



American Institute of CPAs  
1455 Pennsylvania Avenue, NW  
Washington, DC 20004-1081

October 23, 2012

Mr. Curt Wilson  
Associate Chief Counsel (Passthroughs & Special Industries)  
Internal Revenue Service  
1111 Constitution Avenue, NW  
5300 IR  
Washington, DC 20224

RE: Certain S Corporation Pro Rata Distributions and the Creation of a Second Class of Stock

Dear Mr. Wilson:

The American Institute of Certified Public Accountants (AICPA) appreciated the August 7, 2012 conference call and discussion we had with your office regarding various S corporation recommendations the AICPA included in its comments on Notice 2012-25, the 2012-2013 Guidance Priority List.<sup>1</sup>

In response to your request during the call, this letter provides further background about our recommendation that Private Letter Rulings (PLRs) 201017019 and 200308035 involving S corporations be incorporated into the language of Treas. Reg. § 1.1361-1(1)(2)(iv). Specifically, this recommendation calls for modifying the regulations to address whether a second class of stock is created by an S corporation's pro rata distributions made to pay: (1) taxes in year one; (2) redemptions in year two; (3) additional taxes in year three for an amendment of its year one tax return; and (4) subsequent distributions to pay additional year one taxes.

The AICPA is the world's largest member association representing the accounting profession, with nearly 386,000 members in 128 countries and a 125 year heritage of serving the public interest. 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.

This letter provides: (1) an overview of PLRs 201017019 and 200308035; and (2) an attachment regarding our draft language for modifying Treas. Reg. § 1.1361-1(1)(2)(iv).

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<sup>1</sup> See AICPA letter (dated May 1, 2012) to Acting Treasury Assistant Secretary (Tax Policy) Emily S. McMahon and IRS Chief Counsel William J. Wilkins regarding the Treasury/IRS 2012-2013 Guidance Priority List.

### **The PLRs and Current Law**

In PLR 201017019, the Internal Revenue Service (IRS) concluded that an S corporation's amendment to its stockholders' agreement would not cause the corporation to have more than one class of stock for purposes of section 1361(b)(1)(D) of the Internal Revenue Code. The amendment would allow the corporation to make a distribution to each person that was a shareholder during the "relevant" taxable year if any item of the corporation's taxable income, gain, loss deduction, or credit were adjusted or amended after the corporation's original return for that taxable year was filed. The distributions: (1) had to be made in accordance with the shareholders' respective interests in the corporation's taxable income or loss for that taxable year; (2) had to take into account any interest or penalties attributable to the post-filing adjustment; and (3) had to be made at a time selected by the corporation, but in any event, at a reasonable time after the adjustment was finally determined. The corporation represented that any distribution under the amendment was to be allocated proportionately among shareholders by reference to their respective interests in the corporation's taxable income or loss for the relevant period. The purpose of the amendment was to allow the corporation to assist its shareholders in paying additional tax liability due to the adjustment or amendment.

Treas. Reg. § 1.1361-1(1)(2)(iv) provides that a governing provision does not alter the rights to distribution and liquidation proceeds merely because the governing provision provides that, as a result of a change in stock ownership, distributions in a taxable year are to be made on the basis of the shareholders' varying interests in the S corporation's income in the current or immediately preceding taxable year. If distributions pursuant to the provision are not made within a reasonable time after the close of the taxable year in which the varying interests occur, the distributions may be recharacterized depending on the facts and circumstances, but will not result in a second class of stock.

In essence, the principles of Treas. Reg. § 1.1361-1(1)(2)(iv) were applied to the facts of PLR 201017019, so that the corporation may make distributions under the amendment to the stockholders' agreement in a taxable year more than one year removed from the relevant period. Furthermore, the payment policy described in the ruling appears to relate to distributions on specific dates or events, and there is at least an implication that there may be more than one distribution, subject to different formulae, within a single corporate taxable year.

Similarly, PLR 200308035 applied the principles of the regulations to provide for distributions made in a later year to follow distributions that would have been made under the governing instrument, had taxable income been computed properly for that prior year.

### **Recommendations**

The AICPA recommends that Treas. Reg. § 1.1361-1(l)(2)(iv) be amended to accomplish the following objectives:

1. Incorporate the rulings of PLR 201017019 and 200308035 into Treas. Reg. § 1.1361-1(l)(2)(iv), to allow for distributions associated with taxable income to be made, regardless of the year in which taxable income is modified. As stated above, our draft language to implement this language is provided as an attachment to this letter.
2. Confirm that an S corporation can simultaneously make both pro rata distributions according to current stock ownership and other distributions that meet the varying interest rule without creating a second class of stock.
3. Clarify that a distribution in the current year can take into account varying interests of both the preceding and current years without creating a second class of stock.

We appreciate the opportunity to offer these comments on PLRs 201017019 and 200308035. Should the IRS determine that incorporation of these two PLRs into Treas. Reg. § 1.1361-1(l)(2)(iv) is not feasible, we recommend that the IRS issue a revenue ruling which adopts the holdings of the PLRs.

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If you would like to discuss our comments on REG-13404-07 in more depth or have any questions, please contact me at (401) 831-0200, or [patt@pgco.com](mailto:patt@pgco.com); Kevin J. Walsh, Chair of the S Corporation Technical Resource Panel at (907) 456-2222, or [kw Walsh@wksepa.com](mailto:kw Walsh@wksepa.com); Benson S. Goldstein, AICPA Senior Technical Manager, at (202) 434-9279, or [bgoldstein@aicpa.org](mailto:bgoldstein@aicpa.org).

Sincerely,



Patricia Thompson, CPA  
Chair, Tax Executive Committee

## Attachment

### Certain S Corporation Pro Rata Distributions and the Creation of a Second Class of Stock

#### Suggested Revision to Treas. Reg. § 1.1361-1(l)(2)(iv)

**Treas. Reg. § 1.1361-1(l)(2)(iv) revised.** Distributions that take into account varying interests in stock during a taxable year. A governing provision does not, within the meaning of paragraph (l)(2)(i) of this section, alter the rights to liquidation and distribution proceeds conferred by an S corporation's stock merely because the governing provision provides that, as a result of a change in stock ownership, distributions in a taxable year are to be made on the basis of the shareholders' varying interests in the S corporation's income in the current TAXABLE YEAR, IN THE immediately preceding taxable year, *or in both such taxable years. in addition, if with respect to a prior taxable year any s item is adjusted or amended after the filing of the s corporation's original return for that prior taxable year, a second class of stock does not exist merely because the governing provision provides that the s corporation may make distributions, during the current taxable year to shareholders of such prior taxable year, proportionately among those shareholders by reference to their respective interests in the s corporation's taxable income or loss for such prior taxable year.* If distributions pursuant to the provision are not made within a reasonable time after the close of the taxable year in which the varying interests *or change in S items* occur, the distributions may be recharacterized depending on the facts and circumstances, but will not result in a second class of stock. *distributions that otherwise will not result in a second class of stock (e.g., distributions that reflect actual stock ownership as of a particular date) that are made during a taxable year in addition to distributions that take into account varying interests in stock pursuant to this paragraph (l)(2)(iv) do not result in a second class of stock.*