INTERNAL REVENUE SERVICE
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October 23, 1998

LEGEND

Company =

The Plan =

Shareholder =

State =

X =

d1 =

d2 =

d3 =

d4 =

d5 =

Dear :

This letter responds to your letter dated July 20, 1998, and subsequent correspondence dated September 23, 1998, written on behalf of Company, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

FACTS

The information submitted discloses that Company, which was incorporated in State on d1, filed an election to be an S corporation effective d2. Subsequently, on d3, the Company issued X shares of its common stock to the Plan, an impermissible shareholder under § 1361(b)(1)(B). The Plan was established for the benefit of Shareholder, a Company shareholder.

In d4, Company's legal adviser discovered that the Plan was an impermissible shareholder of an S corporation and that Company's S election had terminated on d3. On d5, the Plan sold its shares in Company to Shareholder.

Company and each of its shareholders who were shareholders during the period of termination agree to make any adjustments consistent with the treatment of Company as an S corporation.

LAW AND ANALYSIS

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1361(b)(1)(B) provides that a "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not have as a shareholder a person (other than an estate and other than 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 than an election under § 1362(a) shall be terminated whenever (at any time after the first day of the first taxable year for which corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(d)(2)(B) provides that a termination of an S corporation election is effective on and after the date of cessation.

Section 1362(f) 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 § 1362(d)(2) or (3); (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 the 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 § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary for that 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.

The committee reports to the Subchapter S Revision Act of 1982, in discussing § 1362(f) state, 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.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-724; H.R. Rep. No. 825, 97th Cong., 2d Sess. 12 (1982), 1982-2 C.B. 730, 735.

CONCLUSION

After applying the relevant law to the facts submitted and representations made, we conclude that the termination of Company's subchapter S election on d3 was inadvertent within the meaning of § 1362(f).

Under § 1362(f), Company will be treated as continuing to be an S corporation during the period from d3 to d5, and thereafter, assuming Company's S corporation election was valid and was not otherwise terminated under § 1362(d). For the period d3 through d5, Shareholder will be treated as the shareholder for the X

shares issued to the Plan on d3. Accordingly, all shareholders of Company, in determining their respective income tax liabilities beginning d3, and thereafter, must include the pro rata share of the separately and nonseparately computed items of Company as provided in § 1367, and take into account any distributions made by company as provided by § 1368. This ruling will be null and void if Company or any of its shareholders fail to comply with these requirements.

Except for the specific ruling above, no opinion is expressed or implied concerning the federal tax consequences of the facts of this case under any other provision of the Code. No opinion is expressed regarding whether Company is otherwise qualified to be an S corporation.

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

Sincerely,

Jeff Erickson
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Branch 3
Office of the Assistant Chief
Counsel
(Passthroughs and Special
Industries)

Enclosures (2)

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