Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:1-PLR-114202-98
Date:
December 21, 1998

Legend

X =

Y =

A =

B =

C =

D =

D1 =

D2 =

D3 =

D4 =

D5 =

State =

This responds to your letter dated November 16, 1998, and prior correspondence, written on behalf of X, requesting a ruling that the termination of X's S

corporation status was inadvertent under § 1362(f) of the Internal Revenue Code.

Facts

X is a corporation that was incorporated in State on D1. X made an S corporation election under § 1362(a) effective for its taxable year beginning on D2. On D2, A, B, C, and D (Shareholders) were X's sole shareholders. On D3, C contributed C's X stock to Y, a partnership. On D3, none of the Shareholders knew that C's transfer of X stock to Y would terminate X's Subchapter S status. The transfer of X stock to Y was not motivated by tax avoidance or retroactive planning. On D4, Y's accountant learned that Y owned shares of X stock. On D5, Y distributed the X stock back to C so that Y no longer owned shares of X.

X, the Shareholders, and Y agree to make any adjustments (consistent with the treatment of X as an S corporation) that the Secretary may require for the period of termination.

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) 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 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.

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

Under § 1362(f), if an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3), the corporation will be treated as continuing to be an S corporation during the period specified by the Secretary if (1) the Secretary determines that the termination was inadvertent, (2) 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 (3) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to the subsection, agrees to make any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary regarding the period.

With respect to § 1362(f), S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24, provides, 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.

Conclusions

Based solely on the facts submitted and representations set forth above, we conclude that X's S election terminated on D3, when C transferred C's X stock to Y. We also conclude that the termination of X's S corporation election, as described above, was inadvertent within the meaning of § 1362(f).

Pursuant to § 1362(f), X will continue to be treated as an S corporation during the period from D3 to D5, and thereafter, unless X's S election is otherwise terminated under § 1362(d). In addition, during the period D3 to D5, C (and not Y) will be treated as the owner of the X stock which C contributed to Y. Therefore, the Shareholders must include their pro rata share of the separately stated and nonseparately computed items of X as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368, as if Y never held X stock. If X, the Shareholders, or Y fail to comply with the requirements of this paragraph, this ruling is null and void.

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 the original election made by X to be an S corporation was a valid election under § 1362.

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.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely yours,

Signed/Daniel J. Coburn
DANIEL J. COBURN
Assistant to the Branch Chief, Branch 1
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

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