American Bar Association
Section of Taxation Comments on Draft Revenue Procedure Addressing Issues Under Section 1362(f)*

I. Introduction

For many corporations and shareholders, an election to be treated as an S corporation is a valuable tax-planning tool, as it allows the income of the corporation to be taxed at just one level (as opposed to the two-level tax scheme generally applicable to C corporations). Unfortunately, the complexity involved in determining whether a corporation is eligible for S corporation treatment often leads to inadvertently invalid or terminated S corporation elections.

Fortunately, Congress and the Service generally have been very forgiving of errors with respect to S corporation elections. Specifically, section 1362(f) grants to the Service authority to provide relief to corporations that have made mistakes relating to their eligibility to elect or maintain S corporation status. Over the years, the Service has exercised that authority through the private letter ruling (PLR) process and through the issuance of Revenue Procedures providing less costly and cumbersome methods for obtaining relief.

Recently, however, the Service indicated that it will no longer issue PLRs relating to certain commonly encountered issues relating to the validity of an S corporation election. Specifically, Bradford Poston, an attorney in the Service’s Office of Chief Counsel, announced an informal “no-rule” position for certain types of section 1362(f) relief often requested by S corporations (the Informal No-Rule Position). Mr. Poston indicated that, although resource constraints contributed to the decision to stop issuing the letter rulings, there is also “doubt about the correctness and/or the value” of some of the section 1362(f) letter rulings that have been issued. Thus, it is possible

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*These Comments were submitted to the Internal Revenue Service on May 4, 2017, and are reprinted in The Tax Lawyer as a service to Tax Section members. Minor stylistic changes have been made to comport with the style of The Tax Lawyer.

1 Deanna W. Harris prepared this Introduction to accompany publication of the Comments on the Draft Revenue Procedure in The Tax Lawyer. The S Corporations Committee acknowledges and thanks Deanna W. Harris for preparation of the Introduction and for her valuable comments and assistance on this project.


3 Madara, supra note 2. Mr. Poston confirmed the Informal No-Rule Position of the Service and provided further context in a panel discussion before the S Corporation Committee of the Section of Taxation of the ABA on May 12, 2017.

that the Informal No-Rule Position may expand as issues are raised that the Service views as “comfort rulings” or rulings that do not provide protection to taxpayers.

The Informal No-Rule Position relates to three no-rule areas. Two of the three areas relate to the one class of stock requirement for S corporation eligibility: disproportionate distributions and situations in which a principal purpose of the arrangement must be determined. The final no ruling area involves late or incomplete elections and incorrect return filings.

The first informal section 1362(f) no-rule area—and the one that the Service believes is the largest category of rulings affected by the Informal No-Rule Position—involves S corporations that have made disproportionate distributions. At times, an S corporation makes (or is treated as making) distributions to its shareholders that differ as to timing or amount. When these distributions are contrary to the governing provisions and merely temporary mistakes rectified upon discovery, many practitioners assumed that the disproportionate distributions should not result in a second class of stock.5

The Service has issued many favorable rulings on this issue. Some of those rulings specifically concluded that the disproportionate distributions did not result in the corporation having a second class of stock.6 Other rulings were less clear on the applicable standard, concluding that if the disproportionate distributions resulted in a second class of stock that terminated the S election, they did so inadvertently.7 The second line of reasoning raised questions for practitioners who might otherwise have concluded that there was no inadvertent termination, which may have increased the number of taxpayers seeking PLRs at a point in time when the Office of Chief Counsel’s staff was diminishing. Mr. Poston has acknowledged that the use of differing rationales was likely a cause for the increase in ruling requests.

The final category of issues that the Service will no longer rule on involves certain defective elections and incorrect return filings. Mr. Poston stated that in many of these situations, the Service does not “consider that by itself to be something that presents a real threat to the validity of an S election.”8 Presumably, in making his comments, Mr. Poston was referring to “substantial compliance,” a judicial doctrine that holds that strict compliance with all the requirements of an election (in this case, the S corporation election made on Form 2553) may not be necessary if the taxpayer fulfills the essential statutory purpose of the election.9 Mr. Poston’s message seems to be that

5 See Minton v. Commissioner, 94 T.C.M. (CCH) 606, 609, 2007 T.C.M. (RIA) ¶ 2007-327, at 2015-16 (affirming the Tax Court determination that the transaction did not create a second class of stock, sustaining the deficiency assessed against the taxpayer).
8 Madara, supra note 4.
taxpayers would not need to request a PLR, and in fact should not request a PLR, if they have substantially complied with the election requirements, and in any event, it is unlikely that the Service would begin issuing substantial compliance rulings. However, it may be less than obvious to many taxpayers which of the more than 15 items of information requested on the Form 2553 are insignificant.

The Service’s desire to reduce the number of PLRs issued under section 1362(f) during a year is understandable. Nevertheless, without formal guidance, it may lead to confusion and uncertainty for taxpayers. First, there is the equitable argument that not every taxpayer has the same access to Service officials or Service positions that are not disseminated through formal means. Further, although taxpayers may welcome the news that PLRs are not necessary in certain circumstances, practitioners may take little comfort that a ruling is not necessary based solely on a non-binding speech by one Service attorney at a tax conference. Thus, taxpayers certainly would benefit from formal guidance on which taxpayers could rely with respect to the no-rule areas.

For the reasons discussed above, it would be extremely helpful if the Service announced its position in a more traditional manner in which the parameters of the no-rule areas are clarified. Ideally, such an announcement would describe the situations for which a PLR is unnecessary, and also indicate any necessary action a taxpayer should take to ensure proper compliance. It appears that the Service is open to this suggestion.

In light of the Service’s willingness to entertain the possibility of issuing a safe harbor, members of the American Bar Association Section of Taxation’s Subcommittee on S Corporations and another tax practitioner drafted a proposed revenue procedure. On May 4, 2017, the ABA Section of Taxation submitted for the Service’s consideration a version of that draft (the “Draft Revenue Procedure”), the language of which follows this introduction.10

The Draft Revenue Procedure describes certain situations in which the Service will not issue a PLR. In addition, the Draft Revenue Procedure sets forth certain safe harbors intended to provide certainty for certain taxpayers affected by the Informal No-Rule Position. We hope that the Service will give due consideration to the approach taken in the Draft Revenue Procedure. If the Draft Revenue Procedure (or something closely resembling it) is not published by the Service, we encourage the Service to consider issuing other guidance to taxpayers with regard to the Informal No-Rule Position—both to make taxpayers aware of it and to alleviate uncertainty resulting from it.

II. Comments on Draft Revenue Procedure Addressing Issues Under Section 1362(f)

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been

approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Paul R. Kugler, of the Section’s Committee on S Corporations (the “Committee”). Substantive contributions were made by Laura D. Howell-Smith and Carol Kulish. The Comments were reviewed by Dana A. Lasley, Chair of the Committee. The Comments were further reviewed by Ronald A. Levitt, the Section’s Council Director for the Committee, and Julian Y. Kim, the Section’s Vice Chair (Government Relations).

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member of the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact: Paul R. Kugler
(202) 533-6420
pkugler@kpmg.com

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SECTION 1. PURPOSE

This revenue procedure provides guidance for small business corporations that question the validity or continuation of an election under section 1362(a) of the Internal Revenue Code to be an S corporation (an “S corporation election”). Specifically, this revenue procedure describes situations in which the Internal Revenue Service (the “Service”) will not rule under section 1362(f) with respect to the validity or continuation of an S corporation election because the Service believes that the validity or continuation of the S corporation election is adequately addressed by existing law with respect to disproportionate distributions or substantial compliance. This revenue procedure also provides guidance that taxpayers may rely upon in determining whether an S corporation election is in effect with respect to a corporation in certain other situations.

SECTION 2. BACKGROUND

.01 In General. Section 1361(a)(1) defines an “S corporation,” with respect to any taxable year, as a small business corporation for which an S corporation election is in effect for that year. Section 1361(b)(1) defines a “small business corporation” as a domestic corporation that is not an ineligible corporation and that does not – (A) have more than 100 shareholders; (B) have as a shareholder a person (other than an estate, a trust described in section 1361(c)(2), or a property described in section 1361(c)(6)) who is not an individual; (C) have a nonresident alien as a shareholder; and (D) have more than one class of stock.

.02 One Class of Stock. Section 1361(b)(1)(D) provides that a small business corporation must have only one class of stock. Under Regulation section 1.1361-1(l) a corporation is generally treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Regulation section 1.1361-1(l)(2) provides that the determination of whether all outstanding shares of stock confer identical rights in distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the “governing provisions”). A commercial contractual agreement, or loan agreement, is not a binding agreement relating to distributions and liquidating proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and Regulation section 1.1361(1)(l). Although a corporation is not treated as having more than one class of stock as long as the governing provisions provide for identical distribution and liquidation
rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

.03 S Corporation Election. Section 1362(a)(1) provides that, except in a situation described in section 1362(g), a small business corporation may elect to be treated as an S corporation. However, section 1362(g) provides that if a corporation has made an S corporation election and that election has terminated under section 1362(d), the corporation (and any successor corporation) is not eligible to elect to be an S corporation for any taxable year before its fifth taxable year that begins after the first taxable year for which the termination is effective. An S corporation election is made by filing Form 2553, Election by a Small Business Corporation.

Section 1362(a)(2) provides that an S corporation election is valid only if it is signed and consented to by all persons who are shareholders in the corporation on the day on which the election is made. Section 1362(b) provides that, to be valid for a particular taxable year, the election must be filed any time in the taxable year preceding the desired effective date or at any time on or before the 15th day of the 3rd month of the desired taxable year. Once made, section 1362(c) provides that an S corporation election will be effective for the taxable year for which it is made and for all succeeding taxable years until the election is terminated under section 1362(d).

Regulation section 1.1362-6(a)(1) provides that, to be valid, an S corporation election must identify the election being made, set forth the name, address, and taxpayer identification number of the corporation, and be signed by a person authorized to sign the return required to be filed under section 6037. To make the S corporation election, a small business corporation must file a completed Form 2553; the election is not valid unless all shareholders of the corporation at the time of the election consent to the election in the manner provided in Regulation section 1.1362-6(b)(1). That section provides that a shareholder’s consent must be in the form of a written statement that sets forth the name, address, and taxpayer identification number of the shareholder, the number of shares of stock owned by the shareholder, the date (or dates) on which the stock was acquired, the date on which the shareholder’s taxable year ends, the name of the S corporation, the corporation’s taxpayer identification number, and the election to which the shareholder consents. The statement must be signed by the shareholder under penalties of perjury. Except as provided in Regulation section 1.1362-6(b)(3)(iii) (which provides for an extension of time for submission of shareholder consents in certain situations), the election of the corporation is not valid if any required consent is not filed in accordance with these rules.

.04 Inadvertent Termination or Inadvertent Invalid Election Relief. Section 1362(f) grants the Service authority to provide relief in situations where a corporation’s S corporation election was not effective for the taxable year for which it was made by reason of a failure to meet the requirements of section 1361(b), or where the corporation’s S corporation election terminates
under sections 1362(d)(2) or (3). A corporation is eligible for relief under this provision if:

1) the Secretary determines that the circumstances resulting in the ineffectiveness or termination were inadvertent;

2) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were taken so that the S corporation is a small business corporation; and

3) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to section 1362(f), agrees to make any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to the period.

If a corporation is eligible for relief under this provision, then, notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation will be treated as an S corporation during the period specified by the Secretary. Regulation section 1.1362-4(b) provides that the determination of whether an invalid election was inadvertent is made by the Commissioner. It further provides that the corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the invalid election was inadvertent. This regulation provides that the fact that the event causing the invalidity of the election was not reasonably within the corporation's control and was not part of a plan, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish inadvertence. Regulation section 1.1362-4(e) provides that the corporation and all persons who were shareholders of the corporation at any time during the period specified by the Commissioner must consent to any adjustments that the Commissioner may require. Each consent should be in the form of a statement agreeing to make the adjustments. The statement must be signed by the shareholder (in the case of shareholder consent) or a person authorized to sign the return required by section 6037 (in the case of corporate consent). Regulation section 1.1362-4(f) provides that the status of the corporation after the invalid election and before the determination of inadvertence shall be determined by the Commissioner. Inadvertent invalid election relief may be granted retroactively for all years for which the circumstances giving rise to the invalid election is effective, in which case the corporation is treated as if its election was valid. Alternatively, relief may be granted only for the period in which the corporation again became eligible for subchapter S treatment, in which case the corporation is treated as a C corporation during the period for which the corporation was not eligible to be an S corporation.

.05 Substantial Compliance. In limited circumstances, taxpayers have been excused from strict compliance with procedural regulatory requirements as long as the taxpayer “substantially complied” by fulfilling the essential statutory purpose of the election. However, a substantial compliance defense does not apply to a failure to comply with the essential requirements of the
governing statute. In ascertaining whether a particular provision of a regulation must be literally complied with, it is necessary to examine its purpose, its relationship to other provisions, the terms of the underlying statute, and the consequences of failing to comply with the provision in question.

SECTION 3. SCOPE

.01 In General. This revenue procedure describes situations in which the Service believes a private letter ruling is not necessary to resolve any questions about the validity or continuation of a corporation’s S corporation election because the issue is adequately addressed by existing law. To provide guidance that taxpayers may rely upon in determining the validity or continuation of an S corporation election in these circumstances, this revenue procedure – (i) provides a safe harbor that taxpayers may rely upon in determining whether an S corporation election remains in effect with respect to a corporation notwithstanding that disproportionate distributions have been made by the corporation; and (ii) describes certain situations in which the Service will treat an S corporation election as valid notwithstanding the omission of certain information requested on the Form 2553.

.02 Relief if this Revenue Procedure is Not Applicable. If the requirements described in § 4.02 or § 4.03 of this revenue procedure are satisfied, the Service will not issue a private letter ruling granting relief under section 1362(f) with respect to the relevant disproportionate distributions or omitted information. An entity with concerns about the validity or continuation of its S corporation election for reasons other than those described in this revenue procedure may seek inadvertent invalid election or inadvertent termination relief under section 1362(f) under Revenue Procedure 2013-30, 2013-30 I.R.B. 173, or Regulation section 1.1362-6(b)(3)(iii), or if neither is applicable, by requesting a private letter ruling. The procedural requirements for requesting a letter ruling are described in Revenue Procedure 2017-1, 2017-1 I.R.B. 1, or its successors.

SECTION 4. SAFE HARBOR FOR DISPROPORTIONATE DISTRIBUTIONS

.01 In General. As noted above, to make a valid S corporation election (or to avoid termination of an otherwise valid S corporation election), a corporation must have a single class of stock. The determination of whether all outstanding shares of stock confer identical rights in distribution and liquidation proceeds generally is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds, although other actual or deemed distributions may raise questions as to whether a corporation has a second class of stock. In recent years, the Service has received requests for private letter rulings providing inadvertent termination relief under section 1362(f) in situations in which the only issue regarding the continuing validity of an
S corporation election relates to certain disproportionate distributions made by the corporation.

.02 Safe Harbor. The Service has concluded that a corporation should not be treated as having more than one class of stock solely as a result of disproportionate distributions made by the corporation in certain situations. Specifically, the Service will not treat a corporation as having more than one class of stock solely because it made disproportionate distributions to one or more of its shareholders if:

(1) The corporation’s “governing provisions” (as that term is described in Regulation section 1.1361-1(l)(2)(i)) provide the shareholders with identical rights to distribution and liquidation proceeds;

(2) the corporation has made (or is deemed to have made) a distribution to a shareholder that occurs earlier than or exceeds the amount of the distributions the shareholders would have received if all actual or deemed distributions had been made to the corporation’s shareholders in proportion to their stock ownership (a “disproportionate distribution”); and

(3) the corporation either –
   (i) makes a distribution (or distributions) to a shareholder (or shareholders) that did not receive a disproportionate distribution such that, after the additional distributions are considered, all distributions by the corporation have been proportionate to stock ownership (taking into account permissible differences due to issuances, redemptions, or sales of stock); or
   (ii) requires a shareholder that received a disproportionate distribution to return the excess amount to the corporation.

.03 Other Considerations. The safe harbor provided in § 4.02 of this revenue procedure applies only for purposes of determining whether a corporation’s S corporation election is negatively impacted by the differences in timing or amount of the corporation’s distributions to its shareholders. Thus, this revenue procedure will not prevent the recharacterization or other treatment of the differences in timing under other Code sections or federal tax principles. In addition, if any amount that was in fact a distribution was improperly deducted by the corporation, the corporation and its shareholders during the year of the deduction may be subject to federal income tax, interest, and penalties with respect to the improper deduction.

SECTION 5. INCONSEQUENTIAL OMISSIONS DISREGARDED

.01 In General. As noted above, in certain situations a taxpayer that fails to comply strictly with the requirements for making an election may nevertheless be treated as having substantially complied with those requirements, such that the election nevertheless is treated as valid for federal tax purposes. In recent years, the Service has received requests for private letter rulings providing inadvertent invalid election relief under section 1362(f) in situations in which the only potential invalidity of an S corporation election relates to certain omissions of information on the Form 2553. For example, Part I of Form 2553 asks for the date the filing corporation was incorporated.
Further, consistent with the requirements of Regulation section 1.1362-6(b) (1) described above, Form 2553 requests information such as the number of shares of stock owned by the shareholder or the dates on which the shareholders acquired their stock. Many requests for inadvertent invalid election relief under section 1362(f) relate to omission of these types of information.

.02 Substantial Compliance. The Service has concluded that a corporation may have substantially complied with the requirements for making an S corporation election even in situations in which certain information has inadvertently been omitted from the Form 2553 filed by the S corporation. Thus, the Service will treat as valid an S corporation election filed by a corporation if –

(1) The only question as to the validity of the election is the inadvertent omission of (or inadvertent erroneous response to) one or more of the following requests on Form 2553:
   (i) The date the corporation was incorporated;
   (ii) The corporation’s state of incorporation;
   (iii) Whether the corporation’s name or address changed after applying for its EIN;
   (iv) The corporation’s selected tax year;
   (v) The name and title of an officer or legal representative the Service may contact for more information as well as that person’s contact information;
   (vi) The number of shares or percentage of ownership of a particular shareholder;
   (vii) The date or dates on which stock was acquired;
   (viii) The social security number or employer identification number of one or more shareholders; and
   (ix) The date on which any shareholder’s tax year ends.

(2) The corporation provides the information necessary to correct the inadvertent omission or erroneous information to the Internal Revenue Service Center with which the Form 2553 was filed in a statement that:
   (i) Contains as a heading “SUBMITTED [PURSUANT] TO REV. PROC. 2017-X;
   (ii) Provides the name, address, and employer identification number of the corporation; and
   (iii) Describes the relevant omission or incorrect information and provides the necessary correction.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for all applications (including those applications now being considered by the Service) for section 1362(f) relief satisfying the requirements of § 4.02 or § 5.02 of this revenue procedure.