Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:2 – PLR-137475-04
Date:
August 13, 2004

Legend

X:

Y:

A:

B:

C:

State:

D1:

D2:

D3:

Dear :

This responds to a letter dated June 14, 2004, and additional correspondence, submitted on behalf of X, requesting a ruling under § 1362(a) of the Internal Revenue Code.

Facts

The represented facts are as follows: X was incorporated under State law on D1. X filed an election to be treated as an S corporation under § 1362 for its taxable year beginning D1. As of D2, A, B and C were the shareholders of X. On D2, Y, a C corporation, purchased all of X's stock. As part of the purchase transaction the parties made a § 338(h)(10) election to treat the stock purchase as an asset purchase.

On D3, due to unforeseen circumstances, Y transferred all of X's stock back to A and B. X and its shareholders then requested permission to make a new S election for X beginning D3.

Law and Analysis

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.

Section 1361(b)(1) defines a "small business corporation" as 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.

Section 1362(a)(1) 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 1362(c) provides that an election under § 1362(a) shall be effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, until such election is terminated under § 1362(d).

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(d)(2)(B) provides that any termination under § 1362(d) shall be effective on and after the date of cessation.

Section 1362(g) provides that if a small business corporation has made an election under § 1362(a) and if such election has been terminated under § 1362(d), the corporation (and any successor corporation) shall not be eligible to make an election under § 1362(a) for any taxable year before its fifth taxable year which begins after the first taxable year for which the termination is effective, unless the Secretary consents to the election.

Section 1.338-1(a) of the Income Tax Regulations provides, in part, that elections are available under § 338 when a purchasing corporation acquires the stock of another corporation (the target) in a qualified stock purchase. It also provides that although target is a single corporation under corporate law, if a § 338 election is made, then two separate corporations, old target and new target, generally are considered to exist for purposes of subtitle A of the Internal Revenue Code. Old target is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the discharge of its liabilities (see § 1.1001-2(a)), and new target is treated as acquiring all of its assets from an unrelated person in exchange for consideration that includes the assumption of those liabilities. (Such transaction is, without regard to its characterization for Federal income tax purposes, referred to as the deemed asset sale and the income tax consequences thereof as the deemed sale tax consequences.) If a § 338(h)(10) election is made, old target is deemed to liquidate following the deemed asset sale.

Section 1.338-1(b) provides that, with exceptions not relevant here, the new target is treated as a new corporation that is unrelated to the old target for purposes of subtitle A of the Internal Revenue Code.

Section 1.338-1(b)(3)(iii) provides that old target and new target must use the same employer identification number.

Section 1.338-2(c)(17) provides the definitions for the terms target, old target, and new target for purposes of § 338. Target is a target corporation as defined in § 338(d)(2). Old target refers to target for periods ending on or before the close of target's acquisition date. New target refers to target for subsequent periods.

Section 1.338(h)(10)-1(c)(2) provides that a § 338(h)(10) election is made jointly by P [purchasing corporation] and the selling S corporation shareholders on Form 8023 in accordance with the instructions to the form. S corporation shareholders who do not sell their stock must also consent to the election.

Section 1.338(h)(10)-1(d)(3)(i) provides, in part, that old T is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the discharge of its liabilities in a single transaction at the close of the acquisition date (but before the deemed liquidation). Old T realizes the deemed sale

tax consequences from the deemed asset sale before the close of the acquisition date while old T is a member of the selling consolidated group (or owned by the selling affiliate or owned by the S corporation shareholders). When T is an S corporation target, T's S election continues in effect through the close of the acquisition date (including the time of the deemed asset sale and the deemed liquidation) notwithstanding § 1362(d)(2)(B).

Section 1.338(h)(10)-1(d)(4)(i) provides, in part, that old T is treated as if, before the close of the acquisition date, after the deemed asset sale in § 1.338(h)(10)-(d)(3), and while old T is owned by the S corporation shareholders, it transferred all of its assets to the S corporation shareholders and ceased to exist. The transfer from old T is characterized for Federal income tax purposes in the same manner as if the parties had actually engaged in the transactions deemed to occur because of § 338 and taking into account other transactions that actually occurred or are deemed to occur. In most cases, the transfer will be treated as a distribution in complete liquidation to which § 336 or 337 applies.

Section 1.338(h)(10)-1(d)(5) provides, in part, that if T is an S corporation target, S corporation shareholders (whether or not they sell their stock) take their pro rata share of the deemed sale tax consequences into account under § 1366 and increase or decrease their basis in T stock under § 1367. S corporation shareholders are treated as if, after the deemed asset sale in § 1.338(h)(10)-(d)(3) and before the close of the acquisition date, they received the assets transferred by old T in the transaction described in § 1.338(h)(10)-1(d)(4)(i). In most cases, the transfer will be treated as a distribution in complete liquidation to which § 331 or 332 applies.

Conclusion

Based solely on the information submitted and the representations made, we conclude that X's S corporation election did not terminate under § 1362(d)(2)(A) when Y, a C corporation, purchased all of X's stock because the parties made a § 338(h)(10) election. A § 338(h)(10) election treats X's S corporation election as continuing through Y's deemed purchase of X's assets and X's deemed liquidation, and treats X as a new corporation after the liquidation. Thus, X's shareholders do not need permission under § 1362(g) to make a new S corporation election for X when A and B reacquired X's stock from Y on D3. Accordingly, provided that X makes an election to be an S corporation by filing a completed Form 2553 with the appropriate service center effective D3 within 60 days following the date of this letter, then such election will be treated as timely made for X's taxable year beginning D3. A copy of this letter should be attached to the Form 2553.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code, including whether X was or is a small business corporation under § 1361(b).

This ruling is directed only to the taxpayer who 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 sent to X's authorized representative.

Sincerely,

J. Thomas Hines
Chief, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

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