S Corporations: 10 Traps for the Unwary

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This article discusses the S corporation rules, several common S corporation traps for the unwary, how to prevent a violation of a rule, and how to rectify an inadvertent termination of S corporation status.

S corporation tax treatment appears to be the best of both worlds; S corporations avoid double taxation (as compared to C corporations), and S corporation treatment can reduce the amount of employment taxes paid by employee-shareholders (as compared to partners in a partnership). However, the benefits of S corporation status come with rigid rules that may be overlooked, putting S corporation status in jeopardy.

> Shareholders must make a one-time election for S corporation treatment. To qualify to make the election, the shareholders and entity must satisfy several (sometimes burdensome) requirements.

In cases where the S corporation rules have been broken, an entity instead may be treated as a C corporation for U.S. federal income tax purposes, which can have devastating consequences to the entity and the shareholders in terms of substantive income tax, penalties, and interest. Further, the longer the rules have been broken, the more tax exposure to the entity and its shareholders.

Below, we describe generally the S corporation rules and then outline ten traps for the unwary. Additionally, we describe ways to prevent a violation of a rule or how to rectify an inadvertent termination of S corporation status. We will refer to S corporation "shares" herein; however, both a state law corporation and a state law limited liability company may be treated as an S corporation for U.S. federal income tax purposes.

Ten common traps for the unwary involving S corporations include the following, as discussed below:

1. Invalid S Corporation Election
2. Defective Organizational Documents
3. Ineligible Shareholder: A Disregarded Entity Converts into a Partnership
4. Ineligible Shareholder: Failure to Transfer or File QSST and ESBT Elections
5. Ineligible Shareholder: Transfer Pursuant to Bankruptcy Administration
6. Second Class of Stock: Unreasonable Compensation
7. Second Class of Stock: Disproportionate Distributions
8. Second Class of Stock: Recharacterized Shareholder Loans
9. Second Class of Stock: Incentive Compensation
10. Special Concerns with Constructive Partnerships

S CORPORATIONS GENERALLY

An entity, including a corporation or a limited liability company, that satisfies the requirements under Section 1361 of the Internal Revenue Code of 1986, as amended (the "Code") may elect to be treated as an "S corporation" for U.S. federal income tax purposes. An S corporation generally does not pay U.S. federal corporate income tax like a C corporation.[1] Instead, income, loss, deductions, and credits pass through to the S corporation's shareholders for U.S. federal income tax purposes, similar to the taxation of entities treated as partnerships for U.S. federal income tax purposes. Unlike partners in a partnership, however, the owners of an S corporation can be employees of the S corporation. This allows such owners of S corporations to pay employment taxes on a reasonable salary only and avoid payment of employment taxes on the S corporation's net income.

Shareholders must make a one-time election for S corporation treatment.[2] To qualify to make the election, the shareholders and entity must satisfy several (sometimes burdensome) requirements. Specifically, Section 1361(b)(1) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation[3] and which does not (1) have more than 100 shareholders, (2) have as a shareholder a person (other than an estate, a trust described in Section 1361(c)(2), or an organization described in Section 1361(c)(6)) who is not an individual, (3) have a nonresident alien as a shareholder, and (4) have more than one class of stock. Because Section 1361(b)(1)(B) requires every shareholder of an S corporation to be an individual, an estate, or a certain type of trust, this means that Section 1361(b)(1)(B) prohibits corporations and partnerships from owning S corporations. Below, we look at certain of these rules in more depth.

Eligible Shareholders. As described above, every shareholder of an S corporation must be a U.S. resident individual, an estate, or a certain type of trust. Section 1361(c)(2)(A) provides that the following trusts will be treated as eligible shareholders of an S corporation:

1. A trust which is treated as owned by an individual who is a citizen of the United States under Sections 671 through 679 (a "Grantor Trust");
2. A trust that was a Grantor Trust immediately before the death of the deemed owner and which continues to exist for the two-year period following the deemed owner's death;
3. A trust to which stock has been transferred by a will, but only for the two-year period beginning on the day on which such stock is transferred to it (*i.e.*, a testamentary trust);
4. A trust created primarily to exercise the voting power of stock transferred to it and meeting certain other requirements (*i.e.*, a voting trust);

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5. An electing small business trust (an "ESBT"); and
6. Certain types of individual retirement accounts holding stock of a bank or a depository holding company.

Additionally, Section 1361(d) provides that a qualified subchapter S trust (a "**QSST**") may qualify as an eligible S corporation shareholder. ESBTs and QSSTs are discussed in further depth below.

The deemed owner of a Grantor Trust, and not the trust itself, is treated as the shareholder for purposes of the S corporation rules. As a result, the grantor of a Grantor Trust holding S corporation stock must be a U.S. citizen or resident.

As described above, a Grantor Trust remains an eligible S corporation shareholder under Section 1361 for two years after the deemed owner's death. At the expiration of the two-year period and to continue the S corporation status, the trust must (1) transfer the S corporation stock to an eligible S corporation shareholder or (2) make an election to be treated as an ESBT or a QSST. In certain circumstances, a trust may make an election under Section 645 to treat the trust as part of the estate, which would provide an extended period of time for the trust to hold the S corporation stock beyond two years, but only for a "reasonable" period of estate administration.[4]

Certain Treasury Regulations and IRS authorities contemplate the qualification of a disregarded entity as an eligible S corporation shareholder under Section 1361(b)(1)(B) if the regarded owner of the disregarded entity qualifies as an S corporation shareholder under Section 1361(b)(1)(B).[5] The use of disregarded entities as S corporation shareholders creates several traps for the unwary that we discuss in detail below.

S Corporation Economics. As described above, an S corporation may have only one class of stock. Reg. 1.1361-1(l)(1) provides, in part, that 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. Notably, Section 1361(c)(4) provides that "a corporation shall not be treated as having more than 1 class of stock solely because there are differences in voting rights." Reg. 1.1361-1(l)(2)(i) provides that a determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state laws, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). Although 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, Reg. 1.1361-1(l)(2)(i) provides that 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.

Every shareholder of an S corporation must be a U.S. resident individual, an estate, or a certain type of trust.

Reg. 1.1361-1(l)(2)(vi), Example 2, describes an S corporation ("S") with two equal shareholders, A and B, who are entitled to equal distributions under S's bylaws. S distributes $50,000 to A in the current year but does not distribute $50,000 to B until one year later. The circumstances indicate that the difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds. As such, Example 2 concludes that the difference in timing of the distributions to A and B does not cause S to be treated as having more than one class of stock. This example shows that a violation of the single-class-of-stock requirement may be remedied with a true-up distribution and is consistent with the relief provided by the IRS for the treatment of disproportionate distributions under Revenue Procedure 2022-19, as discussed in more detail below.

IRS RELIEF

Section 1362(f) provides that the Secretary of the Treasury may provide relief to taxpayers who have "inadvertently" violated the S corporation rules (and therefore terminated their S corporation status). Under Reg. 1.1362-4(b), the "fact that the terminating event or invalidity of the election was not reasonably within the control of the corporation . . . or the fact that the terminating event or circumstance took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event or circumstance, tends to establish that the termination or invalidity of the election was inadvertent." Treasury and the IRS have issued certain procedures to streamline the relief process for S corporations under Revenue Procedure 2013-30 and Revenue Procedure 2022-19.[6] We discuss when these relief procedures may be useful below.

Where taxpayers do not qualify for streamlined relief under the revenue procedures, taxpayers may file a private letter ruling ("**PLR**") request with the IRS to ask to be treated as an S corporation. In addition to the professional fees incurred to prepare the PLR request and collateral documents (such as shareholder consents) and to interact with the IRS in connection with any questions and supplementary requests the IRS may have, the current cost to submit a PLR request is generally $38,000, subject to relief for certain small businesses. The IRS has issued several favorable private letter rulings with respect to corporations that have filed invalid S corporation elections[7] and terminated an S corporation election inadvertently by adopting erroneous language in governing documents.[8]

TRAPS FOR THE UNWARY: HOW S CORPORATIONS GO AWRY

Below, we describe several common S corporation traps for the unwary. We also discuss mechanisms taxpayers may use to avoid inadvertently violating the S corporation rules and ways to otherwise remedy a violation of the rules.

DEFECTIVE S CORPORATION ELECTION

There are several ways an entity may fail to qualify as an S corporation on the intended effective date of its S corporation election. For example, an S corporation election may be defective for the following reasons:

- The election is filed with the IRS before the entity has been legally formed;[9]
- The election is filed late;
- The election contains an administrative error; or
- The entity does not qualify as an S corporation on the intended effective date.

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The S corporation election is made on Form 2553 and must be filed with the IRS within two months and 15 days after the beginning of the tax year the election is to take effect.[10] The election must contain the signature of every shareholder as well as the signature of any spouse of a shareholder who has a community property interest in the shares.[11]

If the entity does not meet all the S corporation requirements on the intended effective date, the entity cannot be treated as an S corporation as of that date. For example, if an entity files Form 2553 on 1/1/2024, and as of that date, the entity has more than 100 shareholders, the entity could not be treated as an S corporation as of 1/1/2024.

How to Avoid: Taxpayers should work with advisors who understand the S corporation rules, and advisors should thoroughly consider the S corporation requirements prior to suggesting that an entity become an S corporation. To avoid the cost of remedying any problems in connection with making the elections, it is important to identify the person responsible for preparing and filing the S corporation election and any related trust election(s) and ensuring that they are properly executed and timely filed.

How to Remedy: Some violations of the S corporation rules may simply bar an entity from electing S corporation status, such as having more than 100 shareholders, having foreign or other ineligible shareholders, or having more than one class of stock outstanding. But for procedural missteps, taxpayers may be able to obtain relief from the IRS. Additionally, in lieu of submitting a costly PLR request to the IRS, taxpayers that qualify may remedy an invalid S corporation election by following Revenue Procedure 2013-30 and Revenue Procedure 2022-19.[12]

Generally, to qualify for relief under Section 1362(f) and either of Revenue Procedure 2013-30 or Revenue Procedure 2022-19, the following conditions must be met:

- The ineffective S corporation election was ineffective by reason of either a failure to meet the definition of a "small business corporation" or a failure to obtain shareholder consents;
- The IRS determines that the circumstances that kept the election from taking effect were inadvertent;
- Within a reasonable time after the discovery of the circumstances resulting in the ineffectiveness of the election, steps are taken to make the corporation a "small business corporation" or to get the required shareholders consents;[13] and
- The corporation and all persons who owned stock during the period for which relief is granted agree to make certain adjustments required by the IRS, and those adjustments must be consistent with the treatment of the corporation as an S corporation.

Some violations of the S corporation rules may simply bar an entity from electing S corporation status. But for procedural missteps, taxpayers may be able to obtain relief from the IRS.

Under Rev. Proc. 2013-30, an entity and its shareholders may request relief for late elections and must request relief within three years and 75 days of the intended effective date of the S corporation election. However, an entity and its shareholders may request relief beyond this period in some circumstances if the following conditions are met:

- The corporation is not seeking late corporate classification election relief concurrently with a late S corporation election;
- The corporation fails to qualify as an S corporation solely because the Form 2553 was not timely filed;
- The corporation and all of its shareholders reported their income consistent with S corporation status for the year the S corporation election should have been made, and for every subsequent taxable year (if any);
- At least six months have elapsed since the date on which the corporation filed its tax return for the first year the corporation intended to be an S corporation;
- Neither the corporation nor any of its shareholders was notified by the IRS of any problem regarding the S corporation status within six months of the date on which the Form 1120-S for the first year was timely filed; and
- The completed Form 2553 includes statements signed under penalties of perjury from all shareholders during the period between the date the S corporation election was to have become effective and the date the completed Form 2553 is filed that they have reported their income on all affected returns consistent with the S corporation election for the year the election should have been filed and for all subsequent years.

Under Rev. Proc. 2022-19, an inadvertent error or omission on Form 2553 that does not involve a shareholder consent, a selection of a permitted year, or an officer's signature may be eligible for streamlined relief. To perfect the Form 2553 for other errors or omissions, the taxpayer should write to the IRS service center identified in Rev. Proc. 2022-19 explaining the error or omission and making the necessary correction. Rev. Proc. 2022-19 provides specific guidance regarding how to remedy errors related to shareholder consents, the selection of a permitted year, or an officer's signature.

DEFECTIVE ORGANIZATIONAL DOCUMENTS

As described above, an S corporation may have only one class of stock outstanding. Whether the single-class-of-stock requirement is satisfied is based on the entity's governing documents.[14] Accordingly, governing documents that allow for disproportionate allocations of flow-through income, gain, loss, or deduction, or disproportionate distributions of cash may violate the single-class-of-stock requirement even if a company never makes a disproportionate allocation or distribution.

For example, shareholders of an S corporation may adopt an LLC agreement that contains customary partnership taxation language providing for capital accounts, allocations in accordance with Section 704(b), and liquidating distributions in accordance with the positive capital accounts of the owners. This situation may occur if the LLC agreement is drafted by counsel that is not familiar with S corporation requirements. In our experience, this is a common trap for the unwary, and many

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S corporations operate with these provisions in place in their charters and/or LLC agreements and only discover the issue years into operation or possibly at the time of a sale of the company.

How to Avoid: Taxpayers should consult with an advisor familiar with the S corporation rules before forming an entity or making any changes to an S corporation's governing documents. Advisors could suggest that an S corporation place a restriction on multiple classes of stock in its charter or other formation document. Additionally, advisors should confirm that S corporation-specific language is included in any LLC agreement or stockholders' agreements and that no partnership tax language is included.

An S corporation may have only one class of stock outstanding. Whether the single-class-of-stock requirement is satisfied is based on the entity's governing documents.

How to Remedy: Once organizational documents violating the S corporation rules have been adopted, the S corporation election will be in jeopardy. If such defect is present on the intended effective date of an S corporation election, such adoption may result in an ineffective election. If such defect arises at a later date, the S corporation's status may terminate. In those cases, the S corporation may seek IRS relief pursuant to Section 1362(f) if the shareholders want to avoid C corporation treatment.

Alternatively, taxpayers that have violated the S corporation rules through their governing documents may be eligible for relief under Revenue Procedure 2022-19. Specifically, Revenue Procedure 2022-19 provides that if an S corporation and its shareholders meet certain requirements, an S corporation election that is invalid or terminated solely as the result of one or more "non-identical governing provisions" may receive retroactive relief. To qualify, the taxpayer must meet the following requirements:

- The corporation has or had one or more non-identical governing provisions;
- The corporation has not made, and for U.S. federal income tax purposes is not deemed to have made, a disproportionate distribution to a shareholder;
- The corporation timely filed a return on Form 1120-S for each taxable year of the corporation beginning with the taxable year in which the first non-identical governing provision was adopted and through the taxable year immediately preceding the taxable year in which the corporation made a request for corrective relief under Revenue Procedure 2022-19; and
- Before any non-identical governing provision is discovered by the IRS, all of the requirements described in Revenue Procedure 2022-19 are satisfied.

Taxpayers who qualify under Revenue Procedure 2022-19 must take action to correct or remove the non-identical governing provisions and follow certain other administrative requirements. In short, the administrative requirements resemble the documentation a taxpayer typically must assemble to submit a PLR request to the IRS; however, the corporation need only retain the documentation in its corporate records. Taxpayers do not need to notify the IRS of the inadvertent termination or the changes made pursuant to Revenue Procedure 2022-19 unless the S corporation is audited.

INELIGIBLE SHAREHOLDER: A DISREGARDED ENTITY CONVERTS INTO A PARTNERSHIP

As described above, certain Treasury Regulations and IRS authorities contemplate the qualification of a disregarded entity as an eligible S corporation shareholder if the regarded owner of the disregarded entity qualifies as an S corporation shareholder. Under that authority, individual taxpayers may hold their S corporation shares through a wholly owned LLC or a grantor trust, in each case, where the direct holder of shares is disregarded for U.S. federal income tax purposes. Although the use of an LLC or grantor trust may have non-tax benefits (*e.g.*, preventing the indirect shareholder's name from disclosure on certain filings), such investment vehicles can be a trap for the unwary.

S corporations with disregarded entities as direct shareholders find themselves in trouble when a change occurs at the level of the disregarded entity that causes the entity to become regarded for U.S. federal income tax purposes. For example, a married individual may hold interests in an S corporation through a wholly owned LLC; however, a judge may order the married individual to transfer a 50% interest in the LLC to the individual's spouse as part of a divorce settlement. In that case, the LLC would convert into a partnership for U.S. federal income tax purposes on the date of the transfer. Because a partnership is not an eligible shareholder of an S corporation, the S corporation election would terminate upon the transfer, possibly unbeknownst to the S corporation until after the transfer.

A similar result can occur when an individual holding an interest in an S corporation through a wholly owned LLC transfers an LLC interest in other contexts, such as upon death, as payment for services (*e.g.*, the issuance of a profits interest), or in connection with estate planning or other intra-family transfers without realizing the effects on the S corporation. Like in the instance of divorce, these types of transfers may cause an LLC to have multiple members and convert into a partnership for U.S. federal income tax purposes, terminating the S corporation election.

How to Avoid: S corporations should consider adding transfer and other restrictions to their governing documents to protect against having an ineligible shareholder, such as the following restrictions: (1) no shareholder will transfer shares of the S corporation to an ineligible shareholder or take any action to cause an eligible shareholder to become an ineligible shareholder; (2) if a shareholder purports to make a transfer of an interest in the S corporation to an ineligible shareholder or take any action that would cause an eligible shareholder to be an ineligible shareholder, such transfer or action will be void and have no effect, and (3) no shareholder will take or fail to take any action of any nature whatsoever that could directly or indirectly cause the termination of the company's S corporation election. Additionally, the S corporation could require its shareholders to indemnify the company and the other shareholders from any U.S. federal, state, or local income tax consequences resulting from a terminated S corporation election caused by a shareholder.

How to Remedy: Once an ineligible shareholder holds S corporation shares,

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the S corporation election is terminated. In that situation, the S corporation may seek IRS relief pursuant to Section 1362(f) if the shareholders want to avoid C corporation treatment. In this instance, taxpayers would need to submit a PLR request to the IRS for relief and would not qualify for relief under any of the available IRS Revenue Procedures.

INELIGIBLE SHAREHOLDER: FAILURE TO TRANSFER OR FILE QSST AND ESBT ELECTIONS

As described above, certain trusts are eligible S corporation shareholders. Of these trusts, a Grantor Trust that holds S corporation shares remains an eligible S corporation shareholder for the two-year period following the death of the grantor. Additionally, a testamentary trust that receives S corporation shares pursuant to a will remains an eligible S corporation shareholder for the two-year period following the death of a shareholder. In each of these cases, the S corporation shares must be transferred to an eligible S corporation shareholder by the end of a two-year period; however, taxpayers sometimes lose track of this requirement over the two-year period or a probate administration may extend beyond a reasonable period. As a result, taxpayers either fail to transfer the shares or make a timely QSST or ESBT election, causing the trust shareholder to become an ineligible shareholder.

How to Avoid: Advisors should review the trust agreements of any trust shareholders to (1) determine whether the trusts are eligible S corporation shareholders, (2) determine what trust level elections are required, if any, and (3) make the advisor aware of any steps that would need to be taken in the event of a change at the level of the trust — for example, upon the death of the settlor. Additionally, as previously discussed, S corporations should consider adding transfer and other restrictions to their governing documents to protect against having an ineligible shareholder. S corporations should also require shareholder trusts to provide copies of trust agreements and notify the S corporation of any proposed amendments to trust agreements before they are implemented.

The LLC agreement or shareholders agreement for an S corporation may contain the restrictions discussed above as well as require that the shareholders execute all documents required for the company to maintain its S corporation election, including that shareholders be required to provide the S corporation with copies of all timely filed QSST and ESBT elections.

Treasury and the IRS have issued certain procedures to streamline the relief process for S corporations under Revenue Procedure 2013-30 and Revenue Procedure 2022-19.

How to Remedy: When an S corporation terminates due to the failure of a shareholder to elect to be treated as an ESBT or a QSST, relief under Section 1362(f) may be available if the requirements of Revenue Procedure 2013-30 described above are satisfied. The trustee of an ESBT or current income beneficiary of a QSST must sign the election form and include certain statements certifying its qualification for ESBT and QSST status. If the requirements for relief under Revenue Procedure 2013-30 are not met, a taxpayer may seek relief by requesting a PLR.

INELIGIBLE SHAREHOLDER: TRANSFER PURSUANT TO BANKRUPTCY ADMINISTRATION

As described above, an estate of an individual in bankruptcy is a permissible S corporation shareholder; however, as part of the bankruptcy administration, the S corporation shares could be transferred to an ineligible S corporation shareholder, such as a creditor of the individual in bankruptcy. In this case, the bankruptcy of an individual shareholder could also cause the termination of an S corporation election.

How to Avoid: As previously discussed, S corporations should consider adding transfer and other restrictions to their governing documents to protect against having an ineligible shareholder. We recommend that the LLC agreement or shareholders agreement for an S corporation contain the restrictions discussed above as well as require that the shareholders execute all documents required for the company to maintain its S corporation election.

How to Remedy: Once an ineligible shareholder holds S corporation shares, the S corporation election is terminated. In that situation, the S corporation will have to seek IRS relief pursuant to Section 1362(f) if the shareholders want to avoid C corporation treatment. In this instance, taxpayers would need to submit a PLR request to the IRS for relief and would not qualify for relief under any of the available IRS Revenue Procedures.

SECOND CLASS OF STOCK: UNREASONABLE COMPENSATION

An attractive feature of S corporation status for a small business is the ability for employee-shareholders to potentially limit their annual employment tax liability. As described above, employee-shareholders generally do not owe self-employment tax on distributions from S corporations (as compared to partnerships).[15] As a result, an employee-shareholder may be tempted to provide themselves a modest salary, which would be subject to employment taxes, and take a large distribution, which would not be subject to self-employment tax.

The IRS has asserted that S corporations may not underpay employee-shareholders to avoid employment taxes and has recharacterized wages as a disguised dividend.[16] For example, if a third-party would pay an employee a salary of $130,000, but such person's S corporation pays the employee a salary of $10,000, the IRS could recharacterize the $120,000 payment as salary. Section 1366(e) specifically allows the IRS to reallocate income between family members who are all shareholders of the same S corporation.

A recharacterization of distributions as wages may then cause the distributions that were made to shareholders to become disproportionate. It may be especially difficult for taxpayers to defend a low salary in cases where the employee-shareholder performs the bulk of the services that generate income and the company is engaged in service activities. The regulations provide that certain "commercial contractual agreements," including employment agreements, are not treated as binding agreements relating to distribution and liquidation proceeds for purposes of determining whether the single-class-of-stock requirement is met, unless such agreements are entered into with a principal purpose of circumventing such requirement.[17]

In contrast, an employee-shareholder may be tempted to inflate their salary and take a small distribution to avoid providing larger, proportionate distributions to all shareholders. However, like in cases of unreasonably low salaries, the IRS could recharacterize a portion of the salary as a distribution. A recharacterization may then cause the distributions that were made to shareholders to become disproportionate. If the IRS were to find that the excessive compensation was purposely used to circumvent the single-class-of-stock requirement, the IRS could find that the S corporation status terminated due to a second class of stock.[18]

How to Avoid: In order to rebut any presumption that compensation is being used to circumvent the single-class-of-stock requirement, it is advisable to make a good faith determination of reasonable compensation payable to employee-shareholders, taking into account the relevant facts and circumstances, which may include the following: (1) compensation paid to non-owner employees; (2) compensation levels, if known, paid in the industry or by competitors; (3) the amount of capital required to be contributed by the shareholder to the corporation;[19] and (4) the amount of leverage in the business (i.e., the ability of the business to profit from the services provided by non-owner employees). Further, it is advisable that all compensation arrangements with employee-shareholders be memorialized in contemporaneous written agreements.

Advisors should inform their clients about the risks of underpaying or overpaying employee-shareholders. Tax return preparers should flag this issue for clients when preparing tax returns and noticing the underpayment of employee-shareholders.

How to Remedy: While the underpayment of wages alone should not cause the termination of an S corporation election, a recharacterization of distributions as wages could cause aggregate distributions to be treated as disproportionate. In this case, if the recharacterization occurs as part of an audit, the S corporation may be able to work with the IRS to obtain relief for the termination of S corporation status. Alternatively, the S corporation may need to seek relief pursuant to Section 1362(f), which may require the S corporation to submit a PLR request. If an advisor catches this issue close in time, the S corporation may be able to true-up the wages and distributions paid.

SECOND CLASS OF STOCK: DISPROPORTIONATE DISTRIBUTIONS

In our experience, this is an issue that frequently causes taxpayers to be at risk of inadvertently terminating their S corporation election. As described above, S corporations must have a single class of stock, meaning all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Often, taxpayers desire to distribute different amounts to the shareholders. For example, taxpayers may desire to provide a preferred return to certain shareholders or provide certain family members in a family business more than others (e.g., the parents want to pay the child-shareholder that is involved in the business a larger distribution than the child-shareholder who is not involved in the business). An S corporation can compensate employee-shareholders with different, reasonable salaries, but if an S corporation makes disproportionate distributions to its shareholders, such distributions will terminate the S corporation election.

How to Avoid: S corporations should include a single-class-of-stock restriction in the S corporation's charter where possible under state law. Additionally, advisors should educate their clients as to the single-class-of-stock requirement. Tax return preparers should recommend that S corporations make distributions to shareholders at the same time and in a proportionate manner. Tax return preparers who learn of disproportionate distributions should recommend that the S corporation true-up any under-distributed shareholders as quickly as possible. As described above, a true-up that occurs in the following tax year may correct disproportionate distributions made in the preceding year without terminating the S corporation election.

How to Remedy: Once the S corporation makes disproportionate distributions, the S corporation election may be terminated. The S corporation may seek IRS relief pursuant to Section 1362(f) if the shareholders want to avoid C corporation treatment. In this instance, taxpayers would need to submit a PLR request to the IRS for relief and would not qualify for relief under any of the available IRS Revenue Procedures. However, as discussed above, Revenue Procedure 2022-19 provides that the IRS will not provide a PLR in instances where true-up distributions are made, and the taxpayer seeks a ruling in which the IRS must determine whether the true-up distributions remedy an inadvertent termination.

SECOND CLASS OF STOCK: SHAREHOLDER LOANS

It is common for business owners to capitalize a company in part through shareholder loans to the company. If a shareholder loan to an S corporation were recharacterized as equity for U.S. federal income tax purposes, the S corporation could be treated as having an impermissible second class of stock. For that reason, it is critical for an S corporation that any such loan be properly documented. The applicable Treasury regulations also provide for a safe harbor under which certain loan agreements will not be recharacterized as a second class of stock, even if such loan agreements would be treated as equity under general tax principles.[20]

To qualify for the "straight-debt" safe harbor, the debt must satisfy the following four conditions: (1) there is a written unconditional promise to pay a sum certain in money; (2) the interest rate and interest payment dates are not contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock, or similar factors; (3) the debt is not convertible into stock; and (4) the debt is held by an eligible S corporation shareholder. While the straight-debt safe harbor protects from violations of the single-class-of-stock requirement, the IRS may recharacterize purported debt for other purposes of the Code.

How to Avoid: Any loans to an S corporation should either (1) qualify for the straight-debt safe harbor described above or (2) satisfy all requirements under general tax principles to be respected as debt.

How to Remedy: If debt issued by an S corporation is recharacterized as equity (and if the straight-debt safe harbor does not otherwise apply), the S corporation election is likely to be terminated. The S corporation may seek IRS relief pursuant to Section 1362(f) if the shareholders want to avoid C corporation treatment. In this instance, taxpayers would need to submit a

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PLR request to the IRS for relief and would not qualify for relief under any of the available IRS Revenue Procedures.

SECOND CLASS OF STOCK: INCENTIVE COMPENSATION

The single-class-of-stock requirement presents a significant obstacle to issuing incentive compensation from an S corporation to employees. However, phantom stock, stock appreciation rights ("**SARs**") and performance bonuses can be used to reward employees of S corporations if structured properly. These programs compensate employees based upon the S corporation's performance without giving the employee actual ownership, which could run afoul of the S corporation rules if incentive compensation is deemed to be a second class of stock. Regs. 1.1361-1(b)(3) and (4)provide safe harbors for restricted stock and deferred compensation plans that meet specific requirements.

How to Avoid: Advisors should make themselves aware of the various incentive equity options available for S corporations to assist clients in implementing plans to retain valuable employees. Advisors should be keenly aware of types of incentive equity that are not available to S corporations, such as the issuance of profits interests (which are commonly used with entities treated as partnerships for U.S. federal income tax purposes), to avoid the implementation of plans that will terminate the S corporation election. As with employee-shareholder compensation, taxpayers should document the reasonableness of incentive compensation and document such compensation in writing.[21]

How to Remedy: Once the S corporation is treated as having a second class of stock, the S corporation election may be terminated. The S corporation may seek IRS relief pursuant to Section 1362(f) if the shareholders want to avoid C corporation treatment. In this instance, taxpayers would need to submit a PLR request to the IRS for relief and would not qualify for relief under any of the available IRS Revenue Procedures.

SPECIAL CONCERNS WITH CONSTRUCTIVE PARTNERSHIPS

Shareholders of S corporations should be cautious when making agreements regarding the S corporation business through side agreements outside of the S corporation. Such a side agreement can be treated as a constructive partnership. In that case, a litany of negative consequences can result, such as treatment of the constructive partnership as an S corporation shareholder (i.e., an ineligible shareholder) and/or an aggregation of distributions that result in disproportionate distributions. In either case, the existence of a constructure partnership may terminate the S corporation election.

How to Avoid: Advisors to S corporations should ask for all documents pertaining to a business structure, including side letter agreements, and should review all documentation for the possibility of constructive partnerships. Where the flexibility of a partnership structure is warranted, the Treasury Regulations specifically allow for an S corporation to become a partner in a bona fide partnership without treating the S corporation's partner as an S corporation shareholder.[22] In that case, we recommend that the S corporation enter into a formal partnership agreement with its partners to document the arrangement.

How to Remedy: Once the S corporation is treated as having an ineligible shareholder or as having made disproportionate distributions, the S corporation election may be terminated. The S corporation may seek IRS relief pursuant to Section 1362(f) if the shareholders want to avoid C corporation treatment. In this instance, taxpayers would need to submit a PLR request to the IRS for relief and would not qualify for relief under any of the available IRS Revenue Procedures.

CONCLUSION

The benefits of S corporation status come with rigid rules that may be overlooked, putting S corporation status in jeopardy. However, there are ways to prevent a violation of an S corporation rule or to rectify an inadvertent termination of S corporation status.

[1] Exceptions apply, including in the following circumstances: (1) S corporations that previously were taxed as C corporations and sell assets that were appreciated on the effective date of their S corporation elections within the five-year period following such effective date (*see* Section 1374), and (2) S corporations that have both C corporation earnings and profits and for which more than 25% of their gross receipts consist of passive investment income (*see* Section 1375).

[2] Section 1361(a)(1), Section 1362.

[3] Generally, an "ineligible corporation" means a financial institution, an insurance company, or a domestic international sales corporation.

[4] Regs. 1.641(b)-3(a), 1.645-1(e)(2)(i), and 1.645-1(e)(3)(i).

[5] Reg. 301.7701-3(b); Reg. 1.1361-1(e); Reg. 1.1361-1(e)(3)(ii)(F).

[6] Rev. Proc. 2013-30 modified and superseded Rev. Proc. 2003-43, Rev. Proc. 2004-48, and Rev. Proc. 2007-62; superseded the relief provided in Situation 1 of Rev. Proc. 97-48; obsoleted the relief provided in Situation 2 of Rev. Proc. 97-48; modified and superseded the relief of Rev. Proc. 2004-49, § 4.01 and § 4.02; and obsoleted the relief provided in Rev. Proc. 2004-49, § 4.03.

[7] *See, e.g.*, P.L.R. 201936005 (5/22/2019) (treating an S corporation election as valid on Date 4 even though (1) as of Date 4, E was a shareholder, failed to sign and submit Form 2553, and was an ineligible shareholder under Section 1361(b)(1)(B) and (2) even if the S election was valid, the election would have terminated when the partnership agreement was amended to contain terms creating a second class of stock); P.L.R. 201815003 (12/29/2017) (treating the corporation as an S corporation as of Date 3 even though B was an ineligible shareholder under Section 1361(b)(1)(B) on Date 3).

[8] *See, e.g.*, P.L.R. 202021007 (2/20/2019) (waiving a termination as inadvertent when the corporation's members entered into an operating agreement containing partnership provisions that created a second class of stock, which issues were perpetuated in an amendment to the operating agreement); P.L.R. 201908019 (11/13/2018) (waiving a termination as inadvertent when an S corporation acquired three other S corporations, terminating the latter's elections, even though remedial actions were not taken immediately upon discovery of the terminations because the corporations expected their tax and legal advisors to correct the problem, but the advisors did not do so, and were taken when a new tax advisor pointed out the continuing issues and sought relief from the Service); P.L.R. 201905002 (10/23/2018) (waiving a termination as inadvertent where a corporation's operating agreement contained provisions calling for liquidating distributions to be made according to members' capital accounts, which termination was triggered when the corporation, originally owned by one member, acquired additional members); P.L.R. 201519008 (12/19/2014) (waiving a termination as inadvertent where the corporation relied on its in-house accountant and made disproportionate distributions with respect to its stock).

[9] *See* Reg. 1.1362-6(a)(2)(iii), *Example 1*.

[10] *See* Instructions for Form 2553 (Rev. December 2020).

[11] *Id.*; *see* Rev. Proc. 2004-35 (providing automatic relief for certain taxpayers requesting relief for late shareholder consents for S elections in community property states).

[12] Pursuant to Rev. Proc. 2022-19, the following topics are not eligible for P.L.R. requests: (1) potential violations of the single-class-of-

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stock requirement where the IRS must determine whether a taxpayer entered into an agreement (*e.g.*, a buy-sell agreement, an agreement restricting the transferability of stock, or a redemption agreement) the principal purpose of which was to circumvent the single-class-of-stock requirement; (2) whether disproportionate distributions have "an appropriate tax effect in accordance with the facts and circumstances;" (3) inadvertent errors or omissions on Form 2553; (4) a lack of written acknowledgement that the IRS has accepted the corporation's S corporation election (*e.g.*, because such letter was lost or never received); and (5) the filing of a U.S. federal income tax return that is inconsistent with an S corporation election (*e.g.*, filing a Form 1065, U.S. Return of a Partnership).

[13] These consents need to be received from all persons who were shareholders at any time included in the period for which retroactive relief is being sought, regardless of whether such persons happen to be shareholders at the time the relief is being requested. Locating former shareholders and securing their cooperation can sometimes be challenging.

[14] Reg. 1.1361-1(l)(2)(i).

[15] Rev. Rul. 59-221.

[16] Rev. Rul. 77-44; *see e.g., Joseph Radtke*, 712 F. Supp 143 (E.D. Wis. 1989), *aff'd per curiam*, 895 F.2d 1196 (7th Cir. 1990) (recharacterizing dividends as compensation where an attorney paid himself a salary of $0 and dividends of $18,225 in a year); *Watson*, 757 F. Supp.2d 877 (S.D. Iowa 2010), *aff'd*, 668 F.3d 1008 (8th Cir. 2012) (treating dividends paid to a shareholder-owner as additional compensation to the $24,000 salary paid to such shareholder-owner); *Sean McAlary Ltd., Inc.*, T.C. Sum. Op. 2013-62 (8/12/2013) (rejecting a compensation agreement and focusing on qualifications, hours, duties, and success to recharacterize a dividend as compensation); *Glass Blocks Unlimited*, TCM 2013-180 (recharacterizing purported loan repayments as compensation where the employee-shareholder did not receive a salary).

[17] Reg. 1.1361-1(l)(2)(i).

[18] Reg. 1.1361-1(l)(2)(vi), *Example 3*.

[19] The shareholders are entitled to a reasonable return on their capital contributions in the form of dividends.

[20] Reg. 1.1361-1(l)(5)(iv).

[21] As discussed above, the Treasury Regulations provide that certain "commercial contractual agreements" including employment agreements, are not treated as binding agreements relating to distribution and liquidation proceeds for purposes of determining whether the single-class-of-stock requirement is met, unless such agreements are entered into with a principal purpose of circumventing such requirement. Reg. 1.1361-1(l)(2)(i).

[22] Reg. 1.701-2(d), *Example 2*.

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Intercompany restructuring should not result in the inclusion of a deferred intercompany gain in gross income under Reg. section 1.1502-13(c)(6)(ii)(D).

LTR 202412009 addresses a fact pattern not specifically covered in the consolidated return regulations and concludes that an intercompany restructuring should not result in the inclusion of a deferred intercompany gain in gross income under Reg. section 1.1502-13(c)(6)(ii)(D).

Parent Owner is a domestic partnership that owned all of the outstanding stock of Parent. Parent was the common parent of a consolidated group (the "Parent Consolidated Group"). The Parent Consolidated Group was engaged in Business A, conducted by DE 8 and its subsidiaries. Sub 1, a domestic corporation that was not a member of the Parent Consolidated Group after Date 2, and its subsidiaries conducted (and continue to conduct) Business B.

Parent owned all the equity of DE 1, DE 2, and DE 3, each a domestic entity disregarded as separate from its owner for federal income tax purposes (a "disregarded entity"). DE 3 owned all the equity of DE 4, a domestic disregarded entity. DE 4 owned all the equity of DE 5, DE 6, and DE 7, each a domestic disregarded entity.

Parent owned a certain percent of the outstanding common stock of Sub 1. DE 1 and DE 5 also owned certain percent of the outstanding common stock of Sub 1. The combined ownership of Sub 1 by Parent, DE 1 and DE 5 immediately before Date 2 was sufficient for Sub 1 to be consolidated with Parent. Public investors owned the remaining outstanding common stock of Sub 1.

DE 6 owned all the equity of DE 8, a domestic disregarded entity. DE 8 owned all the equity of DE 9, a domestic disregarded entity, and various other corporate subsidiaries and disregarded entities, including Sub 3, a domestic corporation. DE 9 owned all the equity of DE 10, a domestic disregarded entity. DE 10 owned all the equity of Sub 2, a domestic entity treated as a corporation for federal income tax purposes. Sub 2 owned certain assets that are used in and relevant to the operation of Business B by Sub 1.

Prior to Date 3, DE 3, DE 4, DE 6, DE 7, and DE 8 were corporations. During Date 3, DE 3, DE 4, DE 6, DE 7, and DE 8 were converted to limited liability companies treated as disregarded entities (the "Date 3 Conversions").

As a result of past transactions, a deferred intercompany gain under Reg. § 1.1502-13 (the "DIG") existed with respect to a portion of Sub 1 stock (the "DIG Stock"). Prior to Date 1, DE 8 owned all of Sub 1. The DIG resulted from DE 8's distribution on Date 1 of a certain percent of the common stock of Sub 1 to DE 6 in a transaction to which section 311 applied (the "Date 1 Distribution"). DE 6 further distributed the DIG Stock to DE 4, which then contributed it to DE 7, which was then a newly formed, wholly owned subsidiary.

Subsequent to the Date 1 Distribution, ownership of the common stock of Sub 1 (other than the DIG Stock) was transferred within the Parent Consolidated Group in various transactions. Parent determined that Sub 1 and its subsidiaries were no longer members of the Parent Consolidated Group as of Date 2 as the combined result of various transactions involving Sub 1 shares, including dispositions of Sub 1 shares (the "Deconsolidation Event").

Parent engaged in the Completed Transaction for what it represented to be valid business reasons. The relevant steps of the Completed Transaction, which occurred on or before Date 4, are summarized below:

Before Date 4: 1) Parent distributed the equity of DE 2, a dormant or non-operational entity, to Parent Owner; 2) DE 2 formed a new domestic corporation ("New Parent"); 3) New Parent formed a new domestic disregarded entity ("DE 11"); 4) The stock of Sub 2 was distributed from DE 10, through DE 9, DE 8, DE 6, DE 4, and DE 3, to Parent in a series of transactions intended to be disregarded for federal income tax purposes; 5) DE 8 caused each of its domestic subsidiaries treated as corporations for federal income tax purposes, except for Sub 3, to be converted into limited liability companies treated as disregarded entities. Each conversion was intended to qualify as a section 332 liquidation; 6) DE 8 distributed the excess cash held by DE 8 and its subsidiaries to Parent in a series of transactions intended to be disregarded for federal income tax purposes; 7) DE 5, through DE 4 and DE 3, and DE 1 distributed their respective shares of Sub 1 common stock to Parent in transactions intended to be disregarded for federal income tax purposes.

On Date 4: 1) An unrelated corporation ("Buyer") acquired all the equity of DE 6 from DE 4 in a transaction was intended to be treated as a taxable asset sale for federal income tax purposes (the "Business A Disposition"). The consideration received by DE 4 in the transaction was distributed, through DE 3, to Parent in transactions intended to be disregarded for federal income tax purposes. A portion of the consideration will be used to satisfy liabilities and to redeem Parent shares held by employees of DE 8, with the remainder distributed to Parent Owner; 2) Parent distributed the equity of DE 1 and DE 3 to Parent Owner (the "Interests"). The Interests represent ownership interests in dormant or non-operational entities. Parent Owner then contributed the equity of Parent, DE 1, DE 3, and a newly formed domestic disregarded entity to DE 2; 3) Parent merged with and into DE 11, with DE 11 surviving, in a transaction that, together with Steps 2 and 3, was intended to be an F reorganization (the "Parent Reorganization"). As a result of the Parent Reorganization, New Parent succeeded to the DIG.

After the Parent Reorganization and as a continuation of the transactions on Date 4, the following occurred: 4) DE 11 distributed its shares of Sub 1 common stock, cash, and the equity of Sub 2 to New Parent in transactions intended to be disregarded for federal income tax purposes; 5) New Parent distributed the equity of DE 11 to DE 2; 6) Sub 1 formed a new domestic disregarded entity ("DE 12"); 7) New Parent merged with and into DE 12 with DE 12 surviving (the "Downstream Merger") in a transaction intended to be as an A reorganization.

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Among other things, Parent represented that the effects of the Date 1 Distribution have not previously been, and in no event would have resulted in, the Date 1 Distribution being reflected, directly or indirectly, on the Parent Consolidated Group's consolidated return, and that the Parent Consolidated Group has not derived, and no taxpayer will derive, any federal income tax benefit from the Date 1 Distribution that gave rise to the DIG.

Treas. Reg. section 1.1502-13(c)(6)(ii)(D) states in relevant part that the Commissioner may determine that treating the selling member's intercompany items as excluded from gross income is consistent with the purposes of the Code and Regulations in cases where the intercompany item constitutes gain if the effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the group's consolidated return, and the group has not derived, and no taxpayer will derive, any Federal income tax benefit from the intercompany transaction that gave rise to the intercompany gain or the redetermination of the intercompany gain.

The Service ruled that the DIG is redetermined to be excluded from gross income under Treas. Reg. section 1.1502-13(c)(6)(ii)(D).

Implications. The substance of the transaction was an F Reorganization of Parent, which had no effect on the DIG, followed by an A Reorganization of Parent's successor into Sub1. Sub1 appeared to be the new parent of the consolidated group. This wasn't a transaction specifically covered in the consolidated return regulations, so the taxpayer sought, and received, a ruling that the DIG was redetermined to be excluded from gross income. Key representations were that the effects of the Date 1 Distribution have not previously been, and in no event would have resulted in, the Date 1 Distribution being reflected, directly or indirectly, on the Parent Consolidated Group's consolidated return, and that the Parent Consolidated Group has not derived, and no taxpayer will derive, any federal income tax benefit from the Date 1 Distribution that gave rise to the DIG. ■

Nonprofit captive insurance company's income is excludible from gross income under section 115(1)

LTR 202413009 rules that a nonprofit captive insurance company's income is excludible from gross income under section 115(1) because the company exercises an essential governmental function.

Taxpayer was formed as a nonprofit corporation to be a captive insurance company that provides reinsurance coverage to Authority. Authority is Taxpayer's sole member, and Taxpayer's articles of incorporation and bylaws provide that only Authority may be a member of Taxpayer.

Authority is a public agency formed under state law whose income is excludable from gross income under section 115(1). The participants in Authority are independent public charter schools approved by either a local school district, a county board of education, or a Board of Education.

Authority's purpose is to provide its participants with a way to acquire insurance coverage that would otherwise be unavailable or too expensive for its participants to obtain by allowing participants to collectively purchase or finance insurance coverage and providing means for the participants to share risk, pool reserves, self-insure, or self-reinsure.

Authority underwrites insurance policies for various types of risks faced by its participants. It assumes coverage related to the policies by administering risk-based insurance pools. Where the pool coverage is insufficient, Authority reinsures its policies through third-party commercial insurers. Taxpayer represents that because these third-party insurance policies can be expensive and have burdensome requirements, Authority created Taxpayer to reduce reliance on third-party commercial insurance policies by having Taxpayer provide a portion of the reinsurance requirements of Authority. Taxpayer does not provide services to anyone other than Taxpayer.

Under each reinsurance agreement, Authority pays premiums to Taxpayer and in return it receives reinsurance coverage from Taxpayer. Taxpayer's board of directors invests these premiums to earn additional income. Taxpayer's only sources of income are this investment income and the premiums received from Authority. This income is used by Taxpayer to pay the reinsurance policy and other operational expenses of Taxpayer, including a range of professional services it represents it cannot otherwise effectively or responsibly provide internally. All payments to third-party service providers are at arm's length for fair market value. These professional services include insurance-based accounting and finance solutions, policy documentation, claims management and administration, and various compliance services.

Taxpayer's articles of incorporation provide that Taxpayer's net assets are distributable to its sole member, Authority, upon dissolution. In the event that when Taxpayer dissolves, Authority no longer exists or fails to be an organization whose income is excludable from its gross income under section 115, Taxpayer's articles of incorporation provide that its net income will go to one or more organizations whose income is excludable from gross income under section 115.

Section 115(1) provides that gross income does not include income derived from any public utility or the exercise of any essential governmental function and accruing to a state or political subdivision thereof.

Rev. Rul. 77-261, 1977-2 C.B. 45, holds that the income from an investment fund, established pursuant to state law for the temporary investment of cash balances of a state and its participating political subdivisions, is excludable from gross income under section 115. The ruling reasons that the investment of positive cash balances by a state or political subdivisions thereof to receive yield on the funds until needed to meet expenses is a necessary incident of the power of the state or political subdivision to collect taxes and other revenue for use in meeting governmental expenses. In addition to concluding that income from such an investment activity was income from the exercise of an essential governmental function, the ruling also concludes

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that since the state and its participating political subdivisions had an unrestricted right to their proportionate share of the investment fund's income, the fund's income accrued to them.

Rev. Rul. 90-74, 1990-2 C.B. 34, holds that income of an organization formed, operated and funded by political subdivisions of a state to pool their casualty risks is excluded from gross income under section 115(1). The ruling also holds that income of such an organization formed to pool risks in lieu of purchasing insurance to cover their public liability, workers' compensation, or employees' health obligations is excluded under section 115(1) if private interests do not, except for incidental benefits to employees of the participating state and political subdivisions, participate in or benefit from the organizations.

The Service ruled that Taxpayer's income from underwriting reinsurance policies for Authority is excludable from gross income under section 115(1) because Taxpayer's income from these reinsurance activities is derived from its exercise of an essential governmental function and such income accrues to a state or any political subdivision thereof. The Service reasoned that by providing reinsurance to a public agency, Taxpayer performs an essential governmental function as provided in Rev. Rul. 90-74. It specifically noted that Taxpayer's income will be used solely to provide benefits to Authority, that upon Taxpayer's dissolution its net assets will be distributed to Authority and that private interests do not benefit from Taxpayer's activities more than incidentally.

Implications. The governmental function here was the provision of insurance coverage to public employees that otherwise would have been unavailable or too expensive to obtain. ■

REIT's fees for rental of storage space are "rents from real property"

LTR 202413004 rules that a REIT's fees for the rental of storage space and certain ancillary services are rents from real property.

Taxpayer is a corporation that intends to elect to be taxed as a real estate investment trust ("REIT") within the meaning of section 856. Taxpayer also intends that an existing or newly formed subsidiary of Taxpayer will elect to be classified as a corporation for U.S. federal income tax purposes and will make a joint election with Taxpayer to be treated as a taxable REIT subsidiary ("TRS") of the Taxpayer.

Taxpayer intends to acquire various properties throughout the country ("Properties"). Taxpayer represents that each of the assets that comprise a Property is either land, an interest in land, an improvement to land, an inherently permanent structure, or a structural component of an inherently permanent structure.

Taxpayer will enter into agreements with unrelated third-party individuals or businesses ("Tenant" or collectively "Tenants") for the use of a specified amount of space at a Property for the storage of Equipment ("Storage Agreements"). A Storage Agreement may allocate specifically identified storage space for a particular Tenant's use, and all Storage Agreements will allocate a specified amount of space reserved for the Tenant's use. A Storage Agreement may provide that a particular Tenant's allocated amount of storage space may be available at any one of its Properties.

A Tenant will pay a fixed dollar amount for the use of storage space at a Property or Properties ("Storage Fee"). Tenants will be obligated to pay the Storage Fee regardless of whether they use their storage space. The Storage Fee may be increased from time to time if Taxpayer determines that market conditions (e.g., inflation or an increase in the fair rental value of the storage space) merit an adjustment to the applicable Storage Fee. Such adjustment will only be made in connection with the renewal of a Storage Agreement. Taxpayer represents that the amount of a Storage Fee will not depend in whole or in part on the income or profits of any person.

The Properties may include unattended parking areas adjacent or in close proximity to the storage area of any such Property. Taxpayer represents that any parking area will be appropriate in size for the number of Tenants expected to use storage space at the Property, and such Tenants' guests and customers. There will be no additional charge for the use of the parking area. The parking areas will not have an attendant and neither Taxpayer nor any other entity will perform any activities other than routine maintenance, repair, and the provision of electricity for lighting and electric vehicle charging stations ("EV Stations") in connection with the parking areas.

Taxpayer will engage a third-party utility provider that is an independent contractor from whom Taxpayer does not derive or receive any income (an "IK") to provide Tenants with certain utility services, such as furnishing electricity to light the Properties and, at some Properties, furnishing electricity to power and charge Equipment and to power EV Stations. Taxpayer intends to make electricity available in storage areas (including through EV Stations) to power and charge Tenant Equipment and in parking areas through EV Stations for Tenants, and their guests and customers, to charge vehicles. Tenants will be charged a higher Storage Fee for storage space with access, or in close proximity, to electricity sources (including EV stations) to power and charge Equipment. Taxpayer will not charge a separate access fee for the use of the EV Stations; however, a user will be charged for the electricity it draws from an EV Station. Taxpayer represents any usage of EV Stations by persons other than Tenants and Tenants' guests and customers will be de minimis.

Taxpayer may provide security at some or all of the Properties. Taxpayer represents that the provision of security is a service that is customarily furnished to tenants of similar properties in the geographic markets in which the Properties are located.

Generally, Tenants will move their own Equipment into and out of the storage area, but in cases in which a Tenant's Equipment can be stacked, the Tenant will deliver its Equipment to a staging area at the appropriate Property. One or more employees of the TRS or an IK will move the Tenant's Equipment to the appropriate area within the Property. Taxpayer represents that the movement of Tenant Equipment in the

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above manner is a service that is customarily furnished to tenants of similar properties in the geographic markets in which the Properties are located.

Some Properties may include certain amenities that will be available to all Tenants of that Property, such as EV stations, shower facilities, or weigh stations ("Amenities"). At some Properties, access to the Amenities will be available for no charge ("Included Amenities"), while at other Properties, Tenants may be charged a separate fee for access to an Amenity. No services other than utilities, cleaning, and basic maintenance will be provided with respect to such Amenities. Taxpayer represents that the services provided in connection with the Amenities are customarily provided to tenants of similar properties in the applicable geographic region. When Tenants are charged a separate fee for access to an Amenity, Taxpayer will treat any amounts it receives for such access as other than rents from real property for purposes of section 856(d).

Taxpayer represents that any impermissible tenant service income ("ITSI") for any tax year will not exceed 1% of all amounts received or accrued during such tax year directly or indirectly by the Taxpayer with respect to a Property within the meaning of section 856(d)(7)(B).

Taxpayer intends to enter into a lease with its TRS as tenant ("TRS Lease") pursuant to which Taxpayer will lease a specified amount of storage space at some or all of its Properties to the TRS on a long-term basis under the limited rental exception of section 856(d)(8)(A). The TRS will sublease portions of such space to third parties who wish to enter into arrangements for the use of storage space on a short term basis. Taxpayer represents that with respect to each Property, at least 90% of the leased space will be rented to persons other than the TRS or any other related person and that the amounts paid as rents from real property to Taxpayer pursuant to the TRS Lease will be substantially comparable to Storage Fees paid by Tenants for comparable space. Taxpayer also represents that rent attributable to personal property, if any, which is leased under or in connection with the lease of real property pursuant to any TRS Lease, will not exceed 15% of the total rent for the tax year paid by the TRS for both the real and personal property leased under, or in connection with, such TRS Lease.

Section 856(c)(2) provides that at least 95% of a REIT's gross income must be derived from, among other sources, rents from real property. Section 856(c)(3) provides that at least 75% of a REIT's gross income must be derived from, among other sources, rents from real property.

Section 856(d)(1) provides that rents from real property include (subject to exclusions provided in section 856(d)(2)): (A) rents from interests in real property; (B) charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated; and (C) rent attributable to personal property leased under, or in connection with, a lease of real property, but only if the rent attributable to such personal property for the taxable year does not exceed 15% of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.

Section 856(d)(2)(A) provides that the term "rents from real property" does not include any amount received or accrued, directly or indirectly, with respect to any real or personal property, if the determination of such amount depends in whole or in part on the income or profits derived from any person from such property.

Reg. section 1.856-4(a) defines the term "rents from real property" generally as the gross amounts received for the use of, or the right to use, real property of the REIT.

Reg. section 1.856-4(b)(1) provides that, the term "rents from real property" includes charges for services customarily furnished or rendered in connection with the rental of real property, whether or not the charges are separately stated. Services furnished to the tenants of a particular building will be considered customary if, in the geographic market in which the building is located, tenants in buildings which are of a similar class are customarily provided with the service. In particular geographic areas where it is customary to furnish electricity or other utilities to tenants in buildings of a particular class, the submetering of such utilities to tenants in such buildings will be considered a customary service. To qualify as a service customarily furnished, the service must be furnished or rendered to the tenants of the REIT or, primarily for the convenience or benefit of the tenant, to the guests, customers, or subtenants of the tenant.

Section 856(d)(7)(C)(i) provides that services furnished or rendered, or management or operation provided, through an independent contractor from whom the REIT does not derive or receive any income or through a TRS of the REIT shall not be treated as furnished, rendered, or provided by the REIT.

Section 856(d)(2)(C) provides that any ITSI is excluded from the definition of "rents from real property". Section 856(d)(7)(C)(ii) provides that ITSI shall not include any amount which would be excluded from unrelated business taxable income under section 512(b)(3) if received by an organization described in section 511(a)(2). Section 512(b)(3) provides, in part, that there shall be excluded from the computation of unrelated business taxable income all rents from real property and all rents from personal property leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service. Under regulations, such items as the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, and the collection of trash are treated as incidental amounts.

Revenue Ruling 2004-24, 2004-1 C.B. 550, states that income from providing parking facilities at a rental real property qualifies as rents from real property in the case where the parking facility is unattended, for the use of the tenants of its buildings and their guests, customers, and subtenants, located in or adjacent to a building occupied by tenants of the REIT, and is appropriate in size for the number of tenants and their guests, customers, and subtenants who are expected to use the facility.

Based on Taxpayer's representations the service ruled that: (1) Storage Fees received by Taxpayer from unrelated third parties under Storage Agreements for the use of space at Properties are rents from real property within the meaning of section 856(d) for purposes of the Income Tests; (2) the services and Included Amenities will not give rise to ITSI within the meaning of section 856(d)(7) and will not cause any portion of the Storage Fees

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to fail to qualify as rents from real property within the meaning of section 856(d); (3) the amounts Taxpayer receives for the provision of such services and Included Amenities constitute rents from real property within the meaning of section 856(d) for purposes of the Income Tests; and (4) the amounts received by Taxpayer pursuant to a lease of space at Properties to its TRS constitute rents from real property within the meaning of section 856(d) for purposes of the Income Tests.

Implications. Whether a REIT earns rental income can be highly fact-specific. The taxpayer was prudent in seeking a ruling establishing the details of the business arrangement and showing that amounts that were arguably not attributable to rental income fit within the definition of rental income for REIT purposes. ■

S Corporation granted relief for failing to timely make ESBT election to preserve S Corporation status

The Service in LTR 202413006 granted relief to an S Corporation that did not timely make elections to preserve S Corporation status.

X, an S Corporation, was owned by A, an individual, through two separate trusts, Trust 1 and Trust 2. The trusts were eligible S corporation shareholders under section 1361(c)(2)(a)(i). A died and after A's death, Trust 1 elected to be included in A's estate under section 645. A's estate was closed on Date 4. Under section 1361(c)(2)(a)(ii) Trust 2 qualified as an eligible S corporation shareholder for the two-year period beginning on the day the shares of X stock were transferred to it, ending Date 5.

X represents that beginning on Date 3, both Trust 1 and Trust 2 met the requirements of an Electing Small Business Trust (ESBT) within the meaning of §1361(e)(1)(A). However, the trustees of Trust 1 and Trust 2 did not make a timely election for Trust 1 or Trust 2 to be treated as ESBTs under §1361(e)(3), thus causing X's S corporation election to terminate on Date 4.

X represents that there was no tax avoidance or retroactive tax planning involved in the failure of Trust 1 or Trust 2 to file an ESBT election and the resulting termination of X's S corporation election. X and its shareholders agreed to make any adjustments required as a condition of obtaining relief under the inadvertent termination rule as provided under section 1362(f) of the Code that may be required by the Secretary.

Section 1361(a)(1) provides that the term "S corporation" means, with respect to any tax year, a small business corporation for which an election under section 1362(a) is in effect for such year.

Section 1361(b)(1) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in section1361(c)(2), or an organization 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.

Section 1361(c)(2)(A)(iii) provides that, for purposes of section 1361(b)(1)(B), a trust with respect to stock transferred to it pursuant to the terms of a will may be a shareholder, but only for the 2-year period beginning on the day on which such stock is transferred to it.

Section 1361(c)(2)(A)(v) provides that for purposes of section 1361(b)(1)(B), an ESBT is a permissible shareholder. Section 1361(e)(1)(A) provides that, for purposes of §1361, except as provided in §1361(e)(1)(B), the term "electing small business trust" means any trust if (i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in section 170(c)(2)-(5), or (IV) an organization described in section 170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary, (ii) no interest in such trust was acquired by purchase, and (iii) an election under section 1361(e) applies to such trust.

Section 1361(e)(3) provides that an election under section 1361(e) shall be made by the trustee. Any such election shall apply to the tax year of the trust for which the election was made, and subsequent tax years of such trust unless revoked with the consent of the Secretary.

Section 1.1361-1(m)(2)(i) of the Income Tax Regulations provides, in part, that the trustee of an ESBT must make the ESBT election by signing and filing, with the service center where the S corporation files its income tax return, a statement that meets the requirements of §1.1361-1(m)(2)(ii).

Section 1.1361-1(m)(2)(iii) provides that the ESBT election must be filed within the time requirements prescribed in §1.1361-1(j)(6)(iii) for filing a QSST election.

Section 1362(d)(2)(A) provides that an election under §1362(a) shall be terminated whenever (at any time on or after the 1st day of the 1st tax year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(d)(2)(B) provides that any termination under §1362(d)(2)(A) is effective on and after the date of cessation.

Section 1362(f) provides, in relevant part, that if (1) an election under §1362(a) by any corporation was not effective for the tax year for which made (determined without regard to §1362(b)(2)) by reason of a failure to meet the requirements of §1361(b) or to obtain shareholder consents or was terminated under §1362(d)(2), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken so that the corporation for which the election was made or the termination occurred is a small business corporation or to acquire the required shareholder consents, and (4) the corporation for which the election was made or the termination occurred, and each person who was a shareholder in such corporation at any time during the period specified pursuant to §1362(f), agrees to make the adjustments (consistent with the treatment of such corporation as an

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S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such ineffectiveness or termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 645(a) provides that if both the executor (if any) of an estate and the trustee of a qualified revocable trust elect the treatment provided in section 645, such trust shall be treated and taxed as part of such estate (and not as a separate trust) for all tax years of the estate ending after the date of the decedent's death and before the applicable date.

Section 645(b) provides that for purposes of section 645(a) the term "applicable date" means (A) if no return of tax imposed by chapter 11 of the Code is required to be filed, the date which is 2 years after the date of the decedent's death, and (B) if such a return is required to be filed, the date which is 6 months after the date of the final determination of the liability for tax imposed by chapter 11 of the Code.

The Service concluded that X's S corporation election terminated on Date 4, because no ESBT election was filed for Trust 1. Additionally, the Service concluded that had X's S corporation election not terminated on Date 4, X's S corporation election would have terminated on Date 5 because no ESBT election was filed for Trust 2. Lastly, the Service concluded that the termination of X's S corporation election on Date 4 was inadvertent within the meaning of section 1362(f). Accordingly, the Service ruled that X will be treated as an S corporation effective Date 4 and thereafter, provided that X's S corporation election was otherwise valid and was not otherwise terminated under section 1362(d).

The Service made its ruling contingent on the trustees of Trust 1 and Trust 2 filing an appropriately completed ESBT election for Trust 1 and Trust 2 effective on Date 4 and Date 5, respectively, and upon Trust 1, Trust 2, and their beneficiaries filing timely amended federal income tax returns for all open years consistent with the treatment of Trust 1 and Trust 2 as ESBTs effective Date 4 and Date 5, as necessary.

Implications. The S Corporation's error was apparently inadvertent. The Service conditioned the ruling on amended returns being filed that were consistent with the desired treatment.

Organization's promotion of athletic competitions not exempt under section 501(c)(3)

LTR 202413013 denies section 501(c)(3) status to a taxpayer that was engaged in the promotion of athletic competitions.

The taxpayer applied for exempt status under section 501(c)(3). It attested that it had the necessary organizing document, that its organizing document limits its purposes to one or more exempt purposes within the meaning section 501(c)(3). The taxpayer further attested that it is organized and operated exclusively to further charitable purposes and that it has not and will not conduct prohibited activities under the statute.

Pursuant to a supplemental request for information the taxpayer stated that its mission is to host an annual festival featuring trail and mountain bike races, a family treasure hunt, and other events to entertain younger participants. The taxpayer stated that it is conducting events that contribute to the character and culture of the town and bring tourism to support small businesses and town revenue. It also stated that its events promote holistic wellness through sports for all ages.

The trail races and mountain bike races are organized by F; "professionals in the outdoor industry". F charges entry fees for the six events they manage, and the taxpayer stated that it would support F financially. The taxpayer charges money for its events.

Section 501(c)(3) provides for the recognition of exemption of organizations that are organized and operated exclusively for religious, charitable or other purposes as specified in the statute.

Rev. Rul. 70-4, 1970-1 C.B. 126 states an organization engaged in promoting and regulating a sport for amateurs is not exempt under section 501(c)(3) but is exempt under section 501(c)(4). The organization was formed for the stated purposes of promoting the health of the general public by encouraging all persons to improve their physical condition and of fostering by educational means, public interest in a particular sport for amateurs. The Service stated in that ruling that promotion and regulation of a sport for amateurs as described neither improve nor develop the capabilities of the individual nor instruct the public on subjects useful to the individual and beneficial to the community within the meaning of the regulations. Therefore, these activities are not educational within the meaning of section 501(c)(3). However, the organization by promoting and regulating a sport for amateurs is providing wholesome activity and entertainment for the social improvement and welfare of the community. This promotes the common good and general welfare of the people of the community.

Rev. Rul. 77-365, 1977-2 C.B. 192 amplified Rev. Rul. 65-2, ruling that the definition of "educational" (which is an exempt purpose under section 501(c)(3)) contains no limitation with regard to age in defining that term. The organization is organized and operated only to instruct and educate individuals of all ages and skill levels in a particular sport. Therefore, by instructing individuals of all ages in a given sport the organization is improving or developing their capabilities. The organization in the ruling, however, did not establish rules, set standards for equipment, or sponsor league competition for the sport in which it provides instruction.

In *Better Business Bureau of Washington, D.C., Inc. v. United States*, 326 U.S. 279 (1945), the Supreme Court determined the activities of that organization were aimed at promoting the prosperity and standing of the business community and therefore served a substantial private purpose. It concluded that the presence of a single nonexempt purpose, if substantial in nature, will preclude exemption regardless of the number or importance of statutorily exempt purposes.IRC Section 501(c)(3) sets forth two main tests for qualification for exempt status. As stated in Treas. Reg.

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Section 1.501(c)(3)-1(a)(1), an organization must be both organized and operated exclusively for purposes described in Section 501(c)(3). You are not operating in accordance with Treas. Reg. Section 1.501(c)(3)-1(c)(1) because you are not primarily engaged in activities that accomplish exclusive exempt purposes specified in Section 501(c)(3). You are conducting a festival which serves a substantial social and recreational purpose. Further, you are promoting adult sports competitions. Therefore, you are precluded from exemption under Section 501(c)(3). Accordingly, the Service stated that the taxpayer is similar to the organization in Rev. Rul. 70-4 in that it is hosting, organizing and/or sponsoring a two-day event featuring competitive races for individuals/families. The Service stated that an organization engaged in promoting and regulating a sport for amateurs is not exempt under section 501(c)(3), but rather, is better qualified for exemption under Section 501(c)(4). The Service further stated that an organization providing instruction cannot also set rules or engage in arranging competition. Therefore, the promotion and regulation of a sport for amateurs as the taxpayer described serves the common good and general welfare of the people of the community, but this is not exclusively educational within the meaning of Section 501(c)(3).

The Service analogized the taxpayer to the organization described in *Better Business Bureau v. US*. It reasoned that although the taxpayer may have some educational and charitable purposes, such as teaching people a sport, educating on wellness, and working with youth, it is operated for a substantial nonexempt purpose of competitive athletic events. Further, its festival is also serving social and recreational purposes in a more than incidental manner.

Implications. The exclusivity of one or more exempt purposes under section 501(c)(3) was lacking in the taxpayer's ruling request. Promotion of athletic competition does not qualify under section 501(c)(3).

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IRS's Eligible Basis Lacks Basis

This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice.

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This past February, the Tax Court smacked down the IRS's concept of "eligible basis" for purposes of low-income housing credits ("LIHCs") in *23rd Chelsea Associates v. Commissioner*.[1] In so doing, the Tax Court held that bond issuance financing costs, even for tax-exempt bonds, can be included in the Section 42 "eligible basis" of qualified low-income buildings. This reverses a long-standing position taken by the IRS in technical advice memorandum ("TAM") 200043015.

23rd Chelsea Associates, L.L.C. ("23rd Chelsea"), the taxpayer, was a partnership that built a multifamily residential apartment complex—called the "Tate"— in New York City from 2001 to 2002. 23rd Chelsea financed this construction with a loan from the New York State Housing Finance Agency (the "HFA"). The HFA, itself, raised funds for the construction loan by issuing bonds, some of which were tax-exempt. As a condition for the HFA granting 23rd Chelsea the construction loan, the HFA required 23rd Chelsea to satisfy several requirements. First, the Tate was to be subject to restrictions on the eventual tenant mix (by income level) and the rental rates for low-income tenants. These restrictions preserved the tax-exempt status of the HFA's bonds and would help qualify the Tate for LIHCs. Second, 23rd Chelsea was to fully secure the construction loan and related payment obligations by obtaining letters of credit from Bayerische Hypo-und Vereinsbank AG ("Hypo Bank") or another lender approved by the HFA. Third, the HFA required 23rd Chelsea to, directly or indirectly, pay certain financing costs. These costs included an origination fee payable to Hypo Bank for its letters of credit and fees payable to the HFA for costs incurred in issuing the bonds necessary to provide 23rd Chelsea the construction loan.

23rd Chelsea claimed LIHCs under Section 42 with respect to the Tate for 2003 through at least 2009. Assuming certain requirements are met, a taxpayer can receive a LIHC equal to the "applicable percentage" (published annually by the IRS) of a residential rental property's "qualified basis." The amount of a property's "qualified basis" depends on its "eligible basis." Under Section 42(d)(1) and Section 42(d)(4), a new building's "eligible basis" will equal its "adjusted basis" at the end of the first taxable year of the credit period, but only to the extent such adjusted basis is allocable to residential rental property and comes before any reduction for depreciation.

In calculating its LIHCs, 23rd Chelsea included in the Tate's eligible basis a portion of the various financing costs it incurred in connection with the HFA construction loan, including fees paid to the HFA and Hypo Bank as part of securing the construction loan and the letters of credit, respectively. 23rd Chelsea included each component of the financing costs in the Tate's eligible basis only to the extent that it deemed that component to relate to both (i) the portion of the real estate composed of residences and common areas, and (ii) costs incurred during the construction period.

Nonetheless, the IRS issued a final partnership administrative adjustment ("FPAA") determining, in part, that 23rd Chelsea should not have included the financing costs in the eligible basis used to calculate the LIHCs. The IRS's position rested on two arguments: first, the IRS argued that the financing costs were not properly capitalizable to the Tate, but instead were capitalizable to the loan itself, and thus were not depreciable under the modified accelerated cost recovery system ("MACRS"). Consequently, they were not part of the qualified low-income building that gave rise to an LIHC. Second, the IRS argued that the legislative history of Section 42 demonstrated that costs allocable to securing tax-exempt bonds (i.e., the fees paid to the HFA) are not includable in eligible basis.

According to the IRS, *none* of the financing costs should have been included in eligible basis. This argument matched the position of the IRS in TAM 200043015. Like 23rd Chelsea, the taxpayer in that TAM included certain bond issuance costs in its eligible basis under Section 42. The IRS determined that costs incurred in obtaining a loan (or a tax-exempt bond) are capitalized and amortized over the life of the loan or bond; accordingly, so said the IRS, bond issuance costs are not capitalizable to depreciable property (such as the Tate) but instead to the loan, which is intangible property and not subject to MACRS. Thus, the costs cannot be included in the building's eligible basis, because they are not capitalized to the building at all.

The Tax Court neutralized this argument by holding that Section 42 eligible basis can include indirect bond issuance costs attributable to the taxpayer's production and construction of the relevant property. The Tax Court first sought to define "adjusted basis" because Section 42 defines "eligible basis" as "adjusted basis." The Tax Court concluded that "adjusted basis" includes a property's share of properly allocable indirect costs. This conclusion flowed from a three-step analysis: (i) a property's properly allocable share of indirect costs must be capitalized to that property pursuant to Section 263A, (ii) "capitalize" means to charge to a capital account or basis pursuant to the Section 263A regulations, and (iii) basis is adjusted for any expenditures charged to the capital account pursuant to Section 1016(a)(1). Thus, the Tate's eligible basis included its share of properly allocable indirect costs.

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The Tax Court further held that the costs incurred by 23rd Chelsea related to obtaining the bond issuance were properly allocable to the Tate. The Section 263A regulations provide that "indirect costs" are "all costs other than direct material costs and direct labor costs." Indirect costs are properly allocable to a taxpayer-produced property when those costs "directly benefit or are incurred by reason of the performance of production . . . activities." That phrase was interpreted by the Tax Court under a Second Circuit decision, *Robinson Knife Mfg. Co., Inc. & Sub. v. Commissioner*,[2] to mean that capitalizable indirect costs are costs that are a "but-for" cause of the taxpayer's production activities. The Tax Court concluded that the bond issuance costs were necessary to induce the HFA to provide the construction loan, and thus were a "but-for" cause of the production activities. The costs were properly allocable to the Tate, and not the construction loan itself, as the costs were incurred "by reason of" the production activities related to the Tate. Additionally, other portions of Section 263A provide support for this position, as they require interest on loans used to finance the production of property to generally be capitalized to the relevant produced property if paid or incurred during the "production period" and allocable to property with "a long useful life." In 23rd Chelsea's case, it included the financing costs in eligible basis only to the extent of the Tate's construction (i.e., production) period and allocated such costs to the Tate—residential real property with a long useful life.

In both *23rd Chelsea* and TAM 200043015, the IRS attempted to use the legislative history of Section 42 to rebut this argument with respect to tax-exempt bonds. In the TAM, the IRS admitted that "an argument can be made" that Section 263A allows indirect costs of real property produced by the taxpayer to be capitalized by that taxpayer. Thus, "under the general rules of [S]ection 263A," the indirect costs could reasonably be allocated to the property produced. Nonetheless, the IRS cited a conference report stating that "residential rental property" under Section 42 meant "residential rental property" as used in Section 103. Section 103, in turn, is linked to Section 142. Section 142 defines "exempt facility bond" to mean any bond issued as part of an issue where 95% or more of the net proceeds are used to provide "qualified residential rental projects." The conference report, in discussing whether net proceeds under Section 142 were used for *any* exempt purpose (including qualified residential rental projects) that met the 95% test, noted that amounts paid for costs of bond issuance are not reduced from the amounts that qualify for the 95% test because they are not treated as "spent" for that test. From this, the IRS concluded that, because tax-exempt bond issuance costs are not included as costs for the 95% test, they should not be treated as costs spent for (and thus capitalizable in the basis of) qualified low-income buildings under Section 42. To do otherwise, so argued the IRS, would create "disparate treatment" between Section 42 and Section 142 and, further, reject the conference report's definition of "residential rental property."

The Tax Court rejected this argument for two reasons. First, the plain text of Section 42 was clear; there was no ambiguity that warranted the IRS's long-winded explanation of the legislative history. This conclusion is consistent with the Supreme Court's decision in *Gitlitz v. Commissioner*,[3] where the Court refused to look at the legislative history or purpose of a Code provision when the statutory language was clear. Second, and even assuming the legislative history of Section 42 was relevant to the case, the Tax Court's holding did not provide for "disparate treatment" of Section 42 and Section 142. The Tax Court's interpretation of "residential rental property" in Section 42 did not actually differ from the definition provided in the legislative history; rather, the Tax Court recognized that Congress imposed different requirements on the use of tax-exempt bonds for purposes of the two sections. Under Section 142, 95% of bond proceeds (a threshold unreduced by financing costs) must be used to provide certain exempt property, including qualified residential rental projects. By contrast, bond issuance costs are includable in eligible basis under Section 42. The definition of "residential rental property" does not change, only the required uses and allocation of bond proceeds and costs.

In sum, the Tax Court overruled an IRS position that had been held (and continually litigated, as shown in *23rd Chelsea*) for over twenty years. The plain text of Section 42 and the capitalization rules of Section 263A state that eligible basis, as a derivative of adjusted basis, includes bond issuance costs that are related to the production of property. Nonetheless, the IRS took a position contrary to that plain text due to their refusal to consider uniform capitalization rules regarding taxpayer-produced property and a questionable interpretation of Section 42's legislative history. As *23rd Chelsea* demonstrates, such questionable positions can be overturned, even decades later, when pressure tested.

We welcome our readers' comments.

End Notes

1 162 T.C. No. 3 (Feb. 20, 2024).

2 600 F.3d 121, 131–32 (2d Cir. 2010).

3 531 U.S. 206 (2001).

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