



IRS Issues New Guidance To Clarify and Provide Simplified Procedures for Resolving Certain Issues Related to S Corporation Elections

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The IRS recently issued Revenue Procedure 2022-19 (?Rev. Proc. 2022-19? or ?the Revenue Procedure?), offering taxpayers clarification and new simplified procedures for resolving certain issues related to S corporation elections without the need for a private letter ruling (PLR).

Prior to the new guidance, multiple common mistakes related to S corporation elections required resolution via a PLR request, adding both time and expense to obtaining and maintaining S corporation tax status. Frequently, such issues are discovered only during due diligence for a potential sale, when the additional time required for a PLR may delay or derail a deal.

The Revenue Procedure lists six issues that may be resolved without a PLR, including:

- Entering into agreements and arrangements without a principal purpose of circumventing the one class of stock requirement;
- Addressing disproportionate distributions despite governing provisions that provide for identical distribution and liquidation rights;
- Addressing certain errors or omissions on IRS Forms 2553 and 8869;
- Verifying S elections or QSub elections;
- Filing a federal income tax return inconsistent with an S election or a QSub election; and
- Correcting one or more non-identical governing provisions.

Entering into agreements and arrangements without a principal purpose of circumventing the one class of stock requirement

A corporation with more than one class of stock cannot qualify as an S corporation. Generally, a corporation has one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds as determined by the company's governing provisions (i.e., articles of incorporation or organization, bylaws, state law, or binding agreements related to distribution and liquidation proceeds).

The Revenue Procedure provides that, if an S corporation or its shareholders enter into arrangements or agreements that are not governing provisions, such as buy-sell agreements, redemption agreements, agreements restricting transferability of shares, certain short-term underwritten advances, and certain debt instruments treated as equity for federal income tax purposes, then the IRS will not treat the S corporation as having violated the single class of stock requirement if the principal purpose of the agreement or arrangement was not to circumvent the single class of stock requirement. Commercial contracts are not a binding agreement or governing provision unless the principal purpose of the agreement was to circumvent the one class of stock requirement.

Addressing disproportionate distributions despite governing provisions that provide for identical distribution and liquidation rights

A disproportionate distribution is any distribution by the corporation based on share ownership that differs in timing or amount among shareholders.

The IRS will not treat any disproportionate distributions by an S corporation as violating the one class of stock requirement so long as the corporation's governing provisions provide for identical distribution and liquidation rights.

Addressing certain errors or omissions on IRS Forms 2553 and 8869 (qualified subchapter S subsidiary election or a QSub election)

An inadvertent error or omission on IRS Form 2553 or Form 8869 does not invalidate an S election or a QSub election unless the error or omission is with respect to a shareholder consent, a selection of a permitted year (as defined in IRC § 1378(b) and related Treasury Regulations), or an officer's signature.

The Revenue Procedure offers a simplified procedure for resolving inadvertent errors or omissions as well as for addressing the more serious errors or omissions listed above.

Verifying S elections or QSub elections

Generally, the IRS mails the taxpayer written acknowledgement of acceptance of the entity's S election or the subsidiary's QSub election. These written acknowledgements are often requested by a purchaser during due diligence for a pending sale as a means of confirming the seller entity's tax status.

The Revenue Procedure provides a means for taxpayers to receive replacement acceptance letters.

Filing a federal income tax return inconsistent with an S election or a QSub election

S Corporations file a Form 1120-S, and a QSub is included on its parent's Form 1120-S.

The Revenue Procedure clarifies that an inconsistent federal income tax return filing will not terminate an S election or QSub election. Instead, the corporation must file amended tax returns for any open taxable years consistent with its S corporation or QSub status.

Correcting one or more non-identical governing provisions

A "non-identical governing provision" means a governing provision that alone or as part of another governing provision results in the S corporation having more than one class of stock, even if the S corporation never made a non-pro rata distribution or liquidating distribution. A non-identical governing provision invalidates or automatically terminates an S election.

The Revenue Procedure provides a relief procedure for correcting the validity or continuation of an S corporation due solely to non-identical governing provisions.

To qualify for the relief, the corporation must satisfy all of the following requirements:

- The corporation has or had one or more non-identical governing provisions;
- The corporation has not made, or is not deemed to have made, a disproportionate distribution to any current or former shareholder;
- The corporation has timely filed an IRS Form 1120-S for each applicable tax year of the corporation beginning with the tax year in which the first non-identical governing provision was adopted and through the tax year immediately preceding the tax year in which the corporation sought relief; and
- The corporation satisfied all other requirements of the Revenue Procedure prior to the IRS discovery of any non-identical governing provision. The other requirements include certain corrective relief statements that must be completed by the S corporation and its shareholders and retained by the corporation for IRS inspection.

To take account of the simplified relief procedures set forth by the Revenue Procedure, the IRS will no longer issue PLRs for certain matters covered by the Revenue Procedure. Specifically, the IRS will no longer issue a PLR addressing whether a principal purpose of a commercial contractual agreement, buy-sell agreement, agreement restricting the transferability of stock, redemption agreement, or other instrument, obligation, or arrangement is to circumvent the one class of stock requirement. In addition, the IRS will no longer issue a PLR addressing the validity or continuation of an S election with regard to one or more disproportionate distributions, a missing administrative letter accepting an S election or a QSub election, or the filing of a federal income tax return that is inconsistent with a corporation's status as an S corporation or a QSub.

Rev. Proc. 2022-19 is generally effective October 11, 2022 and contains a transition rule for pending PLR requests.

Should you have any questions regarding the impact of this Revenue Procedure for your S corporation

or general questions regarding the validity of your S election, please do not hesitate to reach out to any member of the firm's Tax Section.

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