

Internal Revenue Service

Department of the Treasury

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Date:

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Legend

X =

Y =

A =

B =

State =

D1 =

D2 =

D3 =

D4 =

D5 =

n% =

This responds to your December 23, 1998 letter, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

X was incorporated under State law on D1. X elected subchapter S status, effective D2.

On D3, pursuant to a stock purchase agreement, Y, a subchapter S corporation, acquired n% of X stock from A.

On or about D4, X became aware that Y's ownership of X's stock terminated X's S election in that Y is not an eligible S corporation shareholder. Prior to D4, X was not aware that issuing stock to Y terminated its S election.

On D5, pursuant to a second stock purchase agreement, Y acquired the remaining X stock from B. Accordingly, as of D5, Y held 100% of the stock of X. Y has timely filed an election to treat X as a qualified subchapter S subsidiary (QSUB).

X represents that issuing stock to Y was not motivated by tax avoidance or retroactive tax planning. In addition, X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary with respect to the period specified by § 1362(f) of the Code.

LAW AND ANALYSIS

Section 1361(a) of the Code defines an "S corporation", with respect to any taxable year, as a small business corporation for which an S election under § 1362(a) is in effect for that year.

Section 1361(b)(1)(B) provides that a "small business corporation" cannot 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.

Section 1361(b)(3)(A) provides that, generally, a corporation that is a QSUB shall not be treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of a QSUB shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation. Section 1361(b)(3)(B) defines a QSUB as any domestic corporation that is not an ineligible corporation if 100% of the stock of such corporation is held by the S corporation and the S corporation elects to treat such corporation as a QSUB.

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

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 effectiveness 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 in the corporation at any time during the period specified pursuant to this subsection, 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.

The committee reports accompanying the Subchapter S Revision Act of 1982, in discussing § 1362(f) as it relates to inadvertent terminations, state, in part, as follows:

If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.

The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped the taxpayers and the government will work out agreements that protect the revenues without undue hardship to taxpayers It is expected that the waiver may be made retroactive for all years, or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24.

CONCLUSIONS

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Based solely on the facts submitted and representations made, we conclude that X's subchapter S election terminated on D3 as the result of Y acquiring X stock. We also conclude that the termination was inadvertent under § 1362(f). We further conclude that, effective D5, X became a QSUB of Y. Therefore, under the provisions of § 1362(f), X will be treated as an S corporation from D3 until D5, provided that X's S corporation election did not otherwise terminate under § 1362(d). Finally, we conclude that Y and B were the shareholders of X during the period from D3 until D5.

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.

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

Sincerely,
Signed/David R. Haglund

David R. Haglund
Senior Technician Reviewer, Branch 1
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

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

