



March 28, 2023

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RE: Provide Clarification Under Revenue Procedure 2022-19

Dear Assistant Secretary Batchelder, Mr. Paul, and Ms. Porter:

The American Institute of CPAs (AICPA) appreciates the guidance and additional relief provided by the Department of the Treasury (“Treasury”) and the Internal Revenue Service (IRS) through Rev. Proc. 2022-19¹ (the “Rev. Proc.”) from certain inadvertent invalid S corporation elections or S-election terminations. We are pleased to offer recommendations to clarify and expand certain provisions of the Rev. Proc. to increase its utility and widen its scope.

I. Amend Section 3.06(2)(b)(ii) of Rev. Proc. 2022-19

Overview

In general, the Rev. Proc. provides taxpayer assistance procedures, including under section 1362(f),² to allow S corporations and their shareholders to resolve frequently encountered issues with certainty and without requesting a private letter ruling (PLR) from the IRS. The Rev. Proc. also provides a new opportunity for taxpayers to retroactively address situations in which they may discover an inadvertent occurrence of a “non-identical” governing provision, and thus a potential second class of stock, without the taxpayer requiring a PLR.

Section 3.06 of the Rev. Proc. provides, among other requirements, that for an S corporation to be eligible for relief for non-identical governing provisions, it must not have made, or must not have been deemed to have made, a disproportionate distribution. For many S corporations, this could be a limiting requirement to access the relief afforded under Section 3.06. Specifically, while

¹ I.R.B. 2022-41.

² Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

The Honorable Lily Batchelder
Mr. William M. Paul
Ms. Holly Porter
March 28, 2023
Page 2 of 5

disproportionate distributions alone may not create a second class of stock, if such disproportionate distributions have been made by an entity with a non-identical governing provision, the S corporation may be unable to utilize the retroactive relief provisions of Section 3.06.

Section 3.06 of the Rev. Proc. has the potential to provide significant benefit to S corporations that have inadvertently executed non-identical governing provisions. However, without an amendment to the disproportionate distribution requirement of Section 3.06, its applicability may be significantly limited, resulting in the need for PLRs, which are costly to taxpayers and administratively burdensome to both taxpayers and the IRS.

Recommendation

The AICPA recommends that Treasury and the IRS modify Section 3.06(2)(b)(ii) of Rev. Proc. 2022-19 to provide that only disproportionate distributions made pursuant to a non-identical governing provision disqualify the corporation from relief under Section 3.06.

Analysis

The recommendation will expand the potential application of Section 3.06 to cover common fact patterns and to avoid conflating two separate and distinct situations. A taxpayer may have a non-identical governing provision that it is not able to address through the Rev. Proc. due to the occurrence of one or more unrelated disproportionate distributions. If a disproportionate distribution is not made pursuant to a non-identical governing provision, it should not exclude a taxpayer from seeking corrective relief of such non-identical governing provision under Section 3.06.

The following is an illustrative example of a common situation that would not qualify for relief under Section 3.06 of the Rev. Proc. as currently drafted:

Example

T, a limited liability company, filed the appropriate election to be taxed as a small business corporation, in 2005. During formation, T's legal counsel created an LLC operating agreement with standard boiler-plate language, including section 704(b) provisions. P, an unrelated taxpayer, enters into an agreement with the shareholders of T to purchase the stock of T. In P's due diligence, the parties involved identify the LLC as containing one or more non-identical governing provision(s). In addition, it is discovered that the S corporation had a series of deemed disproportionate distributions related to several personal expenses being remitted by the S corporation on behalf of certain S corporation shareholders. It is unclear if the arrangement for the payment of such expenses may constitute a governing provision. There may have been further disproportionate distributions from the S corporation, as well, going back to 2005 for which the Company is unaware. However, none of the disproportionate distributions have any relationship to the non-identical governing provisions established through the LLC operating agreement.

The Honorable Lily Batchelder
Mr. William M. Paul
Ms. Holly Porter
March 28, 2023
Page 3 of 5

To qualify for relief under Rev. Proc. 2022-19, Section 3.06, T must represent that the S corporation did not have any disproportionate distributions (actual, deemed, or constructive). T is unable to do so, and therefore is ineligible for relief under Section 3.06, and must seek out a PLR request to address correcting the non-identical governing provision(s) contained in the LLC agreement.

As noted, the AICPA commends the IRS on the practical solution provided under Section 3.06 to reduce the administrative burden of PLR requests. We believe that our recommendation fits into the intention of the relief while removing an unrelated and unintentional restriction.

II. Amplify Section 3.02 of Rev. Proc. 2022-19

Overview

Treasury Reg. § 1.1361-1(l)(2)(i) provides that a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights. However, this regulation does not require a binding agreement to be in writing. A common concern is that a pattern of distributions favoring one shareholder over another may create a binding agreement rising to the level of a governing provision and may result in a second class of stock which terminates the corporation's S election.

Section 3.02 of the Rev. Proc. provides that an S corporation with governing provisions which grant identical distribution and liquidation rights will not result in the termination of S corporation status. The Rev. Proc. further states that taxpayers with governing provisions which grant identical distribution and liquidation rights do not need to seek relief from the IRS in the form of a PLR to correct situations in which distributions may have departed from such governing provisions. However, outside of the reference to Treas. Reg. § 1.1361-1(l)(2)(i), the Rev. Proc. does not otherwise discuss the types of arrangements which might create a governing provision, including whether a pattern of disproportionate distributions might create a binding agreement for such purposes.

Recommendation

The AICPA recommends that Treasury and the IRS amplify Section 3.02 of Rev. Proc. 2022-19 to provide the factors that determine an arrangement relating to the distributions of an S corporation which constitute a governing provision under Treas. Reg. § 1.1361-1(l)(2)(i) and applicable law. Additionally, we recommend providing examples of arrangements that have and have not been determined to constitute a governing provision under applicable law.

Analysis

Treasury Reg. § 1.1361-1(l)(2)(i) states that a corporation is not treated as having more than one class of stock if the governing provisions provide for identical distribution and liquidation rights.

The Honorable Lily Batchelder
Mr. William M. Paul
Ms. Holly Porter
March 28, 2023
Page 4 of 5

The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds under the regulations is based on the S corporation's governing provision (e.g., corporate charter, articles of incorporation, bylaws, applicable state law, and certain binding agreements relating to distribution and liquidation proceeds).

Treasury Reg. § 1.1361-1(l)(2)(i) does not require a binding agreement to be in writing. However, a concern exists amongst taxpayers that a pattern of disproportionate distributions favoring one shareholder over another may create a binding agreement relating to distributions which might have the result of terminating the corporation's S election.

Consistent with Treas. Reg. § 1.1361-1(l)(2)(i), Section 3.02 of the Rev. Proc. states that an S corporation with governing provisions which grant identical distribution and liquidation rights will not result in the termination of S corporation status. The Rev. Proc. further states that taxpayers with governing provisions granting identical distribution and liquidation rights do not need to seek relief from the IRS in the form of a PLR to correct situations in which distributions may have departed from such governing provisions. However, outside of the reference to Treas. Reg. § 1.1361-1(l)(2)(i), the Rev. Proc. does not otherwise discuss the types of arrangements which might create a governing provision, including whether a pattern of disproportionate distributions create a binding agreement.

Taxpayers with written governing provisions containing equal rights to distribution and liquidation proceeds with an extended history of disproportionate distributions may be uncertain whether Section 3.02 of the Rev. Proc. will apply to their fact pattern, or if the S corporation must pursue a more costly PLR to address correcting a second class of stock concern.

This example illustrates one type of agreement that may inadvertently violate the identical distribution and liquidation requirements and could be scrutinized under Section 3.02 of the Rev. Proc. and Treas. Reg. § 1.1361-1(l)(2)(i):

Example

X, an S corporation, has two shareholders, Parent and Child, who each own 50% of the outstanding stock of X. X's governing provisions provide for identical distribution and liquidation rights. X owns a company aircraft which is generally used for business purposes. While the aircraft is not in use for business purposes, it may be used personally by Parent or Child. Both Parent and Child correctly identify the personal use of the aircraft as a non-deductible expenditure and treat any such expenditure as a distribution from X to each shareholder based on usage. Furthermore, Parent and Child have an understanding that Parent has priority using the aircraft for personal purposes. Due to Parent's priority, Parent incurs twice the amount of deemed distributions for use of the plane as Child.

Fact patterns such as this example create uncertainties for taxpayers when assessing a corporation's distributions and liquidation provisions. Therefore, the AICPA recommends updating the Rev. Proc. to include guidance to assist taxpayers with determining which situations violate the identical

The Honorable Lily Batchelder
Mr. William M. Paul
Ms. Holly Porter
March 28, 2023
Page 5 of 5

distribution and liquidation requirements of Treas. Reg. § 1.1361-1(l)(3)(i) and examples of applicable law which affect this determination.

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Bryan Keith, Chair, AICPA S Corporation Taxation Technical Resource Panel, at (202) 419-1417 or bryan.keith@andersen.com; Jon Williamson, AICPA Senior Manager – Tax Policy & Advocacy, at (216) 509-2972 or jon.williamson@aicpa-cima.com; or me at (601) 326-7119 or JanLewis@HaddoxReid.com.

Sincerely,



Jan Lewis, CPA
Chair, AICPA Tax Executive Committee