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December 29, 2003
 Chief Counsel Ruling 20030285

This letter responds to your letter dated *****, for a Chief Counsel Ruling for *****. You have requested a ruling that ***** had a valid S corporation election for California corporate income/franchise tax purposes as of April 1, 1997.

FACTS

According to the information submitted with your letter, ***** was incorporated in California on *****. ***** initially filed its federal income tax returns and California corporate income/franchise tax returns as a C corporation. ***** filed a Federal Form 2553 Election by a Small Business Corporation, to elect to be classified as an S corporation under section 1362, effective April 1, 1989.

The IRS originally accepted ***** election to be treated as an S corporation effective April 1, 1989, stating in part that:

Your election to be treated as an S – corporation with an accounting period of March is accepted. The election is effective beginning Apr. 1, 1989, subject to verification if we examine your return.

You have represented that, at the time the election was made, some of the shareholders of ***** were married and some or all of these married shareholders may have held their shares of ***** stock as community property. In addition, you have further represented that some or all consents of spouses may not have been filed.

Subsequently, ***** became aware that its S corporation election might be invalid during negotiation for the sale of all of ***** shares in 2002. In November 2002, ***** requested an extension of time to file all requisite shareholder consents from the Internal Revenue Service (IRS) pursuant to Internal Revenue Code (IRC) section 1362(f) in accordance with the procedures set forth in Treasury Regulation section 1.1362-6(b)(3)(iii).

On April 23, 2003, the IRS granted ***** an extension of time to file a consent stating:

We have accepted your request under IRC 1.1362-6(b)(3)(iii), extension of time to file consent. Your original election remains in effect until it is revoked or terminated.

***** has also made the following factual representations:

1. ***** possible failure to file the consents of two shareholders as of April 1, 1989, or of the spouses of married shareholders who may have had a community property interest in any shares outstanding at April 1, 1989, was inadvertent and not made for a tax avoidance motive.
2. ***** has filed its federal and California franchise tax returns as an S corporation for the taxable years ending ***** , both dates inclusive, on form 1120-S (100S in the case of California), issuing proper Schedules K-1 to all of its shareholders;
3. ***** has never made an election to be treated as a C corporation for purposes of California franchise and income tax laws;
4. Prior to the sale of the stock of ***** , no action was taken and no event occurred, that would invalidate or terminate the status of ***** as an S corporation under the CRTC;
5. All shareholders of ***** from April 1, 1997, through June 30, 2002, have represented that they have reported on their personal federal and California income tax returns their shares of income, deductions, gains, losses, credits, and other relevant tax items as shown on the annual K-1's, and have agreed to make any adjustments required that are consistent with the treatment of the corporation as an S corporation.

LAW AND ANALYSIS

California follows federal law with respect to S corporations using the following statutory scheme. The Revenue and Taxation Code states that the Internal Revenue Code (IRC) provisions that relate to S corporations apply, except as otherwise provided. (See Rev. & Tax. Code § 23800.)

Because the IRC is continually revised, California uses the concept of a "specified date" to identify which version of the IRC is applied to which taxable years for California purposes. (See Rev. & Tax. Code § 23051.5.) As a result, changes in federal law do not automatically change state law. The California State Legislature must first review the federal changes and modify the "specified date" before any federal changes become effective.

As noted above, ***** original S corporation federal election was made and intended to be effective for its taxable year beginning ***** . The relevant IRC provision regarding S corporation elections stated in part that:

An election under this subsection shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.

(Int. Rev. Code § 1362 , sub. (a)(2).)

As stated previously, California incorporated this provision. In addition, California had the following additional provisions regarding elections in general and S corporation elections, in particular. In general, California law provided that:

Whenever this part allows a taxpayer to make an election, the following rules shall apply:

(1) A proper election filed in accordance with the Internal Revenue Code or regulations issued by "the secretary" shall be deemed to be a proper election for purposes of this part, unless otherwise expressly provided in this part or in regulations issued by the Franchise Tax Board.

(Rev. and Tax. Code § 23051.5, subd. (g)(1).¹)

In particular, with respect to S corporation elections, California law provided that:

For income years beginning in 1988 and 1989 –

A corporation which did not have in effect a valid federal election for the preceding year and which makes a federal election for the income year under Section 1362(a) of the Internal Revenue Code shall be deemed to have made an election to be treated as an "S corporation" for purposes of this part on the same date as the date of its federal election, unless that corporation elects on its return to continue to be treated as a "C corporation" for purposes of this part.

(Rev. and Tax. Code § 23801(a)(3)(B).²)

The Revenue and Taxation Code also provided that:

A corporation may not elect to be treated as an "S corporation" unless it has in effect for federal purposes a valid election under Section 1362(a) of the Internal Revenue Code for the same year.

¹ As amended through December 31, 1989

² As amended through December 31, 1989

(Rev. and Tax. Code § 23801(a)(1).³)

Before 1996, there was no federal statutory authority to allow retroactive relief for invalid elections due to failure to obtain timely shareholder consents. In 1996, Congress passed legislation to amend IRC section 1362(f) to provide the IRS the statutory authority to waive the effect of an invalid election caused by an inadvertent failure to obtain the required shareholder consents.⁴

For federal purposes, these revisions applied retroactively to S corporation elections for taxable years beginning after December 31, 1982. (*Small Business Job Protection Act of 1996*, P.L. 104-188 (August 20, 1996), 110 Stat. 1755, 1779, § 1305.)

California generally conformed to this federal revision in 1997 by changing the "specified date" of its conformity to the IRC from January 1, 1993, to January 1, 1997 (for taxable and income years beginning on or after January 1, 1997). (Sen. Bill No. 455 (1997-1998 Reg. Sess.) Stats. 1997, ch. 611, § 2.) At the same time, California modified this federal provision to allow relief for invalid S corporation elections **only** for income years beginning on or after January 1, 1997, as set forth in the following Revenue and Taxation Code provisions:

³ As amended through December 31, 1989

⁴The amended IRC section 1362(f) stated that:

If –

(1) an election under subsection (a) by any corporation –

(A) was not effective for the taxable year for which made (determined without regard to subsection (b)(2)) by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents, or

(B) was terminated under paragraph (2) or (3) of subsection (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, such corporation shall be treated as an S corporation during the period specified by the Secretary.

23801(a)(5)(B) (i). A corporation that becomes an "S corporation" for an income year beginning before January 1, 1997, under the provisions of Section 1305 of the Small Business Job Protection Act of 1996 (P.L. 104-188) for federal purposes, shall become an "S corporation" for purposes of Part 10 (commencing with Section 17001) and this part, for its first income year beginning on or after January 1, 1997, unless a timely election to continue as a "C corporation" is made.

23801(j) The provisions of Section 1362(f) of the Internal Revenue Code, relating to inadvertent invalid elections or terminations, shall apply only for income years beginning on or after January 1, 1997, with respect to elections under Section 1362(a) of the Internal Revenue Code for income years beginning on or after January 1, 1997.

(Sen. Bill No. 455 (1997-1998 Reg. Sess.) § 73.)

ANALYSIS

***** failure to obtain shareholder consents to the original S corporation election in 1989 resulted in an invalid S corporation election for California purposes. As a result, for California purposes, ***** remained a C corporation.

***** requested relief for the invalid election from the IRS for the first time in 2002. Subsequently, the IRS granted the relief in 2003. At the time the IRS granted the relief in 2003, it had the statutory authority to do so for federal purposes retroactively to ***** original election date in 1989. Therefore, for federal purposes, ***** S corporation election was effective beginning April 1, 1989.

However, California's conformity to the federal statutory relief provision specifically provided that relief from the invalid election applied only to income years beginning on or after January 1, 1997. Therefore, the Franchise Tax Board may only rule that ***** S corporation election was valid for income years beginning on or after January 1, 1997, for California income/franchise tax purposes. Thus, based solely on the facts submitted and representations made with respect to the named taxpayer, we conclude that ***** S corporation election was valid for income (taxable) years beginning on or after January 1, 1997, for California income/franchise tax purposes. However, no opinion is expressed in this Chief Counsel Ruling as to ***** status for California income/franchise tax purposes for income years beginning before January 1, 1997.

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer and are based upon and limited to the facts you have submitted. In particular, one of the facts submitted is as follows. When the

IRS originally accepted ***** S corporation election, the acceptance was subject to verification of all of the election requirements. The subsequent relief granted by the IRS verified only one of these election requirements, i.e., that the proper shareholder consents were filed as of the date of the original election. Please be advised that we have performed no additional independent verification of the facts represented by the named taxpayer and, thus, are unable to express an opinion as to whether ***** satisfied any additional requirements of the IRS with respect to ***** corrective action relating to their 1989 S corporation election.

In the event of a change in relevant legislation, or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes, should they occur.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of paragraph (1) of subdivision (a) of section 21012 of the Revenue and Taxation Code. Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or in response to any notices or inquiries which might be issued.

Very truly yours,

Ann Hoover Hodges
Tax Counsel III