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S Corporation Committee

Important Developments in the Federal Income Taxation of S Corporations

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I. Cases


Taxpayers were shareholders in Total Health Concepts, LLC, a Colorado limited liability company taxed as an S corporation (“THC”). At trial, the two issues were (i) whether the Taxpayers have substantiated that they should be allowed cost of goods sold (“COGS”) greater than those allowed by the IRS’s examination report and (2) whether the IRS properly disallowed business expense deductions pursuant to section 280E. The Tax Court concluded that the Taxpayers had failed to substantiate higher COGS, refused to consider whether section 280E applied to the business expenses, concluding instead that the Taxpayers failed to substantiate any of the business expenses for which the deductions were disallowed.

The Tenth Circuit held that the Tax Court erred in denying the business expense deductions for failure to substantiate them under section 162 because the IRS based the deficiency notice solely on section 280E. The Tenth Circuit then considered the Commissioner’s argument that judgment in its favor can be affirmed on the alternative ground that the Taxpayers failed to disprove the applicability of section 280E. The Taxpayers argued that requiring them to bear the burden of proving the IRS erred in applying section 280E violated their Fifth Amendment privilege against self-incrimination, and further argued that if the burden is properly assigned to the IRS, it must bear the consequences of any failure of proof. However, the Tenth Circuit rejected the Taxpayers’ contention that bearing the burden of proving the IRS erred in rejecting THC’s business deduction under section 280E violated their Fifth Amendment privilege. The Tenth Circuit further held that because the Taxpayers offered no evidence that THC was engaged in a business other than trafficking, the Tax Court’s decision upholding the deficiency was affirmed.


Attorney David Morowitz incorporated the Law Office of David Morowitz (the “Corporation”) in 1999 as a Rhode Island corporation taxable as an S Corporation. In 2009, Attorney Patrick Barry joined Mr. Morowitz’s practice as a partner, and Mr. Morowitz changed the name of the Corporation to “Morowitz & Barry, Ltd.” When he did so, he did not dissolve the original corporation, amend its corporate structure, or change its Federal Employer Identification Number – he simply filed articles of amendment with the State of Rhode Island changing its name, and entered into a shareholder agreement with Mr. Barry governing ownership and treatment of the clients Mr. Morowitz had prior to Mr. Barry’s joining the practice (the “Pre-Existing Clients”).

The shareholder agreement between Mr. Morowitz and Mr. Barry stated that any fees earned and monies paid with respect to the Pre-Existing Clients would belong to Mr. Morowitz, not the Corporation. Furthermore, any expenses relating to the Pre-Existing Clients would be by paid by Mr. Morowitz personally. Despite this language in the shareholder agreement, the retainers for Pre-Existing Clients continued to be held by the
Corporation, and Mr. Morowitz did not require any Pre-existing Clients to execute new retainer agreements with Morowitz & Barry, Ltd. or him personally.

On his 2010 individual tax return, Mr. Morowitz filed a Schedule C claiming deductions for the following expenses: (1) “case costs” for Pre-Existing Clients in the amount of $9,997 and $2,137 (which were paid out of the Corporation’s bank account), and (2) payments to the Corporation’s legal secretaries in the amount of $15,000 for work performed on a Pre-Existing Client’s case. The IRS disallowed all of these deductions, and Mr. Morowitz filed suit in the US District Court of Rhode Island (the “Court”). In response, the Commissioner filed a motion for summary judgment.

In its opinion, the Court denied Mr. Morowitz’s characterization of his work for Pre-Existing Clients as a separate business from the Corporation. Based on the facts presented, the Court determined that the “case costs” were expenses of the Corporation, and that Mr. Morowitz’s payment of these expenses constituted a loan or a contribution to the capital of the Corporation. While payment of these expenses may have been deductible to the Corporation, it would not have been deductible to Mr Morowitz.

The Court also determined that Mr. Morowitz’s payment of $15,000 to the legal secretaries for their work on a Pre-Existing Client’s case was not made for work separate and apart from that of the Corporation. Although Mr. Morowitz made this payment from his personal funds, and the retainer agreement for the client matter had been signed with the Law Office of David Morowitz, Ltd., the proceeds awarded from this Pre-Existing Client’s case were deposited into the Corporation’s trust account and subsequently paid from that trust account. Therefore, the Court found that these payments, whether made properly or not, stem from the business of the Corporation. Since these expenditures were made on behalf of the Corporation’s business, Mr. Morowitz may not claim them as business deductions.

In a final note, the Court addressed Mr. Morowitz’s argument that the shareholder agreement’s exclusion of the income and expenses relating to Pre-Existing Clients from the Corporation’s income and expenses supports treatment of the Pre-Existing Clients’ cases as a business separate from the Corporation. Citing Harding v. Comm’r. (TC Memo 1970-179), the Court held that “[a] shareholder cannot convert a business expense of his corporation into a business expenses of his own simply by agreeing to bear such an expense.” Furthermore, it noted that “parties are free to contract and, when parties agree to a transaction, federal law then governs the tax consequences of the agreement, whether contemplated or not.”

C.  

**ATL & Sons Holdings, Inc. v. Commissioner** (152 T.C. No. 8) (3/13/2019)

Mr. and Mrs. Allen, the sole shareholders of ATL & Sons Holdings, Inc. (“ATL”), filed Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return, with respect to their 2012 personal income tax returns. However, they did not file a Form 7004, Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns, on behalf of ATL. Mr. and Mrs.
Allen filed ATL’s Form 1120S on September 13, 2013, and filed their personal Form 1040 on October 14, 2013.

On November 13, 2013, the IRS assessed a section 6699 penalty for late filing in the amount of $2,340 relating to ATL’s income tax return for tax year 2012. The assessment appeared on ATL’s IRS transcript with a transaction code “166,” which indicated “computer generated assessment of Delinquency Penalty.” No supervisory approval of the penalty determination was obtained before the penalty was assessed.

When preparing their 2013 income tax returns, Mr. and Mrs. Allen followed the same process they used for tax year 2012 (filing a Form 4868 for themselves, but no Form 7004 for ATL). The IRS initially proposed a penalty against ATL for late filing of its Form 1120S for tax year 2013, but later relented. The IRS did not, however, relent with respect to the 2012 penalty.

On April 27, 2015, the IRS credited an overpayment for tax year 2013 of $394.03 against ATL’s outstanding penalty liability for tax year 2012. On January 15, 2016, the IRS sent ATL a Notice of Intent to Levy in an effort to collect the remaining unpaid penalty liability of $1,945.97. Mr. Allen timely mailed a Form 12153, Request for Collection Due Process or Equivalent Hearing, to the IRS on ATL’s behalf on February 12, 2016.

Mr. Allen argued that ATL’s tax year 2012 penalty liability was improperly assessed because: (1) he and Mrs. Allen requested an extension to file ATL’s tax year 2012 return by submitting their Form 4868; (2) ATL had reasonable cause for its failure to timely file since the two shareholders of ATL (Mr. and Mrs. Allen) requested an extension to file their 2012 Form 1040 and ATL’s failure to timely file did not adversely impact Mr. and Mrs. Allen’s tax liability; and (3) the IRS prematurely applied ATL’s tax year 2013 overpayment against its tax year 2012 penalty liability. Following a hearing before IRS Appeals, the Settlement Officer issued a decision letter to ATL on June 20, 2016 upholding the proposed levy action. ATL filed a petition challenging the Settlement Officer’s determination on July 19, 2016, and the Commissioner filed his answer on September 12, 2016, moving for summary judgment.

The Tax Court made the following findings with respect to each of ATL’s arguments:

1. **Validity of Form 4868 as ATL’s Request for Extension.** The Tax Court noted that since an S corporation is an entity separate from its shareholders, and is required to file its own annual information return (Form 1120S), it must file a separate form (Form 7004) to request an extension of time to file. For this reason, Mr. and Mrs. Allen’s filing of a Form 4868 was not a valid request for an extension of time to file ATL’s Form 1120S.

2. **Reasonable Cause for Waiver of Penalty Based on No Adverse Tax Impact to Shareholders.** The Tax Court rejected ATL’s argument that no penalty should be assessed due to the fact that ATL’s late filing of its return did not result in its shareholders having to pay additional tax, noting that the penalty assessed under section 6699(a) is not tied to the amount of tax due. Rather, the section 6699(a)
penalty is based on an S corporation’s failure to file its returns, and is imposed for each month or fraction thereof for which the failure to file continues. Since the monthly penalty amount is determined by multiplying $195 by the number of persons who were shareholders in the S corporation during any part of the taxable year (in this case 2), and ATL filed its return almost 6 months late, the penalty amount of $2,340 was correctly imposed.

The Tax Court also rejected Mr. Allen’s contention that, since ATL’s shareholders were aware of its business loss for tax year 2012 and had the information necessary to calculate their own tax liability despite the fact that a Form 1120S had not been timely filed, reasonable cause existed for waiver of the penalty under Code § 6699. In doing so, the court stated:

ATL evidently conceives that the sole purpose of the Form 1120S is to give a shareholder the information that he or she needs in order to file a Form 1040 tax return; and since Mr. and Mrs. Allen knew the affairs of ATL, did eventually file their Form 1040 timely (under an extension), and did not fail to report any income, the intended purpose of the S corporation’s filing requirement was accomplished and the penalty was moot. ATL cites no authority in support of its claim that the penalty should be waived on the grounds that its two shareholders were aware of the information to be shown on the return. Section 6699 does not include a condition of harm before the penalty is imposed; it simply imposes a penalty when the filing is late (without reasonable cause). A taxpayer may not disregard a filing deadline and be excused from this penalty simply because it reckons that no harm was done. (Emphasis added.)

3. Premature Application of Overpayment for Tax Year 2013 to Liability for Tax Year 2012. In evaluating ATL’s claim that the IRS prematurely applied ATL’s tax year 2013 overpayment to its tax year 2012 tax liability, the Tax Court reviewed the requirements of section 6751(b)(1). Section 6751(b)(1) provides that “no penalty…shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate.” However, section 6751(b)(2)(B) provides an exception to the supervisory approval requirement for “any other penalty automatically calculated through electronic means.” The Tax Court concluded that, since the penalty under section 6699 is based on a fixed amount ($195 per shareholder times the number of months between the due date of the return and the filing date of the return), and since the penalty was assessed via a computer-generated assessment of delinquency penalty, ATL’s penalty qualified for the exception under section 6751(b)(2)(B).

The plaintiff, Ms. Bonilla, was married to Robert Bonilla (“Mr. Bonilla”) in 1986. Mr. Bonilla was a professional baseball player. On February 23, 1994, Mr. Bonilla incorporated Bobby Bo Investments, Inc. (“BBI”), a Florida for-profit corporation, to hold investments for him. As of February 23, 1994, Mr. Bonilla was the President, sole shareholder, officer, and director of BBI.

According to a website for the State of Florida Division of Corporations, BBI was administratively dissolved on August 25, 1995. At that time, Mr. Bonilla was still the President, sole shareholder, officer, and director of BBI. There was no evidence in that BBI had ever been reinstated following its administrative dissolution in 1995.

Ms. Bonilla and Mr. Bonilla were divorced on May 22, 2009, pursuant to the Memorandum of Decision of the Connecticut Superior Court (“2009 Divorce Decree”). As part of the 2009 Divorce Decree, the Court ordered that ownership of certain companies, including BBI, “shall be divided equally” between Mr. Bonilla and Ms. Bonilla within 30 days. On April 28, 2010, Ms. Bonilla filed a Motion for Contempt, stating that “[no] division of these assets has occurred.” Id.

On December 14, 2010, the Superior Court held a hearing in the divorce proceedings. At this hearing, the parties agreed that Ms. Bonilla “will actually be the owner” and “will have ownership” of BBI. The parties agreed that Ms. Bonilla and her attorney would bear the burden of effectuating the transfer of interests.

During the 2010 and 2011 tax years, BBI was an S corporation. BBI did not file any tax return for the 2009, 2010, and 2011 tax years. However, Performance Imaging (a company in which BBI invested after it was administratively dissolved) provided Ms. Bonilla with BBI’s Forms K-1 for tax years 2010 through 2016, which listed BBI’s address as Ms. Bonilla’s address. Ms. Bonilla forwarded the K-1s to her accountant, but did not report any portion of BBI's share of Performance Imaging's income on her 2010 and 2011 tax returns.

After a tax examination of Performance Imaging, the IRS increased Ms. Bonilla's ordinary income for the 2010 and 2011 tax years by $780,393 and $55,117, respectively, equal to 69.51% of Performance Imaging's corrected 2010 and 2011 ordinary business income. The IRS assessed taxes against Ms. Bonilla for the 2010 and 2011 tax years of $235,783 and $19,291, respectively. Including fees and penalties, the IRS claimed that Ms. Bonilla owed the IRS $323,164.42 for the 2010 tax year, and $21,871.74 for the 2011 tax year.

Ms. Bonilla paid the full amounts claimed by the IRS on April 11, 2016, and filed a refund claim with the IRS on the same date. The IRS denied the administrative claim on October 3, 2016, but the government conceded on April 4, 2018 that $372,023 of the $780,393 increase to Ms. Bonilla's income for the 2010 tax year was incorrect, and directed the IRS to partially abate the tax, penalties, and fees levied against Ms. Bonilla.
The IRS conceded that Ms. Bonilla was entitled to a partial credit to her 2010 tax liability, but no credit to her 2011 tax liability.

Ms. Bonilla filed a Motion for Summary Judgment under Code § 7422 seeking a refund of taxes, interest, and penalties from the government on the grounds that (1) BBI could not have acquired an interest in Performance Imaging because BBI had been administratively dissolved; (2) the December 2010 divorce hearing was an unenforceable “agreement to agree;” and (3) the IRS improperly determined her ownership interest in BBI without first issuing the statutory Notice of Deficiency required by law. The government filed its own Motion for Summary Judgment alleging that the court was without jurisdiction to hear some of Ms. Bonilla's arguments since, under the Variance Doctrine, a taxpayer bringing suit under Code § 7422 “may not raise different grounds than those brought to the IRS” in the prior administrative refund claim.

On March 8, 2019, the US District Court of Connecticut (the “Court”) heard oral arguments on both Motions for Summary Judgment. The Court denied Ms. Bonilla’s Motion for Summary Judgment, and granted the government’s Motion for Summary Judgment. In doing so, the Court ruled as follows on the arguments presented:

1. **Preemption under the Variance Doctrine**: The Court concluded that Ms. Bonilla’s claim that her divorce decree resulted in an unenforceable agreement to agree was not a substantial variance from the arguments raised in the her administrative claim to the IRS. Therefore, the Variance Doctrine did not preclude the Court from addressing this argument.

2. **Classification of the Ms. Bonilla’s divorce decree as an “agreement to agree” under Connecticut Law**: After reviewing the applicable Connecticut law, the Court determined that Ms. Bonilla “failed to put forward sufficient evidence upon which a jury could conclude that the stipulated agreement presented in the December 2010 divorce proceedings was an unenforceable ‘agreement to agree.’” Further, the Court found that there is “no genuine issue of material fact as to whether the parties intended to enter into an agreement to resolve all outstanding divorce issues, including ownership of BBI, that the Court approved the stipulation, and that the stipulation thereafter became an Order of the Court.” For that reason, the Court determined that, under the current case law in Connecticut, the stipulated order between Ms. Bonilla and her husband was “binding to the same degree as a judgment obtained through litigation.”

3. **Improper determination of Ms. Bonilla’s ownership interest in BBI due to failure to issue the statutory Notice of Deficiency**: The Court acknowledged that Code § 6213 required that “no assessment of a deficiency in respect of any tax...shall be made, begun, or prosecuted until [a notice of deficiency] has been mailed to the taxpayer.” Although it noted that Code § 6213 provided taxpayers like Ms. Bonilla with the option of seeking injunctive relief prior to paying any tax relating to an assessment made without requisite notice, the Court also noted that “once a taxpayer has paid the amount sought by the government and pursues ‘an
action for the recovery of federal income taxes,’ she has a cause of action to recover the overpayment, in which the burden of proof is on the plaintiff-taxpayer to show that she has overpaid her tax. See *Heublein, Inc. v. United States*, 996 F.2d 1455, 1461 [72 AFTR 2d 93-5324] (2d Cir. 1993); see also *Lewis v. Reynolds*, 284 U.S. 281, 283 [10 AFTR 773], modified, 284 U.S. 599 (1932); *Van Antwerp v. United States*, 92 F.2d 871, 873 [20 AFTR 325] (9th Cir. 1937) (holding that the burden of proof in a refund suit is on the taxpayer to show she does not owe taxes, “regardless of the legality of the Commissioner's action in collecting the alleged deficiency without sending the deficiency notice specified” by statute).” Therefore, since Ms. Bonilla had already paid the tax assessed, her only remedy was demonstrating that she had overpaid her tax. She was precluded from contesting the validity of the assessment.

4. **Validity of Ms. Bonilla’s ownership of BBI in 2010 and 2011:** Ms. Bonilla argued that summary judgment in her favor is appropriate because (1) BBI, as an administratively dissolved corporation, could not transfer its shares to her; (2) Ms. Bonilla was never issued any BBI shares under Florida law or the Uniform Commercial Code (“UCC”); and (3) Ms. Bonilla was not a beneficial owner of BBI in 2010 or 2011. In analyzing these arguments, the Court noted that, “since BBI was an S corporation, beneficial ownership, not technical legal title, is controlling. *United States v. Pirro*, 212 F.3d 86, 103 [85 AFTR 2d 2000-1774] (2d Cir. 2000) (McLaughlin, J., dissenting) (citing *Danenberg v. Comm'r*, 73 T.C. 370, 390, 1979 WL 3864 (1979); *Ragghianti v. Comm'r*, 71 T.C. 346, 349, 1978 WL 3361 (1978)).”

The Court explained its holding that Ms. Bonilla was indeed a beneficial owner of BBI in 2010 and 2011 as follows:

It is undisputed that the parties entered into a stipulated oral agreement before the same state court in December 2010. At the December 2010 hearing, the parties agreed that Ms. Bonilla would become the sole owner of BBI, and that the burden would be on Ms. Bonilla's attorneys to carry out the paperwork required to effectuate the transfer. See Dec. 2010 Tr. at 13:16. The court so ordered the agreement. Id. at 26:24. Notwithstanding the undisputed fact that expected paperwork was never signed, and that Ms. Bonilla never received legal title to BBI's shares, the parties entered into an enforceable agreement, later incorporated into a court order, that separated their marital property and resolved all outstanding issues in the divorce. Ms. Bonilla, as a matter of Connecticut law, had an enforceable, beneficial interest in the full ownership of BBI, as of December 14, 2010.

…
The beneficial owner of shares in an S Corporation is liable for the
taxes owed on her pro rata share of the corporation's income,
regardless of whether distributions are made. See 26 C.F.R.
§ 1.1366–1(a). Here, there is no genuine issue of material fact that
the Connecticut divorce vested beneficial ownership of BBI in
Ms. Bonilla, as to half of the company, at least 30 days following
the 2009 Divorce Decree and, as to all of the company following
the December 2010 hearing. Ms. Bonilla is therefore responsible
for the taxes owed on her pro rata share of BBI's income in the
2010 and 2011 tax years.


James and Julie Kress (“Plaintiffs”), gifted minority shares of the stock of Green Bay
Packaging, Inc. (“GBP”), an S corporation, to their children and grandchildren in 2006,
2007, and 2008. The IRS challenged the amounts Plaintiffs reported on their gift tax
returns, finding that the fair market value of Plaintiffs’ stock equaled the price used for
actual share transactions between GBP and its employees.

The sole issue presented in the case was what the fair market value of the GBP stock
Plaintiffs gifted to their children and grandchildren was in the tax years 2007, 2008, and
2009. The court stated that the fair market value of non-publicly traded stock is generally
determined by using one or a combination of the following: the market approach, the
income approach, or the asset-based approach.

The IRS’s expert determined the fair market value of the gifted shares by using the
market approach and the income approach and ascribing a weight to each. The court held
that the IRS expert’s valuation conclusions overstated the value of a minority-held share
of GBP stock for a variety of reasons. First, the IRS expert’s valuation under the market
approach in his 2009 analysis was inflated because he did not adequately account for the
2008 recession and relied on an outlier as a comparable company. Second, the IRS
expert did not properly value the non-operating assets. In his assessment, the IRS expert
separated the non-operating assets out of GBP’s operating financials, valued the non-
operating assets independently, added the values back to the business’ operating value,
and then accounted for the assets at almost their full value. However, the valuation
method of adding back the full value of non-operating assets is more properly employed
when an entire business, rather than a minority stock interest, is being valued. Third, the
court found that the IRS expert’s discounts for lack of marketability were too low. In
determining the discounts for lack of marketability, the IRS expert considered the cost of
an initial public offering, even though he did not expect GBP to go public.

Finally, the court found GBP’s subchapter S status was a neutral consideration with
respect to the valuation of its stock. Notwithstanding the tax advantages associated with
subchapter S status, there were also noted disadvantages, including the limited ability to
reinvest in the company and the limited access to credit markets. It was therefore unclear if a minority shareholder enjoys those benefits.

The court then reviewed the reports and testimony of two of the Plaintiffs’ witnesses, and found the valuation methodology of one of them (“Emory”) to be most sound. Emory was a certified appraiser who spent ample time with the company and management and truly understood GBP’s business. As a result of this understanding, he used more accurate projections to value the business and more adequately accounted for the effects of the economic recession. His analysis recognized the variability and non-quantifiable judgments by which various factors were taken into consideration and impacted the price of a share of minority stock. Emory did not create his valuations with the benefit of hindsight, for the purpose of litigation, or for Plaintiffs’ benefit in transferring their stock to their children and grandchildren. He provided credible and thorough valuations supporting the value of the stock Plaintiffs reported on their tax returns.

The court then addressed the Government’s assertion that Plaintiffs’ experts both erred in considering the Family Transfer Restriction (the “Restriction”) contained in GBP’s Bylaws to calculate the discount for lack of marketability. Plaintiffs maintained that the Restriction should be considered when determining the value of their shares because its limitation on the shareholders’ ability to transfer shares lowers their value. Generally, under section 2703(a), the valuation of any stock is to be determined without considering restrictions to sell the stock. However, pursuant to section 2703(b), any restriction that (1) is a “bona fide business arrangement;” (2) is not a device to transfer such property to members of the decedent’s family for less than full and adequate consideration in money or money's worth; and (3) includes terms that are comparable to similar arrangements entered into by persons in an arms’ length transaction shall be considered when valuing such property.

The court analyzed the first two requirements and found that the Restriction passed both tests. However, the court found that the third requirement (that the Restriction be comparable to similar arrangements entered into by persons in an arms’ length negotiation) was not met. Treas. Reg. § 25.2703-1(b)(4)(i) provides that Plaintiffs must submit specific evidence showing that the “right or restriction is treated as comparable to similar arrangements entered into by persons in an arm's length transaction if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm's length.” Though Plaintiffs contended restrictions like the Restriction are common in the commercial world, they failed to produce any evidence that unrelated parties dealing at arms’ length would agree to such an arrangement. For this reason, the court found that the Restriction did not satisfy the requirements set forth in section 2703, and it was improper for Emory to consider the Restriction in determining the discount for lack of marketability.


Cavanaugh was the CEO and sole shareholder of Jani-King International, Inc. (“Jani-King”), a commercial cleaning franchisor operating as an S corporation. In November 2002, Cavanaugh went on a Thanksgiving vacation to the Caribbean island of St.
Maarten, where he owned a residence. With him were his girlfriend, Colony Anne (“Claire”) Robinson, and Jani-King employees Ronald Walker (his bodyguard) and Erika Fortner (his employee and former girlfriend). On November 28, 2002, Claire died at the residence, likely of a cocaine overdose.

Claire’s mother (“Robinson”) sued Cavanaugh and Jani-King, alleging that Claire’s death was caused by the Jani-King employees acting in the course and scope of their employment. She alleged that Cavanaugh, Walker, and Fortner facilitated Claire’s access to and ingestion of cocaine, causing her death.

After some discovery, Jani-King’s board of directors met to discuss the suit. Cavanaugh explained to the board that he believed the claims were frivolous but was willing to personally contribute his own defense costs, estimated to be $250,000. Jani-King’s corporate counsel explained to the board that Robinson would likely not prevail in her suit, but a negative outcome was possible. They acknowledged the “substantial possibility of a negative impact on the company’s relationship with its franchisees and the company's business” that could result from negative publicity arising from the suit. Jani-King’s counsel ultimately recommended that the company settle, and the board authorized a settlement payment of up to $5 million.

The parties settled the lawsuit for $2.3 million to be paid over the course of two years. Cavanaugh paid $250,000 toward the settlement, Jani-King the remainder. Jani-King reimbursed Cavanaugh for his portion of the settlement. Jani-King then deducted its settlement payment, the reimbursement payment, and its related legal expenses as ordinary and necessary business expenses. Because Jani-King is an S corporation, its deductions flowed through to and were reflected on Cavanaugh’s personal tax returns.

The IRS disallowed the claimed deductions, and despite having paid $2.3 million ostensibly to avoid protracted litigation and the attendant negative publicity, Cavanaugh decided to fight for the deductions, contesting the IRS’s determination that the expenses did not qualify as ordinary and necessary business expenses.

Cavanaugh first argued that the Supreme Court’s holding in United States v. Gilmore, 372 U.S. 39 (1963) should not apply because it does not address a situation where a corporation is directly named in the underlying suit. In Gilmore, the Supreme Court held that when determining the deductibility of litigation expenses as business expenses, “the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test.” If the claim “arises in connection with the taxpayer's profit-seeking activities,” related expenses may properly be characterized as a business expense rather than a personal expense.

The Fifth Circuit declined Cavanaugh’s invitation to follow the scarce out-of-circuit cases cited by him that distinguished Gilmore’s origin-of-the-claim test when the taxpayer corporation is named in the underlying suit. Accordingly, the Fifth Circuit held
that simply being named in the Robinson suit was insufficient to prove that Jani-King’s expenses were deductible business expenses.

The Fifth Circuit then applied the origin-of-the-claim test, and concluded that Jani-King’s deduction of the settlement payment and related legal expenses should be disallowed. The court stated, “We must look not only at the allegation that Jani-King employees were acting within the course and scope of their employment, but also at the allegation that they provided cocaine leading to Claire’s death. The origin of the claim is the employees’ providing cocaine, not their employment by Jani-King.” Accordingly, the court held that the Tax Court’s findings were not clearly erroneous and the settlement payment and related legal fees arose from a claim originating in non-business activity and Jani-King’s business expense deductions were properly disallowed.

Cavanaugh also contended that Jani-King’s reimbursement payment to him was deductible. The Fifth Circuit stated that a company’s payment under an indemnification agreement can be an ordinary and necessary business expense. However, Cavanaugh failed to argue that the requirements of Jani-King’s Bylaws’ indemnification provision were met, and accordingly he waived the argument that Jani-King was contractually obligated to reimburse him. Thus, the reimbursement was not a required payment.

Generally, paying another's debt is not an ordinary and necessary business expense. However, the Tax Court has recognized an exception when such a payment is made to “protect or promote [the taxpayer’s] own business.” Lohrke v. Commissioner, 48 T.C. 679, 684-85 (1967). However, even if a taxpayer meets the “protect and promote” test, the taxpayer must still show that the expense is an ordinary and necessary business expense. Cavanaugh argued only that the settlement was necessary to protect Jani-King’s business, not that the reimbursement payment was necessary to do so. Nor did Cavanaugh contend that he was unable to make the payment. Therefore, Cavanaugh did not show that the Tax Court’s findings regarding Jani-King’s reimbursement payment were clearly erroneous. Accordingly, the reimbursement payment was not deductible as a business expense.


Petitioners owned Highland Tank & Manufacturing Co. (“Highland Tank”), Highland Tank of New York, Inc. (“HTNY”), Highland Tank of North Carolina, Inc. (“HTNC”), Lowe Engineering Co., Inc. (“Lowe”) and Bigbee Steel & Tank Co. (“Bigbee,” with Highland Tank, HTNY, HTNC, Lowe and Bigbee being collectively referred to as “HT&A”). Each HT&A entity elected to be treated as an S corporation. HT&A had approximately 400 employees at six different locations, and during the years at issue had annual revenues of between $54,138,272 and $61,086,066.

Petitioners formed Syzygy Insurance Co., Inc. (“Syzygy”), a microcaptive insurance company. Syzygy and HT&A participated in the captive insurance program of Alta Holdings, LLC (“Alta”), a company in the business of running captive insurance programs and providing management services for captive insurance companies.
Participants in Alta’s program consisted of companies purchasing captive insurance and their related captive insurance companies. Typically, participants did not directly purchase policies from their captive insurance companies but from fronting carriers related to Alta.

HT&A paid premiums directly to the fronting carriers, but the fronting carriers ceded 100% of the insurance risk. Each fronting carrier charged a “fronting fee,” which was deducted from the gross premiums HT&A paid to the fronting carrier. The responsibility for paying a covered claim could best be understood as a two-layered arrangement. The first $250,000 of a single loss was allocated to layer 1, and any loss between $250,000 and $1 million was allocated to layer 2. Alta uniformly allocated 49% of each captive participant’s premiums to layer 1 and 51% to layer 2. Syzygy reinsured the first $250,000 of any HT&A claim (layer 1 claims). Shortly after the fronting carriers received HT&A’s premiums, they ceded 49% of the net premiums to Syzygy.

For HT&A’s claims between $250,000 and $1 million (layer 2 claims), Syzygy agreed to reinsure its quota-share percentage of losses. The quota share was the ratio of: (1) the net premium HT&A paid to that portfolio to (2) the aggregate net premiums the portfolio received for the insurance period. Additionally, Syzygy provided layer 2 reinsurance for a diverse array of approximately 857 policies issued to unrelated companies in the fronting carriers’ pools. Syzygy reinsured approximately 40 to 50 unrelated companies per pool. Three and one-half months after the policy periods ended, the fronting carriers ceded the remaining 51% of net premiums to Syzygy less the amount of any claims paid for layer 2 losses.

The IRS selected petitioners’ returns for examination and timely issued notices of deficiency. With respect to Syzygy, the IRS determined that Syzygy did not engage in insurance transactions and was not an insurance company. With respect to the individual petitioners, the IRS determined: (1) the arrangement was invalid for lack of economic substance, (2) the premium payments were not payments for insurance, and (3) the amounts deducted were not ordinary and necessary business expenses.

The issues before the Tax Court were (1) whether the amounts received by Syzygy as premiums should be excluded from its gross income and (2) whether the individual petitioners were entitled to the benefit of deductions taken by their S corporations for insurance under section 162.

With respect to the first issue, the Tax Court held that the arrangement among HT&A, Syzygy, and the fronting carriers lacked risk distribution and was not insurance in the commonly accepted sense. Because the arrangement was not insurance, Syzygy’s section 831(b) election (which would provide for an alternative taxing structure whereby Syzygy would be subject to tax only on its investment income) was invalid and Syzygy was forced to recognize the premiums it received as income.

Further, because the arrangement was not insurance, the individual petitioners could not deduct the purported premium payments or any fees as payments for insurance.
However, petitioners argued that the purported premium payments were payments for indemnification that were deductible as ordinary and necessary business expenses. The Tax Court noted that there is little precedent addressing whether amounts paid for an invalid insurance arrangement can nevertheless be deductible under section 162(a). The Tax Court stated, “In the context of captive insurance there may be instances where noninsurance payments for indemnification protection might be appropriate and helpful to the development of the insured. But, at the bare minimum, for such payments to be considered appropriate and helpful, the indemnified party must intend to seek indemnification if a covered event occurs. Otherwise, there is no valid purpose for making such payments. In these cases, HT&A’s failure to file claims that they thought were covered under the deductible reimbursement policies leads us to find that there was no intent to seek indemnification for covered losses. Accordingly, the payments are not deductible as ordinary and necessary expenses.”


Petitioner Donovan McNeely and Jeffery McKay incorporated M&M Properties, Inc. (“M&M”) on October 23, 2008, as 50% shareholders, and elected that M&M be taxed as an S corporation. M&M was involved exclusively in the northern California real estate market until Mr. McKay's cousin, Justin Sinnott, presented M&M with the opportunity to purchase distressed rental real estate properties in other parts of California. Mr. Sinnott said that M&M would purchase these properties, collect rental income, and then sell the property to the current tenant (who did not qualify for traditional loan financing) for a premium.

Contrary to Mr. Sinnott’s representations, this “investment opportunity” was in fact a complex real estate fraud transaction which essentially faked a short sale of property to a cash buyer (e.g., M&M) and issued a grant deed to the cash buyer (e.g., M&M). No one paid the bank holding the note on the property. Thus, after the bank foreclosed on the property, the cash buyer (e.g., M&M) would no longer have ownership of the property. In some transactions the fraud scheme would use real title companies which had title insurance, but in other transactions they would use fake title companies created under the fraud scheme.

Between 2008 and 2011, M&M purchased between 14 and 16 properties. While the record is unclear on how many of these properties were purchased as part of the fraud scheme, at least six properties (six Southern California properties) were subject to the fraud scheme. Petitioners untimely filed their Form 1040, U.S. Individual Income Tax Return, for the tax year 2011, claiming a $407,327 Schedule A deduction under section 165 for a theft loss related to the six Southern California properties. M&M's return, filed on September 6, 2012, did not report the theft losses.

After reviewing both objective and subjective factors, the Tax Court found that M&M's prospect of recovery was simply unknowable and nothing more than speculation and conjecture at the end of 2011. By the end of 2011, M&M had not engaged an attorney, filed insurance claims, or made any effort to recoup any of the losses. Thus, it would
have been impossible for M & M to conclude, when others had recovered and M & M had been advised of potential recovery options, there was no reasonable prospect of recovery.


Rick Ferguson (“Ferguson”) was a majority shareholder of Rick Ferguson, Inc. (“RFI”), a C corporation, and Pinnacle Precast Co. (“Pinnacle”), an S corporation. RFI was the entity through which Ferguson operated as a general contractor on custom home construction jobs. Pinnacle manufactured, supplied, and installed cast stone.

RFI, Pinnacle and Ferguson were the subject of a multimillion-dollar lawsuit initiated by homeowner-clients (“homeowners”), the primary grievance of which pertained to the manufacture and installation of cast stone. In 2011, the lawsuit was settled. Ferguson, RFI and Pinnacle were all parties to the settlement agreement. As a part of the settlement, Ferguson transferred nine parcels of real estate to the homeowners, and also gave the homeowners a check, which was drawn from Ferguson’s personal bank account. Pinnacle recorded the aggregate value of the check payment and the fair market value of the real estate transfer (collectively, the “Settlement Payment”) on its books for 2011 as a loan from Ferguson. However, no loan documents were prepared, nor interest accrued on the purported loan.

On its 2011 tax return, Pinnacle reported gross receipts of $94,987 and claimed deductions for ordinary business expenses, which included: (i) $101,393 in legal fees, (ii) the Settlement Payment, and (iii) an ordinary loss from the deemed sales of three (of nine) parcels that were transferred to the homeowners. Pinnacle reported long-term capital gains from the deemed sales of the other six parcels. On their 2011 income tax return, Ferguson and his wife (collectively, “petitioners”) reported a passthrough loss from Pinnacle and carried it forward to their 2012 return.

The IRS issued a notice of deficiency to petitioners, disallowing petitioners’ passthrough loss deduction from Pinnacle in its entirety. Instead, the IRS treated the Settlement Payment as an unreimbursed employee business expense pertaining to Mr. Ferguson’s employment with RFI and disallowed in full Pinnacle’s deduction of the legal fees and ordinary loss. The IRS allowed petitioners to claim an itemized deduction for the Settlement Payment, but did not make similar allowances for the legal fees or the ordinary loss from the deemed sales of the parcels. The IRS’s adjustments resulted in the disallowance of petitioners’ carryforward net operating loss for 2012.

The Tax Court first addressed whether petitioners were entitled to deduct the Settlement Payment as an ordinary and necessary business expense on Schedule C. The petitioners and IRS agreed that the petitioners are entitled to deduct the Settlement Payment as a trade or business expense under section 162, but disagreed as to whether the Settlement Payment should be deducted from gross income in computing petitioners’ AGI (if the Settlement Payment was treated as an unreimbursed employee business expense, the
deduction would be limited by section 67(a), and petitioners may be subject to AMT liability because miscellaneous itemized deductions are not taken into account in the determination of taxpayers’ AMT income). Looking to the origin of the claims, the Tax Court concluded that the origin of the claims was the work performed by RFI and Pinnacle, both of which filed corporate returns for 2011. Accordingly, petitioners could not deduct the Settlement Payment on Schedule C.

The Tax Court next addressed petitioners’ contention that Pinnacle should be treated as having paid the settlement, and that Ferguson intended the Settlement Payment to be a loan to Pinnacle because it was responsible for the work that gave rise to the homeowners’ claims. The Tax Court concluded that Ferguson knew Pinnacle would be unable to repay him when he funded the settlement and, accordingly, Ferguson did not intend to establish a creditor-debtor relationship with Pinnacle. Thus, his payment of the settlement was not a loan to Pinnacle.

Finally, the Tax Court addressed petitioner’s argument that even if Ferguson’s payment of the settlement was not a loan, the payment was nevertheless attributable to Pinnacle’s trade or business and deductible by Pinnacle as an ordinary and necessary business expense. According to petitioners, Ferguson’s payment of the settlement was a contribution to the capital of Pinnacle if it was not a loan. Although the Tax Court disagreed with petitioners’ contention that the lawsuit was solely attributable to Pinnacle, the court concluded that an allocation of the deduction for the Settlement Payment was appropriate. The Tax Court stated, “It is clear from the record that the lawsuit that gave rise to the Settlement Payment was partially attributable to RFI and partially attributable to Pinnacle. Furthermore, the settlement was paid by Ferguson, the controlling shareholder of both corporations. Accordingly, after a thorough review of the record, including the lawsuit pleadings and the settlement agreement, we allocate 50% of the Settlement Payment to RFI and 50% to Pinnacle.”

Because Ferguson personally funded the Settlement Payment, 50% of which was an expense of Pinnacle, the Tax Court deemed 50% of the payment as a capital contribution to Pinnacle. Accordingly, Pinnacle was permitted to deduct 50% of the Settlement Payment for 2011, and petitioners were entitled to their pro rata share of any loss produced by the deduction.

II. Private Letter Rulings

A. PLR 201852001 – Inadvertent terminations – Failure to file ESBT election for trusts (2/1/2019)

X was incorporated on Date 1 under the laws of State. Effective Date 2, X elected to be taxed as an S corporation. On Date 3, Trust 1 acquired shares in X. On Date 4, Trust 2 and Trust 3 acquired shares in X. The trustee of Trust 1 did not make a timely election by Date 5 to treat X as an Electing Small Business Trust (an “ESBT”), causing an inadvertent termination of X’s S corporation status. In addition, the trustees of Trust 2 and Trust 3 did not make timely elections by Date 6 to treat Trust 2 and Trust 3 as
ESBTs. Therefore, had X’s S corporation election not terminated on Date 5, it would have terminated on Date 6.

X represented that Trust 1, Trust 2 and Trust 3 had, at all times, met the requirements of an ESBT within the meaning of section 1361(d)(3), except that the trustees of Trust 1, Trust 2, and Trust 3 did not make timely ESBT elections under section 1361(e)(3). X further represented that Trust 1, Trust 2, and Trust 3 had not filed their income tax returns consistent with being ESBTs for Years 1.

X also represented that, other than the failure to make valid ESBT elections by Date 5 and Date 6, X qualified as a small business corporation at all times since its election on Date 2. X further represented that X and its shareholders have treated X as an S corporation at all relevant times. In addition, X represented that X had filed its income tax returns consistent with having a valid S election in effect for all taxable years since X elected to be an S corporation. X also represented that X, its shareholders, and the beneficiaries of Trust 1, Trust 2, and Trust 3, would amend their income tax returns for Years 2 within 120 days of the date of the ruling letter to reflect treatment of Trust 1, Trust 2, and Trust 3 as ESBTs.

Finally, X represented that its S corporation election termination was inadvertent and was not motivated by tax avoidance or retroactive tax planning, and X and its shareholders agreed to make any adjustments required as a condition of obtaining relief under the inadvertent termination rule as provided under section 1362(f) that may be required by the Secretary.

The IRS ruled that, based solely on the facts submitted and the representations made, the termination of X’s S election was inadvertent within the meaning of section 1362(f). Accordingly, X will be treated as an S corporation effective Date 3 and thereafter, provided X’s S corporation election is not otherwise terminated under section 1362(d).

B. PLR 201852002 – Inadvertent terminations – Failure to file ESBT election for trusts (2/1/2019)

X was incorporated on Date 1, under the laws of State. Effective Date 1, X elected to be taxed as an S corporation. However, a valid Electing Small Business Trust (an “ESBT”) election effective Date 2 was not made for Trust 1, Trust 2, Trust 3, Trust 4, Trust 5, and Trust 6, each a shareholder of X. Accordingly, Trust 1, Trust 2, Trust 3, Trust 4, Trust 5, and Trust 6 were ineligible shareholders of X and X’s S corporation terminated on Date 2.

X represented that X and its shareholders treated X as an S corporation at all relevant times. X further represented that each Trust 1, Trust 2, Trust 3, Trust 4, Trust 5, and Trust 6 had filed its income tax returns consistent with being an ESBT. X represented that the failure to file a valid ESBT election for Trust 1, Trust 2, Trust 3, Trust 4, Trust 5, and Trust 6 was inadvertent and was not motivated by tax avoidance or retroactive tax planning. Further, X represented that X and its shareholders agreed to make any
adjustments (consistent with the treatment of X as an S corporation) that may be required by the Secretary.

The IRS ruled that, based solely on the facts submitted and the representations made, X’s S election terminated on Date 2 because of the failure to file a valid ESBT election for Trust 1, Trust 2, Trust 3, Trust 4, Trust 5, and Trust 6. The IRS further concluded that the termination of X’s S election was inadvertent within the meaning of section 1362(f). Therefore, X will be treated as an S corporation effective Date 2 and thereafter, provided X’s S corporation election is otherwise valid and not otherwise terminated under section 1362(d).

C. PLR 201852003 – Inadvertent terminations – Failure to file QSST election for trusts (2/1/2019)

X was incorporated under the laws of State and elected to be an S corporation effective on Date 1. On Date 2, shares of X were transferred to Trust. X represented that Trust was eligible to elect qualified subchapter S trust (“QSST”) treatment under section 1361(d). However, the beneficiary of Trust inadvertently failed to timely make a QSST election. Therefore, X’s S election terminated on Date 2.

X represented that X and each of its shareholders filed consistently with the treatment of X as an S corporation since Date 1. X further represented that the termination was not motivated by tax avoidance or retroactive tax planning. X and its shareholders agreed to make any adjustments that the Commissioner may require, consistent with the treatment of X as an S corporation.

The IRS ruled that, based solely on the facts submitted and the representations made, X’s S corporation election terminated on Date 2, because of the inadvertent failure of the beneficiary of Trust to make a QSST election, and that this termination of X’s S election was an inadvertent termination within the meaning of section 1362(f). Accordingly, pursuant to the provisions of section 1362(f), X will be treated as continuing to be an S corporation from Date 2 and thereafter, provided X’s S corporation election was valid and not otherwise terminated under section 1362(d).

D. PLR 201852004 – Entity classifications – Election to be treated as an association taxable as a corporation – S corporations – Corrective elections – Reasonable cause for failing to make a timely S election (2/1/2019)

X was an eligible entity that was formed on Date 1 under the laws of State. X intended to be classified as an association taxable as a corporation and to elect to be an S corporation for federal tax purposes, with both elections effective Date 2. However, X failed to properly and timely file Form 8832, Entity Classification Election, and Form 2553, Election by a Small Business Corporation.

The IRS ruled that, based solely on the facts submitted and representations made, X satisfied the requirements of Treas. Reg. §§ 301.9100-1 and 301.9100-3. As a result, X
was granted an extension of time of 120 days from the date of the letter to file a Form 8832 with the appropriate service center to elect to be classified as an association taxable as a corporation for federal tax purposes, effective Date 2.

Further, the IRS concluded that X established reasonable cause for failing to make a timely election to be an S corporation effective Date 2. Accordingly, provided that X makes an election to be an S corporation by filing a completed Form 2553 effective Date 2, along with a copy of the letter, with the appropriate service center within 120 days from the date of the letter, then such election will be treated as timely made.

E. PLR 201852011 – Election to treat subsidiary as QSub – Extensions (2/1/2019)

X was formed as a corporation on Date 1 and elected to be taxed as an S Corporation effective Date 2. Sub incorporated on Date 3. X wholly owned Sub. X requested permission to file a QSub election for Sub effective Date 3.

X represented that neither X nor its shareholders were aware of the requirement to make QSub election to obtain the desired tax treatment for Sub. X further represented that it reported consistently with the treatment of Sub as a QSub.

The IRS ruled that, based solely on the facts submitted and representations made, X satisfied the requirements of Treas. Reg. § 301.9100-3. Accordingly, X was granted an extension of time of 120 days from the date of this letter to elect to treat Sub as a QSub effective Date 3.

F. PLRs 201902002, 201902003, 201902004, 201902005, 201902006, 201902007, 201902008, 201902009, 201902010, 201902011, 201902012, 201902013, 201902014, 201902015, 201902016, and 201902017 – Inadvertent terminations – Inadvertent transfer to ineligible shareholder (2/7/2019)

X was formed under the laws of State on Date 1 as a limited liability company. X elected to be treated as an S corporation effective Date 2. On Date 3, all of the shares in X were transferred to Partnership, a partnership for federal tax purposes. Partnership, as a partnership, was an ineligible shareholder of an S corporation. On Date 4, X learned that the transfer of stock to Partnership terminated X's S election. On Date 5, X and its shareholders took remedial action by having Partnership transfer all of its shares in X to eligible S corporation shareholders A, B, and C. After Date 5, all income and other items from the X shares were allocated to A, B, and C. Between Date 3 and Date 5, all the partners of Partnership were eligible shareholders of an S corporation.

X represents that it did not intend for its S corporation election to terminate and that the events that resulted in the termination were not motivated by tax avoidance or retroactive tax planning. X represents that all shareholders filed their returns consistent with X being an S corporation. Further, X and its shareholders agree to make any adjustments required by the Secretary consistent with the treatment of X as an S corporation.
The IRS ruled that, based solely on the information submitted and the representations made, we conclude that X's S election terminated on Date 3 when all of the shares of X stock were transferred to Partnership), and that this termination was inadvertent within the meaning of Code § 1362(f). Accordingly, the IRS concluded that, pursuant to Code § 1362(f), X will be treated as continuing to be an S corporation on and after Date 3, provided that X's S corporation election was valid and not otherwise terminated under Code § 1362(d). Furthermore, Partnership will be treated as the shareholder of X from Date 3 until Date 5, at which point A, B, and C will be treated as the shareholders. Therefore, the shareholders of X must include in income their pro rata share of the separately stated and nonseparately computed items of X as provided in Code § 1366, make any adjustments to basis as provided in Code § 1367, and take into account any distributions made by X as provided in Code § 1368.

PLRs 201902018, 201902019, 201902020, and 201902021 – Request for extension of time to file S election and relief from inadvertent termination (2/7/2019) X was formed under the laws of State on Date 1 as a limited liability company. X's shareholder intended that X elect S corporation treatment effective Date 1. However, X’s Form 2553, Election by a Small Business Corporation, was not timely filed. In addition, X discovered that its sole shareholder, Partnership, was an ineligible S corporation shareholder. On Date 2, X and Partnership took remedial action by having Partnership transfer all of its shares in X to eligible S corporation shareholders A, B, and C. Between Date 1 and Date 2, all the partners of Partnership were eligible shareholders of an S corporation.

X represents that it did not intend for its S corporation election to terminate, and that the events that resulted in the termination were not motivated by tax avoidance or retroactive tax planning. X represents that all shareholders filed their returns consistent with X being an S corporation. Further, X and its shareholders agree to make any adjustments required by the Secretary consistent with the treatment of X as an S corporation.

X requested that the IRS grant it the following: (1) an extension of time under Reg. § 301.9100-3 of the Procedure and Administration regulations for X to make a late entity classification election to be treated as an association taxable as a corporation, effective as of Date 1; (2) relief to make a late S corporation election under Code § 1362(b)(5) of the Code effective as of Date 1; and (3) relief under Code § 1362(f) of the Code.

Based solely on the information submitted and the representations made, the IRS concluded as follows:

(1) That X satisfied the requirements of Regs. §§ 301.9100-1 and 301.9100-3 and, as a result, would be granted an extension of time of 120 days from the date of the PLR (1/11/2019) to file a Form 8832 with the appropriate service center electing to be treated as an association taxable as a corporation for federal tax purposes, effective Date 1. (The IRS required that the taxpayer attach a copy of this PLR to its Form 8832.)
(2) That X has established reasonable cause for failing to make a timely election to be an S corporation effective Date 1. Therefore, provided that X made an election to be an S corporation by filing a completed Form 2553 effective Date 1 (along with a copy of the PLR) with the appropriate service center within 120 days from the date of the PLR, X’s S corporation election would be treated as timely made for Date 1.

(3) That X’s S election terminated on Date 1 (when all of the shares of X stock were owned by Partnership), and that this termination was inadvertent within the meaning of Code § 1362(f). Accordingly, under Code § 1362(f), X will be treated as continuing to be an S corporation on and after Date 1, provided that X’s S corporation election was valid and not otherwise terminated under Code § 1362(d). Additionally, Partnership will be treated as the shareholder of X from Date 1 until Date 2, at which point point A, B, and C will be treated as the shareholders. As a result, the shareholders of X must include in income their pro rata share of the separately stated and nonseparately computed items of X as provided in Code § 1366, make an adjustments to basis as provided in Code § 1367, and take into account any distributions made by X as provided in Code § 1368.

G. PLRs 201902018, 201902019, 201902020, and 201902021 (2/8/2019)

X was formed under the laws of State on Date 1 as a limited liability company. X's shareholder intended that X elect S corporation treatment effective Date 1. However, X’s Form 2553, Election by a Small Business Corporation, was not timely filed. In addition, X discovered that its sole shareholder, Partnership, was an ineligible S corporation shareholder. On Date 2, X and Partnership took remedial action by having Partnership transfer all of its shares in X to eligible S corporation shareholders A, B, and C. Between Date 1 and Date 2, all the partners of Partnership were eligible shareholders of an S corporation.

X represents that it did not intend for its S corporation election to terminate, and that the events that resulted in the termination were not motivated by tax avoidance or retroactive tax planning. X represents that all shareholders filed their returns consistent with X being an S corporation. Further, X and its shareholders agree to make any adjustments required by the Secretary consistent with the treatment of X as an S corporation.

X requested that the IRS grant it the following: (1) an extension of time under Reg. § 301.9100-3 of the Procedure and Administration regulations for X to make a late entity classification election to be treated as an association taxable as a corporation, effective as of Date 1; (2) relief to make a late S corporation election under Code § 1362(b)(5) of the Code effective as of Date 1; and (3) relief under Code § 1362(f) of the Code.

Based solely on the information submitted and the representations made, the IRS concluded as follows:
(1) That X satisfied the requirements of Regs. §§ 301.9100-1 and 301.9100-3 and, as a result, would be granted an extension of time of 120 days from the date of the PLR (1/11/2019) to file a Form 8832 with the appropriate service center electing to be treated as an association taxable as a corporation for federal tax purposes, effective Date 1. (The IRS required that the taxpayer attach a copy of this PLR to its Form 8832.)

(2) That X has established reasonable cause for failing to make a timely election to be an S corporation effective Date 1. Therefore, provided that X made an election to be an S corporation by filing a completed Form 2553 effective Date 1 (along with a copy of the PLR) with the appropriate service center within 120 days from the date of the PLR, X’s S corporation election would be treated as timely made for Date 1.

(3) That X's S election terminated on Date 1 (when all of the shares of X stock were owned by Partnership), and that this termination was inadvertent within the meaning of Code § 1362(f). Accordingly, under Code § 1362(f), X will be treated as continuing to be an S corporation on and after Date 1, provided that X's S corporation election was valid and not otherwise terminated under Code § 1362(d). Additionally, Partnership will be treated as the shareholder of X from Date 1 until Date 2, at which point A, B, and C will be treated as the shareholders. As a result, the shareholders of X must include in income their pro rata share of the separately stated and nonseparately computed items of X as provided in Code § 1366, make an adjustments to basis as provided in Code § 1367, and take into account any distributions made by X as provided in Code § 1368.

H. PLR 201902026 – Request for additional time to file S corporation election (2/8/2019)

X was organized on Date #1 under the laws of State as a limited liability company. On Date #2, Y, an S corporation, merged with X with X the surviving entity. X represents that it intended the merger to qualify for tax-free treatment under Code § 368(a)(1)(F) of the Internal Revenue Code (“Code”). X intended at all times to be treated as an S corporation for federal tax purposes, effective Date #2. However, due to inadvertence, X failed to timely file Form 8832, Entity Classification Election, to be classified as an association taxable as a corporation effective Date #2.

Based solely on the facts submitted and the representations made, the IRS concluded that X satisfied the requirements of Reg. § 301.9100-3, and granted X an extension of time of one hundred twenty (120) days from the date of the PLR (1/11/2019) to file Form 8832 with the appropriate service center to elect to be classified as an association taxable as a corporation for federal tax purposes, effective Date #2. The IRS also required that the taxpayer attach a copy of the PLR to its Form 8832.
I. PLR 201902028 – Request for additional time to file S corporation election (2/8/2019)

On Date 1, Purchaser, a State A limited liability company that is taxed as a partnership for federal income tax purposes, acquired all of the stock of S Corporation, a State A corporation that elected to be treated as an S corporation for federal income tax purposes, from Shareholders in exchange for cash (the “Disposition”). It has been represented that the Disposition qualified as a “qualified stock disposition” as defined in Code § 1.336-1(b)(6). On Date 2, S Corporation converted to an LLC under the laws of State A. LLC is a disregarded entity for federal income tax purposes, whose sole owner, for federal income tax purposes, is Purchaser.

Prior to Date 3, the due date for S Corporation’s tax return for the taxable year that included Date 1, the Parties entered into a written, binding agreement providing that a Code § 336(e) election would be made with respect to the Disposition. However, for various reasons, the Election Statement was not timely filed. Subsequently, a request was submitted under Reg. § 301.9100-3 of the Procedure and Administration Regulations for an extension of time to file the Election Statement. The Parties each represented that they are not seeking to alter a return position for which an accuracy-related penalty has been or could be imposed under Code § 6662.

Regulations promulgated under Code § 336(e) permit certain sales, exchanges or distributions of stock of a corporation to be treated as asset dispositions if: (1) the disposition is a “qualified stock disposition” as defined in Code § 1.336-1(b)(6); and (2) a Code § 336(e) election is made. Reg. § 1.336-2(h)(3) provides that a Code § 336(e) election for an S corporation target is made by: (i) all of the S corporation shareholders, including those who do not dispose of any stock in the qualified stock disposition, and the S corporation target entering into a written, binding agreement, on or before the due date (including extensions) of the federal income tax return of the S corporation target for the taxable year that includes the disposition date, to make a Code § 336(e) election; (ii) the S corporation target retaining a copy of the written agreement; and (iii) the S corporation target attaching the Code § 336(e) election statement, described in Reg. § 1.336-2(h)(5) and (6), to its timely filed (including extensions) federal income tax return for the taxable year that includes the disposition date.

Information, affidavits, and representations submitted by the Parties, Company Official, and Tax Professional explained the circumstances that resulted in the failure to timely file the Election Statement. The information established that the Parties reasonably relied on a qualified tax professional who failed to timely file, or to advise them to timely file, the Election Statement, and the request for relief was filed before the failure to file the Election Statement was discovered by the Internal Revenue Service. See Reg. § 301.9100-3(b)(1)(i) and (v).

Based on the facts and information submitted, including the representations made, the IRS concluded that the Parties acted reasonably and in good faith, the requirements of Regs. §§ 301.9100-1 and 301.9100-3 are satisfied, and the IRS’s grant of relief in this situation will not prejudice the interests of the government. Accordingly, the IRS granted
the taxpayer an extension of time to file the required Code § 1.336-2(h)(3)(iii) election statement, using the following procedure: (1) LLC (as successor of the S Corporation) must file the Code § 1.336-2(h)(3)(iii) 45 days from the date of the PLR (1/11/2019), and (2) all relevant Parties must file or amend, as applicable, all returns and amended returns (if any) necessary to report the transaction consistently with the making of a Code § 336(e) election for the taxable year in which the transaction was consummated (and for any other affected tax year) within 120 days of the date of this PLR.

The IRS conditioned its extension of time to file on the Parties’ tax liabilities (if any) being not lower, in the aggregate, for all years to which the Code § 336(e) election applies than it would have been if the Election Statement had been timely filed (taking into account the time value of money).

J. PLR 201903007 – Inadvertent terminations – Failure to file QSST election for trusts (2/15/2019)

X was incorporated under the laws of State on Date 1 and elected to be treated as an S corporation effective Date 2. As of Date 2, A’s shares of X were held through Trust 1, a grantor trust that was treated as entirely owned by A.

On Date 3, A died and Trust 1 ceased to be a grantor trust. Nevertheless, Trust 1 continued to qualify as a permissible S corporation shareholder under section 1361(c)(2)(A)(ii) for the 2-year period beginning Date 3. Trust 1’s trust agreement provided that upon the death of A, the X stock held by Trust 1 was to be held by six shares, Share 1A, Share 1B, Share 1C, Share 1D, Share 1E, and Share 1F (collectively, the “Trust 1 Shares” and each a “Trust 1 Share”). Each Trust 1 Share was treated as a separate share under section 663(c).

X represented that each of the Trust 1 Shares would have qualified as a qualified subchapter S trust (a “QSST”) under section 1361(d)(1) on Date 4 except for the fact that the sole beneficiary of each share failed to make an election under section 1361(d)(2) to treat the share as a QSST. Accordingly, the Trust 1 Shares became ineligible shareholders of X and X’s S corporation election terminated effective Date 4.

On Date 5, B, a shareholder of X died. Pursuant to B’s last will and testament, B’s estate transferred B’s X stock to Trust 2 on Date 6. Trust 2 qualified as a permissible S corporation shareholder under section 1361(c)(2)(A)(iii) for the 2-year period beginning on Date 6, the day on which the X stock was transferred to it. Effective Date 6, trustees held Trust 2 in five shares. Four shares, Share 2A, Share 2B, Share 2C, and Share 2D (the “Trust 2 Shares”), held X stock and were administered as QSSTs, effective Date 7. Although the Trust 2 Shares were administered as QSSTs, no election under section 1362(d)(2) was made to treat the Trust 2 shares as QSSTs effective Date 7 and the governing document of Trust 2 did not satisfy the requirements to qualify the Trust 2 shares as QSSTs.
On Date 7, the Trust 2 Shares became ineligible shareholders of X. On Date 8, the beneficiaries the Trust 2 Shares and the trustees of Trust 2 entered into a binding non-judicial settlement agreement under State law effective as of Date 6 to qualify the Trust 2 shares as QSSTs.

X represented that all income was reported on all affected returns consistent with the treatment of X as an S corporation for Date 2 and thereafter. X further represented that the beneficiaries of the Trust 1 Shares and the Trust 2 Shares filed their federal income tax returns consistent with the Trust 1 Shares and Trust 2 Shares being treated as QSSTs. X represented that the circumstances resulting in the termination of X’s S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning. X and its shareholders also agreed to make any adjustments that the Commissioner may require, consistent with the treatment of X as an S corporation.

The IRS ruled that, based solely on the information submitted and the representations made, X’s S corporation election was terminated on Date 4, when the Trust 1 Shares became ineligible shareholders. The IRS also ruled that the termination of X’s S corporation election was an inadvertent termination within the meaning of section 1362(f). Further, had X’s S corporation election not already terminated on Date 4, it would have terminated on Date 7, when the Trust 2 Shares became ineligible shareholders. Similarly, this termination would have also been inadvertent. Accordingly, pursuant to the provisions of section 1362(f), X will be treated as an S corporation from Date 4 and thereafter, provided that X’s S corporation election was otherwise valid and not otherwise terminated under section 1362(d).

K. PLR 201904001 – Inadvertent termination due to nonproportional distributions to LLC owners (2/21/2019)

X began business on Date 1 and is organized under the laws of State. Between Date 2 and Date 3, X had two owners, and was classified as a partnership for federal income tax purposes. During this time, X’s Operating Agreement provided that current distributions were to be made to the two owners in accordance with their “Ownership Ratios,” while distributions made upon dissolution would be made in accordance with the owners’ “positive Capital Account balances.” Certain distributions (the “LLC distributions”) that X made to the owners between Date 2 and Date 3 caused the owners’ capital accounts to become disproportionate to the owners’ ownership ratios.

Effective Date 3, X elected to be classified as an S corporation, and did not make any changes to its Operating Agreement. As a result of the LLC distributions, the Operating Agreement created a right to nonproportional distributions to X’s owners. This caused X to have multiple classes of stock within the meaning of Code § 1361(b)(1)(D), thereby causing X’s S corporation election to be ineffective.

On Date 4, X amended its Operating Agreement to clarify that all liquidating distributions are to be made in accordance with the shareholders’ ownership ratios. X represented that, between Date 3 and Date 4, all distributions were made in accordance
with its shareholders’ relative stock ownership, and that all taxable income was also allocated in a pro rata manner. X further represented that X and its shareholders intended for X to be an S corporation at all times from Date 3 and onward and that X has filed all returns consistent with X’s treatment as an S corporation since Date 3. X and its shareholders agreed to make any adjustments required as a condition of obtaining relief under the inadvertent termination rule as provided in Code § 1362(f).

Based solely on the facts submitted and the representations made, the IRS concluded that X’s S corporation election on Date 3 was ineffective as a result of X having more than one class of stock. However, the IRS also concluded that this ineffectiveness was inadvertent within the meaning of Code § 1362(f), and acknowledged that X had taken corrective action in order to meet the requirements to be a small business corporation under Code § 1361(b). Based on the inadvertent character of this termination, and the corrective action X had taken to satisfy the requirements of Code § 1361(b), the IRS permitted X to be treated as an S corporation effective as of Date 3 and thereafter, provided X’s S corporation election was otherwise valid and has not otherwise terminated under Code § 1362(d).

L. PLR 201904009 – Request for extension of time to make qualified DISC election (2/21/2019)

Taxpayer was a domestic corporation wholly owned by Individual and members of Individual’s extended family that operates in connection with the export of agricultural produce grown by Opco. Opco is an S corporation that is also owned by Individual and his extended family, in the same proportions as Taxpayer. Individual has long managed Taxpayer and Opco.

Law Firm A and Accounting Firm have provided tax services to Opco and related entities for many years.

Shortly before Date 1, Individual consulted with Law Firm A about benefits that an interest charge domestic international sales corporation (“IC-DISC”) may provide. Individual engaged Law Firm A to set up Taxpayer as an IC-DISC and prepare initial corporate and tax filings, and engaged Accounting Firm to prepare Taxpayer’s returns.

A few weeks later, on Date 2, Taxpayer inadvertently filed Form 2553, “Election by a Small Business Corporation (Under section 1362 of the Internal Revenue Code)” (“S election”), to take effect as of incorporation, instead of a DISC election.

A few weeks after that, on Date 3 (and before the 15th day of the third month of Taxpayer’s first taxable year), Taxpayer sent the Service a revocation letter regarding the S election. The revocation was to be retroactive to incorporation. The letter, which stated that the S election was due to inadvertent error and that Taxpayer was meant to be a DISC, was signed by all of Taxpayer’s shareholders.
On Date 4, the Service promptly responded with a letter that the revocation request could not be considered because there was no record of an S election. In other words, Taxpayer erroneously attempted to make an S election rather than a DISC election, but apparently also failed to make the S election in the first place. Taxpayer and Accounting Firm further discussed the matter of the S and DISC elections with the Service. Several months later, at Accounting Firm’s recommendation, Taxpayer engaged Law Firm B to submit the ruling request at issue.

The IRS found that Taxpayer’s status as an S corporation for its first taxable year would have precluded it from electing to be a DISC for that year, and a retroactive revocation at the time of the ruling would not have been possible under section 1362(d). Additionally, the IRS concluded that Taxpayer never made a valid S election. Even if Taxpayer had successfully made the S election, Taxpayer’s revocation of such election during the first two and a half months of its first taxable year would have been retroactively effective as of the first day of that year.

For this reason, the IRS found that Taxpayer’s attempted S election posed no barrier to its request for classification as a DISC. Based on the facts and representations submitted with Taxpayer’s ruling request, the IRS concluded that Taxpayer satisfied the requirements of Reg. § 301.9100-3(a), and granted Taxpayer a 60 day extension from the date of the PLR to file Form 4876-A electing to be an IC-DISC for its first taxable year. So long as Taxpayer filed Form 4876-A within 60 days of the date of the PLR, the IRS would consider it to be timely filed.

M. PLR 201905002 – Inadvertent terminations – Ineffective elections – Creation of second class of stock – Election to treat subsidiary as Q Sub (3/1/2019)

X was organized as a limited liability company under the laws of State on Date 1. A was the sole shareholder of X on Date 1. X elected to be an S corporation effective Date 2. On Date 3, X acquired from B all the membership interests of Y, a State limited liability company that made a timely election to become a qualified subchapter S subsidiary (“QSub”) of X effective Date 3. However, on Date 3, X’s Operating Agreement included provisions regarding partnerships. Section 2.10 of the Operating Agreement provided, in part, that the members intend that X shall be treated as a partnership for tax purposes and to file its returns consistent with such treatment. Section 9.3 provided, in part, that if X were to be liquidated, assets of X were to be distributed to its members in proportion to their respective positive capital account balances. When X’s members discovered the effect of the partnership provisions, they amended X’s Operating Agreement effective Date 4 to remove the partnership provisions and provide identical distribution and liquidation rights to X’s members.

X represented that the termination of X’s S corporation election and ineffectiveness of Y’s QSub election were inadvertent and not the result of retroactive tax planning. X further represented that no federal tax return of any person had been filed inconsistent with a valid S corporation election having been made for X effective Date 2 and a valid QSub election having been made for Y effective Date 3. X also represented that all distributions and allocations of income to its shareholders had been made pro rata in
accordance with their interests in X. X, Y, and X’s shareholders agreed to make any adjustments required by the Service consistent with the treatment of X as an S corporation and Y as a QSub.

The IRS concluded that, based solely on the facts submitted and representations made, X’s S corporation election terminated on Date 3 and Y’s QSub election was ineffective on Date 3 because X had more than one class of stock due to the provisions in the Operating Agreement. The IRS further concluded that the termination of X’s S corporation election and the ineffectiveness of Y’s QSub election were inadvertent within the meaning of section 1362(f). Accordingly, under the provisions of section 1362(f), X will be treated as an S corporation from Date 3 and thereafter, provided that X’s S corporation election was otherwise valid and not otherwise terminated under section 1362(d). Furthermore, under section 1362(f), Y will be treated as a QSub from Date 3, and thereafter, provided the QSub election for Y was otherwise valid and had not terminated under section 1362(b)(3)(B).

N. PLR 201908009 – Ability to Re-Elect S Corporation Status Prior to End of Five-Year Waiting Period Imposed by Code §1362(g) (3/21/2019)

Company was incorporated in State in Year 1, and made an S corporation election effective on Date 1. All of Company’s shares were held by Trust, a grantor trust under subpart E of part 1 of subchapter J of chapter 1 as entirely owned by A.

On Date 2, A, Trust’s grantor, died. A’s spouse, B, became the income beneficiary of Trust on Date 2. When B died, X and Y became the income beneficiaries of Trust.

On Date 3, Company’s S election terminated. Trust proposed to sell all of Company’s stock to an employee stock ownership plan being formed by the employees of Company. As a result of the sale, the employee stock ownership plan would be the sole shareholder of Company. Company requested permission to re-elect S corporation status effective prior of Date 4, despite the fact that Date 4 was prior to expiration of the five-year waiting period imposed by Code § 1362(g).

Based solely on the facts submitted and representations made, the IRS concluded that Company met its burden under Reg. § 1.1362-5(a), and granted Company permission to re-elect S corporation status effective prior to Date 4. Accordingly, provided that Company filed a completed Form 2553 (along with a copy of this PLR) with the appropriate service center within 120 days following the date of this PLR, Company’s election would be treated as timely made as of the first day of the Company’s taxable year beginning prior to Date 4.

O. PLR 201908012 – Request for Permission to File a Late Election to Be Treated as an Electing Small Business Trust (ESBT) (3/21/2019)

X was incorporated on Date 1, under the laws of State. Effective Date 2, X elected to be taxed as an S corporation. On Date 3, Trust 1 acquired shares of X; however, no election was made to treat Trust 1 as an Electing Small Business Trust (ESBT). Therefore, X’s S
election terminated on Date 3. X, its shareholders, and Trust 1 agreed that, in the event that IRS approved Trust 1’s classification as an ESBT, they would amend their income tax returns for the years in question within 120 days following issuance of the PLR.

In its request for this ruling, X represented as follows: (i) that Trust 1 had at all times met the requirements of an ESBT within the meaning of Code § 1361(e), except that the trustees of Trust 1 did not make a timely ESBT election under Code § 1361(e)(3); (ii) that Trust 1 had not filed its income tax return consistent with being an ESBT; (iii) that, other than the failure to make a valid ESBT election, X qualified as a small business corporation at all times since its election on Date 2; (iv) that X and its shareholders treated X as an S corporation at all relevant times; (v) that X filed its income tax returns consistent with having a valid S election in effect for all taxable years since X elected to be an S corporation; (vi) that termination of X’s S corporation election was inadvertent and was not motivated by tax avoidance or retroactive tax planning; and (vii) that X and its shareholders agreed to make any adjustments required by the Secretary as a condition of obtaining relief under the inadvertent termination rules of Code § 1362(f).

Based solely on the facts submitted and the representations made, the IRS concluded that X’s S election terminated on Date 3 due to Trust 1’s failure to file an ESBT election. However, the IRS also concluded that X’s S election termination was inadvertent within the meaning of Code § 1362(f). Therefore, the IRS held that X would be treated as an S corporation effective Date 2 and thereafter, provided that X’s S corporation election was valid and not otherwise terminated under Code § 1362(d).

The IRS stated that this its decision in this ruling was contingent upon satisfaction of the following two conditions within 120 days following the date of the PLR: (1) remittance of an adjustment payment, along with a copy of this PLR, to the IRS; and (2) submission of an election to treat Trust 1 as an ESBT effective Date 3, along with a copy of this PLR, to the appropriate IRS service center.

P. PLR 201908015 and 201908017–Inadvertent Termination of S Corporation Election (3/21/2019)

X was formed on Date 1, under the laws of State. Effective Date 2, X elected to be taxed as an S corporation. On Date 3, X amended its operating agreement. This amendment provided for allocations that were not pro rata, creating a second class of stock. Therefore, X’s S corporation election terminated effective Date 3.

X represented that it had taken action to correct the second class of stock issue. X represented that neither X nor its shareholders intended to terminate X’s Subchapter S election, and that X and its shareholders had filed returns in a fashion consistent with X being classified as an S corporation. In addition, X represented that, other than the termination due to a second class of stock, X qualified as a small business corporation at all times since its election on Date 2. Lastly, X and its shareholders agreed to make any adjustments required by the Secretary as a condition of obtaining relief under the inadvertent termination rule as provided under Code § 1362(f).
Based on the facts submitted and the representations made, the IRS concluded that X’s S corporation status terminated on Date 3, but that the termination was inadvertent within the meaning of Code § 1362(f). Therefore, the IRS stated that it would treat X as an S corporation effective as of Date 3, provided that X’s S corporation election was not otherwise terminated under Code § 1362(d).

Q. PLR 201908019 – Relief for Inadvertent Termination of Election to Be Treated as an S Corporation (3/21/2019)

W, X and Y were incorporated under the laws of State on Date 1, Date 2 and Date 3, respectively. W, X and Y made a timely S corporation election effective for each Corporation’s respective date of incorporation.

Beginning in Year 1, W, X and Y (collectively, the “Corporations”) underwent a restructuring, whereby Z was formed as a single member limited liability company and elected to be treated as an S corporation. On Date 4, Z acquired a portion of the stock of Y. On Date 5, Z acquired a portion of the stock of each of W and X.

In Year 2, Z’s member was informed that Z’s ownership caused the termination of the Corporations’ S corporation elections. Z’s member relied on its tax and legal advisors to take corrective action, but no action was taken.

In Year 3, Z’s member was informed by a new tax advisor that the termination caused by the Year 1 restructuring had not been corrected. The Corporations then underwent a restructuring in Year 4 on Date 6, whereby Z acquired all of the stock of W and X and transferred the stock of Y to eligible S shareholders. Z also intended to elect to treat W and X as qualified subchapter S subsidiaries (“QSubs”) under Code § 1361(b)(3)(B)(ii) and Reg. § 1.1361-3, effective as of Date 6.

The Corporations represented that termination of their S corporation elections was inadvertent and was not the result of tax avoidance or retroactive tax planning. Further, the Corporations represented that no federal income tax return of Z’s member had been filed inconsistent with valid S corporation elections having been made for the Corporations effective as of Date 1, Date 2 and Date 3. The Corporations and their shareholders also represented that they would agree to any adjustments consistent with the treatment of the Corporations as S corporations that may be required by the Secretary as a condition of obtaining relief.

Based solely on the facts submitted and representations made, the IRS concluded that Z’s ownership caused inadvertent terminations of the Corporations’ S corporation elections within the meaning of Code § 1362(f). The IRS further concluded that, pursuant to the provisions of Code § 1362(f), the Corporations would be treated as S corporations effective Date 1, Date 2 and Date 3, respectively, and continuing thereafter, provided that: (i) the Corporations’ S corporation elections were valid, and (ii) the elections were not otherwise terminated under Code § 1362(d).
Except as specifically ruled above, the IRS expressed no opinion in this PLR concerning any of the following: (i) the federal tax consequences of any aspect of the transactions described above; (ii) Z’s or the Corporations’ eligibility to be S corporations; (iii) whether W and X were eligible to elect to be treated as QSubs; and (iv) whether any of the Corporations’ shareholders were permissible shareholders for purposes of Code § 1361(b)(1)(B).

R. PLR 201909002 – Installment method – Consent to revoke election out of installment method reporting (3/29/19)

Taxpayer was an S corporation owned by Shareholder 1 and Shareholder 2 (collectively referred to as “shareholders”). All the stock in Taxpayer was sold on Date 1 to an unrelated corporation. The buyer and the shareholders jointly made an election under section 338(h)(10) to treat the sale of the stock as if Taxpayer sold all of its assets and then immediately liquidated.

In return for the sale of Taxpayer, the shareholders received (1) a cash payment on Date 1, (2) an additional cash payment to be paid in 12 months placed in escrow, subject to certain claims and indemnification (escrow amount); and (3) a contingent earn-out of future payments (based on post-sale performance objectives) to be paid in increments over the three years following the end of Year 1.

Soon after Date 1, Taxpayer’s accountant prepared a draft final short year Form 1120S for the year ending Date 1 (short year return) for Taxpayer. Shareholder 1, an officer of Taxpayer, signed the draft short year return. Taxpayer’s accountant filed the short year return with the IRS before the effective due date of the short year return. Excepting Shareholder 1, no other party to the sale transaction reviewed the short year return.

On the short year return, Taxpayer’s accountant reported the gain on the deemed sale of assets using both the cash payment at closing on Date 1 plus the escrow amount. Taxpayer’s accountant did not include the contingent earn-out amounts to be paid over three years as part of the sale proceeds. Taxpayer effectively elected out of the installment method under section 453 by including the escrow amount on the short year return.

Shareholder 1 filed his federal income tax return for Year 1 consistent with the treatment on Taxpayer’s return, relying on the K-1 from Taxpayer to govern his reporting. Thus, Shareholder 1 reported as income his portion of the sales proceeds – both the cash received upon the sale of Taxpayer and the escrow amount, but none of the contingent earn-out.

Shareholder 2 determined that his K-1 inadvertently included the escrow amount as part of the amount realized from the sale of Taxpayer. Instead of following the K-1, Shareholder 2 filed his federal income tax return for Year 1 reporting only his portion of the cash received upon the sale of Taxpayer, intending to report the escrow amount and any contingent earn-outs when received in years following Year 1.
Taxpayer’s accountant provided an affidavit indicating that the accountant made the erroneous computation of gain (cash payment at closing plus the escrow amount). The affidavit stated that the decision to elect out of the installment method under section 453 was made solely by the accountant, who generated the K-1s for the shareholders. Taxpayer’s accountant’s affidavit also indicated that the shareholders were unaware that the return for Year 1 elected out of the installment method.

Shareholder 1 also provided an affidavit indicating that he did not plan or participate in the decision to elect out of the installment method under section 453 and, although he followed the K-1, Taxpayer’s accountant’s action was the sole reason the installment method was not used. Shareholder 2 also provided an affidavit, wherein he stated that he did not plan or participate in the decision to elect out of the installment method under section 453 and, in fact, he alerted Shareholder 1 of the erroneous election out, and ultimately filed his federal income tax return for Year 1 inconsistent with the K-1 he received from Taxpayer.

Taxpayer and the shareholders represented that the requested revocation of the election out of the installment method did not have as one of its purposes the avoidance of federal income taxes and no taxable year of Taxpayer or the shareholders in which payments were received was closed to assessment or collection pursuant to section 6501(a).

The IRS granted Taxpayer permission to revoke its election out of the installment method for the sale of Taxpayer on Date 1, and provide corrected K-1’s to the shareholders. Taxpayer’s accountant’s erroneous action when preparing Taxpayer’s short year return led the accountant to inadvertently elect out of the installment method under section 453. The shareholders were not aware of the accountant’s action, nor did the shareholders plan or participate in the action. Although Shareholder 1 signed the Taxpayer’s return as an officer of the Taxpayer, he was unaware of Taxpayer accountant’s action. When the shareholders realized the accountant’s erroneous computation, Taxpayer filed a request for permission to revoke its election out of the installment method. The information submitted indicated that Taxpayer and the shareholders’ desire to revoke the election out of the installment method was due to inadvertence rather than hindsight by the Taxpayer or shareholders, or a purpose of avoiding federal income taxes.

S. PLR 201909005 – Inadvertent terminations – Failure to file ESBT and QSST elections for trusts (3/29/2019)

X was incorporated under the laws of State on Date 1, and elected to be an S corporation effective Date 2. On Date 3, A transferred a shares of X stock to Trust 1. X represented that Trust 1 was treated as a wholly-owned grantor trust under sections 671 and 676.

On Date 4, A died and Trust 1 ceased to be a grantor trust with respect to A’s interests, but would have continued to qualify as an eligible S corporation shareholder under section 1361(c)(2)(A)(ii) for the two-year period beginning on the day of the deemed owner’s death.
On Date 5, before the end of the two-year period, Trust 1 transferred shares of X stock to Trust 2. X represented that Trust 2 qualified to elect to be treated as an electing small business trust (an “ESBT”), however, the trustee failed to make a timely ESBT election within the meaning of section 1361(e)(1)(A)(v), thereby causing X’s S corporation election to terminate on Date 5.

On Date 6, Trust 2 distributed shares of stock in X to Trust 3. X represented that Trust 3 qualified to elect to be treated as a qualified subchapter S trust (a “QSST”) but the beneficiary failed to make a timely QSST election within the meaning of section 1361(d)(2). The failure to make the QSST election Date 6 would have terminated X’s S corporation election had it not already been terminated Date 5.

X represented that the circumstances resulting in the termination of their respective S corporation elections were inadvertent and not motivated by tax avoidance. X further represented that it filed returns consistent with its status as an S corporation. X and its shareholders agreed to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary.

The IRS ruled that, based solely on the facts submitted and representations made, X’s S corporation election terminated beginning on Date 5, when the stock in X was transferred to Trust 2, because the trustee of Trust 2 failed to timely file the ESBT election under section 1361(e)(1)(A)(v). However, the IRS concluded that the termination was inadvertent within the meaning of section 1362(f). Moreover, had X’s S corporation election not already terminated on Date 5, it would have terminated on Date 6, when stock was transferred to Trust 3 and the beneficiary of Trust 3 failed to a timely file QSST election under section 1361(d)(2). Similarly, this termination was inadvertent within the meaning of section 1362(f).

Immediately prior to Purchaser’s acquisition, through a disregarded entity, of all of the stock of S Corporation from Shareholders on Date 1 (the “Stock Disposition”), Purchaser was a partnership for federal income tax purposes. Purchaser owned all of the interests in a State A limited liability company that was disregarded from Purchaser for federal income tax purposes. S Corporation was a State B corporation that was classified as an S corporation for federal income tax purposes. Shareholders owned all of outstanding stock of S Corporation.

On Date 1, Shareholders sold all of the stock of S Corporation to Purchaser. The Parties intended to make a section 336(e) election for the Stock Disposition but, for various reasons, a timely election was not fully made. Subsequently, a request was submitted, under Treas. Reg. § 301.9100-3, for an extension of time to file the Election Statement. The Parties each represented that they were not seeking to alter a return position for which an accuracy-related penalty had been or could be imposed under section 6662 at the time of the request.

Information, affidavits, and representations submitted by the Parties, Company Official, and Tax Professional explained the circumstances that resulted in the failure to timely file
the Election Statement. The information established that S Corporation reasonably relied on a qualified tax professional who failed to timely file, or advise Target to timely file, the Election Statement, and that the request for relief was filed before the failure to timely file the Election Statement was discovered by the IRS.

The IRS ruled that, based on the facts and information submitted, including the representations made, the Parties acted reasonably and in good faith, the requirements of Treas. Reg. §§ 301.9100-1 and 301.9100-3 were satisfied, and granting relief would not prejudice the interests of the government. Accordingly, an extension of time was granted under Treas. Reg. § 301.9100-3 to file the Election Statement.


X was organized on Date 1 under the laws of State. X filed Form 2553 Election by a Small Business Corporation intending to elect to be an S corporation effective Date 2; however, the election was invalid.

X represented that since Date 2, it has filed its federal income tax returns consistent with being an S corporation. X represented that its invalid S corporation election was inadvertent and was not motivated by tax avoidance or retroactive tax planning. Further, X represented that X and its shareholders would make any adjustments required as a condition of obtaining relief under the inadvertent termination rule as provided under section 1362(f) that may be required by the Secretary.

The IRS ruled that, based solely on the facts submitted and the representations made, X’s S corporation election was inadvertently invalid within the meaning of section 1362(f). Pursuant to the provisions of section 1362(f), X will be treated as an S corporation from Date 2.


Effective Date 1, X elected to be treated as an S corporation. On Date 2, A and B transferred shares of X to Trust, an irrevocable trust created by A and B. It is represented that Trust is eligible to be an electing small business trust (an “ESBT”) under section 1361(e). However, the trustee of Trust did not file a timely ESBT election for Trust and X’s S corporation election terminated on Date 2.

X represented the failure to file the ESBT election for Trust was inadvertent and was not motivated by tax avoidance or retroactive planning. X had filed all returns consistent with X’s status as an S corporation since Date 2. X and its shareholders agreed to make any adjustments required as a condition of obtaining relief under the inadvertent termination rule as provided in section 1362(f).

The IRS ruled that, based solely on the facts and representations submitted, X’s S corporation election was terminated on Date 2 because trustee of Trust failed to file an
ESBT election for Trust, and this termination was inadvertent within the meaning of section 1362(f). Pursuant to the provisions of section 1362(f), X will be treated as an S corporation from Date 2, and thereafter, provided X was otherwise eligible to make an S corporation election and provided that any such election would not have otherwise been terminated under section 1361(d). Further, Trust will be treated as an ESBT effective Date 2.

V. PLR 201910018 – Gain or loss recognized on property distributed in complete liquidation – Qualified stock dispositions – Asset dispositions – Elections – Extensions (3/29/2019)

On Date 1, Purchasers, two individual taxpayers, acquired all of the stock of S Corporation Target, a State A corporation that elected to be treated as an S corporation for Federal income tax purposes, from Seller in exchange for cash and a note (the “Disposition”). It was represented that the Disposition qualified as a “qualified stock disposition” as defined in Treas. Reg. § 1.336-1(b)(6).

The Parties entered into a written, binding agreement providing that a section 336(e) election would be made with respect to the Disposition on Date 1. The Election Statement and S Corporation Target’s tax return for the taxable year ending on Date 1 were required to be filed by Date 2. However, for various reasons, the tax return and Election Statement were not timely filed. Subsequently, a request was submitted under Treas. Reg. § 301.9100-3 for an extension of time to file the Election Statement. The Parties each represented that they were not seeking to alter a return position for which an accuracy-related penalty has been or could be imposed under section 6662 at the time of the request for relief.

Information, affidavits, and representations submitted by the Parties, Company Official and Tax Professional explained the circumstances that resulted in the failure to timely file the Election Statement. The information established that the Parties reasonably relied on a qualified tax professional who failed to timely file, or to advise them to timely file, the Election Statement, and the request for relief was filed before the failure to file the Election Statement was discovered by the IRS.

The IRS ruled that, based on the facts and information submitted, including the representations made, the Parties acted reasonably and in good faith, the requirements of Treas. Reg. §§ 301.9100-1 and 301.9100-3 were satisfied, and granting relief would not prejudice the interests of the government. Accordingly, an extension of time was granted under Treas. Reg. § 301.9100-3 to file the Election Statement.


Immediately prior to Purchaser’s acquisition, through a disregarded entity, of all of the stock of S Corporation from Shareholders on Date 1 (the “Stock Disposition”), Purchaser was a partnership for federal income tax purposes. Purchaser owned all of the interests in a State A limited liability company that was disregarded from Purchaser for federal
income tax purposes. S Corporation was a State B corporation that was classified as an S corporation for federal income tax purposes. Shareholders owned all of outstanding stock of S Corporation.

On Date 1, Shareholders sold all of the stock of S Corporation to Purchaser. The Parties intended to make a section 336(e) election for the Stock Disposition but, for various reasons, a timely election was not fully made. Subsequently, a request was submitted, under Treas. Reg. § 301.9100-3, for an extension of time to file the Election Statement. The Parties each represented that they were not seeking to alter a return position for which an accuracy-related penalty had been or could be imposed under section 6662 at the time of the request.

Information, affidavits, and representations submitted by the Parties, Company Official, and Tax Professional explained the circumstances that resulted in the failure to timely file the Election Statement. The information established that S Corporation reasonably relied on a qualified tax professional who failed to timely file, or advise Target to timely file, the Election Statement, and that the request for relief was filed before the failure to timely file the Election Statement was discovered by the IRS.

The IRS ruled that, based on the facts and information submitted, including the representations made, the Parties acted reasonably and in good faith, the requirements of Treas. Reg. §§ 301.9100-1 and 301.9100-3 were satisfied, and granting relief would not prejudice the interests of the government. Accordingly, an extension of time was granted under Treas. Reg. § 301.9100-3 to file the Election Statement.


X was incorporated under the laws of State on D1, and elected to be an S corporation effective on D2. On D3, shares of X were transferred to both Trust 1 and Trust 2 (each a “Trust,” and together, “the Trusts”). X represented that the Trusts were eligible to elect qualified subchapter S trust (QSST) treatment under Code § 1361(d). However, the respective beneficiaries of the Trusts inadvertently failed to timely make QSST elections. Therefore, X’s S corporation election terminated on D3.

X represented that, since D3, X and each of its shareholders have submitted tax filings consistent with X’s treatment as an S corporation. X also represented that the termination of its S corporation status was not motivated by tax avoidance or retroactive tax planning. X and its shareholders agreed to make any adjustments required by the Commissioner as a result of this ruling.

Based solely on the facts submitted and the representations made, the IRS concluded that X’s S corporation election terminated on D3 due to the inadvertent failure of the beneficiaries of each Trust to make QSST elections. However, the IRS also concluded that the termination of X’s S election was an inadvertent termination within the meaning of Code § 1362(f). Accordingly, pursuant to the provisions of Code § 1362(f), the IRS agreed to continue treating X as an S corporation from D3 onward, provided that: (i) X’s
S corporation election was valid and not otherwise terminated under Code § 1362(d), and (ii) within 120 days of the date of this ruling, the beneficiaries of each Trust filed QSST elections with an effective date of D3 with the appropriate IRS service center (along with a copy of this PLR).

Y. PLR 201918001 – Extension of Time to Make a Late ESBT election under Code § 1362(f) (5/3/2019)

X was incorporated on Date 1 under the laws of State. Effective Date 2, X elected to be taxed as an S corporation. On Date 3, A, a shareholder of X, transferred X stock to a grantor trust described in section 1361(c)(2)(A)(i) of which A was the deemed owner (“Trust”).

On Date 4, A died and Trust ceased to be a grantor trust, but continued to qualify as an eligible S corporation shareholder under section 1361(c)(2)(A)(ii) for the 2-year period beginning on the day of the deemed owner's death. However, Trust continued to hold the X stock after the 2-year period had ended on Date 5. According to X, Trust qualified as an Electing Small Business Trust (ESBT), but its beneficiary made no ESBT election. As a result, X's S corporation election terminated on Date 5.

X represented: (1) that Trust had at all times met the requirements of an ESBT within the meaning of section 1361(d)(3), except that the trustee of Trust failed to make a timely ESBT election under section 1361(e)(3); (2) that Trust had not filed its income tax returns consistent with being an ESBT for Year 1; (3) that, other than the failure to make a valid ESBT election by Date 5, X qualified as a small business corporation at all times since its election on Date 2; (4) that X and its shareholders treated X as an S corporation at all relevant times; (5) that X filed its income tax returns consistent with having a valid S election in effect for all taxable years since X elected to be an S corporation; (6) that if the IRS approved X’s request to make a late ESBT election, X, its shareholders, and Trust’s beneficiaries would amend their income tax returns for all open tax years within 120 days of the date of the PLR to reflect treatment of Trust as an ESBT; and (7) that X’s S corporation election termination was inadvertent and was not motivated by tax avoidance or retroactive tax planning.

Based solely upon the facts submitted and the representations made, the IRS concluded that termination of X's S corporation election on Date 5 was inadvertent within the meaning of section 1362(f). The IRS further held that, pursuant to the provisions of section 1362(f), X would be treated as an S corporation as of Date 5, provided X's S corporation election was valid and was not otherwise terminated under section 1362(d).

The IRS conditioned the relief granted under this PLR on the following: (1) the trustee of Trust filing an election to treat Trust as an ESBT effective as of Date 5 (along with a copy of this PLR) within 120 days from the date of this PLR; and (2) X’s shareholders, and the beneficiaries of Trust, amending their income tax returns for all open tax years within 120 days of the date of this PLR to reflect the Trust’s classification as an ESBT.
Z. PLR 201918002 – Reinstatement of S Corporation Election following Inadvertent Termination under section 1362(f) (5/3/2019)

X was incorporated on Date 1 under the laws of State. X elected to be taxed as an S corporation effective as of Date 2; however, no ESBT elections were ever filed for Trust 1, Trust 2, and Trust 3, as shareholders of X. Accordingly, Trust 1, Trust 2, and Trust 3 were ineligible shareholders of X, making X’s S corporation election ineffective.

X represented: (1) that Trust 1, Trust 2 and Trust 3 had at all times met the requirements of an ESBT within the meaning of section 1361(d)(3), except that the trustees of Trust 1, Trust 2, and Trust 3 did not make timely ESBT elections under section 1361(e)(3); (2) that Trust 1, Trust 2, and Trust 3 had not filed their income tax returns consistent with being ESBTs for Year 1; (3) that, other than failing to make valid ESBT elections by Date 2, X qualified as a small business corporation at all times since its election on Date 2; (4) that X and its shareholders treated X as an S corporation at all relevant times; (5) that X filed its income tax returns consistent with having a valid S election in effect for all taxable years since X elected to be an S corporation; (6) that termination of X’s S corporation election was inadvertent and was not motivated by tax avoidance or retroactive tax planning; and (7) that, if the IRS granted X the relief it requested, X and its shareholders would make any adjustments required as a condition of obtaining relief under the inadvertent termination rule under section 1362(f) that may be required by the Secretary.

Based solely on the facts submitted and the representations made, the IRS concluded that X's S election was inadvertently ineffective within the meaning of section 1362(f) as of Date 2 because Trust 1, Trust 2, and Trust 3 were ineligible shareholders of X. Pursuant to the provisions of section 1362(f), the IRS agreed to treat X as an S corporation as of Date 2, provided that X's S corporation election was otherwise effective and not terminated under section 1362(d).

The IRS conditioned the relief granted under this PLR on the following: (1) remittance of an adjustment payment in the amount of $a (along with a copy of this PLR) to the following address: Internal Revenue Service, Kansas City Service Center; 333 W. Pershing Road, Kansas City, MO 64108, Stop 7777, Manual Deposit, within 120 days from the date of this PLR; (2) the trustees of Trust 1, Trust 2, and Trust 3 filing elections (along with copies of this PLR) with the appropriate service center to treat Trust 1, Trust 2, and Trust 3 as ESBTs effective as of Date 2; and (3) X and its shareholders filing any necessary original or amended returns consistent with the relief granted in this PLR (along with a copy of this PLR) within 120 days of the date of this PLR.

AA. PLR 201918003 – Reinstatement of S Corporation Election following Inadvertent Termination under section 1362(f) (5/3/2019)

X was incorporated on Date 1 under the laws of State. X made an election to be taxed as an S corporation as of the same date. On Date 2, shares in X were transferred to Trust 1. At that time, Trust 1, by the terms of its governing documents, did not qualify as an
eligible S corporation shareholder. Thus, X’s S corporation election terminated on Date 2, when X stock was transferred to Trust 1 (an ineligible S corporation shareholder).

On Date 3, shares in X were transferred to Trust 2. At that time, Trust 2, by the terms of its governing documents, did not qualify as an eligible S corporation shareholder. X represented that it was always the intent to have both Trust 1 and Trust 2 qualify as qualified subchapter S trusts (QSSTs).

On Date 4, State’s probate court entered an order approving certain amendments to Trust 1 that qualified it as a valid qualified subchapter S trust (QSST). On Date 5, State’s probate court entered an order approving amendments that qualified Trust 2 as a valid QSST. X represented that: (1) termination of X’s S corporation election was inadvertent and was not motivated by a tax avoidance motive or retroactive tax planning; and (2) if the IRS granted the relief requested by X, X and its shareholders would make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary.

Based solely on the facts submitted and the representations made within those submissions, the IRS concluded that X’s S corporation election terminated on Date 2 when stock was transferred to ineligible shareholders. The IRS further concluded that termination of X’s S corporation election on Date 2 was inadvertent within the meaning of section 1362(f). Therefore, pursuant to the provisions of section 1362(f), the IRS would treat X as an S corporation as of Date 2, provided that X’s S corporation election was valid and not otherwise terminated under section 1362(d).

BB. PLR 201918004 – Reinstatement of S Corporation Election following Inadvertent Termination under section 1362(f) (5/3/2019)

Y was organized as a limited liability company under the laws of State on Date 1, and subsequently made an election to be treated as an S corporation effective as of Date 2. Y’s shareholders signed an operating agreement (“Operating Agreement”) on Date 3. Section 10 of the Operating agreement provided that “Upon dissolution of the Company… the proceeds from the liquidation of the Company’s assets shall be distributed…to the Members in accordance with their respective positive Capital Account Balances; and, the balance, if any, to the Members, in accordance with their respective Percentage Interests.”

On Date 4, Y undertook a reorganization under section 368(a)(1)(F), in which Y transferred all shares of ownership interests into X, a corporation created on Date 4 under the laws of State. X then filed a Form 8869 (Qualified Subchapter S Subsidiary Election), to treat Y as a qualified subchapter S subsidiary, effective as of Date 4. Subsequently, X became the successor to Y for federal income tax purposes. Consistent with Rev. Rul. 2008-18, 2008-1 C.B. 674, X was treated as the successor S corporation to Y for federal income tax purposes and therefore did not make a new S corporation election. After the reorganization, Y filed a Form 8832 (Entity Classification Election), to be disregarded as a separate entity for federal income tax purposes, effective as of Date 5.
Y’s Operating Agreement was effectively replaced by X’s corporate charter, which provided for a single class of stock. While reviewing the reorganization during Year, outside counsel became concerned that Y’s Operating Agreement created a second class of stock. Y and its successor, X, represented: (1) that termination of the S corporation election was inadvertent and not the result of tax avoidance or retroactive tax planning; (2) that no federal tax return of any person has been filed inconsistent with a valid S corporation election having been made for Y and its successor, X, effective as of Date 2; (3) that all distributions and allocations of income to its shareholders were made pro rata in accordance with their interests in both Y and its successor, X; and (4) that, if the IRS granted the requested relief, Y, its successor, X, and its shareholders would make any adjustments required by the Service consistent with the treatment of Y and its successor, X, as an S corporation.

Based solely on the facts submitted and representations made, the IRS concluded that Y's S corporation election terminated on Date 3 when the provisions of its Operating Agreement effectively created more than one class of stock. IRS also concluded that the circumstances resulting in the termination of Y's S corporation election were inadvertent within the meaning of section 1362(f) and, therefore, that Y and its successor, X, would be treated as an S corporation effective as of Date 3, provided that Y and its successor, X's S corporation election was otherwise valid and not otherwise terminated under section 1362(d).

CC. PLR 201918012 – Extension of Time to Make a Late Entity Classification election under Reg. § 301.9100-3 (5/3/2019)

X was formed in State as a limited liability company on Date 1. At the time of its formation, more than one individual owned interests in X. X’s default status was as a partnership for federal tax purposes. X intended to elect to be treated as an association taxable as a corporation and to elect be treated an S corporation for federal tax purposes, with both elections effective as of Date 2.

X inadvertently failed to properly and timely file both Form 8832 (Entity Classification Election) and Form 2553 (Election by a Small Business Corporation). X requested that the IRS provide X with an extension of time under Reg. § 301.9100-3 to make a late entity classification election to be treated as an association taxable as a corporation for federal tax purposes effective as of Date 2. X also requested relief to make a late S corporation election under section 1362(b)(5) effective Date 2. X represented that it acted reasonably and in good faith, that granting relief would not prejudice the interests of the government, and that it was not using hindsight in making the election.

Based solely on the facts submitted and representations made, the IRS concluded that X satisfied the requirements of Reg. §§ 301.9100-1 and 301.9100-3. As a result, the IRS granted X an extension of time of 120 days from the date of this PLR to file a Form 8832 (along with a copy of this PLR) with the appropriate service center electing to be treated as an association taxable as a corporation for federal tax purposes, effective as of Date 2.
In addition, based solely on the facts submitted and representations made, the IRS concluded that X established reasonable cause for failing to make a timely election to be an S corporation effective as of Date 2. Accordingly, provided that X made an election to be an S corporation by filing a completed Form 2553 effective Date 2 (along with a copy of this PLR), with the appropriate service center within 120 days from the date of this PLR, then such election would be treated as timely made as of Date 2.

DD. PLR 201918013 – Impact of Equity Compensation Plan Re-Purchase Terms on One Class of Stock Requirement (5/3/2019)

X was incorporated under the laws of State on Date 1, and elected to be treated as an S corporation effective Date 2. X has one class of voting common stock outstanding. Under an agreement entered into by X and its shareholders (the “Agreement”), shares generally may not be transferred without the prior written consent of the Chairman of X’s Board of Directors.

X adopted an equity compensation plan (the “Plan”), which authorized X to sell shares of X’s stock to key employees of X, or to grant shares or options to purchase shares to such employees. Shares acquired under the Plan are subject to the same transfer restrictions set forth in the Agreement. In addition, shares held by employees may be repurchased under certain circumstances by X (generally, upon termination of employment) at either the “non-forfeiture repurchase price” (which equals the fair market value of the shares), or the “forfeiture repurchase price” (which is the lesser of: (i) the fair market value of the shares or (ii) the price paid, if any, to acquire the shares). Depending on the circumstances, the forfeiture repurchase price could be as low as zero. The repurchase price of the shares would only be the forfeiture repurchase price if the employee engaged in activity meeting the definition of “cause” in the Plan, which generally only includes theft or fraud by the employee that materially harms X.

Some of X’s employees requested (i) permission to transfer their shares of X to a trust for the benefit of themselves and/or their family members, or (ii) that the shares of X that would otherwise be issued to them pursuant to the Plan instead be issued to such a trust. Additionally, X represented it would confirm that any trusts to which shares were transferred were eligible S corporation shareholders. Shares held in such trusts would be subject to the same restrictions under the Agreement and the Plan as shares directly held by employees. X represented that the Agreement and the Plan were not created as a plan to circumvent the one class of stock requirement for S corporations.

Based solely on the facts submitted and representations made, the IRS concluded that the transfer restrictions and repurchase provisions in the Agreement and the Plan would be disregarded in determining whether X’s shares of stock confer identical rights.
III. Guidance


Notice 2019-07 contains a proposed revenue procedure that provides for a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for purposes of section 199A and Treas. Reg. §§ 1.199A-1 through 1.199A-6. To qualify for treatment as a trade or business under the safe harbor, the rental real estate enterprise must satisfy the following three requirements during the taxable year. First, separate books and records are maintained to reflect income and expenses for each rental real estate enterprise. Second, for taxable years beginning prior to January 1, 2023, two hundred fifty (250) or more hours of “rental services” are performed per year with respect to the rental enterprise. For taxable years beginning after December 31, 2022, in any three of the five consecutive taxable years that end with the taxable year (or in each year for an enterprise held for less than five years), two hundred fifty (250) or more hours of “rental services” are performed per year with respect to the rental real estate enterprise. “Rental services” are defined to include (i) advertising to rent or lease the real estate; (ii) negotiating and executing leases; (iii) verifying information contained in prospective tenant applications; (iv) collection of rent; (v) daily operation, maintenance, and repair of the property; (vi) management of the real estate; (vii) purchase of materials; and (viii) supervision of employees and independent contractors. Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners. The term rental services does not include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; planning, managing, or constructing long-term capital improvements; or hours spent traveling to and from the real estate. Third, the taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. Such records are to be made available for inspection at the request of the IRS. The contemporaneous records requirement will not apply to taxable years beginning prior to January 1, 2019.

If an enterprise fails to satisfy these requirements, the rental real estate enterprise may still be treated as a trade or business for purposes of section 199A if the enterprise meets the definition of a trade or business in Treas. Reg. § 1.199A-1(b)(14).

In order for the safe harbor to apply, a taxpayer or RPE must include a statement attached to the return on which it claims the section 199A deduction or passes through section 199A information that the three requirements above have been satisfied. The statement must be signed by the taxpayer, or an authorized representative of an eligible taxpayer or RPE, which states: “Under penalties of perjury, I (we) declare that I (we) have examined the statement, and, to the best of my (our) knowledge and belief, the statement contains all the relevant facts relating to the revenue procedure, and such facts are true, correct, and complete.” The individual or individuals who sign must have personal knowledge of the facts and circumstances related to the statement.

Rev. Proc. 2019-11, which applies to taxable years ending after December 31, 2017, requires that a taxpayer calculate W-2 wages for purposes of section 199A(b)(2) using one of three prescribed methods: the “unmodified box method,” the “modified box 1 method,” or the “tracking wages method.”

Under the unmodified box method, W-2 wages are calculated by taking, without modification, the lesser of (i) the total entries in Box 1 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer; or (ii) the total entries in Box 5 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer.

Under the modified box 1 method, the taxpayer makes modifications to the total entries in Box 1 of Forms W-2 filed with respect to employees of the taxpayer. W-2 wages under this method are calculated as follows: (i) total the amounts in Box 1 of all Forms W-2 filed with SSA by the taxpayer for employment by the taxpayer; (ii) subtract from this total amounts included in Box 1 of Forms W-2 that are not wages for federal income tax withholding purposes, including amounts that are treated as wages for purposes of income tax withholding under section 3402(o) (for example, supplemental unemployment compensation benefits within the meaning of Rev. Rul. 90-72); and (iii) add to this amount obtained the total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.

Under the tracking wages method, the taxpayer actually tracks total wages subject to federal income tax withholding and makes appropriate modifications. W-2 wages under this method are calculated as follows: (i) total the amounts of wages subject to federal income tax withholding that are paid to employees of the taxpayer for employment by the taxpayer and that are reported on Forms W-2 filed with SSA by the taxpayer for the calendar year; plus (ii) the total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.

C. CCA 201912001 (4/12/2019)

An individual owned 100% of an S corporation, which employed the individual’s family member. The family member was considered to be a 2-percent shareholder pursuant to the attribution of ownership rules under section 318. The S corporation provided a group health plan for all employees, and the amounts paid by the S corporation under such group health plan were included in the family member’s gross income.

The issue was whether the family member was entitled to a deduction under section 162(l) for the amounts paid by the S corporation under the group health plan. A 2-percent shareholder-employee in an S corporation, who otherwise meets the requirements of section 162(l), is eligible for the deduction under section 162(l) if the plan providing
medical care coverage for the 2-percent shareholder-employee is established by the S corporation. A plan providing medical care coverage for the 2-percent shareholder-employee in an S corporation is established by the S corporation if: (1) the S corporation makes the premium payments for the accident and health insurance policy covering the 2-percent shareholder-employee (and his or her spouse or dependents, if applicable) in the current taxable year; or (2) the 2-percent shareholder makes the premium payments and furnishes proof of premium payment to the S corporation and then the S corporation reimburses the 2-percent shareholder-employee for the premium payments in the current taxable year. If the accident and health insurance premiums are not paid or reimbursed by the S corporation and included in the 2-percent shareholder-employee’s gross income, a plan providing medical care coverage for the 2-percent shareholder-employee is not established by the S corporation and the 2-percent shareholder-employee in an S corporation is not allowed the deduction under section 162(l).

In order for the 2-percent shareholder-employee to deduct the amount of the accident and health insurance premiums, the S corporation must report the accident and health insurance premiums paid or reimbursed as wages on the 2-percent shareholder-employee’s Form W-2 in that same year. In addition, the shareholder must report the premium payments or reimbursements from the S corporation as gross income on his or her Form 1040.

Accordingly, an individual who is a 2-percent shareholder of an S corporation pursuant to the attribution of ownership rules under section 318 is entitled to the deduction under section 162(l) for amounts that are paid by the S corporation under a group health plan for all employees and included in the individual’s gross income, if the individual otherwise meets the requirements of section 162(l).

IV. Final and Proposed Regulations


The IRS released final regulations concerning the deduction for qualified business income (“QBI”) under section 199A, as well as an anti-avoidance rule under section 643 to treat multiple trusts as a single trust in certain cases. Taxpayers may rely on the final regulations, in their entirety, or the proposed regulations issued on August 16, 2018, in their entirety, for taxable years ending in calendar year 2018.

The final regulations adopt the proposed regulations, with numerous modifications. Like the proposed regulations, the final regulations contain six substantive sections. Treas. Reg. § 1.199A-1 provides operational rules for calculating the section 199A deduction. Treas. Reg. § 1.199A-2 provides rules regarding the determination of W-2 wages and unadjusted basis immediately after acquisition (“UBIA”) of qualified property. Treas. Reg. § 1.199A-3 provides additional guidance on the determination of QBI, qualified REIT dividends and qualified publicly traded partnership income. Treas. Reg. § 1.199A-4 provides rules to allow individuals and relevant passthrough entities (each an “RPE”) to
aggregate trades or businesses, thereby treated the aggregate as a single trade or business. Treas. Reg. § 1.199A-5 addresses specified service trades or businesses (each an “SSTB”) and trades or businesses with SSTB income. Treas. Reg. § 1.199A-6 provides guidance that certain specified entities (including RPEs, publicly traded partnerships, trusts and estates) may need to follow for purposes of computing the entities’ or their owners’ section 199A deductions.

In conjunction with the release of the final regulations, the IRS also released (i) Notice 2019-07, which provides notice of a proposed revenue procedure detailing a proposed safe harbor under which a rental real estate enterprise may be treated as a trade or business solely for purposes of section 199A; as well as (ii) Rev. Proc. 2019-11, which provides additional guidance on the definition of W-2 wages, including amounts treated as elective deferrals.


The IRS released final regulations relating to application of the transition tax rules under section 965. Section 965 was enacted as a mechanism to prevent US taxpayers from escaping taxation on income that is earned, but not distributed, by a foreign corporation. By imposing a “transition tax” on the untaxed foreign earnings of US shareholders that essentially taxes undistributed earnings as if they were repatriated to the US, section 965 reduces the potential benefit a US shareholder may realize by shifting their investment to a foreign corporation.

Section 965(a) provides that, for the last tax year of a deferred foreign income corporation (“DFIC”) that begins before Jan. 1, 2018, the subpart F income of the corporation (as otherwise determined for such tax year under section 952) is increased by any previously untaxed, non-effectively connected post-1986 earnings and profits (E&P) of the corporation measured as of one of two measuring dates (November 2, 2017 or December 31, 2017). Additionally, section 965(b) requires US shareholders of deferred foreign income corporation (defined by section 965(d)(1) as “any specified foreign corporation of such US shareholder which has accumulated post-1986 deferred foreign income (as of the date referred to in paragraph (1) or (2) of subsection (a)) greater than zero”) and at least one E&P deficit foreign corporation (defined by section 965(b)(3)(B) as “with respect to any taxpayer, any specified foreign corporation with respect to which such taxpayer is a United States shareholder, if, as of November 2, 2017—(i) such specified foreign corporation has a deficit in post-1986 earnings and profits, (ii) such corporation was a specified foreign corporation, and (iii) such taxpayer was a United States shareholder of such corporation”), the amount which would (but for this subsection) be taken into account under section 951(a)(1) by reason of subsection (a) as such United States shareholder’s pro rata share of the subpart F income of each deferred foreign income corporation shall be reduced by the amount of such United States shareholder’s aggregate foreign E&P deficit which is allocated under paragraph (2) to such deferred foreign income corporation.
Section 965(i)(1) states that, “in the case of any S corporation which is a United States shareholder of a deferred foreign income corporation, each shareholder of such S corporation may elect to defer payment of such shareholder's net tax liability under this section with respect to such S corporation until the shareholder's taxable year which includes the triggering event with respect to such liability. Any net tax liability payment of which is deferred under the preceding sentence shall be assessed on the return of tax as an addition to tax in the shareholder's taxable year which includes such triggering event.” Section 965(i)(2)(B) clarifies that, in the case of a transfer of less than all of the taxpayer's shares of stock in the S corporation, “such transfer shall only be a triggering event with respect to so much of the taxpayer's net tax liability under this section with respect to such S corporation as is properly allocable to such stock.”

Treas. Reg. § 1.965-7(c)(3)(i) states that “each shareholder of an S corporation (including a person listed in Reg. § 1.1362-6(b)(2) with respect to a trust or estate, but not a domestic pass-through entity itself) that is a United States shareholder of a deferred foreign income corporation may elect under Code § 965(i) and this paragraph (c) to defer the payment of the shareholder's section 965(i) net tax liability with respect to the S corporation until the shareholder's taxable year that includes a triggering event described in paragraph (c)(3) of this section.” However, Treas. Reg. § 1.965-7(c)(3)(iv) provides an exception to the tax recognition requirements for certain “eligible transfers.” In order to prevent recognition of tax upon an event that would otherwise qualify as a “triggering event,” the eligible S Corporation shareholder and their transferee must satisfy certain requirements, including the requirement that they enter into a transfer agreement meeting the requirements of Reg. § 1.965-7(c)(3)(iv)(B). Newly-enacted Reg. § 1.965-7(c)(3)(iv)(B) clarifies that, in the case of multiple partial transfers of S corporation stock by the same shareholder, the selling shareholder may enter into a separate transfer agreement with each eligible transferee.


Prior to the enactment of Public Law 115–97 (the “Tax Cuts and Jobs Act,” or “TCJA”), a change in the immigration status of an electing small business trust’s (“ESBT’s”) potential current beneficiary (“PCB”) from resident alien to nonresident alien (“NRA”) would terminate the ESBT’s election. Furthermore, this change in immigration status and the resulting failure of the trust to qualify as an ESBT under section 1361(c)(2)(B)(v) would terminate the S corporation of which the ESBT is a shareholder. TJCA § 13541(a) amended section 1361(c)(2)(B)(v) to provide that the rule treating each PCB of an ESBT as a shareholder does not apply for purposes of the eligible-shareholder requirement of section 1361(b)(1)(C). As a result of this amendment, a change in the residency classification of an ESBT’s PCB from resident alien to NRA will not prevent the S corporation of which the ESBT is a shareholder from meeting the requirements of section 1361(b)(1)(C).

On April 19, 2019, the IRS published proposed regulations implementing the change created by TJCA § 13541(a). These new proposed regulations modify the allocation rules
under Reg. § 1.641(c)–1 to require that income of an ESBT that would otherwise have been allocated to a nonresident alien deemed owner under the grantor trust rules be reallocated from the grantor portion of the ESBT to the S portion of the ESBT. Additionally, the proposed regulations also updated section 1361(c)(2)(B)(v) and Reg. § 1.1361–1(m) to make conforming revisions regarding the ability of nonresident aliens to be permissible current beneficiaries of ESBTs.

Without these proposed regulations, TCJA’s expansion of an ESBT’s permissible PCBs to include an NRA could create situations in which income attributed to the grantor portion of an ESBT could escape federal income taxation (a result which is inconsistent with the congressional intent behind enactment of TJCA § 13541(a)). For example, if an NRA were the deemed owner of a grantor trust that elected to be an ESBT, and thus was to be allocated foreign source income of the S corporation or income not effectively connected with the conduct of a U.S. trade or business under section 864(c)(4)(B), that NRA would not be required to include such S corporation items in income under section 671 because the NRA would not be liable for federal income tax on such income under section § 871(a) or (b). Alternatively, if an NRA is a resident of a country with which the United States has an income tax treaty, U.S. source income of the S corporation also might be exempt from tax or subject to a lower rate of federal income tax in the hands of that NRA.

V. Other

[N/A]

VI. Acts / Legislative Developments

A. [N/A]