Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:NED:BOS:TL-N-5391-00
MJGormley

date: September 29, 2000
to: District Director, New England District
Attn: E:PPQMB:Steve Winsten Stop 41175

from: District Counsel, New England District, Boston

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subject: [redacted]
Earliest Statute of Limitations: [redacted]

DISCLOSURE STATEMENT

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This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

1. Whether the taxpayer meets the requirements of I.R.C. § 1361 and qualifies as a Subchapter S corporation.

2. If the taxpayer does not meet the eligibility requirements of I.R.C. § 1361, whether the taxpayer may be prevented from denying its S corporation status based on an estoppel argument.

3. Whether the TEFRA rules apply to this case.

CONCLUSION

Although the taxpayer does not meet the eligibility requirements of I.R.C. § 1361 and does not qualify as a Subchapter S corporation, the taxpayer is estopped from denying its S corporation status under the doctrine of consistency. Accordingly, the statute of limitations on assessment and collection is open as to four of the individual shareholders until [redacted]. As to the fifth shareholder, a notice of deficiency may be issued to her at any time because she has not filed a federal income tax return for the years in issue. Finally, because the corporation has five or fewer shareholders, the rules of TEFRA do not apply in this case.

FACTS

This memorandum is being written in response to your request for advice regarding whether the above-referenced taxpayer meets the requirements of I.R.C. § 1361 and qualifies as a Subchapter S corporation. If the taxpayer does not meet the eligibility requirements for Subchapter S status, you have asked whether the taxpayer can be estopped from denying its S corporation status under an estoppel theory. Finally, you have asked us to determine whether the rules of TEFRA apply in this case.

You have provided us with the following facts. Articles of Organization for [redacted], were filed with the Office of the [redacted] Secretary of State on [redacted]. The stated purpose of the corporation was to engage in "the purchase and resale of goods and general merchandise...in and between the United States and other countries of the world...." The corporation was authorized to issue [redacted] shares of common stock. The street address of the corporation was [redacted] and the names and addresses of the directors and officers of the corporation were listed as follows:

President:
[redacted], [redacted]

Treasurer:
[redacted], [redacted]

Clerk: [redacted], [redacted]

Directors:
[redacted], [redacted]

The name and business address of the resident agent of the corporation was listed as . was the incorporator. The "First Consent of the Directors" voted to ratify and confirm the election by the incorporator of the President, Treasurer and Clerk. All of the directors, with the exception of were named as Vice Presidents. The shares of the common stock were issued to (%), to (%), to (%), to (%) and to (%).

The initial return for was filed on a Form 1120-A, U.S. Corporation Short-Form Income Tax Return and covered the period through . Subsequent returns were filed on Forms 1120S based upon the corporation's Form 2553, Election by a Small Business Corporation, filed . On the Form 2553, five equal shareholders were listed, each holding shares as of . Those five shareholders were . A social security number was listed for each shareholder[1] and the election was signed by , Treasurer, on . This election was accepted by the Internal Revenue Service. Shareholders identified on K-1s attached to the S Corporation returns matched the individuals listed on the Form 2553 but the percentages of ownership differed. Here, the stock ownership percentages matched the First Consent of Directors, showing % held by and % held by each of the other four shareholders.

The Forms 1120S that were filed in the four years following the Subchapter S election had Schedules K-1 attached for each of

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[1] It is noted 's identification number was listed as an EIN on the Form 2553 and the K-1 attached to the first 1120S that was filed for : . On later filed K-1s attached to the 1120S returns, this same number was listed as a SSN: .

the shareholders. All the shareholders were listed as residing in [redacted]. Specifically, with regard to [redacted], her address on the [redacted] K-1 was listed as [redacted] the same address as that of [redacted] and [redacted]. On the [redacted] and [redacted] K-1s, [redacted]'s address was listed as [redacted]. The [redacted] were also listed at this address, while [redacted] and [redacted] were listed as residing at a different street address in [redacted].

An examination of the taxpayer's return for the year ending [redacted] was initiated based upon the taxpayer's use of the cash method of accounting with the presence of inventory. Contact was first made with the taxpayer's representative, [redacted] on [redacted]. [redacted] was also the preparer of the return. The first meeting between the representative and the revenue agent took place on [redacted]. At that time the revenue agent questioned the citizenship of the various shareholders. The representative stated all shareholders were U.S. citizens. By [redacted] the revenue agent had prepared his final proposed adjustments and a meeting was held with both the representative and [redacted] on [redacted] of [redacted]. The adjustments as proposed total $[redacted] and result in an increase to reported income of $[redacted].

During this meeting the revenue agent solicited statute extensions for the shareholders' individual Forms 1040. At this time it was noted by the agent that there was no record of [redacted] having filed a federal income tax return for [redacted] and that her social security number did not appear to be valid. [redacted]'s citizenship was questioned and the representative stated that [redacted] was a U.S. citizen. She agreed to check on the correctness of the social security number and to inquire regarding [redacted]'s failure to file a tax return. Statute extensions for the other four shareholders were received from the representative on [redacted] and the statutes of limitations on assessment for each taxpayer were extended to [redacted].[2] At a later meeting on [redacted], the issue of [redacted]'s citizenship was again raised, along with the absence of a timely filed return for this individual.

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[2] Initially, the revenue agent obtained consents to extend the statute to [redacted]. However, due to procedural changes brought about by RRA'98, the agent had to re-solicit statute extensions. At that time, the taxpayer had a new representative and the latest extension that representative would agree to was [redacted].

The representative stated that [redacted] was not required to file a tax return in the U.S. because her income came from foreign [redacted]) investments and was not taxable in the United States.

On [redacted] a new representative, [redacted] contacted the Revenue Agent and stated he was replacing [redacted] as Power of Attorney (POA) for the taxpayer. During this conversation, [redacted] stated he doubted the validity of the taxpayer's S Corporation status because at least one of the corporate shareholders was a nonresident alien. At the initial meeting held between the revenue agent and the representative, [redacted] provided the following information. Of the five shareholders, only [redacted] was a U.S. citizen at the time the S Corporation election was made. Both [redacted] and [redacted] were nonresident aliens at the time the election was made and became resident aliens as of [redacted]. [redacted] was a resident alien at the time of the election and became a U.S. citizen on [redacted]. [redacted] was and currently is a citizen of [redacted]. The representative provided the revenue agent with a copy of [redacted]'s [redacted] passport and a statement from her that she is a "citizen of [redacted]". Thereafter the revenue agent inquired whether any of the non-U.S. resident shareholders met the substantial presence test of I.R.C. § 7701(b)(1)(A).[3] [redacted] stated that both [redacted] and [redacted] met this test but [redacted] did not.

The taxpayer has now taken the position that the S Corporation election was invalid and [redacted] is in fact a C corporation. The taxpayer wishes to change its prior filing status from that of an S Corporation to a C Corporation. You have taken the position that the taxpayer should be estopped from changing its filing status for [redacted] due to the fact that the statute of limitations on assessment for a C Corporation, running from the date of filing of the taxpayer's [redacted]

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[3] This section provides that if an alien meets the requirements of this section, such an individual shall be treated as a resident of the U.S. for any calendar year. The individual must either be a lawful permanent resident of the U.S., meet the substantial presence test or make a first year election. I.R.C. § 7701(b)(1)(A)(i), (ii) and (iii). In order to meet the substantial presence test, the individual must have been present in the U.S. on at least 31 days in a calendar year and the sum of the number of days during which the individual was present in the U.S. during the current year and the two preceding calendar years must equal or exceed 183 days. I.R.C. § 7701(b)(3)(A). No first year election is being made in this case. I.R.C. § 7701(b)(4).

return, expired [redacted]. You are seeking to assess any deficiencies against the individual shareholders as flow through entities from the corporation, based on their individual statute extensions. Additionally, you believe that returns for the years in which there is an open C Corporation statute should be converted to C corporation filings and that for future years, the taxpayer should file as a C Corporation. Finally, an issue has been raised as to whether the TEFRA rules apply to this case.

LEGAL ANALYSIS

I.R.C. § 6501(a) provides that generally the amount of any tax imposed shall be assessed "within three years after the return was filed". An issue often raised is whether the return referenced by this section is that of an individual taxpayer or that of some source entity from which the taxpayer's disputed tax items derive. In our case, if the individual shareholder's return is that referenced by section 6501(a), the Service has until [redacted] to issue the five individual shareholders statutory notices of deficiency.[4] If however, the return referenced is that of the source entity, [redacted], then the taxpayer has argued the period for assessment expired [redacted] years after the filing of the [redacted] return.

In 1993, the U.S. Supreme Court decided the case of Bufferd v. Commissioner, 506 U.S. 523. In Bufferd, a Subchapter S corporation filed a federal income tax return on which the corporation reported a loss deduction and an investment tax credit. Thereafter, a shareholder in the corporation filed a federal income tax return on which the shareholder claimed a pro rata share of the deductions and credits reported by the corporation. No extension of time for assessment was obtained from the corporation, but the shareholder agreed to an extension with regard to his return. The Commissioner subsequently determined the loss deduction and credit claimed by the corporation were erroneous and sent a notice of deficiency to the shareholder based on the pro rata loss deduction and credit he claimed on his return. The shareholder claimed the Commissioner was time barred from making the proposed adjustment because the disallowance was based on an error in the corporate return for which the three year assessment period had lapsed. The Bufferd Court held that the three year assessment period under I.R.C. § 6501(a) ran from the date when the shareholder's return was filed

[4] Although [redacted] did not execute a statute extension, she has not filed a federal income tax return for the years at issue so the Commissioner may issue her a notice of deficiency at any time. I.R.C. § 6501(c)(3).

and thus the assessment against the shareholder was not time barred.

The Court found that the Commissioner could only determine the correctness of the taxpayer's reported liability after examining the taxpayer's return. The errors on the S corporation's return did not and could not affect the tax liability of the corporation and the Commissioner could only assess a deficiency against the stockholder-taxpayer whose return claimed the benefit of the corporation's errors. The S corporation's return was deficient because it did not contain all of the information necessary to compute the shareholder's taxes. While it might show the shareholder's distributive share of losses, it would not show income, losses, deductions and credits from other sources. "[T]ax returns that 'lack the data necessary for the computation and assessment of deficiencies' generally should not be regarded as triggering the period of assessment. Id. 506 U.S. at 528, citing Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 188 (1957). Therefore, the limitations period within which the I.R.S. may assess the income tax liability of an S Corporation shareholder runs from the date on which the shareholder's return is filed. Bufferd, 506 U.S. at 533.

Based on Bufferd, the statute of limitations on assessment and collections will be computed based on each individual shareholder's return, not the corporate return. Our case is, however, complicated by the issue of the validity of [redacted]'s S corporation election. An S corporation is defined by I.R.C. § 1361(a)(1) as a small business corporation for which an election under I.R.C. § 1362(a) is in effect. A C corporation is a corporation which is not an S corporation. I.R.C. § 1361(a)(2). A small business corporation is a domestic corporation which is not an ineligible corporation and which does not: have more than 75 shareholders; have as a shareholder a person (other than certain exceptions specified in the Code) who is not an individual; have a nonresident alien as a shareholder; and, have more than one class of stock. I.R.C. § 1361(b)(1). In our case, we have a domestic corporation with five individual shareholders and one class of stock. At issue however, is whether one or more of the shareholders is a nonresident alien as proscribed by I.R.C. § 1361(b)(1)(C).

A nonresident alien is defined in § 7701(b)(1) of the Code as an individual who is neither a citizen of the United States nor a resident of the United States within the meaning of subparagraph (A) of § 7701(b)(1). Subparagraph (A) provides an alien individual will be treated as a resident of the United States with respect to any calender year if the individual meets

certain residency requirements. Specifically, the individual must either be a lawful permanent resident of the U.S. or meet the "substantial presence" test of I.R.C. § 7701(b)(3). In general, in order to meet this test, the individual must be present in the United States for a certain prescribed number of days during the calendar year in order to be treated as a resident. In our case, the taxpayer's representative has stated that two of the shareholders are U.S. citizens and two shareholders are resident aliens who have met the substantial presence test. However, the representative has alleged that the requirements of I.R.C. § 1361(b)(1) have not been met in that [redacted] was a citizen of the [redacted] and a nonresident alien who did not meet the substantial presence test. As such, the corporation S election was invalid.

At issue, however, is whether having elected to do business as an S corporation, the taxpayer can now disclaim the validity of that election or will it be estopped, under equitable principles, from denying the validity of that election. The doctrine of estoppel was first applied by the Supreme Court in a tax dispute in Stearns Co. v. United States, 291 U.S. 54 (1934). In that case the taxpayer impliedly waived the statute of limitations and the Commissioner relied on that waiver. The Court held the taxpayer was estopped from denying the waiver. "...[N]o one shall be permitted to found any claim upon his own inequity or take advantage of his own wrong." Id.

Generally, the doctrine of equitable estoppel will apply where a taxpayer has made a representation of fact on which the Commissioner relies to his detriment, and through such reliance and ignorance of the true facts, the Commissioner is induced not to correct the error before its collection is barred by the statute of limitations. See Sangers Home for Chronic Patients v. Commissioner, 72 T.C. 105 (1979). The elements required for application are conduct amounting to a misrepresentation or concealment of a material fact; actual or imputed knowledge of the misrepresentation or concealment by the party to be estopped; absence of knowledge of the facts by the party in whose favor estoppel is applied; intention or expectation of the party to be estopped that the representation or concealment will be acted upon by the other party; reliance by the party seeking estoppel; and, detriment to the party seeking the estoppel resulting from his reliance. Id. [5]

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[5] In the Sangers case, a nursing home consistently reported the income from its business on corporate income tax returns for many years. After the Commissioner proposed deficiencies in the corporation's income tax for several of these years, the taxpayer asserted that the nursing home business was in fact not a

The doctrine of estoppel has been further refined into a theory known as quasi-estoppel or the duty of consistency. The duty of consistency prevents a taxpayer who has benefitted from a past representation from adopting a position inconsistent with that taken in a year barred by the statute of limitations. See Herrington v. Commissioner, 854 F.2d 755, 757 (5th Cir. 1988), cert. denied 490 U.S. 1065 (1989), affg. Glass v. Commissioner, 87 T.C. 1087 (1986). See also Eagan v. U.S., 80 F.3d 13, 16 (1st Cir. 1996)(taxpayer is prevented from claiming he or she should have paid more tax before and so avoiding the present tax). The taxpayer's duty of consistency applies if: the taxpayer made a representation of fact or reported an item for tax purposes in one tax year; the Commissioner acquiesced in or relied on that fact for that year; and, the taxpayer is seeking to change the representation previously made in the later tax year after the earlier year has been closed by the statute of limitations. See Estate of Letts v. Commissioner, 109 T.C. 290 (1997), citing McMillan v. U.S., 64-2 USTC par. 9720 (S.D.W.Va. 1964).

The duty of consistency has developed along two lines. One line has treated the duty as strictly analogous to traditional equitable estoppel and requires a showing that the taxpayer made an intentional misrepresentation or a wrongful misleading silence in obtaining favorable tax treatment. See e.g., Lignos v. U.S., 439 F.2d 1365, 1368 (2nd Cir. 1971); Crosley Corp. v. U.S. 229 F.2d 376, 380-381 (6th Cir. 1956); Piarulle v. Commissioner, 80 T.C. 1035, 1044 (1983). Conversely, the other line does not require the presence of all the technical elements of estoppel.

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corporation but rather a sole proprietorship, later a partnership. As such, the taxpayer argued the statutes of limitations on assessment and collection for the corporation had expired. The Court found the taxpayer, having elected to do business as a corporation, could not later disclaim the corporation's validity for federal tax purposes. The burden is on the taxpayer to see that the form of business he has created for tax purposes and has asserted on his return is valid, not unreal or a sham. The Commissioner is entitled to rely on the taxpayer's representations and the taxpayer will be estopped from changing its position or denying its status after the statute of limitations has run to the Commissioner's detriment. See also Maletis v. U.S., 200 F.2d 97 (9th Cir. 1952)(taxpayer estopped from disclaiming partnership's validity); Halstead v. Commissioner, 296 F.2d 61 (2nd Cir. 1961); Lofquist Realty Co., v. Commissioner, 102 F.2d 945 (1937)(taxpayer estopped from changing its position after Commissioner relied on facts represented); Haag v. Commissioner, 59 F.2d 514 (7th Cir. 1932)(taxpayer estopped from denying her individual partnership status).

Arkansas Best Corp. v. Commissioner, 83 T.C. 640, 659 (1984) aff'd in part and rev'd in part as to other issues 800 F.2d 215 (8th Cir. 1986), aff'd 485 U.S. 212 (1988). See also Unvert v. Commissioner, 72 T.C. 807, 814 (1979) aff'd 656 F.2d 483 (9th Cir. 1981). It "has liberated the application of the doctrine from the traditional requirements of equitable estoppel and has only required a showing of a representation made by the taxpayer in obtaining favorable tax treatment, and not an intentional falsehood or wrongful misleading silence." See LeFever v. Commissioner, 100 F.3d 778, 786 (10th Cir. 1996). See, e.g., Eagan v. Commissioner, 80 F.3d 13, 16 (1st Cir. 1996); Herrington v. Commissioner, 854 F.2d 755, 757 (5th Cir. 1988), cert. denied 490 U.S. 1065 (1989); Elbo Coals Inc. v. U.S., 763 F.2d 818, 821 (6th Cir. 1985). See generally, LeFever v. Commissioner, 103 T.C. 525, 543 (1994), aff'd 100 F.3d 778 (10th Cir. 1996). When this applies the Commissioner may proceed as if the representation or report on which he relied continues to be true, although in fact it is not. Hughes and Luce LLP v. Commissioner, T.C. Memo 1994-559, citing Herrington v. Commissioner, 854 F.2d 755, 757 (5th Cir. 1988), cert. denied 490 U.S. 1065 (1989).

In our case, the Tax Court would follow the more liberal interpretation of the quasi-estoppel or duty of consistency theory as applied by the First Circuit Court of Appeals.[6] See Golsen v. Commissioner, 54 T.C. 742, 756-757 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971) (The Tax Court will follow the view of the Circuit to which an appeal would lie). In accordance with this application of the doctrine, the Commissioner need only show that the taxpayer made the representation that it qualified as a Subchapter S corporation, the Commissioner relied on that representation, and the taxpayer is now attempting to change that representation in a later year after the period of limitations has expired with regard to the year of representation, to the Commissioner's detriment. The taxpayer's intent is not relevant to the analysis. Here, the taxpayer filed the Form 2553, electing to file as a Subchapter S corporation. Thereafter, the taxpayer filed Forms 1120S, listing all five shareholders as residing in [redacted]. The taxpayer's representative stated on several occasions that all shareholders were U.S. citizens and provided social security numbers for all five shareholders. In reliance on these representations, the revenue agent obtained statute extensions from the individual shareholders, keeping the statute of limitations on assessment and collection open at the shareholder level. After the statute of limitations at the corporate level had expired, and after the Commissioner proposed substantial deficiencies to the shareholders as a result of

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[6] The First Circuit applied the more liberal theory of the duty of consistency in Eagan v. Commissioner, 80 F.3d 13 (1996).

adjustments at the corporate level that flowed through to the shareholders, the taxpayer sought to deny its eligibility to S corporation status. If the taxpayer is allowed to deny its S corporation status, the Service will be harmed in that it will be time barred from making the proper deficiency assessments.

With regard to the TEFRA issue, the audit and examination procedures regarding the assessment of deficiencies applicable to partnerships are also applicable to S corporations in corporate tax years beginning after September 3, 1982 and before January 1, 1997. I.R.C. § 6244. As a result, issues involving an S corporation item of income or deduction will be determined separately in administrative or judicial proceedings involving the individual taxpayer whose tax liability is affected.[7] There is, however, an exception for small S corporations. In accordance with Temporary Regulation § 301.6241-1T(c)(2)(ii), TEFRA procedures will not apply to a small S corporation. A small S corporation is defined as an S corporation with five or fewer shareholders, each of whom is a natural person or an estate. Id. In our case, [redacted] does not meet the Subchapter S eligibility requirements of I.R.C. § 1361 due to the fact that one of its shareholders is a nonresident alien. However, under the doctrine of quasi-estoppel we have concluded [redacted] is estopped from denying its S corporation status for purposes of computation of the statute of limitations on assessment and collection. Assuming arguendo this theory could be extended to apply to [redacted] for purposes of determining the applicability of the TEFRA procedures, [redacted] would be treated as a small S corporation and as such, the TEFRA procedures would not apply in this case.

CONCLUSION

[redacted] does not meet the Subchapter S corporation eligibility requirements of I.R.C. § 1361 due to the fact that at least one of its five shareholders is a nonresident alien. However, the doctrine of consistency applies in this case and the taxpayer is estopped from denying its S corporation status for purposes of the computation of the statute of limitations on assessment and collection. As such, the statute of limitations on four of the five shareholders is open until [redacted] based on consents to extend the statutes of limitation obtained from those shareholders. With regard to the fifth shareholder, [redacted] the statute of limitations is open under I.R.C. § 6501(c)(3) since she has not filed a federal income tax return

[7] The partnership unified audit rules no longer apply to S corporations effective for tax years beginning after December 31, 1996. Code section 6244 as repealed by P.L. 104-188.

for the years at issue. TEFRA procedures do not apply and statutory notices of deficiency should be issued to each shareholder. Finally, with regard to any remaining open years, [redacted] should be converted to a C corporation.

. If you need further assistance in this matter, please contact Michele J. Gormley at 617/565-7858.

MAUREEN T. O'BRIEN
Assistant District Counsel

By: _____
MICHELE J. GORMLEY
Senior Attorney

cc:
Michael Corrado
Assistant Regional Counsel
Northeast Region