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Department of the Treasury

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April 16, 1999

X =

Y =

A =

B =

D1 =

D2 =

D3 =

D4 =

D5 =

x =

y =

Dear :

This letter responds to the letter, dated December 18, 1998, and subsequent correspondence submitted by X's authorized representative on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated on D3 and elected to be an S corporation effective D4. A, the president of X, represents that Y was incorporated on D1 and elected to be an S corporation effective D2. On D5, A, then the sole shareholder of X, transferred x% of X's shares to Y and y%

of X's shares to B, relying on X's accountant for advice as how to properly structure the transaction. However, because Y was not an eligible shareholder of X under § 1361(b)(1)(B), X's S election terminated on D5.

A represents that A was unaware that the transfer of X shares to Y, an ineligible shareholder, would terminate X's S election. A also represents that X and its shareholders, including Y, have consistently filed Form 1120S, U.S. Income Tax Return for an S Corporation, and Form 1040, U.S. Individual Income Tax Return, consistent with X being an S corporation.

A and B represent that they will transfer their interests in X to Y, and that Y will then elect to treat X as a Qualified Subchapter S Subsidiary (QSub). 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).

Section 1361(a)(1) of the Code 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)(B) of the Code provides that for purposes of subchapter S, the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not have as a shareholder a person (other than an estate and other than 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) of the Code provides that a corporation which is a "qualified subchapter S subsidiary" (QSub) shall not be treated as a separate corporation and all assets, liabilities, and items of income, deduction, and credit of the QSub shall be treated as assets, liabilities, and items of the S corporation.

Section 1361(b)(3)(B) provides that the term "qualified subchapter S subsidiary" means any domestic corporation which 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) of the Code provides that an election under § 1362(a) will 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)(A) shall be effective on and after the date of cessation.

Section 1362(f) of the Code 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 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 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.

Based solely on the representations made and the information submitted, we conclude that X's S corporation election terminated on D5, when Y became a shareholder of X.

We further conclude that the termination of X's S election was an inadvertent termination within the meaning of § 1362(f) of the Code. Accordingly, pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation beginning D5 until the effective date of Y's QSub election for X, provided that X's S corporation election was valid and was not otherwise terminated under § 1362(d). In addition, X will be treated as a QSub of Y under § 1361(b)(3), provided that Y files a QSub election with the appropriate service center within 60 days following the date of this letter, to be effective for the date on which X becomes wholly owned by Y. Copies of this letter should be attached to the QSub election and to Y's next federal income tax return. From D5 to the effective date of Y's QSub election for X, Y will continue to be treated as a x% shareholder of X. Therefore, from D5 to the effective date of Y's QSub election for X, the shareholders of X must include their pro rata share of the separately stated and nonseparately computed items of X as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368. If X or its shareholders fail to treat themselves as described above, this ruling will be null and void.

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. § 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, copies of this letter will be sent to X's authorized representative.

Sincerely yours,

J. THOMAS HINES
Senior Technician Reviewer
Branch 2
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
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