

Internal Revenue Service

Department of the Treasury

Index Number: 1362.04-00
9100.00-00

Washington, DC 20224

Number: **199911021**
Release Date: 3/19/1999

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:Br.1-PLR-120212-98
Date:
December 15, 1998

Legend

X =

A =

Sub1 =

Sub2 =

Trust =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

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This responds to your letter dated October 23, 1998, written on behalf of X, requesting relief under §1362(f) and § 301.9100-3 of the Procedure and Administration Regulations.

FACTS

X was incorporated on D1. X filed a timely election to be treated as an S corporation, effective D2.

A, the sole shareholder of X, created Trust on D3. On D4, A transferred shares of X to Trust.

X, A, and Trust intended that Trust be an Electing Small Business Trust (ESBT) under § 1361(e) on D4. However, A's legal counsel, who assisted A in forming Trust, incorrectly advised the trustee of Trust as to when the trustee must elect ESBT status to be effective as of D4.

On D5 and D6, X formed two wholly owned subsidiaries, Sub1 and Sub2, respectively. A, X, Sub1, and Sub2 intended that X elect "Qualified Subchapter S Subsidiary" (QSUB) status under § 1361(b)(3) for Sub1 and Sub2 effective as of D5 and D6, respectively. However, X's attorneys incorrectly advised X as to when X must elect QSUB status for Sub1 and Sub2 to be effective for those dates.

X recently discovered that no ESBT or QSUB elections had been made. Within a reasonable time after its discovery, X has taken steps to correct the aforementioned mistakes. X and its shareholders have agreed to make such adjustments as are necessary to be consistent with X's treatment as an S corporation.

X has represented that no retroactive or "hindsight" tax planning is being undertaken through the submission of its ruling request.

LAW AND ANALYSIS

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

Section 1361(b)(1)(B) provides that one of the requirements for a taxpayer to be a small business corporation is that the taxpayer is a domestic corporation which is not an

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ineligible corporation and does not have as a shareholder a person (other than an estate, a trust described in §1361(c)(2) and certain exempt organizations) who is not an individual.

Section 1361(c)(2)(A)(v) provides that for purposes of § 1361(b)(1)(B), an ESBT may be a shareholder of an S corporation. Section 1361(e)(3) provides that an election to be an ESBT under § 1361(e) is to be made by the trustee of the trust. The election applies to the taxable year of the trust for which made and all subsequent taxable years of the trust unless revoked with the consent of the Secretary.

Notice 97-12, 1997-3 I.R.B. 11, provides a temporary procedure for making an ESBT election. The Notice provides that the ESBT election filed by the trustee of the trust is to become effective not earlier than 15 days and two months before the date on which the election is filed.

Section 1361(b)(3)(B) defines the term “qualified subchapter S subsidiary” as a domestic corporation that is not an ineligible corporation, if 100 percent of the stock of the corporation is owned by the S corporation, and the S corporation elects to treat the corporation as a QSUB. The statutory provisions do not, however, provide guidance on the manner in which the QSUB election is made or the effective date of the election.

Notice 97-4, 1997-2 I.R.B. 24, provides a temporary procedure for making a QSUB election. Under Notice 97-4, a parent corporation makes a QSUB election for a subsidiary by filing Form 966, with certain modifications, with the appropriate service center. The election may be effective for up to 75 days prior to the filing of that form, provided that date is not before the parent corporation’s first taxable year beginning after December 31, 1996, and that the subsidiary otherwise qualifies as a QSUB for the entire period for which the retroactive election is to be effective.

Section 1362(d) provides that an election under § 1362(a) is terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation. Such termination is effective on and after the date of cessation.

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

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period, then, notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation shall be treated as continuing to be an S corporation during the period specified by the Secretary.

Congress' intent in enacting §1362(f) is expressed in S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24, as follows:

If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.

The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped that taxpayers and the government will work out agreements that protect the revenues without undue hardship to taxpayers.... It is expected that the waiver may be made retroactive for all years, or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.

Under § 301.9100-1(c), the Commissioner may grant a reasonable extension of time to make a regulatory election, or a statutory election (but no more than six months except in the case of a taxpayer who is abroad), under all subtitles of the Code, except subtitles E, G, H, and I, if the taxpayer demonstrates to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government. Section 301.9100-1(b) defines the term "regulatory election" as including an election whose deadline is prescribed by a notice published in the Internal Revenue Bulletin.

Sections 301.9100-1 through 301.9100-3 provide standards the Commissioner will use to determine whether to grant an extension of time to make an election. Section 301.9100-2 provides automatic extensions of time for making certain elections. Section 301.9100-3 provides extensions of time for making elections that do not meet the requirements of § 301.9100-2.

Requests for relief under § 301.9100-3 are granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government. Section 301.9100-3(a).

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election under § 1362(a) was terminated on D4 when X shares were transferred to Trust and the trustee of Trust did not make a timely ESBT election under §1361(e)(3) and Notice 97-12. We also conclude that the termination constituted an inadvertent termination within the meaning of § 1362(f). Pursuant to § 1362(f), X will be treated as continuing to be an S corporation from D4, and thereafter, and the trustee of Trust will be deemed to have filed a timely ESBT election on behalf of Trust, effective D4, provided X's S election is not otherwise terminated under § 1362(d), and, provided further, that trustee of Trust files an ESBT election with the service center, effective as of D4, within 60 days of the date of this letter. A copy of this letter should be attached to such election.

We also conclude that the standards of §§ 301.9100-1 and 301.9100-3 have been met. Therefore, X is granted an extension to file QSUB elections for Sub1 and Sub2, effective as of D5 and D6, respectively, until 60 days from the date of this letter. The elections should be made by following the procedure set forth in Notice 97-4. A copy of this letter should be attached to such elections.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed as to whether X made a valid subchapter S election under § 1362 or whether Trust, Sub1, or Sub2 otherwise are qualified S corporation shareholders under § 1361.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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In accordance with the Power of Attorney on file with this office, the original of this letter is being sent to the taxpayer's representative and a copy is being sent to the taxpayer.

Sincerely,

signed/Paul F. Kugler
Paul F. Kugler
Assistant Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2):

Copy of this letter
Copy for section 6110 purpose