

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:  
CC:DOM:P&SI:3 PLR-106589-99  
Date:  
June 6, 1999

LEGEND:

Company =

X =

Y =

Z =

Trust =

A =

B =

C =

D =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

m =

n =

p =

Sate =

Dear

This letter responds to your letter, dated March 30, 1999, and subsequent correspondence written on behalf of Company requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

### **FACTS**

Company was incorporated on Date 1, and elected to be an S corporation effective Date 1. On Date 2, Company issued m shares to X, and n shares to each Y, Z, and Trust. On Date 3, Company discovered that C corporations, X, Y, and Z, and Trust were ineligible shareholders of Company. Consequently Company's S corporation election may have terminated on Date 2.

Subsequently, Company canceled shares of stock held by X, Y, and Z, and reissued the shares of stock to individuals, A, B, C, and D, effective Date 4. In addition, effective Date 5, Company canceled shares of stock held by Trust in return for its original capital contribution of \$p.

Company represents that under its bylaws and State law, the issuance of stock to X, Y, Z, and Trust was void as a matter of law. Company and its shareholders were unaware that the issuance of its stock to X, Y, Z, and Trust would terminate its S corporation status. Company and its shareholders agree to make any adjustments (consistent with the treatment of Company as an S corporation) that may be required.

### **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)(B) provides that one of the requirements for a taxpayer to be a small business corporation is that the taxpayer cannot have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual.

Section 1362(d)(2) provides that 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) if an election under § 1362(a) by any corporation was terminated under § 1362(d)(2), (B) the Secretary determines that the termination was inadvertent, (C) no later than a reasonable period of time after discovery of the circumstances resulting in such termination, steps were taken so that the corporation is a small business corporation, and (D) 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 the 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 Act 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 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.

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.

### **CONCLUSIONS**

Company's S corporation election terminated on Date 2 when it issued shares of stock to X, Y, Z, and Trust, ineligible S corporation shareholders. Based solely on the facts submitted and representations made, we conclude that the termination of Company's subchapter S election on Date 2 was inadvertent within the meaning of § 1362(f).

Under § 1362(f), Company will be treated as continuing to be an S corporation during the period from Date 2 to Date 5, and thereafter, provided that Company's S corporation election is valid and is not otherwise terminated under § 1362(d). Accordingly, Company's shareholders, including X, Y, Z, and Trust, in determining their federal tax liability for the period from Date 2 to Date 6 (for X, Y, and Z) and from Date 2 to Date 5 (for Trust), must include their pro rata share of the separately and nonseparately computed items of Company under § 1366, make any adjustments to stock basis under § 1367, and take into account any distributions made by Company to shareholders under § 1368. If Company or its shareholders fail to treat Company as described above, this ruling will be 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 concerning whether Company is an S corporation for federal tax purposes.

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

Under a power of attorney on file in this office, we are sending a copy of this letter to Company.

Sincerely yours,

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

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