

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Legend

Company =

State =

Shareholders =

A =

B =

C =

Plan =

a =

b =

c =

d =

e =

f =

g =

h =

i =

Dear :

This letter responds to a letter dated February 3, 1999, requesting a ruling on behalf of Company under § 1362(f) of the Internal Revenue Code.

The information submitted discloses that Company was incorporated on a under the laws of State. Company has two majority shareholders, Shareholders, and several minority shareholders. Company made an election to be an S corporation since its incorporation.

On b, Company transferred 20 shares of its stock to the individual retirement account (IRA) of A, one of its shareholders. The IRA constituted an ineligible shareholder. Company was not aware that the IRA was an ineligible shareholder or that the transfer terminated its S election. On c, Company transferred 4 shares of its stock to the Plan of B, another shareholder. Finally, later in the same taxable year another shareholder, C, assigned 7 shares of Company stock to his Plan.

In d, Company learned of the effect of the transfers on its S election. Company immediately repurchased its stock from A's IRA on g. In addition, Company repurchased its stock from B's Plan on h, and from C's Plan on i. Company then began preparing its request for inadvertent termination relief. Company represents that there was no tax avoidance or retroactive tax planning involved in the termination. In addition, Company represents that the termination occurred because of the lack of knowledge of the shareholder eligibility rules for S corporations.

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

Section 1361(b)(1) defines a "small business corporation" as a domestic

corporation that is not an ineligible corporation and that, among other requirements, does not 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.

Section 1362(d)(2) provides that an election to be an S corporation shall be terminated whenever (at any time on or after the first day of the first taxable year for which the corporation is an S corporation) the corporation ceases to be a small business corporation. Section 1362(d)(2)(B) provides that the termination shall be effective on or after the date of cessation.

Rev. Rul. 92-73, 1992-2 C.B. 224, provides that a trust that qualifies as an IRA under § 408(a) is not a permitted shareholder of an S corporation under § 1361. In addition, Rev. Rul. 92-73 notes that, when an S corporation inadvertently terminates due to the transfer of S stock to an IRA, relief may be requested pursuant to § 1362(f).

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in such termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the termination, steps were taken so that the corporation is 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 § 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 termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

The committee reports accompanying the Subchapter S Revision Act of 1982 explain § 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 the 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 to protect the revenue without undue hardship to taxpayers.... [I]t 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.

After applying the relevant law to the facts submitted and the representations made, we conclude that Company's S corporation election terminated on b as a result of the transfer of Company stock to an IRA. We also conclude that the termination was inadvertent within the meaning of § 1362(f).

We further conclude that under the provisions of § 1362(f), Company will be treated as an S corporation from b until i, when Company completed its repurchase of stock from the IRA and the Plans, and thereafter, provided Company had a valid S corporation election and that election was not otherwise terminated under § 1362(d). Provided that Company had a net loss from b to e, or for taxable year f, A's IRA, and B's and C's respective Plans will be treated as shareholders of Company for the shares they held. Otherwise, A, B, and C will be treated as shareholders of Company for the shares held in their IRA or Plans during the termination period. Accordingly, all shareholders of Company, in determining their respective income tax liabilities, must take into account their pro rata shares of the separately and nonseparately computed items of Company under § 1366, makes adjustments to stock basis under § 1367, and take into account any distributions made by Company under § 1368. If Company or the shareholders fail to treat Company as described above, this ruling shall be null and void.

Except as specifically set forth above, we express no opinion concerning the federal tax consequences of the foregoing facts. Specifically, we express no opinion on whether Company otherwise qualifies as an S corporation.

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.

Sincerely yours,

WILLIAM P. O'SHEA
Chief, Branch 3
Office of the Assistant
Chief Counsel
(Passthroughs and Special
Industries)

Enclosure:

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