Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:3-PLR-146460-01
Date:
February 25, 2002

LEGEND

Company A =

Company B =

Shareholders =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Dear :

This letter responds to your letter, dated August 30, 2001, submitted on behalf of Company A and Company B, requesting rulings relating to their S elections under §§ 1362(f), 1361(b)(3)(B), and 1362(b)(5) of the Internal Revenue Code.

FACTS

Company A and Company B represent the following facts. Company A was incorporated on Date 1 under the laws of State. The Shareholders of Company A consist of two individuals and five trusts whose beneficiaries are minors. It is represented that the trusts qualify as qualified subchapter S trusts (QSSTs). On Date 2, Company A filed a timely election under § 1362(a) to be treated as an S corporation effective Date 3.

On the advice of their representatives, the trustees of each trust, not the legal guardians of the minors, signed the QSST election and the S corporation election on Form 2553, Election by a Small Business Corporation. The form was prepared by and executed under the supervision of Company A's counsel. Company A believed that the form was properly executed when it was filed.

On Date 4, Company A submitted articles of incorporation to State for the purpose of incorporating Company B as a wholly-owned subsidiary and transferred part of its business to Company B. Relying on counsel's advice, on Date 5, Company A timely filed a Form 2553 for Company B, intending to elect treatment for Company B as a qualified subchapter S subsidiary (QSub) under § 1361(b)(3) effective Date 4. Company B later received a Notice of Acceptance as an S Corporation from the Service. Counsel was not made aware of the notice at that time. When counsel learned that the QSub election was not made on the correct form, a Form 8869, Qualified Subchapter S Subsidiary Election, and a letter were filed to correct and replace the Form 2553 that was previously submitted.

On Date 6, Company A distributed all of its stock in Company B to Shareholders. Shareholders intended for Company B to continue as a pass-through entity as of Date 6, but failed to file a Form 2553 to elect S corporation status.

Because of the election it had filed, Company A believed it was an S corporation from Date 3 and filed its tax returns as an S corporation. On its tax return, Company A treated Company B as a QSub during the period which Company A owned Company B's stock, therefore, Company B did not file its own return for this period. The

Shareholders filed their returns in accordance with Company A's returns. After Company B's stock was distributed to Shareholders, Company B believed it was an S corporation and filed its return as an S corporation The Shareholders have filed or will file in accordance with Company B's S corporation return.

Company A and Company B request the following rulings: (1) that relief will be granted to Company A under § 1362(f) effective Date 3; (2) that Company B will be treated as a QSub effective Date 4; and (3) that relief will be granted to Company B under § 1362(b)(5) effective Date 6.

ISSUE 1

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

Section 1361(b)(1)(B) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual.

Section 1361(c)(2)(A)(i) provides that for purposes of § 1361(b)(1)(B), a trust all of which is treated (under subpart E of part I of subchapter J of Chapter 1) as owned by an individual who is a citizen or resident of the United States may be a shareholder. Section 1361(c)(2)(B)(i) provides that for purposes of § 1361(b)(1), in the case of a trust described in § 1361(c)(2)(A)(i), the deemed owner shall be treated as the shareholder.

Section 1361(d)(1) provides that in the case of a qualified subchapter S trust with respect to which a beneficiary makes an election under § 1361(d)(2), such trust shall be treated as a trust described in § 1361(c)(2)(A)(i) and, for purposes of § 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under § 1361(d)(2) is made.

Section 1361(d)(2) provides that a beneficiary of a QSST (or his legal representative) may elect to have § 1361(d) apply.

Section 1.1361-1(j)(6)(ii) of the Income Tax Regulations provides that the current income beneficiary of the trust must make the QSST election under § 1361(d)(2) by signing and filing with the service center with which the corporation files its income tax return the applicable form or a statement including the information listed in § 1.1361-1(j)(6)(ii).

Section 1.1361-1(j)(6)(i) provides that any action required by § 1.1361-1(j) to be taken by a person who is under a legal disability by reason of age may be taken by that person's guardian or other legal representative, or if there be none, by that person's natural or adoptive parent.

Section 1362(a)(1) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1362(a)(2) provides that an election under § 1362(a) shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.

Section 1.1362-6(b)(1) provides that except as provided in § 1.1362-6(b)(3)(iii), the election of the corporation is not valid if any required consent is not filed in accordance with the rules contained in § 1.1362-6(b).

Section 1.1362-6(b)(2)(iv) provides that in the case of a trust described in § 1361(c)(2)(A) (including a trust treated under § 1361(d)(1)(A) as a trust described in § 1361(c)(2)(A)(i)), only the person treated as the shareholder for purposes of § 1361(b)(1) must consent to the election.

Section 1.1362-6(b)(2)(ii) provides that the consent of a minor must be made by the minor or by the legal representative of the minor (or by a natural or an adoptive parent of the minor if no legal representative has been appointed).

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was not effective for the taxable 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 paragraph (2) or (3) of § 1362(d), (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 (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 pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

The conference report on the Small Business Job Protection Act of 1996, P. L. 104-188, provides that the Service should be reasonable in exercising this authority and apply standards that are similar to those applied under present law to inadvertent subchapter S terminations. H. R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 222 (1996), 1996-3 C.B. 741, 962.

According to the legislative history of § 1362(f)--

> 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 revenue 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.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24.

Section 1.1362-4(b) provides that, for purposes of § 1.1362-4(a), the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent.

Company A and its Shareholders agree to make any adjustments, consistent with the treatment of Company A as an S corporation, as might be required by the Secretary.

Based on the facts submitted and the representations made, we conclude that Company A's election to be an S corporation was ineffective as a result of the trustee of each trust, rather than the beneficiary or the beneficiary's legal representative, signing the QSST election and the Form 2553 for the trust. We also conclude that the ineffectiveness of Company A's S corporation election was "inadvertent" within the meaning of § 1362(f).

We further conclude that, pursuant to the provisions of § 1362(f), Company A will be treated as an S corporation effective Date 3, and thereafter, if Company A submits a correctly filled out Form 2553 and a QSST election with the proper signatures to the appropriate service center within 60 days from the date of this letter, and provided that Company A's election to be an S corporation was otherwise valid and was not terminated under § 1362(d). The shareholders of Company A must include their pro rata share of the separately stated and nonseparately computed items of Company A as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account any distributions made by Company A as provided in § 1368. If Company A or its shareholders fail to treat themselves as described above, this ruling will be null and void.

ISSUE 2

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.

Section 1.1361-3(a) provides that except as provided in §§ 1361(b)(3)(D) and 1.1361-5(c) (five-year prohibition on reelection), an S corporation may elect to treat an eligible subsidiary as a QSub by filing a completed Form 8869, Qualified Subchapter S Subsidiary Election, with the appropriate service center. Generally, the election may be effective on the date the Form 8869 is filed or up to two months and 15 days prior to the filing of the form, provided that date is not before the parent'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 relief is in effect. If a valid QSub election is made, the subsidiary is not treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of the QSub are treated as assets, liabilities, and items of income, deduction, and credit of the parent S corporation.

Under § 301.9100-1(c) of the Procedure and Administration Regulations, 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. Section 301.9100-1(b) defines the term "regulatory election" as including an election whose due date is prescribed by a regulation published in the Federal Register, or a revenue ruling, revenue procedure, notice, or announcement published in the Internal Revenue Bulletin.

Sections 301.9100-1 through 301.9100-3 provide the 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, but does not apply to QSub 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 will be 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.

Based on the information submitted and the representations made, we conclude that the requirements of § 301.9100-3 have been satisfied. As a result, Company A is granted an extension of time of 60 days from the date of this letter to make an election to treat Company B as a QSub effective Date 4. Company A should submit a copy of the previously filed Form 8869 to the appropriate service center. A copy of this letter should be attached to the Form 8869 filed with the service center.

ISSUE 3

Section 1361(b)(3)(B) provides that to qualify for QSub status 100 percent of the stock of the corporation must be owned by an S corporation.

Section 1361(b)(3)(D) provides that if a corporation's status as a QSub terminates, such corporation (and any successor corporation) shall not be eligible to make an election under § 1362(a) to be treated as an S corporation before its 5th taxable year which begins after the 1st taxable year for which such termination was effective, unless the Secretary consents to such election.

Section 1.1361-5(a)(1)(iii) provides that a QSub election will terminate at the close of the day on which an event occurs that renders the subsidiary ineligible for QSub status under § 1361(b)(3)(B).

Section 1.1361-5(c)(2) provides that in the case of S and QSub elections effective after December 31, 1996, if a corporation's QSub election terminates, the corporation may, without requesting the Commissioner's consent, make an S election before the expiration of the five-year period described in § 1361(b)(3)(D) if immediately following the termination, the corporation (or its successor corporation) is otherwise eligible to make an S election and the relevant election is made effective immediately following the termination of the QSub election.

Section 1362(a) provides that a small business corporation may elect to be an S corporation.

Section 1362(b) provides the rule on when an S election will be effective. If an S election is made within the first two and one-half months of a corporation's taxable year, then the corporation will be treated as an S corporation for the year in which the election is made. If an S election is made after the first two and one-half months of a corporation's taxable year, then the corporation will not be treated as an S corporation until the taxable year after the year in which the S election is made.

Section 1362(b)(5) provides that if (1) an election under § 1362(a) is made for any taxable year after the date prescribed by § 1362 for making the election or no § 1362(a) election is made for any taxable year, and (2) the Secretary determines that there was reasonable cause for the failure to timely make the election, then the Secretary may treat the election as timely made for such taxable year.

Based on the facts submitted and the representations made, we conclude that the distribution of Company B stock to Shareholders terminated the QSub election with respect to Company B on Date 6. Company B may make an S election before the expiration of the five year period described in § 1361(b)(3)(D) without the Commissioner's consent provided that Company B was otherwise eligible to make an S election following the termination and the election is made effective immediately following the termination of the QSub election. We conclude that Company B has established reasonable cause for not making a timely election and is eligible for relief under § 1362(b)(5). Accordingly, if Company B makes an election to be an S corporation by filing with the appropriate service center a completed Form 2553, containing an effective date of Date 6, within 60 days following the date of this letter, then such election will be treated as timely made. A copy of this letter should be attached to the Form 2553 filed with the service center. A copy is enclosed for that

purpose.

Except as specifically ruled above, we express or imply no opinion concerning the federal tax consequences of the transactions described above under any other provisions of the Code, including whether Company A or Company B is a valid S corporation, whether Company B was a valid QSub, and whether any of the trusts is a QSST under § 1361(d)(3).

Under power of attorney on file with this office, we are sending a copy of this letter to Company A, Company B, and to Company B's second authorized representative.

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

Sincerely,
Paul F. Kugler
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes.

cc: