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-103037-00
Date:
May 30, 2000

Company:

Corporation:

Shareholders:

a:
b:
c:
d:

Dear

This responds to your letter on Company's behalf dated February 3, 2000, as well as subsequent correspondence, requesting a ruling under § 1362(f) of the Internal Revenue Code that Company's S corporation election was inadvertently invalid. Company represents the following facts.

Company elected under § 301.7701-3(c) of the Income Tax Regulations to be classified as a corporation, effective a. It elected under § 1362(a) to be treated as an S corporation, effective b.

At the time of its S corporation election, some of the Company shares were held by IRAs and a § 401(k) plan. The tax advisor preparing Company's Form 2553 was not aware of these ownership interests. As a result, the IRAs were allowed to continue holding shares in Company, and the § 401(k) plan failed to consent to the S corporation election.

Company became aware that its S corporation election was invalid only after seeking legal counsel regarding an employee plan issue. Company then obtained a properly executed consent to the S election from the § 401(k) plan and submitted a request for inadvertent invalid election relief.

Company was acquired by Corporation effective c, thus terminating its S election

the same date.

Section 1361(a)(1) provides that, for purposes of the Code, 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 the year.

Section 1362(a)(2) provides that an election under § 1362(a) shall be valid only if all persons who are shareholders in the corporation on the day the election is made consent to the election.

Section 1361(b)(1)(B) provides that, for purposes of subchapter S, the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not, among other things, 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. IRAs are not permitted shareholders.

Section 1362(f) provides that if–

(1)(A) an election under § 1362(a) by any corporation was not effective for the tax 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;

(2) the Secretary determines that the circumstances resulting in the ineffectiveness were inadvertent;

(3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness, 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 § 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 the ineffectiveness, the corporation shall be treated as an S corporation during the period specified by the Secretary.

The conference report on the Small Business Job Protection Act of 1996 (P.L. 104-188) provides that the Service should be reasonable in exercising this authority

and apply standards that are similar to those applied under present law to inadvertent subchapter S terminations. H. Rep. No. 737, 104th Cong., 2d Sess. 222 (1996); 1996-3 C.B. 741, 962.

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. Likewise, it may be appropriate to waive the terminating event when the one class of stock requirement was inadvertently breached, but no tax avoidance had resulted. 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.

Section 1.1362-4(b) provides that, for purposes of § 1.1362-4(a), 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 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.

Company represents that its officers and shareholders were unaware of the S corporation rules regarding IRAs and § 401(k) plans. The IRA owners and § 401(k) plan participants are or were Company shareholders. These owners and participants received Schedules K-1 in their own names and included Company's operating results for d on their individual income tax returns. Company and Shareholders agree to make any adjustments, consistent with the treatment of Company as an S corporation, as might be required by the Secretary.

Based solely on the facts as represented by Company in this ruling request, we conclude that Company's S corporation election was inadvertently invalid within the meaning of § 1362(f). Consequently, we rule that Company will be treated as an S corporation for the period from b to c (the "Period"), unless Company's S election otherwise terminated under § 1362(d).

This ruling is contingent on Company and Shareholders, including the IRAs and § 401(k) plan, treating Company as having been an S corporation for the Period. Accordingly, Shareholders, in determining their respective income tax liabilities, must include the pro rata share of the separately and nonseparately computed items of Company as provided in § 1366, make adjustments to stock basis as provided in § 1367, and take into account any distributions made by Company as provided by § 1368.

Except for the specific ruling above, no opinion is expressed or implied 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 eligibility of Company to have elected 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 Company.

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,
JONI LARSON
Acting Assistant to the Chief, Branch 3
Office of Assistant Chief Counsel
(Passthroughs and Special Industries)

enclosure: copy for § 6110 purposes