Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

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Date:
February 23, 1999

Legend

Company =

Subsidiary =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

State =

FYE =

Year =

Shareholders =

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Dear

This letter responds to a letter dated June 1, 1998, written on behalf of Company, requesting relief under § 1362(f) of the Internal Revenue Code for an inadvertent termination of Company's S corporation status.

FACTS

Company represents the following facts. Company was incorporated on Date 1 under the laws of State. Company's fiscal year ends on FYE. Company elected to be taxed as an S corporation effective Date 2. On Date 3, Company acquired more than 80 percent of the outstanding stock of Subsidiary, a C corporation. Company and its Shareholders were aware that § 1361(b)(2) of the Internal Revenue Code had been amended by § 1308(a) of the Small Business Job Protection Act of 1996 (P.L. 104-188) to allow S corporations to own 80 percent or more of the stock of a C corporation. However, neither Company nor its Shareholders were aware that the change in the law would not be effective for Company until Date 4. It was not until Company's accountants began preparing Company's tax returns for Year that Company became aware that its subchapter S election had terminated on Date 3. Company represents that the Date 3 acquisition was not part of a plan to terminate Company's S corporation status and that the failure to qualify as an S corporation was not motivated by tax avoidance or retroactive tax planning. Company and its Shareholders continued to file returns as if Company's subchapter S election were in effect. Furthermore, beginning Date 4, Company could own more than 80 percent of the stock of Subsidiary and still be considered an S corporation.

Company has requested relief under § 1362(f) for the inadvertent termination of its S corporation status. Company and Shareholders have agreed to make any adjustments required by the Commissioner consistent with the treatment of Company as an S corporation.

DISCUSSION

Under § 1361(a)(1), an S corporation is a small business corporation for which an election under § 1362(a) is in effect. Section 1361(b) defines a small business corporation, in part, as a domestic corporation that is not an ineligible corporation. For taxable years beginning before January 1, 1997, § 1361(b)(2)(A) defined the term "ineligible corporation" to include any corporation which was a member of an affiliated group (determined under section 1504 without regard to the exceptions contained in subsection (b) thereof).

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

Under § 1362(f), a corporation that has lost its S corporation status under § 1362(d)(2) shall be treated as continuing to be an S corporation during the period specified by the Secretary if: the Secretary determines that the termination was inadvertent; the corporation took steps to return to its status as a small business corporation within a reasonable time after the termination; and the corporation and all persons who were shareholders during the specified period agree to make adjustments consistent with the treatment of the corporation as an S corporation.

The committee reports accompanying the Subchapter S Revision Act of 1982 explain 1362(f) 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 that

> taxpayers and the government will work out agreements that protect the revenue without undue hardship to taxpayers ... [I]t 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; H.R. Rep. No. 826, 97th Cong., 2d Sess. 12 (1982), 1982-2 C.B. 730, 735.

CONCLUSION

Company's status as an S corporation terminated when Company acquired more than 80 percent of the stock of Subsidiary on Date 3. Company has shown that the termination was inadvertent.

Pursuant to § 1362(f), Company will be treated as continuing to be an S corporation from Date 3 to Date 4, and thereafter, provided Company's S election is valid and is not otherwise terminated under § 1362(d). Accordingly, in determining their federal tax liability for the period from Date 3 to Date 4, and thereafter, the Shareholders must include their pro rata share of the separately and nonseparately computed items of Company under § 1366, make adjustments to stock basis under § 1367, and take into account any distributions made by Company under § 1368. If Company or the Shareholders fail to treat Company as described above, this ruling shall be null and void.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transaction described above under any other provision of the Code. Specifically, no opinion is expressed as to whether Company is, in fact, an S corporation for federal tax purposes.

This ruling is directed only to the taxpayer who requested it. Under § 6110(k)(3), it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this ruling is being sent to your authorized representative.

Sincerely yours,

Donna M. Young
Senior Technician Reviewer,
Branch 3
Office of the Assistant Chief
Counsel
(Passthroughs and Special
Industries)

Enclosures: 2
Copy of this letter
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