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S Corporation Committee

Important Developments in the Federal
Income Taxation of S Corporations

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Current Developments in the Federal Income Taxation of S Corporations

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I. Cases


Taxpayer and his spouse were the sole shareholders of an S corporation. The S corporation provided the taxpayer with a life insurance policy and paid the $100,000 annual premium in 2005. The corporation deducted the premium, and the taxpayer and his spouse did not include in income the economic benefits flowing from the increase in value of the life insurance value.

The Tax Court ruled that the premium is non-deductible, and such non-deductibility was not disputed before the 6th Circuit. Further, the parties conceded that the insurance policy is a compensatory split-dollar arrangement, not a shareholder arrangement. The taxpayer argues, however, that Treas. Reg. § 1.301-1(q)(1)(i) provides that economic benefits flowing from any type of split-dollar arrangement provided by a corporation to its shareholder are treated as a distribution of property. While the Commissioner argued that such interpretation would defeat the reason for distinguishing between a compensatory split-dollar arrangement and a shareholder split-dollar arrangement, the 6th Circuit noted that there are other reasons for such distinction. The court ruled that the regulation cited is dispositive and renders it irrelevant whether the taxpayer received the economic benefits from the insurance policy as a compensatory or shareholder arrangement and remanded for further proceedings consistent with treating the economic benefits as distributions of property from a corporation to its shareholder.


Husband and wife (Mr. and Ms. Smith) were the sole shareholders of Smith Solutions, Inc. (“Smith Solutions”), an S corporation. The issue was whether Mr. and Ms. Smith were required to include in income the amount of “total income” that Smith Solutions reported in each of its 2011 Form 1120S, 2012 Form 1120S, and 2013 Form 1120S, as well as a certain additional amount of income that the IRS determined for each of those years. In order to resolve that issue, the Tax Court had to decide whether the respective personal services that Mr. Smith and Ms. Smith performed for certain persons during 2011, 2012, and 2013 were performed in their respective individual capacities or as employees or other agents of Smith Solutions.

Where a corporation relies on the personal services of an employee to produce income, the question arises whether the corporation is actually conducting the business or whether the employee is conducting the business in his or her individual capacity. The relevant test is who controls the earning of the income. See, e.g., Haag v. Commissioner, 88 T.C. 604, 611 (1987). In resolving this issue, the Tax Court analyzed (1) the relationship between Smith Solutions and Mr. and Ms. Smith, in order to ascertain whether each of those relationships enabled Smith Solutions to exercise control over the provision to certain persons of certain personal services by each of them and over the receipt of the payments for those respective services; (2) the employment contract resolution that the board adopted; (3) the lack of compensation paid by Smith Solutions to Mr. and Ms. Smith for
the performance of their respective personal services; and (4) the lack of a contractual relationship between Smith Solutions and the persons using the respective personal services of Mr. Smith and Ms. Smith. Based on its analysis, the Tax Court held that Mr. Smith and Ms. Smith failed to carry their burden of establishing that they did not earn the income that Smith Solutions reported as “total income” in each of its 2011 Form 1120S, 2012 Form 1120S, and 2013 Form 1120S.

C. Christopher Schorse, et al. v. Commissioner, T.C. Memo 2018-176 (October 22, 2018)

During Petitioner filed for joint spouse relief for certain understatement penalties by claiming that he and his spouse kept finances separate and petitioner did not review his spouse’s information prior to signing the joint tax return. In determining that the petitioner had sufficient knowledge that innocent spouse relief would not be appropriate, the Tax Court considered that petitioner was the sole owner of an S corporation and would have “at least a cursory understanding of the appropriate tax treatment of profits and losses.”


Petitioner filed tax returns with both individual deficiencies and a deficiency with respect to a 90%-owned S corporation. Petitioner’s S corporation, Carrelton Asset Management, Inc., was a hedge fund management company that managed a hedge fund with 79 investors. Petitioner claims to have paid certain expenses on behalf of Carrelton that increased his basis and allowed him to claim pass-through losses and deductions. Such expenses were charged to a credit card that Petitioner and his wife shared for personal and business expenses, and Petitioner created a spreadsheet of the expenses several years after the expenses were incurred. The Tax Court disallowed the deductions because Petitioner showed only that the expenses were incurred, not that they were incurred on behalf of Carrelton or that he was not reimbursed for such expenses. Thus, Petitioner was not eligible for the pass-through losses and deductions, and a notice of deficiency was upheld.


The Tax Court denied the Commissioner’s motion for summary judgment regarding whether a taxpayer can use the deferral method related to a $15 million advance payment received from a customer in 2008. The Commissioner argued that the use of the deferral method would constitute an impermissible change in accounting method. The taxpayer was a C corporation through 2008 but elected to be an S corporation effective January 1, 2009; it uses the accrual method of accounting and a calendar year tax year. Taxpayer engages in software development, principally to the healthcare industry. Taxpayer’s returns from prior years indicate that Taxpayer had unearned revenue related to advance payments. However, Taxpayer treated the $15 million advance payment differently from prior advance payments because such payment was potentially refundable. During Taxpayer’s first year as an S corporation, Taxpayer determined the risk refund would be required had passed and treated as an advance payment in 2009 that was earned in 2010. Taxpayer later attempted to amend its 2009 tax returns to treat the $15 million as earned in 2009. The Tax Court found that Taxpayer had previously elected to use the deferral method
of accounting, but the Commissioner claimed that the treatment of the $15 million payment indicated use of the deposit method of accounting. The Tax Court ruled that there were questions of material fact related to whether the treatment of the $15 million constituted a method of accounting or whether the change in treatment resulted from a change in the underlying facts. Thus, summary judgment was not appropriate.

F.  


The taxpayer, Boulas, owned a painting business that was organized as an S corporation, but received payment for services from certain customers as an individual rather than through the entity and paid employees outside of the entity without proper withholding. Boulas was indicted for endeavoring to obstruct the IRS, aiding and assisting in the preparation and presentation of false corporate, individual, and employment tax returns, tax evasion, and structuring to evade currency transaction reports. Boulas argued that he couldn’t aid the preparation of false corporate tax returns because his business was organized as an S corporation and therefore does not have an identity separate from Boulas. The court rejected the argument, but did not assert that an S corporation does have an identity separate from its shareholder(s).

G.  


Individual taxpayers operated a medical marijuana dispensary through two entities: a C corporation and an S corporation. Each person claimed deductions for business expenses related to the marijuana business. The court held that Section 280E prohibited such deductions despite the taxpayer’s argument that the S corporation is a management company. Section 280E was applied to the facts presented to prevent the deduction at the corporate level, and therefore to prevent any passthrough deduction.

H.  


Lydia Ramirez (“Taxpayer”) owned and operated several businesses, primarily through S corporations. Taxpayer also owned many rental properties. The businesses mostly made money, while the rental properties mostly lost it. On her 2008 and 2009 tax returns, Taxpayer reported that her businesses produced passive income, which she offset with her rental properties’ passive losses. After an audit, the Commissioner reclassified most of Taxpayer’s business income as active. Taxpayer’s estate did not challenge this reclassification, but sought to change the classification of the rental losses to be active as well. However, Taxpayer owned several properties and, to make the reclassification work, her estate would have to show she was a “real estate professional” and aggregate the time that she put into them.

Sections 162(a) and 212(1) allow taxpayers to deduct most of their business and investment expenses, but section 469 limits those deductions when they arise from “passive activities.” Section 469(c)(1) defines a passive activity as any activity which involves the conduct of any trade or business, and in which the taxpayer does not
materially participate. Real estate rental activities (such as Taxpayer’s rental activities in 2008 and 2009) are \textit{per se} passive unless a taxpayer can prove he or she is a “real estate professional.” Pursuant to section 469(c)(7), a taxpayer qualifies as a real estate professional for a given taxable year if (1) more than half of the personal services such taxpayer performed in such taxable year were performed in real property trades or businesses in which he or she materially participated; and (2) such taxpayer performed more than 750 hours of services during such taxable year in real property trades or businesses in which he or she materially participated. Thus, in order to qualify as a real estate professional, a taxpayer must (1) materially participate in rental activities; (2) perform more than half of his or her personal services in them; and (3) spend more than 750 hours doing so.

Section 469(h)(1) states that material participation means being involved in the operations of the activity on a regular, continuous, and substantial basis. The regulations further refine this definition by setting forth seven ways a taxpayer may materially participate in an activity. Of these seven, the Tax Court identified the following as those that the record potentially supported as having occurred: (1) the individual participates in the activity for more than 500 hours during such year; (2) the individual’s participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year; (3) the individual participates in the activity for more than 100 hours during the taxable year, and such individual’s participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year; and (4) based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during such year.

While the regulations provide the time an individual spends participating in an activity may be established by any reasonable means, the Tax Court has continuously held that a retrospective “ballpark guestimate” is not sufficient. \textit{See, e.g., Moss v. Commissioner}, 135 T.C. 365, 369 (2010). Because the estate offered no documentary evidence to prove the amount of time Taxpayer spent on her rental activities, and instead put forth only uncorroborated testimony of Taxpayer’s daughter and her “guesstimates” of that time, the Tax Court found that the estate failed to prove the number of hours Taxpayer devoted to her real property trade or business and, thus, did not met any of the material participation tests that rely on 100 or 500 hour minimums. Further, the Tax Court could not find that Taxpayer’s participation in her real property trade or business constituted substantially all of the participation in such activity of all individuals in 2008 or 2009. Therefore, the Tax Court held that Taxpayer did not satisfy that test for material participation either. Accordingly, because Taxpayer did not meet any of the material participation tests for her real property trade or business in 2008 or 2009, she was not a “real estate professional” in either of those years and her rental activities were passive.

The Tax Court also addressed the Taxpayer’s failure to aggregate her rental activities. Even if the Tax Court found that Taxpayer was a real estate professional, Taxpayer did not elect under section 469(c)(7)(A) to treat all of her rental properties as a single activity.
on her original return for 2008 or 2009, or any previous year. When a taxpayer who owns more than one rental property doesn’t make this “aggregation election,” the default rule is to treat each rental property as a separate activity.

The aggregation election is a formal requirement, and the Tax Court does not allow taxpayers to aggregate their activities spread among multiple rental properties unless it is met. See Trask v. Commissioner, T.C. Memo. 2010-78 (no aggregation where taxpayer treated all rental properties as single activity on original returns but stated intent to elect only during audit). Taxpayer not only failed to make the formal election on her original return, but also failed to treat her rental properties as a single activity, and even reported all of them as passive activities. Accordingly, there was only one escape hatch available to Taxpayer’s estate – a late aggregation election.

There are two ways in which a taxpayer may make a late aggregation election. One is to ask the IRS for a letter ruling under Treas. Reg. § 301.9100-3. In order for relief to be granted under Treas. Reg. § 301.9100-3, Taxpayer would have had to follow the applicable procedures for requests for a letter ruling, as well as pay the applicable user fee. Taxpayer did neither. Alternatively, Taxpayer could have made a late aggregation election under Rev. Proc. 2011-34. That revenue procedure requires a taxpayer to file an amended return and attach to it an aggregation election statement that includes four specific representations necessary to qualify for relief. Those representations require that a taxpayer be able to show that he or she (1) failed to make an election under Treas. Reg. §1.469-9(g) solely because he or she failed to timely meet the requirements in Treas. Reg. § 1.469-9(g); (2) filed consistently with having made an election under Treas. Reg. § 1.469-9(g) on any return that would have been affected if he or she had timely made the election; (3) timely filed each return that would have been affected by the election if it had been timely made; and (4) has reasonable cause for his or her failure to meet the requirements in Treas. Reg. § 1.469-9(g).

The Tax Court found that the estate could not (and did not) meet the first, second or fourth requirements of Rev. Proc. 2011-34. Accordingly, the estate did not satisfy the conditions for late election under the revenue procedure, meaning the Tax Court would not grant that relief even if it thought it could. Without aggregation, the estate could not satisfy the material participation requirement for any of its properties. Thus, even if Taxpayer was a real estate professional in 2008 and 2009, and even if she had sufficient evidence to establish the hours that she spent on her rental activities, the Tax Court would have to find that Taxpayer’s rental activities were passive in 2008 and 2009.
II. Private Letter Rulings

A. PLR 201840004 – Inadvertent terminations – Ineffective elections – Creation of more than one class of stock (10/5/2018)

X was formed under the laws of State 1 on Date 1 as a limited liability company, and elected to be classified as an association taxable as a corporation and also elected to be an S corporation effective on Date 2. At the time of formation, the members of X adopted an operating agreement that included a provision providing for an order of priority for distributing the assets of X upon liquidation (the “Liquidation Provision”). The Liquidation Provision provided for the distribution of liquidation proceeds in accordance with capital accounts, whereby distributions made by X potentially would not be made to the shareholders of X in accordance with their respective ownership percentages. As a result, the outstanding shares of stock of X did not possess identical rights to distribution and liquidation proceeds. Accordingly, X represented that X did not meet the requirement that it have one class of stock under section 1361(b)(1)(D) on the effective date of its S election on Date 2.

Further, X was initially formed with the intention that X would be treated as a partnership for federal tax purposes and, therefore, the Liquidation Provision did not present any tax issues at that time. On Date 3, the shareholders of X adopted an amended operating agreement whereby X admitted new shareholders and changed from a member-managed limited liability company to a manager-managed limited liability company. The amended operating agreement also contained the Liquidation Provision. On Date 4, the shareholders of X adopted a second amended operating agreement whereby X admitted new shareholders, among other things. Although the distribution of proceeds upon the liquidation of X was slightly modified in the second amended operating agreement, the agreement still contained the Liquidation Provision. On Date 5, X filed Articles of Conversion whereby X converted from a State 1 limited liability company to a State 2 limited liability company. The Plan of Conversion provided that all ownership interests in X would remain the same as those prior to the conversion.

When X’s owners became aware of the second class of stock issue in Year, they sought tax counsel to assist with amending X’s operating agreement to modify the Liquidation Provision to provide that, upon liquidation of X, distributions be made in accordance with the ownership percentages in X, not capital accounts.

X represented that X and X’s shareholders have filed tax returns consistent with X being an S corporation since Date 2. X further represented that the circumstances resulting in the ineffectiveness of X’s S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning. X and each person who was or is a shareholder of X at any time since Date 2 agreed to make any adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary with respect to such period. X further represented X has taken all of the necessary corrective
steps to rectify the ineffectiveness of X’s S corporation election. Specifically, X represented that X has amended its operating agreement to remove all provisions that could create a second class of stock.

The IRS ruled that based on the facts submitted and the representations made, X’s S corporation election was ineffective on Date 2 as a result of the second class of stock due to the Liquidation Provision contained in X’s operating agreement. However, the IRS concluded that this ineffectiveness 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 beginning on Date 2 and continuing thereafter, unless X’s S corporation election otherwise terminated under section 1362(d) for other reasons.

B. PLR 201840008 - Entity classifications – Election to be treated as partnership –Limitations – Consent – Extensions (10/5/2018)

On Date 1, X was formed as a limited liability company under the laws of State. At the time of formation, X had a single owner and was treated as a disregarded entity for federal tax purposes. On Date 2, X elected to be an S corporation effective Date 2. Under Treas. Reg. § 301.7701-3(c)(1)(v)(C), X was also treated as having made an election to be classified as an association taxable as a corporation effective Date 3. On Date 4, new owners acquired interests in X. X represented that as of Date 4, X had a change of ownership of more than fifty percent that would satisfy Treas. Reg. § 301.7701-3(c)(1)(iv).

Based on the information submitted and the representations made, the IRS consented to X changing its classification for federal tax purposes less than 60 months after its previous classification change. As a result, X was granted an extension of time of 120 days from the date of the letter to file Form 8832 with the appropriate service center to elect to be classified as a partnership for federal tax purposes effective Date 5.

C. PLR 201842002 - Gain or loss recognized on property distributed in complete liquidation – Qualified stock dispositions – Asset dispositions – Elections – Extensions (10/19/2018)

On Date 1, pursuant to Securities Agreement, Purchaser, a disregarded entity for federal income tax purposes whose regarded owner was Regarded Owner, acquired all of the stock of S Corporation, a State A corporation, from Shareholders (the “Disposition”). The Disposition qualified as a “qualified stock disposition” as defined in Treas. Reg. § 1.336-1(b)(6). On Date 2, S Corporation converted to LLC under the laws of State A. LLC was a disregarded entity for federal income tax purposes, whose sole owner, for federal income tax purposes, was Regarded Owner.

The Securities Agreement provided that a section 336(e) election would be made with respect to the Disposition. However, S Corporation was not a party to the Agreement nor was the Election Statement timely filed and, consequently, a timely section 336(e) election was not made. The request was submitted, under Treas. Reg. § 301.9100-3, for an extension of time to enter into the Agreement and file the Election Statement. Regarded Owner, S Corporation (by LLC) and Shareholders 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.

The IRS ruled that, based on the facts and information submitted, including the representations made, the taxpayers 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 until 45 days from the date on the letter to enter into the Agreement and file the Election Statement.

D. PLRs 201845003, 201845004, 201845005 – (November 9, 2018)

X elected to be treated as an S corporation effective as of its incorporation date, Date 1. On Date 2, shares of X were transferred to three trusts that were eligible to elect to be treated as Electing Small Business Trusts, but no ESBT election was made. The trusts have filed tax returns consistent with being treated as ESBTs, and the parties represent that the failure to file the elections was inadvertent. The IRS determined that X’s S election terminated on Date 2 as a result of the transfer of stock to the trusts, but such failure was inadvertent, so X will be treated as continuing to be an S corporation from Date 2 and thereafter to the extent the trusts each file an ESBT election within 120 days of the letter, to be effective as of Date 2.

E. PLR 201845008 (November 9, 2018)

X elected to be treated as an S corporation effective as of its incorporation date, Date 1. On Date 2, shares of X were transferred to three trusts that were eligible to elect to be treated as Electing Small Business Trusts, but no ESBT election was made. The trusts have filed tax returns consistent with being treated as ESBTs, and the parties represent that the failure to file the elections was inadvertent. The IRS determined that X’s S election terminated on Date 2 as a result of the transfer of stock to the trusts, but such failure was inadvertent, so X will be treated as continuing to be an S corporation from Date 2 and thereafter to the extent the trusts each file an ESBT election within 120 days of the letter, to be effective as of Date 2.

F. PLR 201845011 (November 9, 2018)

X elected to be an S corporation as of Date 1. On Date 2, X converted its outstanding stock to two classes of stock, terminating its S corporation election. On Date 3, X’s sole shareholder transferred all of the second class of stock to X’s ESOP but did not make a § 1042 election. On Date 4, X redeemed and cancelled all of the non-ESOP shareholder’s stock and only had one class of stock remaining outstanding. X requested permission to reelect to be an S corporation effective Date 5, prior to the end of the 5-year waiting period imposed. The IRS granted such permission, conditioned on the non-ESOP shareholder not making an election under §1042 related to the sale of stock to the ESOP.
G. PLR 201845013 (November 9, 2018)

X was incorporated under state law and intended to be treated as an S corporation, but failed to timely file the proper election. The IRS granted an extension of 120 days from the date of the letter to file the S corporation election for such election to be effective as of X’s formation.

H. PLR 201845021 (November 9, 2018)

X was incorporated under state law and intended to be treated as an S corporation, but failed to timely file the proper election. The IRS granted an extension of 120 days from the date of the letter to file the S corporation election for such election to be effective as of X’s formation.

I. PLR 201845026 (November 9, 2018)

X was incorporated under state law as of Date 1 and intended to be treated as an S corporation effective Date 2, but failed to timely file the proper election. Since Date 2, X has filed tax returns consistently with being treated as an S corporation. The IRS granted an extension of 120 days from the date of the letter to file the S corporation election for such election to be effective as of Date 2.

J. PLR 201845028 (November 9, 2018)

X was incorporated under state law and intended to be treated as an S corporation, but failed to timely file the proper election. X has filed tax returns consistent with S corporation treatment. The IRS granted an extension of 120 days from the date of the letter to file the S corporation election for such election to be effective as of X’s formation.

K. PLRs 201849005 and 201849006 (December 7, 2018)

On Date 1, X, an S corporation, acquired all of the stock of Y, a state law corporation, but failed to timely file an election for Y to be treated as a Qualified Subchapter S Subsidiary. Such QSub election was intended to be effective Date 1 but inadvertently stated Date 3. On Date 2, Trust acquired all of the stock of Y. On Date 2, Y filed an S corporation election that was intended to be effective Date 4 but inadvertently stated Date 1. The taxpayers represent that the failures were inadvertent. The IRS granted 60 day extensions from the date of the letter to file the appropriate elections to be effective as of the intended dates.

L. PLR 201846001 – Inadvertent terminations – Failure to file QSST election for trusts (11/16/2018)

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 transferred shares in X from Trust 1 to Trust 2. Trust 1 was a grantor trust as to A, an eligible shareholder of X under section 1361(c)(2)(A)(i). On Date 4, A transferred shares in X from Trust 1 to Trust 3. The beneficiaries of Trust 1 and Trust 3 failed to make timely qualified subchapter S trust (“QSST”) elections. Thus, X’s S corporation election terminated on Date 5.
X represented that Trust 2 and Trust 3 qualified as QSSTs under section 1361(d) as of Date 5 and thereafter. X further represented that the circumstances resulting in the failure to file a QSST election for Trust 2 and Trust 3 were inadvertent and were not motivated by tax avoidance or retroactive tax planning. 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 the representations made, X’s S corporation election terminated on Date 5 as a result of the failure to make a timely QSST election for Trust 2 and Trust 3. The IRS also ruled that the termination of X’s S election on Date 5 was inadvertent within the meaning of section 1362(f). Pursuant to the provisions of section 1362(f), X was treated as continuing to be an S corporation as of Date 2 and thereafter, provided that (1) the beneficiaries of Trust 2 and Trust 3 filed QSST elections for Trust 2 and Trust 3 with an effective date of Date 3 and Date 4, respectively, with the appropriate service center within 120 days from the date of the letter, and (2) X’s S corporation election was not otherwise terminated under section 1362(d).

M. PLR 201846002 – Inadvertent terminations – Failure to file ESBT election for trusts (11/16/2018)

X was formed under the laws of State on Date 1 and elected to be an S corporation effective Date 2. On Date 3, Trust purchased X stock. X represented that Trust was eligible to be an electing small business trust (“ESBT”) within the meaning of section 1361(e) on Date 3, but the trustee did not timely file an ESBT election. Therefore, because Trust was not a permitted shareholder, X’s S corporation election terminated on Date 3.

X represented that the termination of its S corporation election was not motivated by tax avoidance or retroactive tax planning. X further represented that X and its shareholders have filed consistently with the treatment of X as an S corporation since Date 2. 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 3. The IRS also ruled that the circumstances resulting in the termination were inadvertent within the meaning of section 1362(f). Accordingly, under section 1362(f), X was treated as an S corporation from Date 3 and thereafter, provided X’s S corporation election was otherwise valid and was not otherwise terminated under section 1362(d).

N. PLR 201848001 – Inadvertent terminations – Ineligible shareholders – Failure to file QSST election for trusts (11/30/2018)

X was incorporated on Date 1 under the laws of State and elected to be an S corporation effective Date 2. Prior to Date 3, Trust, a shareholder of X, was a grantor trust that was
treated (under subpart E of part 1 of subchapter J of chapter 1) as owned by A. On Date 3, Trust ceased to be a grantor trust. X represented that as of Date 3, Trust satisfied the qualified subchapter S trust (“QSST”) requirements under section 1361(d)(3). However, B, Trust’s income beneficiary, failed to make an election under section 1361(d)(2) to treat Trust as a QSST effective Date 3. Therefore, X’s S corporation election terminated on Date 3.

X represented that the circumstances resulting in the termination of its S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning. X further represented that it and its shareholders have filed tax returns consistent with the treatment of X as an S corporation and Trust as a QSST. X and its shareholders agreed to make any 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 the representations made, X’s S corporation election was terminated on Date 3 when Trust became an ineligible shareholder. The IRS also ruled that the termination was inadvertent 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 3 and thereafter, provided that X’s S corporation election was valid and was not otherwise terminated under section 1362(d).

O. PLR 201848004 – Inadvertent terminations – Passive investment income (11/30/2018)

Company was incorporated under the laws of State on Date 1 and elected to be treated as an S corporation effective Date 2. At the close of three consecutive taxable years ending Date 5, Company had subchapter C accumulated earnings and profits of $a. Moreover, for each taxable year ending Date 3, Date 4, and Date 5, Company had passive investment income (within the meaning of section 1362(d)(3)) in excess of 25 percent of its gross receipts. As a result, Company’s S corporation election terminated on Date 6.

Company represented that the circumstances resulting in the termination of Company’s S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning. Company and its shareholders consistently treated Company as an S corporation and agreed to make any adjustments consistent with the treatment of Company as an S corporation as may be required by the Secretary.

The IRS ruled that, based solely on the representations made and the information submitted, Company’s S corporation election terminated on Date 6, under section 1362(d)(3)(A), because Company had subchapter C earnings and profits at the close of each of three consecutive taxable years ending on Date 5, and had gross receipts for each of those taxable years more than 25 percent of which were passive investment income. The IRS also ruled that the termination of Company’s S corporation election was an inadvertent termination within the meaning of section 1362(f).
P. PLR 201848010 – Gain or loss recognized on property distributed in complete liquidation – Qualified stock dispositions – Asset dispositions – Elections – Extensions (11/30/2018)

On Date 1, Purchaser, a State A limited partnership that is treated as a partnership for Federal income tax purposes, acquired all of the stock of S Corporation Target, a State B limited liability company that has elected to be treated as an S corporation for Federal income tax purposes, from S Corporation Shareholders (the “Disposition”). It was represented that the Disposition qualified as a “qualified stock disposition” as defined in Treas. Reg. § 1.336-1(b)(6).

S Corporation Target, S Corporation Shareholders, and Purchaser intended to make a section 336(e) election, but, for various reasons, a timely election was not made. Subsequently, this request was submitted, under Treas. Reg. § 301.9100-3, for an extension of time to enter into the agreement referenced in Treas. Reg. § 1.336-2(h)(3)(i) (the “Agreement”) and file the election statement under Treas. Reg. § 1.336-2(h)(3)(iii) (the “Election Statement”). It was represented that none of S Corporation Target, S Corporation Shareholders, or Purchaser sought 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 filing of the request (taking into account any qualified amended return filed within the meaning of Treas. Reg. § 1.6664-2(c)(3)) and for which a new position required or permitted a regulatory election for which relief was requested.

The IRS ruled that, based on the facts and information submitted, including the representations made, S Corporation Target, S Corporation Shareholders, and Purchaser 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, until 45 days from the date on the letter, to enter into the Agreement and file the Election Statement.


Taxpayer represented that it was incorporated as a limited liability company during Year 1 and that it filed its Federal income tax returns as a partnership from Year 1 through Year 3. Taxpayer represented that it filed its Federal income tax return on a calendar year basis.

During Year 2, Shareholder 1, an individual, who at that time owned a profit and loss interest and no capital interest in Taxpayer, purchased all other profit, loss, and capital interests from all other partners of Taxpayer. Simultaneous with this purchase, Shareholder 1 gifted a certain percentage of the profit, loss, and capital interest of Taxpayer to his spouse, Shareholder 2. Taxpayer represented that the purchase of all of the interests in Taxpayer by Shareholder 1 resulted in a technical termination of Taxpayer in Year 2, which caused Taxpayer to file short period returns for the portion of Year 2
predating the technical termination, and for the portion of Year 2 following the technical termination.

As part of Taxpayer’s trade or business, it carried certain items in inventory. In Year 2, Taxpayer elected to account for a certain subset of those inventory items under the last-in, first-out (“LIFO”) method (the “LIFO Inventory”) by filing a Form 970 along with the tax return that it filed for portion of Year 2 following the technical termination. Taxpayer represented that during the period that it has accounted for the LIFO Inventory using the LIFO method for tax purposes, it also accounted for the LIFO Inventory using the LIFO method for book accounting purposes.

In Year 5, Taxpayer, with the assistance of CPA, prepared a Form 2553, Election by a Small Business Corporation, to elect to be treated as an S corporation for the Year 4 taxable year. However, although the Form 2553 was prepared by CPA, it was never filed by Taxpayer due to an administrative oversight. Not realizing that the Form 2553 was never filed, Taxpayer filed its Federal income tax return for the Year 4 taxable year as though the S corporation election had been made. Only after receiving communication from the IRS during Year 5 enquiring about Taxpayer's entity status did Taxpayer and CPA realize that the Form 2553 had never been filed. Consequently, Taxpayer filed a second Form 2553 under the automatic provisions of Treas. Reg. § 301.9100 to elect S corporation treatment for the Year 4 taxable year.

In Year 6, Taxpayer engaged another external tax advisor to prepare its Federal income tax returns. During the transition to the new tax advisor, Taxpayer discovered that it did not file a new Form 970 in Year 4 when it converted to being treated as an S corporation. Taxpayer represented that, because of its conversion from a partnership to an S corporation, it was required to file a new Form 970 in the first year that Taxpayer was considered an S corporation in order to continue using the LIFO method. However, despite not filing a new Form 970, Taxpayer continued using the same LIFO method for its LIFO Inventory that it had been using since Year 2. As a result, Taxpayer filed a request for a private letter ruling requesting an extension of time to file the missing Form 970 for Year 4.

On the basis of Taxpayer’s representations, the IRS ruled that the requirements of Treas. Reg. § 301.9100-3 were satisfied. Accordingly, the Taxpayer was granted an extension of time to file the missing Form 970 for Year 4.

R. PLR 201850018 – Inadvertent terminations – Ineligible shareholders – Election to treat sub as a Qsub (12/14/2018)

X was organized on Date 1 as a corporation under the laws of State. Effective Date 2, Y filed an election to treat X as a qualified subchapter S subsidiary (“QSub”). Originally, Y, an S corporation, owned all of the shares of X.
On Date 3, X entered into a subscription agreement with Z pursuant to which it issued and sold N additional shares of common stock to Z. Various other sales and transfers of X stock to persons other than Y occurred prior to Date 4.

On Date 4, X learned that the transfer of its shares to Z terminated its QSub status. In response, X and Y took corrective action to ensure that all the assets, liabilities, and items of income, deduction and credit of X became and were once more the assets, liabilities, and items of income, deduction and credit of Y.

X represented that X and Y intended for X to be a QSub effective Date 2. X and its current and former 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 on the facts submitted and the representations made, X’s QSub election terminated on Date 3 when X transferred shares of X stock to Z. The IRS also ruled that such termination was inadvertent within the meaning of section 1362(f). Therefore, X was treated as a QSub from Date 2 through Date 5, provided Y’s S corporation election was valid and had not terminated under section 1362(d), and that X’s QSub election was valid and, apart from the inadvertent termination ruling described above, had not otherwise terminated.

S. PLR 201851004 (December 21, 2018)

Distributing elected to be treated as an S corporation on Date 3, after its date of formation and the contribution of Controlled to Distributing. Distributing owns Controlled, a QSub, and seven other QSubs, and has two lines of business that have each been active trades or businesses for the previous 5 years. Business A is conducted through Controlled; Business B is conducted through Distributing. For certain business purposes, Distributing will distribute Controlled to certain shareholders in exchange for all of their Distributing stock of equal value. The IRS ruled that the distribution will cause a termination of Controlled’s QSub election because it will no longer be owned by an S corporation, and the distribution will qualify as a reorganization pursuant to Section 368(a)(1)(D) (in addition to other rulings related to the tax consequences of the reorganization). In addition, Controlled will be eligible to elect to be an S corporation for its first taxable year if it otherwise meets the requirements under Section 1361.

III. Guidance


The IRS provided an updated list of time-sensitive acts that may be postponed for individuals serving in the Armed Forces or for taxpayers affected by Presidentially declared disaster, terroristic, or military action. Rev. Proc. 2007-56 is superseded. Included in the list is filing Form 8752, completing a qualified stock disposition pursuant to Section 336 or a qualified stock purchase pursuant to Section 338, making elections pursuant to Sections 336 and 338, and several other time-sensitive acts relating specifically to S corporations.


The IRS and Treasury intend to propose regulations addressing special enforcement matters, including certain partnership-related items. The procedure notes that partnerships may elect out of the centralized partnership audit regime if such partnership has 100 or fewer partners for the taxable year, measured by counting the number of statements required to be furnished by the partnership and the number of statements required to be furnished by any S corporation partners of the partnership. For these purposes, a QSub is not treated as a corporation separate from its S corporation shareholder, and thus a QSub is an eligible partner. New regulations would provide that such election out of the centralized partnership audit regime would not apply to partnerships with QSubs as partners unless certain requirements are met that are similar to partnerships with S corporation partners. Such regulations may be applicable to all partnership years beginning after December 31, 2017. Comments on the intended regulations must be received by February 22, 2019.


This Revenue Procedure replaces Rev. Proc. 2018-11 and identifies circumstances under which disclosure of an item or position on a taxpayer’s income tax return is sufficient to reduce the penalties for substantial understatement with respect to accuracy related positions or unreasonable positions. The special rule for corporations described in Section 6662(d)(1)(B) relating to the substantial understatement of income tax does not apply to S corporations. When necessary, Schedule M-3 to Form 1120-S is required to constitute adequate disclosure of a position.

IV. Proposed Regulations


The IRS issued proposed regulations to provide guidance regarding the Base Erosion Anti-Abuse Tax (“BEAT”) that is imposed by Section 59A. Pursuant to the proposed regulations, BEAT applies only to applicable taxpayers, defined as corporations that satisfy the gross receipts test and the base erosion test. An applicable taxpayer does not include regulated investment companies, real estate investment trusts, or S corporations.
V.  Other

A. IR-2018-197 (Oct. 9, 2018) – IRS Resources

The IRS issued a news release to encourage small business owners to utilize IRS-provided resources to learn how the changes to the tax law may affect them and to aid in compliance. Such resources include pages on the IRS website related to Tax Reform, a tax tips email subscription program with tips written in plain language, and other news releases, YouTube videos, and webinars.

VI. Acts / Legislative Developments

A. [N/A]