

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

CC:DOM:P&SI:3 PLR-111819-99

Date:

November 5, 1999

Company:

Shareholders –

M:  
N:  
O:  
P:  
Q:  
R:  
S:  
T:  
U:  
V:  
W:  
X:

a:

b:

c:

d:

e:

Dear

This letter responds to your letter dated June 25, 1999, submitted on behalf of Company, requesting a ruling under § 1362(f) of the Internal Revenue Code that the termination of Company's S corporation election was inadvertent. Company represents the following facts.

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Company was incorporated on a and elected under § 1362(a) to be an S corporation effective b, the beginning of its first tax year.

On c, original shareholders M, N, O, P, and Q, pursuant to a buy-sell agreement, sold all their stock in Company to original shareholders R, T, and U, and to new shareholders V and W.

On d, in preparing Company's federal income tax return, Company's accountant discovered that W, being a nonresident alien, was not an eligible shareholder. On e, shareholder W sold all his shares in Company to new shareholder X.

According to § 1361(a)(1), the term "S corporation" means, with respect to any tax year, a small business corporation for which an election under § 1362(a) is in effect for that year.

Section 1361(b)(1) defines the term "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not, among other things, have a nonresident alien as a shareholder.

Section 1362(d)(2) provides that an election under § 1362(a) terminates whenever (at any time on or after the 1<sup>st</sup> day of the 1<sup>st</sup> tax year for which the corporation is an S corporation) the corporation ceases to be a small business corporation, effective on and after the date of cessation.

Section 1362(f) provides, in part, that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in termination, steps were taken so that the corporation is a small business corporation, 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 might be required by the Secretary regarding this period, then, notwithstanding the circumstances resulting in termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) of the Income Tax Regulations provides that the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The fact that the terminating event was not reasonably within the control of the

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corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent.

According to the legislative history of § 1362(f)--

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 revenues without undue hardship to taxpayers. For example, if a corporation, in good faith, determined that it had no earnings and profits, but it is later determined on audit that its election terminated by reason of violating the passive income test for three consecutive years because the corporation in fact did have accumulated earnings, if the shareholders were to agree to treat the earnings as distributed and include the dividends in income, it may be appropriate to waive the terminating events, so that the election is treated as never terminated. 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 (1982); 1982-2 C.B. 718, 723.

After applying the applicable law and regulations to the facts and representations of this ruling request, we conclude that the termination of Company's S corporation election due to an ineligible shareholder was inadvertent within the meaning of § 1362(f).

Consequently, we rule that Company will be treated as continuing to be an S corporation from c to the present, unless Company's S election otherwise terminates under § 1362(d).

Except for the specific ruling above, no opinion is expressed or implied

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concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding the validity of Company's election under § 1362(a) to be an S corporation.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

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

Sincerely,

WILLIAM P. O'SHEA  
Chief, Branch 3  
Office of Assistant Chief Counsel  
(Passthroughs and Special Industries)

Enclosure: copy for § 6110 purposes