Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:1-PLR-100930-01
Date:
March 12, 2001

Legend:

X =

Y =

Z =

A =

D1 =

D2 =

D3 =

D4 =

D5 =

x% =

Country 1 =

State =

This responds to the letter dated December 18, 2000, and subsequent correspondence, submitted on behalf of X requesting relief under § 1362(f) of the Internal Revenue Code.

FACTS

X has represented that the facts are as follows. X was incorporated under the laws of State on D1 and elected to be treated as an S corporation effective D2.

On or around D3, X acquired an interest in Y , a corporation formed under the laws

of Country 1. X's interest in Y represented at least 80 percent of the total value and voting interest in Y. On D4, X transferred its entire interest in Y to A, an individual who owned x% of X's outstanding stock.

In connection with a sale of X to Z, a corporation, on D5, X discovered that the interest it previously held in Y was not a permissible interest to be held by an S corporation. Immediately after this discovery, X sought this letter ruling from the Service. X represents that it did not intend to terminate its S corporation status and that the acquisition of the Y stock was not motivated by tax avoidance or by retroactive tax planning. Further, X represents that X and its shareholders consistently treated X as an S corporation since D2. X also represents that during the period from D3 to D4, X did not receive dividends from Y, nor did X pay interest or receive interest payments from Y. X and all of its shareholders have agreed to make such adjustments that the Commissioner may require consistent with the treatment of X as an S corporation.

LAW AND ANALYSIS

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

For taxable years beginning prior to January 1, 1997, the term "small business corporation" was defined in section 1361(b)(1) as a domestic corporation that is not an ineligible corporation and that does not (A) have more than 35 shareholders, (B) have as a shareholder a person (other than an estate and other than a trust described in section 1361(c)(2)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Further, during this period, section 1361(b)(2) defined an "ineligible corporation" as any corporation which is (A) a member of an affiliated group (determined under section 1504 without regard to the exceptions contained in subsection (b) thereof), (B) a financial institution to which section 585 applies (or would apply but for subsection (c) thereof), (C) an insurance company subject to tax under subchapter L, (D) a corporation to which an election under section 936 applies, or (E) a DISC or former DISC.

Section 1362(d)(2)(A) provides that an election to be treated as a subchapter S corporation terminates whenever (at any time on or after the first day of the first taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation. Under §1362(d)(2)(B), the termination is effective on and after the date the S corporation ceases to meet the requirements of a small business corporation.

Section 1362(f), in relevant part, provides that, if (1) an election under §1362(a) by any corporation was terminated under § 1362(d), (2) the Secretary determines that the termination was inadvertent, (3) no later than a reasonable period of time after discovery of the event resulting in the termination, steps were taken so that the corporation is once

more a small business corporation, and (4) the corporation and each person who was a shareholder of the corporation at any time during the period specified pursuant to §1362(f), agrees to make any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to the period, then, notwithstanding the terminating event, the corporation shall be treated as continuing to be an S corporation during the period specified by the Secretary.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that X's election to be treated as an S corporation terminated on D3 when X acquired at least an 80 percent interest in Y and became a member of an affiliated group. We also conclude that the termination constituted an "inadvertent termination" within the meaning of § 1362(f). Pursuant to § 1362(f), X will be treated as continuing to be an S corporation from D3 through D5, provided that X's S election was not otherwise terminated under § 1362(d). The shareholders of X must include their pro rata share of the separately and nonseparately computed items of X as provided in section 1366, make any adjustments to stock basis as provided in section 1367, and take into account any distributions made by X to the shareholders as provided in section 1368.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed concerning whether the original election made by X to be treated as an S corporation was a valid election under § 1362.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,
Matthew Lay
Assistant to the Branch Chief, Branch 1
Associate Chief Counsel
(Passthroughs and Special Industries)

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