Internal Revenue Service

Department of the Treasury

Washington, DC 20224

UIL 1362.00-00

Contact Person: **199902003**

Telephone Number:

In Reference to: CC:DOM:P&SI:7--PLR-108842-98

Date: OCT 2 1998

Re:

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date 1:

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date 5:

Dear :

We received your letter, dated submitted on X's behalf, requesting a ruling under § 1362(f) of the Internal Revenue Code. This letter responds to that request.

The represented facts are as follows: X is a corporation that elected to be treated as an S corporation under § 1362 effective for its taxable year beginning on date 1. Effective date 1, X and its shareholders filed returns consistent with making the S corporation election. During date 2, X established a plan to create new corporate subsidiary, Y. At that time, X's accountant and tax advisor who was aware of X's S corporation election did not advise X's officers or shareholders that an S corporation could not be a member of an affiliated group, or that X could not own 80 percent or more of the stock of Y, the newly formed corporation. Y was incorporated on date 3. From date 3 until date 5, the officers and shareholders of X were unaware that X's S corporation status had terminated on date 3, the date of Y's incorporation. On date 5, D, a shareholder and officer of X, learned that a provisions of the Small Business Job Protection Act of 1996 (SBJPA) allows an S corporation to have wholly-owned domestic and foreign subsidiaries for tax years beginning after 1996. Upon further research, D confirmed that prior to the enactment of this provision, X had violated the limitations imposed on S corporations with respect to being a member of an affiliated group under § 1504 of the Internal Revenue Code. X then hired a new accounting firm to take immediate steps to seek relief from the termination of X's status as an S corporation.

It has been represented that the terminating event was inadvertent and that the termination was not the result of retroactive tax planning or motivated by tax avoidance. X's shareholders are not knowledgeable in technical tax matters and relied solely on the accountant with regard to all tax issues, including the preparation of X's tax returns. X and its shareholders (A, B, C, D, and E) took steps to seek relief immediately after their discovery of the termination of the S corporation status.

For taxable years beginning after December 31, 1997, § 1361(b) defines a "small business corporation" as a domestic corporation that is not an ineligible corporation and that 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) provided that an "ineligible corporation" means any corporation which is a member of an affiliated group (determined under § 1504 without regard to the exceptions contained in subsection (b) thereof).

Section 1504(a) provides that the term "affiliated group" includes 1 or more chains of includible corporations connected through stock ownership provided that the parent corporation possesses at least 80 percent of the total voting power of the stock of the subsidiary corporation and has a value equal to at least 80 percent of the total value of the stock of the corporation.

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

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 the ineffectiveness or termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the 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 the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to the period, then, notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation is treated as continuing to be an S corporation during the period specified by the Secretary.

With respect to § 1362(f), the committee reports accompanying the Subchapter S Revision Act of 1982 state the following:

> 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. . . . 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; H.R. Rep. No. 826, 97th Cong., 2d Sess. 12 (1982), 1982-2 C.B. 730, 735.

Based on the facts submitted and the representations made, we conclude that: (1) to the extent X's S corporation election under § 1362(a) was ineffective or terminated under § 1362(d), the circumstances resulting in the ineffectiveness or termination were inadvertent within the meaning of § 1362(f); (2) no later than a reasonable period of time after discovery of the circumstances of the ineffective election or termination, steps were taken so that X was once more a small business corporation; and (3) no tax avoidance was intended nor will result from the continued treatment of X as a subchapter S corporation. Therefore, pursuant to § 1362(f), X's election to be an S corporation will be recognized effective date 1, and thereafter, provided that X's subchapter S election is not otherwise terminated under § 1362(d).

During the period from date 3 through date 4, X will be treated as the owner of Y. Accordingly, each of the shareholders of X from date 3 through date 4 must include in income its pro rata share of X's separately and nonseparately computed items as provided in § 1366, make adjustments to stock basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368.

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the above-described facts under any other provision of the Code. Specifically, no opinion is expressed on whether the election made by X to be treated as an S corporation was a valid election under § 1362.

X must forward a copy of this letter to the Internal Revenue Service Center within 60 days of the date of this letter. This ruling shall be null and void if the requirements of this paragraph are not met.

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

Sincerely yours,

Mary A. Berman
Assistant to the Chief,
Branch 7
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
Copy of this letter
Copy for section 6110 purpose