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A Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary: Part VI – Revocation of an S Corporation Election

By Larry Brant on 5.2.24 | Posted in Internal Revenue Code, Tax Laws, Tax Planning

This sixth installment of my multi-part series on Subchapter S is focused on the revocation of an S corporation election.[1] While the rules relating to revocation are fairly straightforward, there are a few nuances that may create traps for unwary taxpayers and their tax advisers.

Background

An S election may be revoked with the consent of greater than 50 percent of the shares held on the date of revocation.[2]

Revocation of an S election does not require the Secretary's consent. Rather, to revoke an S election, the corporation simply must file a written statement with the Service Center where it files its IRS Form 1120S. The statement must include:

- The express intent to revoke the election pursuant to Code § 1372(a).
- The number of shares issued and outstanding, including voting and nonvoting shares at time of revocation.
- The effective date of revocation [not required but suggested].
- Signed shareholder consents reflecting the number and type of shares held by each shareholder.[3]

Revocation Timing Rules

A revocation is effective for the current year (as of the first day of the year) if it is made on or before the 15th day of the third month.[4] Any revocation made after the 15th day of the third month is effective the first day of the next taxable year.[5] The corporation may designate a prospective date in the future upon which the revocation is to become effective.[6]

A corporation may also revoke an election before it becomes effective.[7]

A revocation may be rescinded before the revocation becomes effective.

PRACTICE ALERT: For a rescission of a revocation, consent of all persons who consented to the revocation and all persons who became shareholders after the revocation was filed, but prior to the filing of the rescission, is required. If filed with the Service Center in which the corporation files its IRS Form 1120S before the revocation becomes effective, the rescission is effective on the date filed.[8] Mailing is arguably the filing date.

EXAMPLE 1: Assume a calendar year S corporation. A revocation on February 1, 2024, will be effective January 1, 2024. A revocation on June 1, 2024, will become effective January 1, 2025. A revocation on either February 1, 2024, or June 1, 2024, designating September 1, 2024, as the effective date will become effective September 1, 2024, thereby creating two short tax years.

Two of these provisions may be key tools in a practitioner's toolbox if a corporation has made an S election without knowledge of the Built-In-Gains Tax or some other peril is lurking around the corner; namely:

- The ability to revoke an S election before it becomes effective; or
- The ability to revoke an S election for the current tax year on or before the 15th day of the third month of the year.

In the right circumstances, these provisions could save the day (or at least the impact, in whole or part, of the Built-In-Gains Tax under Code § 1374).

EXAMPLE 2: Corporation makes an S election on November 1, 2024, effective January 1, 2025. At the beginning of December 2024, Corporation's astute tax practitioner, while undertaking a year-end tax review for Corporation, discovers that Corporation will likely have over $2,000,000 of built-in gain in 2025 when it collects its cash basis accounts receivable. In this case, Corporation is able to put the genie back in the bottle by revoking the S election by preparing and filing a statement of revocation on or before December 31, 2024, with IRS Service Center where it files its IRS Form 1120S. The statement clearly states that it intends to revoke the election, how many shares are issued and outstanding, including voting and nonvoting shares at time of revocation, and the effective date of revocation (January 1, 2025). It

has signed shareholders consents attached, indicating the number/type of shares held by each shareholder (to reflect that the required consent was obtained). While not necessary, the revocation should be sent to the Service by U.S. Mail, certified, return receipt requested.

EXAMPLE 3: Same facts as above in Example 2, but the astute tax practitioner does not discover the problem until February 16, 2025, or Corporation does not act on the tax practitioner's advice to revoke the election until February 16, 2025. In this case, Corporation is able to put the genie back in the bottle by revoking the S election by preparing and filing a statement of revocation on or before March 15, 2025, with IRS Service Center where it files its IRS Form 1120S. The statement clearly states that it intends to revoke the election, how many shares are issued and outstanding, including voting and nonvoting shares at time of revocation, and the retroactive effective date of revocation (January 1, 2025). It has signed shareholders consents attached, indicating the number/type of shares held by each shareholder (to reflect that the required consent was obtained). While not necessary, the revocation should be sent to the Service by U.S. Mail, certified, return receipt requested.

As indicated above, if a revocation of an S election is made after the 15th day of the third month of the taxable year, it is effective on the first day of the following taxable year.[9] In the instance where it is discovered that the corporation is exposed to the Built-In-Gains Tax under Code § 1374 after the effective date of the S election and after the time period allowed for a retroactive revocation, it may be possible to limit or eliminate the Built-In-Gains Tax exposure by making a prospective revocation, effective on the first day of the next taxable year.

PRACTICE ALERT: If the corporation can use the taxable income limitation for the current taxable year to eliminate the Built-In-Gains Tax under Code § 1374(d)(2), it should escape the tax altogether since its S election will be revoked as of the first day of the next taxable year. Built-in gain is only recognized during the "recognition period." The "recognition period" only occurs during the time period in which an S election is in effect.

Obstacles to Using Revocation as a Sword

There are a few obstacles, however, that need to be understood if you are toying with the idea of using the "revocation" as a sword to avoid a potential peril such as the wrath of the Built-In-Gains Tax:

- The first obstacle is that re-election will not likely be immediately available. Once an S election is revoked, a taxpayer cannot immediately re-elect S status. Specifically, if a corporation has made an S election and that election has been revoked or terminated, the corporation cannot re-elect S status for five (5) taxable years following the taxable year in which the revocation or termination became effective.[10] The Commissioner may consent to a re-election prior to the expiration of the five (5) years. The Service will consent to requests of taxpayers for an early re-election, but only in cases where there is evidence that no abuse or tax avoidance motive exists relative to the revocation or the re-election.[11] **Be aware:** In the case of a revocation to avoid the application of the Built-In-Gains Tax under Code § 1374, the corporation will most certainly have to wait the full five (5) years for any re-election.
- The second obstacle is that the Built-In-Gains Tax under Code § 1374 may not be able to be eliminated for the current taxable year by using the taxable income limitation. Any attempt to harvest deductions will be closely scrutinized by the Service. Code § 162 requires that expenses be ordinary and necessary, and that compensation expenses be reasonable.[12] The likely temptation for the shareholders of a closely-held corporation would be to increase shareholder compensation in an attempt to zero out taxable income during the single year that the corporation is an S corporation and avoid the Built-In-Gains Tax altogether because, as of the first day of the next taxable year, the corporation will be a C corporation.

Consent to Revocation is Required

In Code § 1362(d)(1)(B), a rather obscure rule exists. As stated above, this provision allows an S election to be revoked with the consent of greater than 50 percent of the shares of the corporation held on the date of revocation. The rule sounds clear enough! Its implications may not, however, be so vivid.

QUERY: How does this rule apply to an S corporation that has outstanding shares with voting and non-voting rights? Does Code § 1362(d)(1)(B) require the consent of more than fifty (50) percent of all shares of stock (voting and nonvoting), only nonvoting shares, or only voting shares?

The Treasury Regulations that correspond with Code § 1362 indicate that more than 50 percent of total shares of an S corporation, which includes both voting stock and nonvoting stock, can effectuate a revocation.[13] No weight is given to voting stock. Thus, theoretically the nonvoting shares alone of an S corporation could consent to revoke the S election.

EXAMPLE: Assume Corporation, an S corporation, has 20,000 shares of voting stock outstanding and 40,000 shares of nonvoting stock outstanding. The nonvoting shares were gifted by the founders to their children as part of estate planning efforts. Theoretically, 30,000

shares of nonvoting stock would be sufficient in this case to revoke Corporation's S election.

The takeaway is simple: If a corporation has nonvoting stock outstanding or plans to issue nonvoting stock (perhaps as part of an estate plan), it should consider limiting or even prohibiting the holders of nonvoting shares from voting those shares to revoke the S election. For that purpose, a carefully drafted written shareholder agreement is required. Practitioners need to be aware of this obscure aspect of Code § 1362(d)(1)(B)! Like some of the other not-so-obvious aspects of Subchapter S, its potential application could be devastating.

Conclusion

Hopefully this multi-part series on some of the obscure aspects of Subchapter S has been illuminating and will help taxpayers and tax practitioners keep clear of the many traps that exist for the unwary. I will, albeit not with any particular regularity, keep adding to this series of blog posts on the not so obvious aspect of Subchapter S. Stay tuned!

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[1] While this may be the sixth and last installment of my multi-part series on S corporations, it is not my last blog post on interesting and important matters relating to S corporations and their shareholders.

[2] Code § 1362(d)(1)(B).

[3] Treas. Reg. § 1.1362-6(a).

[4] Code § 1362(d)(1)(C)(i).

[5] *Id.*

[6] Code § 1362(d)(1)(D).

[7] Treas. Reg. § 1.1362-2(a)(1).

[8] Treas. Reg. § 1.1362-6(a)(4).

[9] Code § 1362(d)(1)(c)(ii).

[10] Code § 1362(g).

[11] *See* PLR 8842007. In that ruling, the IRS accepted a corporation's S election on January 1, 1988 even though the same corporation had elected S corporation status effective January 1, 1987, then revoked the election in early 1987 due to adverse consequences which the election would have had on the corporation's profit sharing plan. The IRS emphasized that the corporation had never benefited from or been subject to S corporation rules and therefore no abuse or tax avoidance was involved in the revocation or reelection. Therefore, the corporation was not forced to sit on the bench during the five-year waiting period and was allowed to rejoin the S Club.

[12] Code § 162 allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

[13] Treas. Reg. § 1.1362-6(a)(3)(i)(b).

Tags: A Journey Through Subchapter S, built-in gains tax, revocation, S corporation, S election, stock