1988

**Tax Court Decision Unsettles IRS Subchapter S Procedures**

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**Repository Citation**  
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TAX COURT DECISION UNSETTLES IRS SUBCHAPTER S PROCEDURES

To the Editor:

Given the crushing caseload that its judges must face, it is not surprising that from time to time the Tax Court renders an opinion that on brief reflection appears, shall we say, ill-advised. However, not since its first opinion in Larson3 has the Tax Court shot itself in the foot with the unerring accuracy displayed in Jon P. Smith.2 In an admirably brief memorandum opinion, the court has declared invalid tens, perhaps hundreds, of thousands of subchapter S elections—some dating back to 1958. Unless the court is concerned that now that it has come to grips with its tax shelter caseload its judges will be facing underemployment, its January 13 opinion in Smith should follow its first Larson opinion into the wastebasket labeled "indiscretions we are not going to live to regret." (For a summary of Smith, see Tax Notes, January 18, 1988, p. 255.)

The problem comes about like this. The making of a subchapter S election has always been a fairly tricky affair. While the form looks like it could be completed by the average high school graduate, somehow it never has quite worked out that way. I have never seen any statistics on the number of S election forms that the Service viewed as inaccurately or incorrectly completed as filed, but my experience suggests that the numbers are legion. The problem of taxpayer—that is, tax advisor—error in completing the election form has been compounded by the very narrow window in time in which a valid election could be made.3 Inevitably, by the time Service personnel identified the inadequacy in the form as filed and returned it to the taxpayer, the time for filing the election had expired. In other areas of administering the provisions of subchapter S prior to the 1982 revision, the Service tended to adopt surprisingly rigid, if not downright hostile, positions. However, with regard to the filing of an incorrectly completed election form, the Service has for at least 20 years been appropriately forgiving. Defective forms were returned to the taxpayer along with a notation to the effect that, if the form was properly completed and returned to the Service within a reasonable period of time, it would be treated as effective on the day first received. Careful practitioners, noting the absence of any statutory basis for the Service's generosity, occasionally worried over whether the Service was bound to respect the validity of a corrected form refilled outside of the prescribed statutory window. I doubt that it ever occurred to anyone, however, that a taxpayer might not be bound by an election so made. Clearly, were the taxpayer not bound by such an election, the Service would have been unable to grant such leniency.

[The Tax Court's] January 13 opinion in Smith should follow its first Larson opinion into the wastebasket labeled 'indiscretions we are not going to live to regret.'

The taxpayer in Smith was one of the countless beneficiaries of the Service's generosity. The election originally filed in 1974 was inexplicably left unsigned. The Service duly returned the form to the taxpayer who caused it to be signed and promptly refilled with the Service. Some years later as deficiency was asserted against the shareholders in the S corporation, apparently attributable to S corporation items. In what all parties must have regarded as an unusually complete enumeration of the grounds for defending against the asserted deficiency, the taxpayer argued that the deficiency could not be sustained since the corporation was not a valid S corporation. Rather, the taxpayer argued, a valid subchapter S election had not been filed within the statutorily prescribed period of time and the Service lacked the authority to extend the time for filing a subchapter S election. Astoundingly, the Tax Court agreed with the taxpayer although it reserved to the Service the right to argue at trial that the taxpayer was estopped to deny the validity of its election.

The implications of this opinion should be a matter of great concern for at least the following reasons.

1. The Tax Court has declared every subchapter S election filed in accordance with the Service's procedures.

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1 In its first effort in Larson, the Tax Court issued an opinion that would have treated virtually all limited partnerships as corporations, an approach that was just slightly ahead of its time. Two weeks later the opinion was withdrawn. Ultimately, the court reversed itself in an opinion that reconfirmed the formalism of the line between corporations and limited partnerships. Larson v. Commissioner, 66 T.C. 159 (1976) acq. 1979-1 C.B. 1.
3 See I.R.C. section 1362(b).
to be avoidable at the option of the taxpayer for all open years. While presumably few of the thousands of taxpayers eligible to do so will actually wish to disown retroactively their S elections,\(^4\) as a matter of sound and practical administration of the tax laws it is simply unacceptable that any taxpayer should be granted that option.

It is not easy to see what useful purpose will be served by litigating the question of whether a taxpayer and the Service had the right to agree that an election was in substantial compliance with the regulations.

The opinion in Smith appears to create two grounds upon which the Service might defend against such attempted retroactive revocations of subchapter S elections. The Service argued that the election in question was valid when filed because the form was in "substantial compliance" with the procedural requirements contained on the form and in the Treasury regulations. The court, however, rejected the argument that a signature was merely procedural or that a form omitting such a signature could be in substantial compliance with the regulations. Arguably, other information required by the form might be accorded less significance and would not prevent the effectiveness of an election. However, under Smith it becomes necessary to explore through case-by-case litigation what manner of defect can be excused under the doctrine of substantial compliance, for the decision denies to the Service the right to make that determination. It is not easy to see what useful purpose will be served by litigating the question of whether a taxpayer and the Service had the right to agree that an election was in substantial compliance with the regulations.

Secondly, the court is apparently willing to entertain the argument that the taxpayer, after having properly executed and filed its election and thereafter operated as an S corporation for six or, perhaps, 16, years, is estopped to now deny that the corporation is a valid S corporation. Again, however, that determination for both this and other taxpayers will require case-by-case litigation invoking the obscure and not well understood rules governing estoppel.

Unfortunately, this quite obvious cause for concern in the wake of the opinion in Smith is only the most trivial of concerns.

2. The court did not actually extend to taxpayers an option to avoid their subchapter S elections. The court held all such elections invalid. As a result, it is not only open to taxpayers to avoid their S elections but also to the Internal Revenue Service. Thus, under the opinion in Smith, the Service is now free to locate each S corporation that took advantage of its generous refiling procedure and attack each of those subchapter S elections for all open years. At this point, there is no indication whatsoever that the Service will adopt such a position and it would be quite surprising if it were to do so. On the other hand, were taxpayers to seek to avoid burdensome S elections, it could hardly be regarded as inequitable for the Service to adopt a similar posture. Of course, if the Service can argue that taxpayers are estopped from avoiding their S elections, taxpayers also should be able to argue that the Service is estopped to deny the validity of the elections it accepted. Yet the very thought of having to sustain a subchapter S election by asserting that the government is estopped to deny the validity of the election is nothing less than a tax practitioner's nightmare.\(^5\) The worst nightmare, however, it yet to come.

3. If the decision in Smith stands as a correct statement of the law, it will simply be impossible for the Service to continue its lenient attitude towards the filing of S elections. If refiled elections have no binding effect on either the taxpayer or the government, invoking such refilings becomes a folly, if not a fraud, and the practice would have to be terminated. As a result, in the future elections bearing trivial defects cannot be saved. They will simply not be effective for the year for which they were filed.\(^6\) That alone should produce a miniboom in malpractice litigation. The worst, however, is yet to come.

Presumably... all elections that were technically defective when made for any of a wide range of reasons, but nevertheless were accepted by the Service, must now be regarded as invalid...

4. Taxpayers can bungle a subchapter S election in quite a wide variety of ways. Incorrectly completing the election form scarcely exhausts the possibilities. Indeed, the blunder currently in vogue is for the beneficiary of a so called qualified subchapter S trust to fail to make the separate election with respect to the trust that is necessary to make the trust a qualified S corporation shareholder.\(^7\) While the recent revision of subchapter S granted the Service the authority to overlook unintentional terminations of subchapter S elections,\(^8\) there is no corresponding statutory authority authorizing the Service to overlook faulty elections. As has been pointed out elsewhere,\(^9\) it is not easy to argue that a corporation that never made a valid election can be treated as inadvertently terminating its election, thereby becoming eligible for the statutory relief. The Service has bravely attempted to bridge that statutory omission. In a series of private rulings the Service has found taxpayers to be in substantial compliance with the statutory provisions, and thus, concluded that the election was effective.\(^10\) If the decision in Smith

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\(^5\)Under current law, the election may be effective for the following year. I.R.C. sections 1362(b)(2) and (3).

\(^6\)I.R.C. section 1361(d)(2).

\(^7\)I.R.C. section 1362(f).

\(^8\)Coven, Making Subchapter S Work, Tax Notes, July 21, 1986, pp. 271, 274.

\(^9\)See, e.g., LTR 8802067 and LTR 8753030.
stands, it seems unlikely that the Service will be able to continue this equally lenient policy. If an unsigned S election does not constitute substantial compliance with the statutory provisions, it is not easy to see how an unfiled trust election can constitute substantial compliance. Presumably, therefore, as matters now stand, all elections that were technically defective when made for any of a wide range of reasons, but nevertheless were accepted by the Service, must now be regarded as invalid and both avoidable by the taxpayer and subject to challenge by the Service.

5. The implications of the decision in Smith do not end with subchapter S. Read more broadly, the opinion stands for the proposition that whenever the Internal Revenue Service has not held a taxpayer to rigid literal compliance with statutory or regulatory requirements, the action taken may, decades later, be challenged by either party. Nothing could be more corrosive of the integrity of the administration of the taxing system. The decision in Smith does not serve the best interests of taxpayers or the Service or the Tax Court. The decision is clearly bad as a matter of tax policy. It will seriously undermine the ability of the Service to administer the tax system in a fair and reasonable manner. Moreover, the decision is equally unnecessary as a matter of law. However, the election in Smith was validly executed. Admittedly, an election filed out of time may be invalid because the Service lacks the statutory authority to extend the time in which the election may be made. However, the election in Smith was originally filed in a timely manner. The conclusion that the prompt but untimely addition of a signature to the timely filed election in accordance with the long-established procedures of a government agency does not constitute substantial compliance with the statutory requirements is the product of a blind and self-destructive formalism. The Tax Court should seriously consider withdrawing and rethinking its position in Smith.

Sincerely,
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