Internal Revenue Service

Department of the Treasury
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Person To Contact:

Telephone Number:

Refer Reply To:
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Date:
September 26, 2003

Legend

X =

Y =

D1 =

D2 =

D3 =

Termination Period =

IRA 1 =

IRA 2 =

$N =

Dear :

This responds to your letter dated, March 12, 2003, 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 , X transferred shares of its stock to IRA 1, an ineligible shareholder, thereby terminating X's S corporation election. On D3, X transferred additional shares to IRA 1, an ineligible shareholder, which would have terminated X's S corporation election, had it not already terminated. During the Termination Period, the beneficiary of IRA 1 died, and the X shares held by IRA 1 were transferred to IRA 2. Y is currently the sole beneficiary of IRA 2. Y has agreed to be treated as the owner of the X shares that IRA 1 and IRA 2 held during the Termination Period.

X represents that the transfers of stock to IRA 1 and IRA 2 were not conducted with any tax avoidance motive. In addition, at all times, X has filed consistently with its belief that it was an S corporation. As soon as X discovered the terminating event, X filed this request for a letter ruling in order to once again become a small business 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) (related to nominees), § 1.1361-1(h) (relating to certain trusts), and, for taxable years beginning after December 31, 1997, § 1361(c)(6) (relating to certain exempt organizations), 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 section 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 its transferred X shares to IRA 1; and (2) had X's S corporation election not terminated on D2, X's election would have terminated on D3 when it issued additional X shares to IRA 1, and again when IRA 1's X shares were transferred to IRA 2. We also conclude that each of these terminating events was inadvertent within the meaning of § 1362(f).

Further, we conclude that, pursuant to § 1362(f), X will be treated as continuing to be an S corporation from D2 and thereafter, assuming X's S corporation election is valid and not otherwise terminated under § 1362(d).

This ruling is contingent on X and all of its shareholders treating X as having been an S corporation for the period beginning on D2, and thereafter. In addition, this ruling is contingent on the termination of IRA 2's shareholder status within sixty days of the date of this letter. Finally, this ruling is contingent on Y: 1) amending returns for all open years to account for the tax consequences associated with the X shares that IRA 2 held as if Y were the owner of the X shares; and 2) making a payment of $N to the appropriate Service Center as an adjustment under § 1362(f)(4).

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/ Dan Carmody

Dan Carmody
Senior Counsel, Branch 1
Office of Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

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