a disproportionate distribution to its shareholders because one shareholder was subject to a higher state income tax rate. Despite the fact that the disproportionate distribution was unrelated to the nonidentical governing provision, the mere presence of the disproportionate distribution means that LLC cannot seek automatic relief under Revenue Procedure 2022-19, and instead must seek relief from its inadvertently ineffective S election via the PLR process.*

To comply with the fourth condition, Revenue Procedure 2022-19 instructs the S corporation to complete a Corporate Governing Provision Statement and its shareholder to complete a Shareholder Statement. Examples of each statement are provided in Appendices A and B of the revenue procedure.[24] Interestingly, the statements are not mailed to the IRS or attached to the Form 1120-S, but rather are simply retained as part of the corporation's records.

Problem #2: Late S Elections

An eligible small business corporation elects to be taxed as an S corporation by filing Form 2553. The statute provides strict time limits for filing the Form 2553 that are often missed.

A newly-formed business that intends to be treated as an S corporation upon formation must file Form 2553 on or before the 15th day of the third moth of the year.[25] For these purposes, the tax year of a new corporation begins on the date that the corporation has shareholders, acquires assets, or begins doing business, whichever is the first to occur.[26] A "month" means a period commencing on the same numerical day of any calendar month as the day of the calendar month on which the tax year began, and ending with the close of the day *preceding* the numerically corresponding day of the succeeding calendar month.

Example. *X Co. begins its first taxable year on January 7, 2025. The first "month" begins on January 7 and ends on February 6th, the second month ends on March 6th, and an additional 15 days arrives at March 21st. Thus, to be an S corporation beginning with its first taxable year, the corporation must make file From 2553 on or before March 21, 2025. Because the corporation had no taxable year immediately preceding the taxable year for which the election is to be effective, an election made earlier than January 7, 2025, will not be valid.*[27]

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[23] Rev. Proc. 2022-19, Sec. 3.06(1)(a).
[24] Rev. Proc. 2022-19, Sec. 3.06(1)(c).
[25] Regs Sec. 1.1362-6(a)(2)(ii)(A).
[26] Regs. Sec. 1.1362-6(a)(2)(ii)(C).
[27] Regs. Sec. 1.1362-6(a)(2)(ii), Example 1.

For an existing corporation, the Form 2553 can be filed at any time during the preceding tax year,[28] or during the current tax year as long as it is filed on or before the 15th day of the 3rd month of the tax year.[29]

Example. *X Co., a calendar-year C corporation, desires to be treated as an S corporation effective January 1, 2025. X Co. may make file the Form 2553 at any time in 2024, and on or before March 15, 2025.*

The statute provides a safety net for a late election by stating that if a Form 2553 that was intended to be effective on the first day of the tax year is filed *after* the 15th day of the 3rd month of the tax year but before the 15th day of the 3rd month of the following tax year, the S election is treated as being made for the beginning of the following tax year.[30]

Example. *X. Co., a calendar year C corporation, desires to make an S election effective January 1, 2025. X Co. files the Form 2553 on May 2, 2025. Because the Form 2553 was filed after March 15, 2025 – the 15th day of the 3rd month of the tax year -- the election will be treated as being effective January 1, 2026.*

A corporation may discover that it has missed the deadline to make the S election for the corporation's desired effective date, or as is often the case, that while the corporation has been filing tax returns as if it were an S corporation, no S election was ever filed.

Fortunately, Section 1362(b)(5) provides that if an S election is filed late for any tax year or no election is made for any tax year, and the Secretary determines that there was reasonable cause for the failure to timely make the election, the Secretary may treat the election as timely made for the tax year.

Thus, the IRS has the power to approve a late S election, and while it can do so using the PLR process, over the decades the Service has published an ever-expanding string of revenue procedures offering S corporations an avenue for automatic relief, all culminating in Revenue Procedure 2013-30.

Fix #2: Revenue Procedure 2013-30

With its publication a little more than a decade ago, Rev. Proc. 2013-30 became the one-stop-shop for all things late S elections, superseding a series of previous revenue procedures by consolidating and expanding the opportunities for late relief. The revenue procedure allows eligible taxpayers to avoid the PLR process by providing late relief for 1) S corporation elections, including S corporation elections made in conjunction with a late entity classification election, 2) ESBT and QSST Elections (more on these later), and 3) QSub elections.

Rev. Proc. 2013-30 allows for a late S corporation election when a corporation – or an eligible entity as defined by Treas. Reg. § 301.7701-3(a) – intended to be classified as an S corporation as of the desired effective date,[31] the election was invalid solely because it was not timely filed,[32] and the taxpayer

[28] Sec. 1361(b)(1)(A).
[29] Sec. 1361(b)(1)(B).
[30] Sec. 1362(b)(3).
[31] Rev. Proc. 2013-30, Sec. 4.02(1).
[32] Rev. Proc. 2013-30, Sec. 4.02(3).

has reasonable cause for its failure to timely file the election and has acted diligently to correct the mistake upon its discovery.[33]

Relief from a late S election is generally obtained by filing Form 2553 within 3 years and 75 days of the desired effective date.[34] In certain situations, however, a taxpayer may request relief for a late S corporation election even when more than 3 years and 75 days have passed since the desired effective date. This can be accomplished only when each of the following requirements are met:[35]

- The corporation is not seeking late corporate classification election relief concurrently with a late S corporation election;
- The corporation fails to qualify as an S corporation solely because the Form 2553 was not timely filed;
- The corporation and all of its shareholders reported their income consistent with S corporation status for the year the S election should have been made, and for every subsequent tax year (if any);
- At least 6 months have elapsed since the date on which the corporation filed its tax return for the first year the corporation intended to be an S corporation; and
- Neither the corporation nor any of its shareholders was notified by the IRS of any problem regarding the S corporation status within 6 months of the date on which the Form 1120S for the first year was timely filed.

Example. *X Co., a state-law corporation that has been filing tax returns as an S corporation since January 1, 2014, discovered in 2025 that it never filed its S election. While Rev. Proc. 2013-30 generally requires that relief be sought within 3 years and 75 days of the desired effective date of the S election, if X Co. meets the requirements of Section 5.04 of Rev. Proc. 2013-30, it can request relief as of January 1, 2014.*

The Form 2553 must be signed by an officer of the corporation authorized to sign and all persons who were shareholders at any time during the period that began on the first day of the tax year for which the election is to be effective and ends on the day the completed Form 2553 is filed.[36] The Form 2553 must state at the top of the document "FILED PURSUANT TO REV. PROC. 2013-30."

Rev. Proc. 2013-30 does not allow a taxpayer to retroactively change its tax status to an S corporation; it merely allows a corporation that has always believed itself to be an S corporation – despite having not made a timely filed election – to obtain late relief and make a valid election. As a result, the completed Form 2553 must include statements from all shareholders during the period between the date the S corporation election was to have become effective and the date the completed Form 2553 is filed 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.[37]

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[33] Rev. Proc. 2013-30, Sec. 4.03(1). To satisfy this final requirement, the corporation must include in its late election a "Reasonable Cause" statement, signed under penalties of perjury, that describes its reasonable cause for failure to timely file the election and its diligent actions to correct the mistake upon its discovery.
[34] Rev. Proc. 2013-30, Sec. 4.02(3).
[35] Rev. Proc. 2013-30, Sec. 5.04.
[36] Rev. Proc. 2013-30, Sec. 5.01.
[37] Rev. Proc. 2013-30, Sec. 5.02.

Example. *X Co., a calendar year C corporation, filed a Form 1120 for 2024. In February of 2025, X Co. realizes that it would have preferred to be taxed as an S corporation for 2024. X Co. cannot use Revenue Procedure 2013-30 to file a late S election for 2023 because the shareholders cannot make the representations that they have reported their income for 2023 consistent with X Co. being an S corporation.*

An S corporation has three options for filing the late Form 2553. First, the Form 2553 can be filed separately with the applicable IRS Service Center.[38] Alternatively, if the S corporation has filed all Forms 1120S for tax years between the effective date and the current year, the election form can be attached to the current year Form 1120S as long as the current year Form 1120S is filed within 3 years and 75 days after the effective date. It's critical to note that an extension of time to file the current year Form 1120S will not extend the due date for relief.[39]

Example. *X Co. desired to be taxed as an S corporation effective January 1, 2022. In order to seek relief under Revenue Procedure 2013-30, X Co. must file the Form 2553 on or before March 15, 2025. If X Co. extends its 2024 tax return to the extended due date of September 15, 2025, this does not extend the deadline for the Form 2553. As a result, if X Co. desires to extend its 2024 return, the Form 2553 will need to be separately filed by March 15, 2025.*

Third, in the case of an S corporation that has not filed Form 1120S for the tax year including the effective date or any year following the effective date, the election form may be attached to the Form 1120S for the year including the effective date as long as (i) the Form 1120S for the year including the effective date is filed within 3 years and 75 days after the effective date, and (ii) all other delinquent Forms 1120S are filed simultaneously and consistently with the requested relief.[40]

Upon receipt of a completed request for relief under the Rev. Proc., the IRS will determine whether the requirements for granting additional time to file the election have been satisfied and will notify the requesting party of the result of this determination.[41]

Problem #3: Ineligible Trust Shareholders

As noted in Problem #1, the statute permits only certain types of trusts to hold shares of stock in an S corporation.[42] The seven types of trusts permitted to be shareholders in an S corporation include:

1. A trust all of which is treated (under subpart E of part I of subchapter J of chapter 1 of the Code) as owned by an individual who is a citizen or resident of the United States (a "grantor trust");[43]
2. A trust which was a grantor trust immediately before the death of the deemed owner and which continues in existence after such death, but only for the 2-year period beginning on the day of the deemed owner's death,[44]
3. A trust with respect to stock transferred to it pursuant to the terms of a will, but only for the 2-year period beginning on the day on which such stock is transferred to it (a "testamentary trust");[45]

[38] Rev. Proc. 2013-30, Sec. 4.03(2)(c).
[39] Rev. Proc. 2013-30, Sec. 4.03(2).
[40] Rev. Proc. 2013-30, Sec. 4.03(2).
[41] Rev. Proc. 2013-30, Sec. 4.05.
[42] Sec. 1361(b)(1)(B).
[43] Sec. 1361(c)(2)(A)(i).
[44] Sec. 1361(c)(2)(A)(ii).
[45] Sec. 1361(c)(2)(A)(iii).

4. A trust created primarily to exercise the voting power of stock transferred to it (a "voting trust");[46]
5. An electing small business trust (an "ESBT");[47]
6. In the case of a corporation which is a bank or a depository institution holding company, a trust which constitutes an individual retirement account under Section 408(a), including one designated as a Roth IRA under Section 408A,[48] and
7. A qualified subchapter S trust (a "QSTT").[49]

Problems with trusts as eligible S shareholders generally come in two categories: eligibility and elections.

Eligibility problems often plague grantor trusts, ESBTs and QSSTs. Each type of trust must satisfy the necessary statutory and regulatory requirements necessary for the trust to qualify as the type of eligible S corporation shareholder it intends to be.

To meet the definition of a grantor trust, the trust document must contain at least one of the powers listed in Sections 671 through 678 to cause the trust to be treated as being owned by an individual (whether or not the grantor).[50]

To qualify as an ESBT, the trust may have multiple income beneficiaries, but may not have as a beneficiary any person other than an individual, estate, or certain charitable organizations.[51] In addition, no interest in the trust can have been acquired by purchase.[52] An ESBT cannot be a trust that has made a QSST election, a tax-exempt trust, or any charitable remainder annuity trust or charitable remainder unitrust (as defined under Section 664(d)).[53]

To meet the requirements of a QSST, all of the income of the trust must be distributed (or required to be distributed) currently to one individual who is a citizen or resident of the United States, and the terms of the trust must require that 1) during the life of the current income beneficiary, there shall be only one income beneficiary of the trust, 2) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary, 3) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust, and 4) upon the termination of the trust during the life of the current income beneficiary, the trust must distribute all of its assets to such beneficiary.[54]

For two types of trusts – ESBTs and QSSTs – merely meeting the statutory requirements necessary to qualify as the intended trust is not enough; rather, ESBT and QSSTs must also file an election with the Service to be recognized as an ESBT or QSST, and as with any tax election, there are procedural requirements that can prove problematic.

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[46] Sec. 1361(c)(2)(A)(iv).
[47] Sec. 1361(c)(2)(A)(v).
[48] Sec. 1361(c)(2)(A)(vi).
[49] Sec. 1361(d).
[50] Regs. Sec. 1.1361-1(h)(1)(i).
[51] Sec. 1361(e)(1)(A)(i).
[52] Sec. 1361(e)(1)(A)(ii).
[53] Sec. 1361(e)(1)(B).
[54] Regs. Sec. 1.1361-1(j)(1).

Both a ESBT and QSST must file an election within the 16-day-and-2-month period beginning on the day on which the trust acquired the stock in the S corporation.[55] An ESBT election must include the information required by Reg. Section 1.1361-1(m)(2)(ii), while a QSST election must include the information required by Reg. Section 1.1361-1(j)(6)(ii).

Example. *On May 1, 2024, a trust that meets all the requirements to be an ESBT acquires stock in X Co., an S corporation. The trust must file the ESBT election before July 16, 2024, the end of the 16-day-and-2-month period beginning on the date the trust acquired the stock.*

There are nuances to the election timing rules that often catch S corporations off guard.

If an ESBT or QSST owns shares of stock in a C corporation that makes an S election retroactive to the first day of the year, the trust must make its election within the 16-day-and-2-month period of the first day of the year.[56]

Example. *A trust that satisfies all of the requirements to be a QSST owns stock in a C corporation. On February 1, 2025, the C corporation files an S election effective January 1, 2025. The trust must make the QSST election before March 16, 2025, the end of the 16-day-and-2-month period beginning on the date the S election was effective*. [57]

If an ESBT or QSST owns shares of stock in a C corporation that makes an S election effective for the first day of the *following* tax year, the trust must make its election within the 16-day-and-2-month period beginning on the day the S election is *filed*.[58]

Example. *A trust that satisfies all of the requirements to be a QSST owns stock in a C corporation. On April 1, 2025, the C corporation files an S election to be effective January 1, 2026. The trust must make the QSST election before June 16, 2026, the end of the 16-day-and-2-month period beginning on the date the S election was filed.*[59]

While the procedural requirements governing ESBT and QSST elections are generally the same, there are some important distinctions. For example, while only one ESBT election is made for a trust, regardless of the number of S corporations whose stock is owned by the trust,[60] a QSST must make a separate election for each S corporation owned by the trust.[61]

Example. *A trust that satisfies all of the requirements to be a QSST receives stock in an X, an S corporation, on January 1, 2024. The trust must make the QSST election before March 16, 2024, the end of the 16-day-and-2-month period beginning on the date the QSST acquired the stock in X. On January 1, 2025, the trust acquires stock in Y, another S corporation. The trust must make a separate QSST election with respect to the shares in Y by March 16, 2025, the end of the 16-day-and-2-month period beginning on the date the QSST acquired the stock in Y. Had the trust been an ESBT, rather than a QSST, the trust would*

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[55] Regs. Sec. 1.1361-1(j)(6)(iii) and Regs. Sec. 1.1361-1(m)(2)(iii).
[56] Regs. Sec. 1.1361-1(j)(6)(iii)(B).
[57] Regs. Sec. 1.1361-1(k)(1), Example 9.
[58] Regs. Sec. 1.1361-1(j)(6)(iii)(B).
[59] Regs. Sec. 1.1361-1(k)(1), Example 10.
[60] Regs. Sec. 1.1361-1(m)(2)(i). Note, however, that if the ESBT holds stock in multiple S corporations that file in different service centers, the ESBT election must be filed with all the relevant service centers where the corporations file their income tax returns.
[61] Regs. Sec. 1.1361-1(j)(6)(i).

need to make only one ESBT election – when it receives the stock in X – by March 16, 2024. The ESBT need not make another ESBT election when it acquires the stock in Y.

In addition, while it is the trustee of an ESBT who must sign the ESBT election[62], the current income beneficiary of a QSST must sign the QSST election.[63] Finally, while a QSST that is making an election simultaneous with an S election may make the election directly on Form 2553, Part III, an ESBT will always have to file its election as a separate statement.

QSST and ESBT elections are frequently missed when the 2-year grace period afforded (1) a grantor trust after the death of the grantor, or (2) a testamentary trust, expires.

Example. *F owns the stock of Corporation P, an S corporation. In addition, F is the grantor of Trust A, a grantor trust, that holds stock in Corporation O, an S corporation. F dies on July 1, 2023. Trust A continues in existence after F's death but is no longer a grantor trust. Trust A will be an eligible S corporation shareholder until June 30, 2025, the last day of the 2-year period that begins on the date of F's death. Assuming that Trust A meets the definition of a QSST as of June 30, 2025, Trust A must make the QSST election no later than September 16, 2025, the end of the 16-day-and-2-month period beginning on July 1, 2025, the date on which Trust A's 2-year grace period expires and Trust A would otherwise become an ineligible S corporation shareholder.* [64]

On August 1, 2023, F's shares of stock in Corporation P are transferred to Trust B pursuant to the terms of F's will. With respect to the stock in Corporation P, Trust B is a testamentary trust, and as a result, is an eligible S corporation shareholder until July 31, 2025, the last day of the 2-year period that begins on the date of the transfer from F's estate to the trust. Assuming as of August 1, 2025, Trust B meets the definition of an ESBT, the trust must file its ESBT election before October 16, 2025, the end of the 16-day-and-2-month period beginning on August 1, 2025, the date on which Trust B's 2-year grace period as a testamentary trust expires and Trust B would otherwise become an ineligible S shareholder.

A common misconception is that if a grantor trust voluntarily turns off grantor status and becomes a nongrantor trust, the trust is similarly granted a 2-year grace period. However, no such rule exists. As a result, the nongrantor trust must immediately meet the definition of either a QSST or an ESBT and must make the appropriate election before the expiration of the 16-day-and-2-month period beginning on the date the trust became a nongrantor trust.[65]

Example. *A is the grantor or Trust C, a grantor trust, that holds stock in Corporation X, an S corporation. On May 1, 2025, A relinquishes his grantor powers, and Trust C becomes a nongrantor trust. Trust C must immediately qualify as a QSST or ESBT and must make the appropriate election no later than July 16, 2025, the end of the 16-day-and-2-month period beginning on the date Trust C became a nongrantor trust.*

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[62] Regs. Sec. 1.1361-1(m)(2).
[63] Regs. Sec. 1.1361-1(j)(6)(ii).
[64] Regs. Sec. 1.1361-1(k)(1), Example 3. Also note, if a grantor trust, after the death of the grantor, meets the definition of an ESBT or QSST before the end of the 2-year grace period, the trust may make the ESBT or QSST election, as appropriate, at any time during the 2-year grace period, but must make the election no later than the end of the 16-day-and-2-month period beginning of the date the 2-year grace period ends. The same is true for the 2-year grace period afforded a testamentary trust. See Regs. Sec. 1.1361-1(j)(6)(iii)(C) and Regs. Sec. 1.1361-1(m)((2)(iv).
[65] Regs. Sec. 1.1361-1(j)(6)(iii)(C).

Fix #3: Revenue Procedure 2013-30

When an ESBT or QSST election is not timely filed, the trust is an ineligible shareholder and the corporation's S election terminates as of the day the trust acquired the stock. Fortunately, Revenue Procedure 2013-30 is once again available to provide relief.

An ESBT or QSST can make a late election by filing the appropriate election form within 3 years and 75 days of the desired effective date.[66] Unfortunately, as opposed to late S elections[67], there is no opportunity to extend the relief period beyond 3 years and 75 days.

Example. *Trust A, which satisfies all of the requirements to be an ESBT, received shares of S corporation stock on January 1, 2021. The trust intended to file its ESBT election prior to March 16, 2021, but the election was never filed. Trust A discovers the problem on June 6, 2024. Because Trust A discovered the mistake after March 15, 2024 – the date that is 3-years-and-75-days after the desired effective date of the ESBT election –Trust A may not seek relief from the late ESBT election using Rev. Proc. 2013-30; rather, the S corporation must undertake the PLR process.*

If instead, Trust A did not receive the ESBT shares until January 1, 2022 and the missed election was discovered on June 6, 2024, the trust would have until March 15, 2025 to file the ESBT election and seek relief using Rev. Proc. 2013-30.

In order to obtain relief for a late ESBT or QSST election, the following requirements must be met:[68]

- The trustee seeking a late ESBT election or the trust beneficiary seeking a late QSST election must have intended the trust to be an ESBT or QSST, respectively, as of the desired effective date;
- The failure to qualify as a ESBT or QSST was solely because the election was not timely filed; and
- The failure to file the timely election was inadvertent and the person seeking relief acted diligently to correct the mistake upon discovery. [69]

Both elections must include statements from all shareholders during the period between the date the S corporation election was to have become effective or was terminated and the date the completed election is filed that they have reported their income on all affected returns consistent with the S corporation election for the year the election should have been made and for all subsequent years.[70]

The trustee of an ESBT or the current income beneficiary of a QSST must sign and file the appropriate election form. In the case of a late ESBT election, no standard form exists; as a result, the relief is requested on a taxpayer-prepared statement, signed under penalties of perjury, which includes:

- A statement from the trustee of the ESBT that includes the information required by Regs. Sec. 1.1361-1(m)(2)(ii);[71] and

[66] Rev. Proc. 2013-30, Sec. 4.02(2).
[67] See the discussion in "Fix #2," above.
[68] Rev. Proc. 2013-30, Sec. 4.02(2).
[69] As a result, both a late ESBT and a late QSST election must include an "Inadvertence Statement" explaining that the failure to file the election was inadvertent and the diligent actions undertaken to correct the mistake upon its discovery.
[70] Rev. Proc. 2013-30, Sec. 6.
[71] Rev. Proc. 2013-30, Sec. 6.01(1).

- A statement from the trustee that all potential current beneficiaries meet the shareholder requirements of Section 1361(b)(1) and that the trust satisfies the requirements of an ESBT under Section 1361(e)(1) other than the requirement to make an ESBT election.[72]

If a late QSST election is made for a QSST that owned shares at the time of the intended S corporation election, the beneficiary of the QSST can file for late relief using Form 2553 and must complete the QSST election in Part III. If the trust acquired shares after a valid election had been made – resulting in an inadvertent termination – the trustee must file a separate statement that includes the following, filed under penalties of perjury:

- A statement from the current beneficiary of the QSST that includes the information required by Regs. Sec. 1.1361-1(j)(6)(ii);[73]
- A statement from the trustee that the trust satisfies the QSST requirements of Section 1361(d)(3) and that the income distribution requirements have been and will continue to be met.[74]

Upon receipt of a completed request for relief under the Rev. Proc., the IRS will determine whether the requirements for granting additional time to file the election have been satisfied and will notify the requesting party of the result of this determination.

Problem #4: Missing Shareholder Consents in a Community Property State

As discussed in Problem #2, it is not uncommon for an S corporation to fail to file a timely S election, forcing the S corporation to seek relief. There are more concerns when filing a Form 2553, however, then merely filing prior to the due date. Regulations provide that an S election is not valid unless all shareholders of the corporation at the time of the election consent to the election,[75] and it is this consent requirement that is the subject of the fourth and final frequently encountered problem area for S corporations.

A proper consent requires not only the signature of the shareholder, but also the shareholder's name, address, and taxpayer identification number, the number of shares of stock owned by the shareholder, the date (or dates) on which the stock was acquired, the date on which the shareholder's taxable year ends, the name of the S corporation, the corporation's taxpayer identification number, and the election to which the shareholder consents. The consent must be signed by the shareholder under penalties of perjury.[76]

Fortunately, Page 2 of the Form 2553 contains all of the above information such that as long as the shareholder completes columns J, L, M and N and signs in column K, the regulatory requirements are generally satisfied.

S corporations often fail to identify *which* shareholders must consent to the election. For example, when an S election is made retroactive to the beginning of the year, all shareholders who owned stock at any point from the desired effective date through the date the Form 2553 was filed must consent to the election, even if the shareholder does not own stock on the day the election is filed.[77]

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[72] Rev. Proc. 2013-30, Sec. 6.03(3).
[73] Rev. Proc. 2013-30, Sec. 6.03(1).
[74] Rev. Proc. 2013-30, Sec. 6.03(2).
[75] Regs. Sec. 1.1362-6(a)(2).
[76] Regs. Sec. 1.1362-6(b)(1).
[77] Regs. Sec. 1.1362-6(b)(3).

Example. *On January 1, 2024, A, B, and C own shares of X, a C corporation. On February 1, 2024, A sells his stock to D. On March 1, 2024, when B, C, and D are the only shareholders of X, the corporation elects to be taxed as an S corporation effective January 1, 2024. In order for the election to be valid, the Form 2553 must include the consent of B, C, D, and even A. Even though A is not a shareholder as of March 1, 2024, because A owned stock in X between January 1, 2024 and March 1, 2024, A must consent to the election.*

An S corporation must also identify *who* is required to consent on behalf of each shareholder. The consent of an estate must be made by an executor or administrator thereof, or by any other fiduciary appointed by testamentary instrument or appointed by the court having jurisdiction over the administration of the estate.[78] In the case of a trust shareholder, who must consent depends on the nature of the trust: for a grantor trust, the deemed owner must consent;[79] for an ESBT, the consent must be made by the trustee;[80] and in the case of a QSST, the income beneficiary must consent to the election.[81]

The most frequent trap in recognizing who must consent to an election belongs not to an estate or trust, however, but rather to a certain type of individual. Regulations require that when stock of an S corporation is owned by husband and wife as community property (or the income from the stock is community property), or is owned by tenants in common, joint tenants, or tenants by the entirety, each person having a community interest in the stock or income therefrom and each tenant in common, joint tenant and tenant by the entirety must consent to the election.[82] This requirement is frequently missed in the nine community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin).

Example. *A and B are married and reside in Texas, a community property state. A owns stock in X, a C corporation. Effective January 1, 2024, X elects to be taxed as an S corporation. Because A and B reside in a community property state, even though only A directly owns stock in X, B has a state-law community property interest in the stock, and must also consent to X's S election. Failure to do so means that X's S election was invalid.*

Fix #4: Revenue Procedure 2004-35

An S corporation that discovers that its S election was invalid because of the failure to obtain all required consents has three possible paths for relief before needing a PLR.

First, the S corporation can seek relief under Reg. Section 1.1362-6(b)(3)(iii), which allows the corporation to request an extension of time to obtain a required consent from the IRS. The S corporation must establish that there was reasonable cause for the failure to file the consent, the request for the extension of time to file a consent must be made within a reasonable time under the circumstances, and the interests of the Government cannot be jeopardized by treating the election as valid. This option for relief does not have a time limit, but is not automatic; the S corporation must request the extension of time from the Service and hope that it is granted.

Next, Revenue Procedure 2022-19 instructs an S corporation with a missing consent to fix the problem using Revenue Procedure 2013-30. Historically, practitioners had debated whether relief under Rev. Proc. 2013-30 was limited to circumstances in which an election was simply missed or filed late. This

[78] Regs. Sec. 1.1362-6(b)(2)(iii).
[79] Regs. Sec. 1.1362-6(b)(2)(iv).
[80] Id.
[81] Id.
[82] Regs. Sec. 1.1362-6(b)(2)(i).

debate was put to rest by Section 3.03(1)(b) of Rev. Proc. 2022-19, in which the Treasury and the IRS specifically provided that taxpayers may seek relief under Rev. Proc. 2013-30, when otherwise applicable, in circumstances whereby an election was invalid because of a missed shareholder consent. Presumably, the S corporation would need to seek relief from a missing consent within 3 years and 75 days of the desired effective date of the S election unless the S corporation meets the requirements in Section 5.04 of Revenue Procedure 2013-30 to go beyond the 3-years-and-75-days lookback period.

There is an administrative burden that comes with pursuing relief from a missing consent via Revenue Procedure 2013-30, however; when filing the new Form 2553 as part of the relief request, the S corporation must obtain the consent of all shareholders who owned stock beginning on the desired effective date of the S election and ending on the date relief is sought,[83] even those who originally consented to the election. This can be a difficult task when the mistake is not discovered until years after the desired effective date, and a shareholder may have died or otherwise become unreachable.

Finally, for the all-too-common problem of a missing spousal consent in a community property state, relief is available under Revenue Procedure 2004-35. The Rev. Proc. provides automatic relief[84] if: (1) the S corporation election is invalid solely because the Form 2553 failed to include the signature of a community property spouse who was a shareholder solely by reason of state community property law; and (2) both spouses have reported all items of income, gain, loss, deduction, or credit consistent with the S corporation election on all affected federal income tax returns.

Relief is sought by filing with the service center with which the corporation files its income tax return a dated statement, signed by each spouse under penalties of perjury, that includes the following information:

- A representation that reads, "This statement is being furnished pursuant to Rev. Proc. 2004-35 for a late filing of shareholder consents for community property spouses of S corporation shareholders in community property states.";
- The name of the corporation, its employer identification number, its address, date of incorporation, state of incorporation, and the intended effective date of its initially filed Form 2553;
- Each spouse's name, social security number or employee identification number, tax year end and the total number of shares owned at the date of the intended election; and
- A statement that the community property spouses reported all items of income, gain, loss, deduction or credit consistent with the S corporation election on all affected returns.

The Service will notify the shareholder of the acceptance or denial of the shareholder's request to file the late shareholder consent.

Example. *A and B are married and reside in Texas, a community property state. A owns stock in X, a C corporation. Effective January 1, 2004, X elects to be taxed as an S corporation. Because A and B reside in a community property state, even though only A directly owns stock in X, B has a state-law community property interest in the stock, and must also consent to X's S election. Failure to do so means that X's S election was invalid. X discovers the failure in 2024. X may obtain automatic relief by filing a statement with the IRS that meets the requirements of Revenue Procedure 2004-35.*

[83] Rev. Proc. 2013-30, Sec. 5.01.
[84] As authorized by Regs. Sec. 1.1362-6(b)(2)(iii).

When All Else Fails

As this article illustrates, S corporations frequently discover that their S elections were invalid when made or inadvertently terminated. Fortunately, Revenue Procedures like 2022-19, 2013-30, and 2004-35 provide automatic relief procedures that will allow an S corporation to fix many of the most common procedural and eligibility problems that arise.

As we've seen, however, there are limits to the relief offered by the revenue procedures. A state-law LLC that elected to be taxed as an S corporation may discover that it has both nonidentical governing provisions and a history of disproportionate distributions, knocking it outside the purview of Revenue Procedure 2022-19. An ESBT that owns stock in an S corporation may find that it never failed the ESBT election, and that the desired effective date of the ESBT election was more than 3-years-and-75-days in the past, removing the S corporation from the ambit of Revenue Procedure 2013-30. Or an S corporation may realize that it did not receive consents from both spouses in a community property state, and if one spouse is deceased, divorced, or otherwise unwilling to sign the consent, Revenue Procedure 2004-35 will be of no help.

Fortunately, the statute provides two forms of additional recourse for those S corporations that can't obtain automatic relief from an inadvertently invalid or terminated S election.

First, Section 1362(b)(5) permits the IRS to treat a late election as timely if the IRS determines that there was reasonable cause for the late filing. As a result, an S corporation that discovers that it filed a late election but that is outside the relief provisions of Rev. Proc. 2013-30 may obtain relief under Section 1362(b)(5) by requesting a PLR. The IRS has granted relief pursuant to Section 1362(b)(5) in hundreds of rulings over the years.[85]

For those S corporations whose election was terminated for a reason other than the late filing of the Form 2553 – for example, an impermissible second class of stock, a missed late QSST or ESBT election, or a missing shareholder consent – and who are unable to obtain automatic relief, Section 1362(f) allows the IRS to waive an inadvertently invalid or terminated S election via the PLR process.

Section 1362(f) provides that a corporation will be treated as an S corporation, even if its election was not effective for the tax year at issue because it failed to meet requirements under Section 1361(b) or to obtain shareholder consents or was terminated, if three requirements are met:

- The circumstances that caused the ineffectiveness or termination were inadvertent;[86]
- Within a reasonable period of time after discovering the problem, the entity took steps to correct it;[87] and
- The corporation and each of its shareholders agree to make adjustments that the Treasury Secretary may require.[88]

The IRS has granted relief from invalid or inadvertently terminated S elections in hundreds of PLRs under Section 1362(f).[89]

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[85] See, for example, PLRs 201507021, 201502004, 201614025, 201728016, 201845028, 201921006, 202048004, 202152016, 202249003.
[86] Section 1362(f)(2).
[87] Section 1362(f)(3).
[88] Section 1362(f)(4).
[89] See, for example, PLRs 202207007, 202210002, 202219005, 202223006, 202231009, 202302004.

The PLR process offers S corporations a valuable safety net, but it's a costly one. An S corporation requesting relief under either Section 1362(b)(5) or Section 1362(f) must pay a user fee of $38,000 for 2024.[90]

Takeaway

Numbers don't like. Even by the most conservative estimates, each year tens of thousands of S corporations need relief from an inadvertently invalid or terminated S election.

[90] The user fee is set each year by the first revenue procedure of the year; i.e., Revenue Procedure 2024-1.