May 02, 2018

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Mr. William M. Paul
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Re: IRS Informal "No-Rule" Policy on Certain S Corporation Matters

Dear Messrs. Kautter and Paul, and Ms. Porter:

It is our understanding that the Internal Revenue Service (IRS or "Service") has informally implemented a "no-rule" policy pursuant to which it will not issue rulings involving certain S corporation matters. The American Institute of CPAs (AICPA) appreciates the opportunity to submit recommendations for the IRS to consider regarding its proposed no-rule policy. Specifically, we request that the IRS:

a. Ensure that the no-rule policy does not become overly broad;
b. Formally define and publish the parameters of the no-rule policy; and
c. Issue a revenue ruling or other authoritative pronouncement to provide clarity for certain S corporation matters on which the IRS will no longer rule.

BACKGROUND

To elect S corporation status, a business must qualify as a small business corporation[1] and file a valid election on Form 2553, *Election by a Small Business Corporation*.[2] For this purpose, a small business corporation is an entity that is treated as a domestic corporation for U.S. federal income tax purposes that is not an "ineligible corporation" and that does not have: (i) more than a

[1] Section 1361(a)(1) of the Internal Revenue Code of 1986, as amended. Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to Treasury regulations promulgated thereunder.
[2] Section 1361(a)(1); Treas. Reg. § 1.1362-6(a)(2).

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permissible number of shareholders; (ii) a person other than an individual or a permitted trust, estate, or tax-exempt organization as a shareholder; (iii) a nonresident alien as a shareholder; and (iv) more than one class of stock.

Certain procedural defects may make an S election invalid if the entity does not qualify as a small business corporation at the time it files its S election. If an entity that validly elected as an S corporation ceases to qualify as a small business corporation, its S election terminates. Under section 1362(f), the IRS may grant a waiver of an inadvertent invalid or terminated S election. Generally, to obtain a waiver of an inadvertent invalid or terminated S election, a taxpayer must obtain a private letter ruling (PLR) from the IRS.[3] The IRS has issued thousands of private letter rulings under section 1362(f).

During a March 2017 tax law conference[4] in Washington, DC, an official from the IRS Office of Associate Chief Counsel (Passthroughs and Special Industries) articulated an informal, no-rule policy on three S corporation matters. The stated impetus for the change in the IRS's historical ruling policy was due, in part, to resource constraints at the IRS. In addition, the official cited a need for change in the IRS's ruling policy as a result of a general concern over the "correctness" and inherent "value" of various private letter rulings that were issued in the past in these three areas.

According to the IRS official, the first new no-rule policy relates to disproportionate distributions made by a corporation and whether the distributions caused the corporation to have more than one class of stock when the distributions were not made pursuant to a governing provision. The second new no-rule policy is in regard to whether an instrument, obligation, arrangement or agreement causes the treatment of a corporation as having more than one class of stock when this result would only occur when a principal purpose of the instrument, obligation, arrangement or agreement is to circumvent the one class of stock requirement. The third new no-rule policy relates to procedural defects in an election under subchapter S, including an S election, a qualified subchapter S subsidiary (QSub) election, a qualified subchapter S trust (QSST) election, and an electing small business trust (ESBT) election.

The IRS official further noted that the informal no-rule policy list summarized above may expand in the future as issues are raised that the IRS views as "comfort rulings" or rulings that are not providing protection to taxpayers.

[3] In an effort to move the resolution of some of these matters from the Office of Associate Chief Counsel (Passthroughs and Special Industries) to the service centers, the Service has occasionally provided expedited procedures for obtaining the requested relief. The latest comprehensive set of procedures is contained in Rev. Proc. 2013-30, 2013-36 I.R.B. 173. However, in cases not within the scope of this revenue procedure, a PLR is the exclusive means of obtaining the required relief. For example, a taxpayer may only obtain section 1362(f) relief through the PLR process, except where the inadvertent termination or ineffective election is solely the result of the failure to make an election for a trust that owns stock in the corporation.

[4] Federal Bar Association Section of Taxation Tax Law Conference in Washington, D.C., March 3, 2017.

AICPA RECOMMENDATIONS

Ensure That the No-Rule Policy Does Not Become Overly Broad

Section 1362(f) was originally enacted as a part of the Subchapter S Revision Act of 1982, and granted the IRS the authority to waive the inadvertent termination of a corporation's S election. In enacting section 1362(f), Congress directed that "the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment."[5] The provisions of section 1362(f) authorizing the Secretary to waive the effect of an invalid S election were enacted as a part of the Small Business Job Protection Act of 1996, and are effective for taxable years beginning after December 31, 1982.[6] In 2004, Congress again amended section 1362(f), expanding the relief for inadvertent invalid or terminated elections to QSub elections. Based on the evolution of section 1362(f) and the legislative history related thereto, Congress presumably views a key responsibility of the IRS as working with taxpayers to maintain the S corporation/QSub status. Creating an environment of uncertainty for taxpayers regarding their S corporation/QSub status is contradictory to this goal. Accordingly, the IRS should ensure that its no rule policy does not become overly broad.

In general, we agree with the informal no-rule policy as described above and appreciate that it will release IRS resources to address other important matters. However, the IRS has a long history of working with taxpayers to provide certainty regarding a corporation's S status and we encourage them to continue. For example, the IRS has issued numerous conditional rulings under section 1362(f) when factually it was unclear whether an entity's S election was invalid or terminated. An IRS official has suggested that in lieu of the IRS issuing a letter ruling to provide a taxpayer with certainty regarding its status as an S corporation, the taxpayer should obtain an opinion letter from its attorney or CPA. While under certain circumstances this approach may qualify as an acceptable alternative, there are instances where the law appears unclear (e.g., whether something rises to the level of a governing provision for purposes of the one class of stock requirement) or professional advisors disagree on whether a small business corporation requirement was violated. Furthermore, an opinion letter does not provide a taxpayer with the same degree of certainty as a private letter ruling. The IRS may disagree with a tax opinion and can audit the issue to determine that the taxpayer owes tax with interest and possibly penalties. Accordingly, it is important that the IRS continues to provide rulings when it is unclear as to whether an entity's S election was invalid or terminated.

[5] S. Rep. No. 97-640, 97th Cong., 2d Sess. 12 (1982), 1982-2 C.B. 718, 723-24.
[6] P.L. 104-188, section 1305(a).

Formally Define and Publish the Parameters of the No-Rule Policy

Notwithstanding the articulation of the government's position during the tax law conference in D.C., the AICPA is concerned that a significant number of S corporation taxpayers are unaware of the IRS's new informal no-rule policy (or are unaware of the full extent of this policy). We believe this situation creates uncertainty for S corporations that are considering pursuing private letter ruling requests. Without clear guidance, taxpayers may incur significant costs in pursuing a ruling request, only to have the request denied. Therefore, we recommend that the IRS officially publish its new no-rule policy to place taxpayers on alert, and to use such guidance to clearly define the parameters of its new policy.

Issue a Revenue Ruling or Other Authoritative Pronouncement to Provide Clarity for Certain S Corporation Matters on Which the IRS Will No Longer Rule

The IRS's private letter ruling process serves a vital function for many taxpayers, especially S corporations. With the new informal no-rule policy, many S corporation taxpayers are left without an avenue to remedy various issues that are specifically unique to S corporations. Therefore, in conjunction with our request for the IRS to formalize its no-rule policy, we further recommend that the Service issue a revenue ruling or other authoritative pronouncement to provide guidance for the areas that it no longer intends to issue private letter rulings.

The AICPA suggests that the revenue ruling or other authoritative pronouncement include the following parameters:

1. <u>The omission of certain information or the provision of erroneous information, not critical to the making of a valid election under subchapter S, does not cause an invalid election</u>.

   An election under subchapter S will qualify as a valid election provided that it adequately identifies the election and the taxpayer for whom the election is made, and contains all required consents. For example, an S election that omits or contains errors with respect to the following information would not become invalid: the entity's date or state of incorporation; the intended effective date of the S election; a shareholder's address or taxpayer identification number; the number of shares of stock owned by a shareholder; and/or the date on which the shareholder acquired shares in the electing entity. Similarly, an ESBT election would not become invalid because it fails to properly identify all potential current beneficiaries or the date on which the trust first became a shareholder.

2. <u>Proper consent to an election under subchapter S, where full and proper consent was intended and eventually secured, does not cause the election to become invalid.</u>

   For example, an election does not become invalid when a parent who is the trustee of a QSST for the benefit of his or her minor child consents to the QSST election and/or the S

election with respect to the shares owned by the QSST as trustee of the QSST and not as the natural parent of the child.

3. Guidance on the effect of having made disproportionate distributions in violation of the governing instruments.

   This guidance should address constructive distributions, including the failure to treat state withholding or composite payments as constructive distributions or loans to the shareholders, and should also address whether remediation is required for disproportionate distributions and how the remediation must occur. Acceptable methods to remediate disproportionate distributions include the S corporation making additional distributions to certain shareholders, certain shareholders returning distributions to the S corporation, treatment of the amount of distribution that is proportionate as a loan to or from the S shareholder (as appropriate), and shareholders transferring funds among themselves as gifts or a taxable transaction.

4. IRS will not challenge the validity of an S election based on a missing officer's consent or a missing shareholder's consent.

   If a corporation has filed as an S corporation since the effective date of its election and, for all open tax years, the shareholders have reported S items consistent with the S election, provide that the IRS will not challenge the validity of the S election based on a missing officer's consent or a missing shareholder's consent. While recognizing that officer consent and shareholder consent are fundamental to the validity of the S election, it appropriate to view the officer's signature on Form 1120S as sufficient evidence of consent to the S election on behalf of the corporation, and the inclusion of S corporation items in a U.S. federal income tax return signed by a shareholder as sufficient evidence of the shareholder's consent to the S election.

5. An automatic waiver of an inadvertent, invalid or terminated S election is available for a limited liability company (LLC).

   Provide an automatic waiver of an inadvertent, invalid, or terminated S election for an LLC whose operating agreement (or other governing provision) contains provisions that may allow for different, not pro rata, distributions or liquidation proceeds (e.g., because they are based on partnership capital accounts). Specifically, this automatic waiver is available provided that since the effective date of the LLC's S election, all distributions have been made proportionate to stock ownership (and / or as permitted under Treas. Reg. § 1.1361-1(l)(2)(iv)) and the offending language is corrected within 12 months of the LLC's discovery that such language may cause the IRS to treat the LLC as having more than one class of stock.

6. The varying interest distribution allowance will expand consistent with prior letter rulings.

   Provide IRS guidance to clarify that a governing provision will not result in the IRS treating a corporation as has having more than one class of stock when it provides that if an S corporation item for a taxable year (i.e., an item of the S corporation that shareholders are required to take into account in determining taxable income) is adjusted. The IRS or a state or local taxing authority may require an adjustment or the S Corporation may need an adjustment as a result of the entity filing an amended federal, state or local tax return. The corporation may make distributions to shareholders in proportion to the allocation of the S corporation items in percentages applicable for such taxable year.[7]

Finally, if the IRS identifies other S corporation qualification matters on which it will no longer issue private letter rulings, we encourage the Service to issue revenue rulings or other authoritative pronouncements to alert taxpayers.

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The AICPA is the world's largest member association representing the accounting profession with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. Please feel free to contact me at (408) 924-3508 or Annette.Nellen@sjsu.edu; Laura Macdonough, Chair, AICPA S Corporation Taxation Technical Resource Panel, at (202) 327-8060 or Laura.Macdonough@ey.com; or Amy Wang, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9264 or Amy.Wang@aicpa-cima.com.

Respectfully Submitted,

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[7] See PLRs 200709004, 201017019, 201306004 and 201306005.