

STATEMENTS OF POLICY

Title 61—REVENUE

DEPARTMENT OF REVENUE

[61 PA. CODE CH. 9]

Effect of Federal Small Business Job Protection Act

The Department of Revenue (Department) has adopted a statement of policy under the authority contained in § 3.2 (relating to statements of policy). This statement of policy adds § 9.16 (relating to the effect of the Federal Small Business Job Protection Act) and shall take effect immediately upon publication in the *Pennsylvania Bulletin*.

The purpose of the statement of policy is to advise the public of the effect of the Federal Small Business Job Protection Act of 1996 on Pennsylvania S corporations. This Federal act is effective for tax years beginning after December 31, 1996. The Department has received numerous inquiries concerning the act's effect on Pennsylvania S corporations. Accordingly, it was determined to be necessary to advise the public of the Department's position prior to the effective date of the Federal Act.

The Small Business Job Protection Act of 1996 amends Subchapter S of the Internal Revenue Code by revising the manner in which Federal Subchapter S corporations may organize. Among other things, these revisions affect the following areas: number of shareholders, types of shareholders, affiliations with other corporations, invalid elections, reelections within 5 years after termination, interim closing of the books upon termination of a shareholder's interest, and basis adjustments for distributions occurring in loss years.

The Tax Reform Code of 1971 (TRC) (72 P. S. §§ 7101—10004) authorizes the shareholders of a small corporation to elect not to be subject to corporate net income tax. The definition of "small corporation" contained in section 301(s.2) of the TRC (72 P. S. § 7301(s.2)) specifically references "subchapter S of Chapter 1 of the Internal Revenue Code of 1954, as amended as of January 1, 1983." Under 1 Pa.C.S. § 1937 (relating to references to statutes and regulations) of the rules of statutory construction, this specific statutory reference locks in the Internal Revenue Code as it existed on January 1, 1983. Subsequent Federal amendments are not applicable to the TRC definition of "small corporation." Therefore, this statement of policy advises the public that the Small Business Job Protection Act of 1996 has no impact on the manner in which Pennsylvania S corporations may organize.

Specific questions relating to information provided in this statement of policy may be directed to the Department of Revenue, Office of Chief Counsel, Dept. 281061, Harrisburg, Pennsylvania 17128-1061.

ROBERT A. JUDGE, Sr.,
Secretary

(Editor's Note: The regulations of the Department of Revenue, 61 Pa. Code Chapter 9, are amended by adding a statement of policy at § 9.16.)

Fiscal Note: 15-382. No fiscal impact; (8) recommends adoption.

Annex A

TITLE 61. REVENUE

PART I. DEPARTMENT OF REVENUE

Subpart A. GENERAL PROVISIONS

CHAPTER 9. REVENUE PRONOUNCEMENTS—
STATEMENTS OF POLICY

§ 9.16. Effect of Federal Small Business Job Protection Act.

(a) *Internal Revenue Code Subchapter S revisions.* The United States Congress has enacted the Small Business Job Protection Act of 1996 (Federal Act) (Pub.L. No. 104-188, 110 Stat. 1755 (1996)) to be effective for tax years beginning after December 31, 1996. This act amends Subchapter S of the IRC by revising the manner in which Federal S corporations may organize. Among other things, these revisions affect the following areas:

- (1) The number of shareholders.
- (2) The types of shareholders.
- (3) Affiliations with other corporations.
- (4) Invalid elections.
- (5) Reelections within 5 years after termination.
- (6) Interim closing of the books upon termination of a shareholder's interest.
- (7) Basis adjustments for distributions occurring in loss years.

(b) *Pennsylvania S corporation tax treatment.* The TRC authorizes the shareholders of a "small corporation" to elect not to be subject to corporate net income tax. Section 301(s.2) of the TRC (72 P. S. § 7301(s.2)) defines a "small corporation" as "any corporation which has a valid election in effect under subchapter S of Chapter 1 of the Internal Revenue Code of 1954, as amended as of January 1, 1983, and which does not have passive investment income in excess of twenty-five percent of its gross receipts."

(c) *Effect of Internal Revenue Code Subchapter S revisions on the TRC.* Section 1937 of Title 1 of the *Pennsylvania Consolidated Statutes* (relating to references to statutes and regulations) provides that a reference to a specific statute includes the statute with all amendments, unless the specific language of the statute clearly includes only the statute as in force as of a specific date. The definition of "small corporation" contained in section 301(s.2) of the TRC specifically references "subchapter S of Chapter 1 of the IRC, as amended as of January 1, 1983." This specific statutory reference locks in the IRC as it existed on January 1, 1983. Subsequent Federal amendments are not applicable to the TRC definition of "small corporation." Therefore, the Federal Act has no impact on the manner in which Pennsylvania S corporations may organize. Corporations that do not qualify for Federal Subchapter S status under the IRC, as amended as of January 1, 1983, are not eligible to elect Pennsylvania S corporation tax treatment.

(d) *Answers to the most frequently asked questions.* Since the enactment of the Federal Act, the Department has received numerous inquiries concerning the impact of the Federal Act on Pennsylvania S corporations. This subsection provides the Department's response to the most frequently asked questions.

(1) *Effect on Pennsylvania S corporations.*

(i) *Question:* Does the enactment of the Federal Act, effective for tax years beginning after December 31, 1996, change the corporations that are eligible to elect Pennsylvania S corporation tax treatment?

(ii) *Answer:* No. The corporations that are eligible to elect Pennsylvania S corporation tax treatment are not changed by the enactment of the Federal Act. Only Federal S corporations that would qualify to elect Federal S corporation tax treatment under the IRC, as amended as of January 1, 1983, are eligible to elect Pennsylvania corporation tax treatment.

(2) *Limitations on number of shareholders.*

(i) *Question:* Will a valid Pennsylvania S corporation lose its Pennsylvania S status if it expands to 75 shareholders as permitted by the Federal Act?

(ii) *Answer:* Yes. Pennsylvania is locked into the IRC as of January 1, 1983. The IRC as of that date does not permit a Federal S corporation to have 75 shareholders. Therefore, a Pennsylvania S corporation would cease to be a small corporation eligible for Pennsylvania S corporation tax treatment and its Pennsylvania S election would be terminated if it expands to 75 shareholders. The corporation would not be eligible to elect Pennsylvania S status for 5 taxable years.

(3) *Ownership interests.*

(i) *Affiliated groups.* The Federal Act permits a Federal S corporation to be a member of an affiliated group as determined under section 1504 of the IRC (generally, an 80% or greater common interest).

(A) *Question:* May a Pennsylvania S corporation be a member of an affiliated group? For example, may it hold an 80% or greater interest in another corporation?

(B) *Answer:* No. Pennsylvania is locked into the IRC as of January 1, 1983. The IRC as of that date does not permit a Federal S corporation to be a member of an affiliated group as determined under section 1504 of the IRC (generally, an 80% or greater common interest). Therefore, a corporation is not eligible for Pennsylvania S corporation tax treatment if it is part of an affiliated group as determined by section 1504 of the IRC. This means that a Pennsylvania S corporation may not own 80% or more of the stock of another corporation.

(ii) *Electing small business trusts.* The Federal Act permits a Federal S corporation to have an electing small business trust (IRC § 1361(e)) as a shareholder.

(A) *Question:* May a Pennsylvania S corporation have an electing small business trust as a shareholder?

(B) *Answer:* No. Pennsylvania is locked into the IRC as of January 1, 1983. The IRC as of that date does not permit a Federal S corporation to have an electing small business trust as a shareholder. Therefore, a corporation is not eligible for Pennsylvania S corporation tax treatment if it has a shareholder that is an electing small business trust.

(iii) *Qualified pension, profit-sharing and stock bonus plans; and IRC § 501(c)(3) exempt organizations.* The Federal Act permits a Federal S corporation to have shareholders that are qualified pension, profit-sharing and stock bonus plans under section 401 of the IRC or exempt organizations under section 501(c)(3) of the IRC.

(A) *Question:* May a Pennsylvania S corporation have a shareholder that is a qualified pension, profit-sharing and stock bonus plan under section 401 of the IRC or an exempt organization under section 501(c)(3) of the IRC?

(B) *Answer:* No. Pennsylvania is locked into the IRC as of January 1, 1983. The IRC as of that date does not permit a Federal S corporation to have a qualified pension, profit-sharing and stock bonus plan under section 401 of the IRC or an exempt organization under section 501(c)(3) of the IRC as a shareholder. Therefore, a corporation is not eligible for Pennsylvania S corporation tax treatment if it has any shareholder that is a qualified pension, profit-sharing and stock bonus plan under section 401 of the IRC or an exempt organization under section 501(c)(3) of the IRC.

(4) *Qualified Subchapter S subsidiaries.*

(i) *Flow through treatment.* The Federal Act permits a Federal S corporation to own a 100% ownership interest in another corporation known as a qualified Subchapter S subsidiary (IRC § 1361(b)(3)(B)(ii)). Upon election of the parent Federal S corporation, the two corporations shall be treated as a single entity and the assets, liabilities, income, deductions and credits of the wholly owned subsidiary shall be treated as belonging to the parent corporation.

(A) *Question:* May a Pennsylvania S corporation own a 100% ownership interest in another corporation and elect qualified Subchapter S subsidiary tax treatment?

(B) *Answer:* No. Pennsylvania is locked into the IRC as of January 1, 1983. The IRC as of that date does not permit a Federal S corporation to own 80% or more of the ownership interest of another corporation. Therefore, a corporation is not eligible for Pennsylvania S corporation tax treatment if it has a qualified Subchapter S subsidiary.

(ii) *Taxation.*

(A) *Question:* How will Pennsylvania tax a Federal S corporation that creates a qualified Subchapter S subsidiary?

(B) *Answer:* Under the IRC as of January 1, 1983, neither the parent Federal S corporation nor the qualified Subchapter S subsidiary would be eligible for Pennsylvania S corporation tax treatment. Both corporations would be required to file Pennsylvania corporate tax reports on a separate company basis with pro forma Federal 1120's identifying the Federal corporate net income tax that would have been reported to the Federal government if they had filed separate returns as C corporations.

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