Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:B1-PLR-168116-02
Date:
January 13, 2003

Legend:

X =

H =

W =

LLC =

x =

y =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Dear :

This responds to your letter dated, October 22, 2002, on behalf of X, requesting inadvertent termination relief under section 1362(f) of the Internal Revenue Code.

Facts

You have represented that the facts are as follows: X filed a timely election under section 1362(a) to be treated as an S corporation effective Date 1. On Date 2, H contributed his shares to LLC. LLC, a state limited liability company with 2 members, was an ineligible shareholder. W held a x% interest in LLC, and H held the remaining y% interest. On Date 3, X's accountant became aware that LLC was an ineligible S corporation shareholder. On Date 4, H transferred all of his interest in LLC to W.

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) provides that for purposes of subchapter S, 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 1361(b)(1) defines a "small business corporation" as a domestic corporation which is not an ineligible corporation and which does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate and other than a trust described in 1361(c)(2)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1362(f) provides that if (1) an election under section 1362(a) by any corporation was terminated under paragraph (2) or (3) of section 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 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 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 section 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 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, 723-24; H.R. Rep. No. 826, 97th Cong., 2d Sess. 12 (1982), 1982-2 C.B. 730, 735.

Conclusion

Based solely on the facts submitted and the representations made, we conclude that X's election to be an S corporation terminated on Date 2 because LLC was an ineligible shareholder. We also conclude that the termination of X's S corporation election was inadvertent within the meaning of 1362(f). Consequently, we conclude that X will be treated as continuing to be an S corporation beginning Date 2 and thereafter, unless X's S election otherwise terminates under section 1362(d).

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, no opinion is expressed as to whether X's original election to be an S corporation was valid under section 1362.

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

Sincerely,

/s/ Dianna K. Miosi

Dianna K. Miosi
Chief, Branch 1
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
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