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-160192-02
Date:
Nov 21 2002

Legend

X =

D1 =
D2 =
D3 =
D4 =
D5 =

IRA 1 =

IRA 2 =

Dear :

This responds to your letter dated, October 30, 2002, on behalf of X, requesting inadvertent termination relief under §1362(f) of the Internal Revenue Code.

Facts

X elected to be an S corporation, effective D1. X has always reported as an S corporation. On D2 and D3, X transferred shares of its stock to IRA 1 and IRA 2, respectively, both of which were ineligible shareholders, thereby terminating X's S corporation election. On D4 X repurchased the shares that IRA 2 held. On D5, X repurchased the shares that IRA 1 held.

X represents that as soon as the terminating event was discovered, it took steps to once again be a small business corporation. X and its shareholders have agreed to make any adjustments that the Commissioner may require consistent with the treatment of X 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. Section 1361(b)(1) defines "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate, other than a trust described in § 1361(c)(2), and other than an organization described in (c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1.1361-1(f) of the Income Tax Regulations provides that except as otherwise provided in 1.1361-1(e)(1) (relating to nominees and paragraph (h) relating to certain trusts), a corporation in which any shareholder is a corporation, partnership, or trust does not qualify as a small business corporation.

Section 1.1361-1(e)(1) provides that the person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation. For example, a partnership may be a nominee of S corporation stock for a person who qualifies as a shareholder of an S corporation. However, if the partnership is the beneficial owner of the stock, then the partnership is the shareholder, and the corporation does not qualify as a small business corporation.

Rev. Rul. 92-73, 1992-2 C.B. 224, holds that a trust that qualifies as an individual retirement account under 408(a) of the Code is not a permitted shareholder of an S corporation under § 1361.

Under § 1362(d)(2), an election to be an S corporation will be terminated whenever the corporation ceases to be a small business corporation.

Section 1362(f) provides that a corporation will be treated as continuing to be an S corporation during the period specified by the Secretary if (1) an election under § 1362(a) by the corporation was terminated under paragraph (2) or (3) of § 1362(d), (2) the Secretary determines that the termination was inadvertent, (3) no later than a reasonable period of time after discovery of the terminating even, 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 § 1362(f), agrees to make any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to that period.

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, provides, in part, that:

> 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 even 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 grating 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.

Conclusion

Based solely on the facts submitted and the representations set forth above, we conclude that (1) X's S corporation election was terminated on D2 when X shares were transferred to IRA 1; (2) had X's S corporation not already terminated, it would have terminated on D3 when X shares were transferred to IRA 2 , and (3) the termination on D2 was inadvertent within the meaning of § 1362(f). Pursuant to § 1362(f), X will be treated as continuing to be an S corporation from D2, and thereafter.

In addition, during the period from D2 to D5, the beneficiary of IRA 1 will be treated as the owner of the IRA 1's shares of X stock. During the period from D3 to D4, the beneficiary of IRA 2 will be treated as the owner of IRA 2's shares of X stock. Accordingly, each beneficiary must include their respective IRA's percent of the separately and nonseparately stated items of X as provided in § 1366, make any adjustments to stock basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368. This ruling is null and void if X or the IRA beneficiaries fail to comply with these requirements.

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. Specifically, no opinion is expressed on whether X's original election to be an S corporation was a valid election under § 1362.

This ruling is directly only to the taxpayer that requested it. Section 6110(k)(3) provides that if may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,

/s/ David R. Haglund

David R. Haglund
Senior Technician Reviewer, Branch 1
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

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