Internal Revenue Service

Number: **200521021**
Release Date: 5/27/2005
Index Number(s): 9100.00-00, 1045.00-00, 1202.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:ITA:B04
PLR-160190-04

Date:

Taxpayers =

Taxpayer =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
Date 10 =
Date 11 =
Date 12 =
Date 13 =
Tax Year 1 =
Tax Year 2 =
X =
State B =
d =
e =
$f =
Y =
State H =
Z =
k =
W =
n =
$p =
q =
$r =
s =
$t =
u =
$v =
v =
$x =
$y =
M =
$aa =
$bb =
Affiant C =

Affiant D =

Dear

This responds to your letter of November 3, 2004, and subsequent correspondence, requesting an extension of time, under § 301.9100-1 and -3 of the Procedure and Administration Regulations, for you to make elections pursuant to § 1045 of the Internal Revenue Code.

FACTS:

Background

On Date 1, Taxpayer formed X, a State B "C" corporation. X designed and manufactured products used to test d systems and equipment. X's products were sold worldwide to businesses that develop, manufacture, install, and support products for the d infrastructure. From Date 2 through Date 3, Taxpayer purchased e shares of X stock for $f.

On Date 4, Y, a State H corporation and wholly-owned subsidiary of Z, merged with X in a tax-free reorganization pursuant to § 368(a)(2)(E). For merger consideration Taxpayer received k shares of Z stock in exchange for e shares of X stock.

On Date 5, Taxpayer formed W, a State B "C" corporation. W designs and manufactures products sold to enterprises as part of their network infrastructure. During Tax Years 1 and 2, W was in the startup phase of operations. During that time, W incurred start-up expenditures under §195(c)(1) and capitalized such costs under § 195(a). However, W's expenditures incurred in connection with research and development were expensed pursuant to § 174(a)(1).

Tax Year 1

From Date 6 to Date 7, Taxpayer sold n shares of Z stock for $p. From Date 8 to Date 9, Taxpayer sold q shares of Z stock for $r. On Taxpayers' individual income tax return they excluded 50 percent of their gain (up to the $5,000,000 limit) from the sale of Z stock held for more than 5 years, pursuant to § 1202(a). On Date 10, Taxpayer acquired s shares of W stock, for $t. This reinvestment in W occurred within 60 days from the sale of Z stock. During this year Taxpayer did not sell or otherwise dispose of any W stock.

Tax Year 2

From Date 11 through Date 12, Taxpayer sold u shares of Z stock for $v. During this year Taxpayer acquired v shares of W preferred stock for $x. Of this reinvestment in W,

$y was reinvested within 60 days from the sale of Z stock. During this year Taxpayer did not sell or otherwise dispose of any W common or preferred stock.

Status of X and W Stock as Qualified Small Business Stock

It is represented that at all times, X stock was qualified small business stock pursuant to the definitional criteria stated in § 1202(c), the qualified small business definition of §1202(d), and the active business requirement set forth in §1202(e). Likewise, it is represented that at all times W stock was qualified small business stock.[1]

Failure to Make Timely § 1045 Elections

Taxpayers employed M (a firm consisting of qualified tax professionals within the meaning of §301.9100-3(b)(1)(v)) to prepare their federal individual income tax returns for Tax Years 1 and 2. Additionally, M prepared the corporate income tax returns for W for the same tax years and audited the corporate financial statements for W for Tax Year 2. Furthermore, on a quarterly basis, M monitored and reviewed Taxpayer's sale of Z stock and traced the transfer and reinvestment of the funds, including amounts reinvested in W. As a result, M knew that Taxpayer reinvested in W the funds derived from the sale of Z, but M failed to identify the available § 1045 election to rollover gain from the sale of qualified small business stock to other qualified small business stock for Tax Years 1 and 2. Thus, the § 1045 election was not made and the entire gain from the sale of Z stock was reported on Taxpayers' timely filed individual federal income tax returns for Tax Years 1 and 2.

On or about Date 13, M discovered that the available election for the rollover of gain from the sale of Z stock to the purchase of W stock for Tax Years 1 and 2 had not been made when the federal income tax returns for those years were filed. For Tax Year 1, gain in the amount of $aa was eligible for rollover under a § 1045 election. An additional $bb was eligible for Tax Year 2.

Additional Representations

[1] W was a start-up corporation at the time the reinvestment in W occurred. For purposes of § 1202(c)(2), § 1202(e) lists the requirements of the "active business" standard. The active business standard is met by a corporation for any period if during such period at least 80 percent of the assets of such corporation are used by such corporation in the active conduct of one or more qualified trades or business and such corporation is an eligible corporation. Section 1202(e)(2) provides a special rule for certain activities. This section states that for purposes of § 1202(e)(1), if in connection with any future qualified trade or business, a corporation is engaged in start-up activities described in § 195(c)(1)(A), activities resulting in the payment or incurring of expenditures that may be treated as research and experimental expenditures under § 174, or activities with respect to in-house research expenses described in § 41(b)(4), then the assets used in such activities shall be treated as used in the active conduct of a qualified trade or business. Thus, Taxpayers represent that, even though W was operating in a start-up mode at the time the proceeds from the sale of Z stock were reinvested in W, W was operating an active business for purposes of §§ 1202 and 1045.

1. Taxpayers' failure to elect deferral under § 1045(a) for Tax Years 1 and 2 was not discovered by the Internal Revenue Service prior to the filing of your request.
2. Taxpayers are not attempting to alter a return position taken for which a penalty has been or could be imposed under § 6662.

3. M did not timely advise Taxpayers about the available § 1045(a) election for Tax Years 1 and 2. Due to this failure, no election was made. Therefore, Taxpayers did not intentionally choose to forgo to make the election.

4. Taxpayers are not using hindsight in requesting relief. Taxpayers have filed all of their federal income tax returns as if timely filed elections had been filed.

5. The interests of the government are not prejudiced, within the meaning of § 301.9100-3(c), because granting relief will not result in the Taxpayers having a lower tax liability in the aggregate for the taxable years to which the election applies than Taxpayers would have had if the election had been timely.

6. The statute of limitations on assessment under § 6501 has not expired for Tax Years 1 and 2, nor will it expire during the likely period for processing this ruling request.

7. Taxpayers will amend the necessary returns if relief under § 301.9100-3 is granted.

APPLICABLE LAW AND ANALYSIS:

Section 1045(a) provides, in part, that in the case of any sale of qualified small business stock held by a taxpayer other than a corporation for more than 6 months and with respect to which such taxpayer elects the application of this section, gain from such sale shall be recognized only to the extent that the amount realized on such sale exceeds--
(1) the cost of any qualified small business stock purchased by the taxpayer during the 60-day period beginning on the date of such sale, reduced by
(2) any portion of such cost previously taken into account under this section.

The time and manner for making the election allowed by § 1045(a) is prescribed by Rev. Proc. 98-48, 1998-2 C.B. 367. Under the revenue procedure the election must have been made no later than the due date (including extensions) for filing the tax return for Tax Year 1 and for Tax year 2.

Section 1045(b)(1) provides that the term "qualified small business stock" has the meaning given such term by § 1202(c). Section 1202(c)(1)(B) provides as one of the defining characteristics of qualified small business stock that it be acquired by the

taxpayer at its original issue (directly or through an underwriter) in exchange for money or other property or in exchange for services provided to such corporation. However, as provided in § 1202(h)(4)(A), for a transaction described in § 351 or a reorganization described in § 368, if qualified small business stock is exchanged for other stock that would not qualify as qualified small business stock but for this subparagraph, such other stock shall be treated as qualified small business stock acquired on the date on which the exchanged stock was acquired.[2]

As previously represented, X stock was qualified small business stock for both §§ 1045 and 1202 purposes. The tax-free reorganization pursuant to § 368(a)(2)(E) between X and Y, resulted in the exchange of Taxpayers' X stock for Z stock. Although Z stock is not qualified small business stock, the Z stock received by Taxpayers is treated as qualified small business stock pursuant to § 1202(h)(4)(A). Also, Z stock is treated as acquired by Taxpayers directly from Z when Taxpayer acquired their stock in X.

Based on the representations submitted by Taxpayers and the forgoing analysis, gain from the disposition of Z stock, to the extent of $aa in Tax Year 1 and $bb in Tax Year 2, would have been deferred under § 1045 by the timely rollover of the gain into original issue stock of W had Taxpayers made a timely election to defer such gain.

Sections §§ 301.9100-2 and 301.9100-3 provide the standards the Commissioner uses to determine whether to grant an extension of time to make a regulatory election. An extension of time is available for elections that a taxpayer is otherwise eligible to make. However, the granting of an extension of time to make elections is not a determination that the taxpayer is otherwise eligible to make one.

Taxpayers specifically request relief by a grant of an extension of time to make a regulatory election pursuant to the provisions of § 301.9100-3. For this purpose, § 301.9100-1(b) defines the term regulatory election to include an election whose deadline is prescribed by a regulation published in the Federal Register, or a revenue ruling, revenue procedure, or notice or announcement published in the Internal Revenue Bulletin.

Section 301.9100-3(a) provides, in part, that requests for relief will be granted when the taxpayer provides evidence (including affidavits described in paragraph (e) of this section) to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the government.

[2] Section 1045(b)(5) states, in part, that rules similar to the rules of § 1202(h) shall apply to elections under § 1045.

Section 301.9100-3(b)(1) provides, in part, that except as otherwise provided (in paragraphs (b)(3)(i) through (iii) of that section), a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer "(i) Requests relief under this section before failure to make the regulatory election is discovered by the IRS; . . . or (v) Reasonably relied on a qualified tax professional . . . and the tax professional failed to make, or advise the taxpayer to make, the election."

Taxpayers' failure to make the regulatory election was not discovered by the Service before Taxpayers submitted their application for relief. Also, as part of their application for relief, Taxpayers submitted satisfactory evidence in the form of affidavits showing that Taxpayers acted reasonably and in good faith, having relied entirely on M to prepare its returns and advise it on tax matters during the tax years at issue. Taxpayers retained tax professionals to handle tax matters on their behalf. In affidavits submitted by M, Affiant C and Affiant D (who are either employed by or otherwise associated with M), admit responsibility for not advising Taxpayers of their right to make a regulatory election to defer gain under § 1045.

Section 301.9100-3(b)(3) provides, in part, that a taxpayer is deemed to have not acted reasonably and in good faith if the taxpayer (i) seeks to alter a return position for which an accuracy-related penalty has been or could be imposed under § 6662 at the time the taxpayer requests relief (taking into account any qualified amended return filed within the meaning of § 1.6664-2(c)(3)) and the new position requires or permits a regulatory election for which relief is requested; (ii) was informed in all material respects of the required election and related tax consequences, but chose not to file the election; or (iii) uses hindsight in requesting relief. In connection with hindsight, if specific facts have changed since the due date for making the election that make the election advantageous to the taxpayer, the IRS will not ordinarily grant relief. In such a case, the IRS will grant relief only when the taxpayer provides strong proof that the taxpayer's decision to seek relief did not involve hindsight.

Taxpayers are not seeking to alter their return position except to make § 1045 elections with respect to the sale of its qualified small business stock in Tax Years 1 and 2. Further, Taxpayers were not informed of the need to make an election under § 1045 and so did not make any conscious choice as to whether or not to make an election. In addition, there is no indication that Taxpayers were using hindsight, as defined above, in requesting this relief. While it is likely that Taxpayers carefully considered all options available to it with its tax advisors before filing this request for relief, specific facts have not changed since the due date for making the election that make the election more advantageous to Taxpayers.

Section 301.9100-3(c)(1)(i) provides, in part, that the interests of the government are prejudiced if granting relief would result in the taxpayer having a lower tax liability in the

aggregate for all taxable years affected by the election than the taxpayer would have had if the election had been timely made (taking into account the time value of money).

Section 301.9100-3(c)(1)(ii) provides, in part, that the interests of the government are ordinarily prejudiced if the taxable year in which the regulatory election should have been made, or any taxable years that would have been affected by the election had it been timely made, are closed by the period of limitations on assessment.

Taxpayers will not have a lower tax liability in the aggregate for any of the years in which the election will apply than Taxpayers would have had if the elections had been timely made (taking into account the time value of money). No taxable year that would be affected by the elections, had they been timely made, is closed by the period of limitations on assessment.

Taken together, these circumstances indicate that the omissions Taxpayers now seek to correct originated from mistakes of their tax advisors, and not from a desire to avoid taxes. Since no prejudice to the government is indicated, Taxpayers' application for relief should be granted.

Accordingly, the consent of the Commissioner is hereby granted Taxpayers for an extension of time to make elections under § 1045 for Tax Years 1 and 2. This extension shall be for a period of 45 days from the date of this letter. A copy of this letter should be attached to the amended returns filed reflecting this election.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any item discussed or referenced in this letter. Specifically, no opinion is expressed or implied concerning whether the stock sold by Taxpayers or the stock purchased constituted qualified small business stock (or was otherwise eligible to be treated as such) or whether the other statutory and regulatory prerequisites for deferral under § 1045 were satisfied. This letter is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent. A copy of the letter is enclosed showing the deletions proposed to be made when it is disclosed under § 6110.

Sincerely,

Robert A. Berkovsky
Branch Chief
Office of Chief Counsel
(Income Tax & Accounting)

Enclosure