

Internal Revenue Service

Department of the Treasury

Index Number: 1362.04-00

Washington, DC 20224

Number: **199934004**
Release Date: 8/27/1999

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:Br.1-PLR-106463-99
Date:
May 18, 1999

Legend.

X =

STATE =

Plan =

A =

D1 =

D2 =

D3 =

D4 =

D5 =

This responds to your representative's letter dated February 4, 1999, submitted on behalf of X requesting relief under § 1362(f) of the Internal Revenue Code.

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SUBMITTED FACTS

X incorporated under STATE law and elected S corporation status effective for its tax year beginning on D1.

On D2, X issued X stock to Plan. On D3, X issued X stock to A. A is a trustee of Plan and the beneficiary of over 99% of Plan's assets. As a result of X's transfer of stock to Plan, X's S corporation status terminated as of that day. X, however, did not know that transferring stock to Plan terminated X's S election. On D4, X issued a second class of stock and was no longer eligible to be taxed under subchapter S of the Code.

During D5, X's accountants realized that X's transfer of stock to Plan on D2 terminated X's subchapter S status. X and A filed their returns for the tax year beginning D1 as though X issued all of the shares directly to A.

X, A, and Plan represent that the terminating event was not motivated by tax avoidance nor was it the result of retroactive tax planning.

LAW AND ANALYSIS

Section 1361(a)(1) of the Code defines an "S corporation" as "a small business corporation for which an election under § 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 § 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) provides that an election to be treated as a subchapter 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) such corporation ceases to be a small business corporation. Under § 1362(d)(2)(B), the termination is effective on and after the date the S corporation ceases to meet the requirements of a small business corporation.

Section 1362(f) 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 of the corporation at any time during the period

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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 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.

With respect to § 1362(f), the committee reports accompanying the Subchapter S Revision Act of 1982 state the following:

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 becomes 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.

Based solely on the facts submitted and the representations made, we conclude that X's election to be treated as an S corporation terminated on D2, when A transferred the X shares to Plan. 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 during the period from D2 to D4, provided X's subchapter S election is not otherwise terminated before D4. During the period from D2 to D4, A will be treated as the sole owner of any X stock held by Plan. If either X, A, or Plan fail to treat X as described above, this ruling shall be void.

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The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as specifically set forth above, no opinion is expressed or implied as to the federal income tax consequences of the transaction described above under any other provision of the Code. Specifically, we express no opinion on whether X's election to be treated as an S corporation was a valid election under § 1362 of the Code.

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.

In accordance with a power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely yours,

Signed/David R. Haglund

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

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