Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
Nov 04 2002

Legend:

X =

State =

D1 =

D2 =

#a =

A =

B =

Z =

Dear :

This responds to a letter dated June 20, 2002, together with subsequent correspondence, submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code.

FACTS

X was incorporated under the laws State. X elected subchapter S status, effective D1. On D2, A and B, husband and wife, owned #a shares of X. On D2, A and B transferred their shares of X stock to Z, an ineligible shareholder, thereby terminating X's S corporation election on D2. On D2, neither X, its officers, nor its shareholders were aware that the stock was transferred to an ineligible shareholder. When counsel discovered this oversight, X submitted this private letter ruling request. X and its shareholders represent that X is taking steps to return to small business corporation status within a reasonable period after discovery of the terminating event.

LAW AND ANALYSIS

Section 1361(a)(1) defines an "S corporation," with respect to any taxable year, as a small business corporation for which an S election under § 1362(a) is in effect for such year.

Section 1361(b)(1)(B) provides that a small business corporation cannot 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 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the 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 day of the cessation. Section 1362(d)(2)(B).

Section 1362(f), in relevant part, provides that if: (1) an election under § 1362(a) by any corporation was terminated under § 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 in the corporation at any time during the period specified pursuant to § 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 such 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.

The Committee reports accompanying the Subchapter S Revision Act of 1982 explain § 1362(f) 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 consequence of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped that the 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.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24; H.R. Rep. No. 826, 97th Cong., 2d Sess. 12 (1982), 1982-2 C.B. 730, 735.

CONCLUSIONS

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election under § 1362(a) was terminated on D2. We also conclude that the termination constituted an inadvertent termination within the meaning of § 1362(f). Pursuant to § 1362(f), X will be treated as continuing to be an S corporation from D2, and thereafter. A and B will continue to be treated as shareholders of X for purposes of §§ 1366, 1367, and 1368 with respect to the #a shares held by Z. This ruling is contingent upon X's return to small business corporation status within 60 days of the date of this letter.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X is a valid S corporation.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to X.

Sincerely,
***/s/* Dan Carmody**

Dan Carmody
Senior Counsel, Branch 1
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

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