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Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
September 27, 1999

LEGEND

Company =

State =

d1 =

d2 =

d3 =

d4 =

d5 =

d6 =

d7 =

A =

B =

x =

y =

Dear

This letter responds to a letter dated April 21, 1999, and subsequent correspondence from your authorized representative on behalf of Company, requesting permission for Company to reelect S corporation status prior to the termination of the five year waiting period required by § 1362(g) of the Internal Revenue Code.

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FACTS

According to the information submitted, Company was incorporated in d1 under the laws of State, and elected to be treated as an S corporation as defined by § 1361(a) on d2. Company's fiscal year, a grandfathered fiscal year pursuant to § 1.444-1T(a)(3)(ii) of the Income Tax Regulations, ends on d3.

On d4, Company revoked its S corporation election effective d5, the first day of Company's fiscal year. On d6, five days after Company filed the revocation of its S election, A and B, Company's sole shareholders, sold x percent of their stock in Company to an Employee Stock Ownership Plan (ESOP), making an election under § 1042 to defer recognition of gain on the sale. Company represents that the ESOP is a qualified plan under § 401(a), and meets the requirements of § 4975(e)(7). Subsequent to submitting this ruling request, A and B sold their remaining y percent interest in Company's stock to the ESOP, again making the election under § 1042.

Company requests permission under § 1362(g) to reelect S corporation status effective d7, a date that is prior to the termination of the five year waiting period required by the code. Company is not requesting a ruling on the validity of A's and B's § 1042 elections.

LAW AND ANALYSIS

Section 1362(a) provides that except as provided in § 1362(g), a small business corporation may elect to be an S corporation.

Section 1361(b)(1)(B) provides that for the purposes of subchapter S, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not 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 1316 of the Small Business Job Protection Act (SBJPA) of 1996, Pub. L. No. 104-188, amended subchapter S to allow certain exempt organizations to be shareholders of an S corporation. For taxable years beginning after December 31, 1997, § 1361(c)(6) of the code provides that for purposes of § 1361(b)(1)(B), an organization which is described in § 401(a) or § 501(c)(3) and is exempt from taxation under § 501(a) may be a shareholder in an S corporation. Under § 1361(c)(6), ESOPs are eligible shareholders of S corporations because they are described in § 401(a) and are exempt from tax under § 501(a).

Section 1042 provides, in general, that a taxpayer may elect in certain cases not to recognize long-term capital gain on the sale of "qualified securities" to an ESOP (as defined in § 4975(e)(7)) if the taxpayer purchases "qualified replacement property" (as

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defined in § 1042(c)(4)) within the replacement period of § 1042(c)(3) and the requirements of § 1042(b) and § 1.1042-1T are satisfied.

The SBJPA amended the code to provide that certain special tax rules relating to ESOPs will not apply with respect to S corporation stock held by an ESOP. Included in these limitations was the rule relating to the rollover of gain on the sale of S corporation stock to an ESOP under § 1042. Section 1042(c)(1), as amended by the SBJPA, provides, in part, that for taxable years beginning on or after January 1, 1998, the term "qualified securities" means employer securities (as defined by § 409(l)) which were issued by a domestic C corporation. Prior to the SBJPA, § 1042(c)(1) provided that "qualified securities" were issued by a "domestic corporation." While allowing an ESOP to be an S corporation shareholder, Congress specifically limited § 1042 to the sale of C corporation stock. Additionally, the SBJPA provided that items of income or loss of an S corporation will flow through to qualified tax-exempt shareholders as unrelated business taxable income (UBTI) under § 512(e). While the UBTI provision as it relates to S corporations owned by ESOPs was repealed by § 1523(a) of the Taxpayer Relief Act of 1997 (TRA), P.L. 105-34, the § 1042 restriction remained intact.

Company revoked its S corporation election just prior to a sale of its stock to the ESOP in a § 1042 transaction. Company now seeks to reelect S corporation status.

Section 1362(d)(1)(A) provides that an election under § 1362(a) may be terminated by revocation.

Section 1362(g) provides that if a small business corporation has made an election under § 1362(a) and if such election has been terminated under § 1362(d), such corporation (and any successor corporation) shall not be eligible to make an election under § 1362(a) for any taxable year before its fifth taxable year for which such termination is effective, unless the Secretary consents to such election.

Section 1.1362-5(a) provides that the Commissioner may permit a corporation to make a new election before the five year period expires. The corporation has the burden of establishing that under the relevant facts and circumstances, the Commissioner should consent to a new election. The fact that more than 50 percent of the stock in the corporation is owned by persons who did not own any stock in the corporation on the date of the termination tends to establish that consent should be granted. In the absence of this fact, consent ordinarily is denied unless the corporation shows that the event causing the termination was not reasonably within the control of the corporation or shareholders having a substantial interest in the corporation and was not part of a plan on the part of the corporation or of such shareholders to terminate the election.

While the SBJPA amended § 1361 to allow ESOPs to be shareholders of S corporations, it prohibited S corporation shareholders from selling their stock to an ESOP and deferring the gain in a § 1042 transaction. To allow Company to terminate

its S corporation election, immediately have its shareholders engage in a § 1042 transaction, and then subsequently reelect S corporation status before the expiration of the five year waiting period under § 1362(g), would contravene the applicable statutes and be contrary to Congressional intent. Even though the ESOP owns more than 50 percent of Company, Company has not met its burden, under the facts and circumstances in this case, of establishing that the Commissioner should consent to the new election.

CONCLUSION

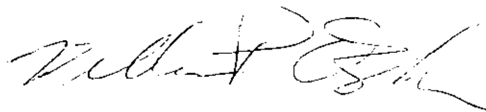
We deny Company's request to reelect S corporation status under § 1362(g) before the expiration of the five year statutory waiting period. Also, because Company is currently prohibited under § 1362(g) from electing S corporation status, it is also prohibited from becoming a qualified subchapter S subsidiary under § 1361(b)(3) during the same period.

This ruling is based solely on the above mentioned facts. We express no opinion on the validity of either Company's original S election, or on the selling shareholders' § 1042 election.

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

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.

Sincerely yours,



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

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