Internal Revenue Service

Department of the Treasury

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Legend

X =

Y =

State =

D1 =

D2 =

D3 =

D4 =

D5 =

This responds to your March 26, 1999 letter, and prior correspondence, submitted on behalf of X, requesting rulings under § 1362(f) of the Internal Revenue Code and that X be given an extension of time to elect to treat Y as a Qualified Subchapter S Subsidiary (QSUB) for its taxable year beginning D4 under § 301.9100 of the Procedure and Administration Regulations.

FACTS

X was incorporated under State law and elected subchapter S status for its first taxable year beginning D1. On D2, X formed a wholly-owned subsidiary, Y. On advice from tax professionals, X filed a Form 966 electing to treat Y as a QSUB as of D2. However, X was not eligible to elect to treat Y as a QSUB as of D2. Therefore, X's formation of Y caused X to become a member of an affiliated group, thereby terminating X's subchapter S corporation election. X was eligible, however, to elect to treat Y as a QSUB as of its taxable year beginning D4, but failed to file timely an election. During the period D2 to D3, Y paid dividends to X.

Until D5, neither X nor its shareholders were aware that the formation of Y terminated X's subchapter S corporation election. X represents that the formation of Y was not motivated by tax avoidance or retroactive tax planning. In addition, X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary with respect to the period specified by § 1362(f). Thus, X will report the dividends it received from Y during the period D2 to D3 consistent with X being a subchapter S corporation for that period. In addition, Y will be taxed under subchapter C of the Code and will be subject to the rules permitting wholly-owned C corporation subsidiaries of S corporations for the period D2 to D3.

LAW AND ANALYSIS

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

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

Section 1361(b)(2)(A), as in effect for taxable years beginning before January 1, 1997, provides that an ineligible corporation is a corporation that is a member of an affiliated group within the meaning of § 1504(a) (without regard to the exceptions contained in § 1504(b)). Section 1504(a) provides than an affiliated group exists where a common parent corporation directly owns at least 80% of the total voting power and at least 80% of the total value of the stock of another corporation.

Section 1361(b)(3)(B) defines the term "qualified subchapter S subsidiary" as a domestic corporation which is not an ineligible corporation if (1) 100 percent of the stock of the corporation is owned by the S corporation, and (2) the S corporation elects to treat the corporation as a QSUB. The statutory provision, however, does not provide guidance on the manner in which the QSUB election is made or the effective date of the election.

Section 1362(d)(2)(A) provides that an S election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the taxable year for which the corporation is an S corporation) the corporation ceases to be a small business corporation. The termination is effective on and after the date of cessation.

Section 1362(f) provides that if: (1) an election under § 1362(a) by any corporation (A) 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 (B) 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 effectiveness 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 in 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 committee reports accompanying the Subchapter S Revision Act of 1982, in discussing § 1362(f) as it relates to inadvertent terminations, state, in part, 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 the 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.

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

Notice 97-4, 1997-1 I.R.B. 24 provides a temporary procedure for making a QSUB election. Under Notice 97-4, a taxpayer makes a QSUB election with respect to a subsidiary by filing a Form 966, subject to certain modifications, with the appropriate service center. The election may be effective on the date the Form 966 is filed or up to 75 days prior to the filing of the form, provided that the 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 election is in effect.

Section 301.9100-1(c) provides that the Commissioner has discretion to grant a reasonable extension of time under the rules set forth in § 301.9100-3 to make a regulatory election. Section 301.9100-1(b) defines a regulatory election as 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 301.9100-1(a).

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 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. Section 301.9100- 3(a).

CONCLUSIONS

Based solely on the facts submitted and representations made, we conclude that X's subchapter S corporation election terminated on D2. We also conclude that the termination was inadvertent under § 1362(f).

Under the provisions of § 1362(f), X will be treated as continuing to be an S corporation during the period from D2 to the present, provided that X's subchapter S corporation election did not otherwise terminate under § 1362(d) and that X is treated as the owner of Y for the period D2 to D3. This ruling is further conditioned on X and Y not filing a consolidated return for the period D2 to D3 and X reporting all dividends distributed by Y for the same period consistent with X being a subchapter S corporation and Y being a wholly-owned C corporation subsidiary of X.

Based solely on the facts submitted and representations made, we conclude that the requirements of § 301.9100-3 have been satisfied. As a result, X is granted an extension of time of sixty (60) days from the date of this letter to elect to treat Y as a QSUB effective as of D4.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X's subchapter S corporation election was a valid election under § 1362 or whether Y otherwise qualifies as a QSUB for federal tax purposes.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

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

Pursuant to the Power of Attorney on file with this office, copies of this letter are being sent to X and X's second authorized representative.

Sincerely,

Signed/Paul K. Kugler
Paul F. Kugler
Assistant Chief Counsel
(Passthroughs and Special Industries)

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