Internal Revenue Service

Department of the Treasury

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LEGEND

X =

Y =

Foreign Entity =

d1 =

d2 =

d3 =

State =

Dear

This letter responds to a letter dated December 21, 1998, and subsequent correspondence, by your authorized representative on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, X, a State corporation, elected to be treated as an S corporation effective d1. On d2, X, which already owned a 65% interest in Y, a Foreign Entity, obtained an 80% interest in Y, terminating X's S corporation election. At the time, X and its shareholders did not realize that X's ownership of 80% of Y violated the requirement in § 1361(b) of the Code (as in effect prior to January 1, 1997) that an S corporation not be an ineligible corporation. In d3, when X's shareholders were considering selling X, the potential buyer's accountants discovered that X's S corporation election had terminated, and X subsequently filed a private letter ruling request with this office.

X represents that the termination of its election was inadvertent and was not motivated by tax avoidance or retroactive tax planning. X and each of its shareholders who were shareholders during the period of termination agree to make any necessary adjustments consistent with the treatment of Company as an S corporation.

LAW AND ANALYSIS

Section 1361(a)(1) defines an S corporation as a small business corporation for which an election under § 1362(a) is in effect.

Section 1361(b)(1) provides that one of the requirements for a taxpayer to be a small business corporation is that the taxpayer is a domestic corporation which is not an ineligible corporation.

Section 1361(b)(2)(A) as in effect prior to January 1, 1997, provided in part, that an ineligible corporation is a corporation which is a member of an affiliated group (determined under § 1504 without regard to the exceptions contained in § 1504(b)). Under this test, an S corporation could not own 80% or more of the stock of another corporation if such stock possessed at least 80% of the total voting power and 80% of the total value of the stock of such corporation.

Effective January 1, 1997, an S corporation that is a member of an affiliated group is no longer an ineligible corporation under § 1361(b).

Section 1362(d)(2) provides that an election to be an S corporation will be terminated whenever the corporation ceases to be a small business corporation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in such termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the termination, steps were taken so that the corporation is 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 the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary for that 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.

After applying the relevant law to the facts submitted and the representations made, we conclude that X's S corporation election terminated on d2 when X became an 80% shareholder of Y. We also hold that the termination was inadvertent within the meaning of § 1362(f).

We further hold that under the provisions of § 1362(f), X will be treated as an S corporation from d2, until January 1, 1997, when X was no longer an ineligible corporation, and thereafter, provided X had a valid S corporation election and that election was not otherwise terminated under § 1362(d). Accordingly, all shareholders of X, in determining their respective income tax liabilities, must include the pro rata share of the separately and nonseparately computed items of X as provided in § 1367, and take into account any distributions made by X as provided by § 1368. This ruling will be null and void if X or any of its shareholders fail to comply with these requirements.

Except as specifically set forth above, no opinion is expressed or implied as to the federal income tax consequences of the transaction described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X is, in fact, an S corporation for federal tax purposes.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. Pursuant to a power of attorney in this office, the original of this letter is being sent to you, and copies will be sent to your authorized representatives.

Sincerely yours,

William P. O'Shea
Chief, Branch 3
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)