Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

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July 8, 1999

Number: **199940020**
Release Date: 10/8/1999

Legend

Company =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Shareholders =

Plans =

IRAs =

Transferring Shareholders =

Dear

This letter is in response to your letter dated July 6, 1988, and subsequent correspondence, submitted on behalf of Company, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

You have represented the following facts. Company was incorporated on Date 1. Company elected to be treated as an S corporation for its tax year beginning Date 2. Subsequent to Date 2, Company attracted additional shareholders by offering the opportunity to purchase a combination of nonvoting common shares and promissory notes. Some of these additional shareholders (Transferring Shareholders) directed that the promissory note be placed in their profit sharing or pension plans (the Plans). Subsequently, some of the plans were terminated, and the promissory notes were transferred to individual retirement accounts (the IRAs) of the shareholders.

Company had difficulty in obtaining permanent financing for its operations, and so had to undertake a series of short term obligations with a variety of financial institutions. Company was able to eventually obtain a permanent financing commitment from one lender; however, at the last minute, the lender insisted that all obligations to the investors (the promissory notes) be paid in full and released. Company complied by issuing additional stock in exchange for the promissory notes on Date 3. As a result, shares were issued to the Plans and the IRAs.

Company was not aware until its accountants began preparing its tax returns that the Plans and the IRAs were ineligible shareholders on Date 3. The transfer was not part of a plan to terminate Company's S corporation election, nor was the failure to qualify as an S corporation motivated by tax avoidance or the result of retroactive tax planning. By operation of law, qualified pension plans described in § 401(a) became eligible shareholders for tax years beginning after December 31, 1997. However, IRAs remained ineligible shareholders. On Date 4, Company redeemed the shares held by the IRAs.

Company has requested relief under § 1362(f) for the inadvertent termination of its S corporation status. Company and Shareholders have consented to make any adjustments required by the Commissioner consistent with the treatment of Company as an S corporation.

DISCUSSION

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 § 1362(a) is in effect for such year.

Section 1361(b)(1)(B), as in effect on Date 3, provided that the term "small business corporation" meant a domestic corporation which was not an ineligible corporation and which did not have as a shareholder a person (other than an estate and other than a trust described in § 1361(c)(2)) who was not an individual. Section 1316(a) of the Small Business Job Protection Act (P.L.104-188) modified § 1361(b)(1)(B) to permit certain exempt organizations (including certain qualified plans described in § 401(a) of the Code) to be eligible shareholders effective for tax years beginning after December 31, 1997.

Section 1362(d)(2)(A) of the Code provides that an election under § 1362(a) will be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation. Section 1362(d)(2)(B) provides that any termination under § 1362(d)(2) shall be effective on and after the date of cessation.

Section 1362(f) of the Code provides that if (1) an election under § 1362(a) by any corporation was terminated under paragraph (2) or (3) of section 1362(d), (2) the Secretary determines that the circumstances resulting in the termination were inadvertent, (3) no later than a reasonable period of time after discovery of 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 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 circumstances resulting in the 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 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 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.

CONCLUSION

Based solely on the information submitted, and the representations made, we conclude that Company's S corporation election terminated on Date 3 as a result of the transfer of stock to the Plans and the IRAs. We also conclude that the termination was an "inadvertent termination" within the meaning of § 1362(f) of the Code. Pursuant to the provisions of § 1362(f), Company will be treated as continuing to be an S corporation from Date 3 to Date 4, and thereafter, provided that Company's S corporation election is valid and is not otherwise terminated and provided that the Plans are eligible shareholders after December 31, 1997.

We further hold that, pursuant to the provisions of § 1362(f) of the Code:

1. During the period from Date 3 through December 31, 1997, the stock owned by each Plan will be treated as owned by the Transferring Shareholder who transferred the note to the Plan and that Transferring Shareholder must include the pro rata share of the separately and nonseparately computed items of Company as provided in § 1366, make any adjustments to stock basis as provided in § 1367, and take into account any distributions made by Company as provided in § 1368.

2. During the period from Date 3 to Date 4, each Transferring Shareholder whose IRA held Company stock will be treated as the owner of the Company stock held by the IRA, and that Transferring Shareholder must include the pro rata share of the separately and nonseparately computed items of Company as provided in § 1366, make any adjustments to stock basis as provided in § 1367, and take into account any distributions made by Company as provided in § 1368.

If Company or its Shareholders fail to treat Company as described above, this ruling will be null and void.

Except for the specific ruling above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code. In particular, we express no opinion as to whether Company is, in fact, an S corporation for federal tax purposes or whether the Plans meet the requirements of § 1361(b)(1)(B) to be eligible shareholders for tax years beginning after December 31, 1997.

This ruling is directed only to the taxpayer who requested it. Under § 6110(k)(3), it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this ruling is being sent to your authorized representative.

Sincerely yours,

Donna M. Young
Senior Technician Reviewer,
Branch 3
Office of the Assistant Chief
Counsel
(Passthroughs and Special
Industries)

Enclosures:
Copy of this letter
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