Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:B2-PLR-146389-01
Date:
November 27, 2001

X =

Y =

Z =

A =

B =

C =

D =

E =

F =

G =

H =

I =

J =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

Year 1 =

Dear :

On November 20, 2000, the Internal Revenue Service issued PLR 200107030 (PLR-110764-00) to X granting a ruling request under § 1362(f) of the Internal Revenue Code. In a letter dated D7, you informed us of an error in the statement of facts presented in the original ruling request. Accordingly, PLR 200107030 is revoked and replaced with this letter which is in accord with the facts of your D7 letter. The conclusions of PLR 200107030 remain the same.

The information submitted states that X was incorporated on D1. X uses the cash method of accounting and its taxable year ends on December 31.

X is engaged in the development, sale and distribution of computer software products. Sometime prior to D4, X entered into a product distribution arrangement with J, an individual resident in the United Kingdom. J sought employment by X as a condition of the distribution arrangement. To facilitate J's employment by X, on or about D5, X established a corporate subsidiary chartered in the United Kingdom known as Y. J became an employee of Y and Y conducted product distribution for X in the United Kingdom.

On or about D2, after the creation of Y on D5, X filed an election to be an S corporation for its taxable year beginning D3. On D2 and D3, X owned 80 percent of the outstanding stock of Y. Neither X nor its shareholders were aware that X was not eligible to make an S corporation election because the ownership of Y made X an ineligible corporation under § 1361(b)(1).

On D6, Z purchased all of the issued and outstanding common stock of X from its shareholders. Z is a C corporation. In connection with the due diligence relative to the purchase by Z of all of X's stock, A, X's former president, learned from legal counsel that at the time of the filing of the S corporation election X was an ineligible corporation because of the ownership of Y's stock. Z has determined to make an election under § 338(h)(10) to treat the purchase of X's stock as a deemed sale of assets of X for federal income tax purposes.

A represents that the ineffectiveness of its election to be taxed as an S corporation was not the result of retroactive tax planning and was not motivated by tax avoidance.

X's shareholders during all or part of the period through D6 were A, B, C, D, E, F, G, H, and I. For Year 1 and all subsequent taxable years, X's shareholders reported on their individual income tax returns consistent with X being an S corporation. X and its shareholders consent to adjustments consistent with the treatment of X as an S corporation.

Section 1362(a) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

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

For taxable years beginning after December 31, 1996, § 1361(b)(1) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2) or an organization described in § 1361(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

For taxable years beginning before January 1, 1997, § 1361(b)(2)(A) defines the term "ineligible corporation" to mean any corporation that is a member of an affiliated group (determined under § 1504 without regard to the exceptions contained in § 1504(b)).

Section 1504(a)(1) defines the term "affiliated group" to mean one or more chains of includible corporations connected through stock ownership with a common parent corporation that is an includible corporation, but only if: (1) the common parent owns directly stock meeting the requirements of § 1504(a)(2) in at least one of the other includible corporations, and (2) one or more of the other includible corporations own directly stock meeting the requirements of § 1504(a)(2) in each of the includible corporations (except the common parent).

Section 1504(a)(2) provides that the ownership of stock of any corporation meets the requirements of § 1504(a) if: (1) it possesses at least 80 percent of the total voting power of the stock of the corporation, and (2) has a value equal to at least 80 percent of the total value of the stock of the corporation.

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 ineffectiveness 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 of the corporation at any time during the period specified pursuant to § 1362(f), 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.

Based solely on the facts submitted, and the representations made, we conclude that X's S corporation election was ineffective because X was an ineligible corporation under former § 1362(b)(2)(A) due to the 80 percent ownership of the stock of Y. We further conclude that the ineffectiveness of X's S corporation election was "inadvertent" within the meaning of § 1362(f).

Under the provisions of § 1362(f), X will be treated as an S corporation from D3 through D6, provided that X's S corporation election was otherwise valid and provided that the election was not otherwise terminated under § 1362(d).

This ruling under section 1362(f) is conditioned on X having reconstructed the subpart F income of Y for all taxable years for which the statute of limitations had not expired and having filed Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, reporting any subpart F income within 90 days of November 20, 2000, for all taxable years of X for which the statute of limitations had not expired. Accordingly, X and its shareholders must have reported all items consistent with the Form 5471 for all taxable years for which the statute of limitations had not expired. Any amended returns required to report items consistent with the Form 5471 must have been filed within 90 days of November 20, 2000.

This letter is also conditioned on X having treated any and all gain from the deemed sale of Y stock under § 338 as dividend income under section 1248(a), if the earnings and profits of Y were not established pursuant to section 1248(h).

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code.

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

Pursuant to a power of attorney on file with this office, a copy of this letter is being forwarded to X.

Sincerely yours,
J. THOMAS HINES, Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
Copy for 6110 purposes