Internal Revenue Service

Department of the Treasury

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Person to Contact:

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LEGEND:

X =

A =

T =

D1 =

D2 =

D3 =

D4 =

D5 =

This letter responds to your letter, dated October 25, 1999, written on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, X is a former C corporation that filed an election to be an S corporation effective D1. A D2 judgment against one of X's shareholders, A, resulted in A's shares being sold at public auction to T on D3. T is a trust that is not an eligible S corporation shareholder under § 1361(b)(1)(B). X's shareholders did not discover that X had an ineligible shareholder until D4. Shortly after D4 on D5, T's shares were redeemed.

X represents that as soon as the termination was brought to its attention it took steps to obtain relief. X also represents that there was no intent to knowingly terminate its S election and that the events that resulted in the termination were not motivated by tax avoidance or retroactive tax planning. X and its shareholders have agreed to make

any adjustments that the Secretary may require, consistent with the treatment of X as an S corporation.

LAW AND ANALYSIS

Section 1361(a)(1) of the Code provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.

Section 1361(b)(1)(B) of the Code provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not have as a shareholder a person (other than an estate and other than a trust described in section 1361(c)(2)) who is not an individual.

Section 1362(d)(2)(A) provides that an S 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 termination.

Section 1362(f) of the Code provides that if (1) an election under § 1362(a) by any corporation (A) was not effective for the taxable year for which made (determined without regard to § 1362(b)(2)) by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consents, or (B) was terminated under paragraph (2) or (3) of § 1362(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 of 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, the corporation shall be treated as 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 § 1362(f) of the Code, states in part:

> 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

After applying the law to the facts submitted and the representations made, we conclude that X's S corporation election under § 1362(a) was terminated when shares of X stock were transferred to T on D3. We conclude that the termination constituted an inadvertent termination within the meaning of § 1362(f). Therefore, under the provisions of § 1362(f), X will be treated as continuing to be an S corporation from D3, provided that X's S corporation election is not otherwise terminated under § 1362(d).

This ruling is contingent on X and all of its shareholders treating X as having been an S corporation for the period beginning D2, and thereafter. Accordingly, all of the shareholders in X, in determining their respective income tax liabilities for the period beginning D2, and thereafter, must include their pro rata share of the separately and nonseparately computed items of X as provided in § 1366, make adjustments to stock basis as provided in § 1367, and take into account any distributions made by X as provided by § 1368.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code.

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

Pursuant to a power of attorney on file with this office, a copy of this letter will be sent to X.

Sincerely yours,
William P. O'Shea, Chief, Branch 3
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

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