Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

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Legend

X =

State =

Date 1 =
Date 2 =
Date 3 =
Date 4 =

A =

This responds to a letter dated December 21, 2000 submitted on behalf of X requesting a ruling under section 1362(f) of the Internal Revenue Code.

FACTS

The information submitted discloses that X incorporated under State law and elected S corporation status effective Date 1. On Date 2, X transferred to A a common stock purchase warrant (Warrant) for X stock. On Date 3, it was determined that the issuance of the Warrant created a second class of stock terminating X's S corporation election. When X discovered that it had issued a second class of stock, X took immediate steps to modify the terms of the Warrant and submitted this request for a ruling.

X represents that an Amendment Agreement, revising the Warrant so that it does not cause X to have a second class of stock, was finalized on Date 4. X further represents that the issuance of the Warrant was not motivated by tax avoidance and that X was unaware that issuance of the Warrant would create a second class of stock.

LAW AND ANALYSIS

Section 1361(a)(1) defines an S corporation as a small business corporation for

which an election under section 1362(a) is in effect. Section 1361(b)(1) defines "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, other than a trust described in section 1361(c)(2), and other than an organization described in (c)(6) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1362(d)(2)(A) of the Code provides that an election to be treated as an S corporation terminates whenever (at any time on or after the first day of the first taxable year for which the corporation is an S corporation) the corporation ceases to be a small business corporation. The termination is effective on and after the date the S corporation ceases to meet the requirements of a small business corporation. Section 1362(d)(2)(B).

Section 1362(f), in relevant part, provides that if (1) an election to be treated as an S corporation was terminated under section 1362(d), (2) the Secretary determines that the termination was inadvertent, (3) no later than a reasonable period of time after discovery of the event resulting in the termination, steps were taken so that the corporation is once more 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 section 1362(f), agrees to make any 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 terminating event, the corporation shall be treated as continuing to be an S corporation during the period specified by the Secretary.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24, in discussing section 1362(f) of the Code, provides, in part, as follows:

> 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 . . . 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.

CONCLUSIONS

Based upon the information submitted and the representations set forth above, we conclude that the termination of X's S corporation election was inadvertent within the meaning of section 1362(f).

Pursuant to the provisions of section 1362(f), X will be treated as continuing to be an S corporation from Date 2 and thereafter, provided that X's subchapter S election is not otherwise terminated under section 1362(d).

Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the above-described facts under any other provision of the Code. In particular, no opinion is expressed or implied concerning whether X's election was valid under section 1362.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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

Sincerely,
/s/David R. Haglund
Senior Technician Reviewer, Branch 1
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
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