Internal Revenue Service

Department of the Treasury

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Legend

X =

A =

State =

D1 =

D2 =

D3 =

D4 =

D5 =

This responds to the July 7, 1999 letter, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

X was incorporated under State law on D1. X elected subchapter S status, effective D2.

On D3, A, an employee and shareholder of X, purchased shares of X stock with proceeds from his individual retirement account (IRA). Shortly thereafter, a stock

certificate was issued in the name of the IRA.

In D4, X's accountants learned that shares of X stock had been issued to the IRA. On D5, after X's accountants informed X that the IRA was an ineligible shareholder, X redeemed the stock held by the IRA.

Prior to D4, neither X, its officers, nor its shareholders were aware that the IRA was an ineligible shareholder and that issuing stock to an IRA terminated X's S election. X represents that issuing stock to the IRA was not motivated by tax avoidance or retroactive tax planning. In addition, X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary with respect to the period specified by § 1362(f) of the Code.

LAW AND ANALYSIS

Section 1361(a)(1) defines an "S corporation", with respect to any taxable year, as a small business corporation for which an S election under § 1362(a) is in effect for such year.

Section 1361(b)(1)(B) provides that a small business corporation 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)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the taxable year for which the corporation is an S corporation) the corporation ceases to be a small business corporation. The termination is effective on and after the day of the cessation. Section 1362(d)(2)(B).

Rev. Rul. 92-73, 1992-2 C.B. 224, holds that a trust qualified as an individual retirement account under § 408 is not a permitted S corporation shareholder under § 1361. Rev. Rul. 92-73 further states that if a shareholder inadvertently causes a termination of an S corporation by transferring stock to a trust that qualifies as an individual retirement account under § 408(a), the shareholder may request relief under § 1362(f).

Section 1362(f) provides that if: (1) an election under § 1362(a) by any corporation was terminated under paragraph § 1362(d)(2)); (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in such effectiveness or termination, steps were taken so that the corporation is a small business corporation; and (4) the corporation, and each person who was a shareholder in 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 such ineffectiveness or 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, in discussing § 1362(f) as it relates to inadvertent terminations, state, 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 the 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.

CONCLUSIONS

Based solely on the facts submitted and representations made, we conclude that X's subchapter S election terminated on D3 as the result of the IRA acquiring X stock. We also conclude that the termination was inadvertent under § 1362(f). Therefore, under the provisions of § 1362(f), X will be treated as an S corporation from D3 and thereafter, provided that X's S corporation election was otherwise valid and is not otherwise terminated under § 1362(d). In addition, during the period from D3 to D5, A will be treated as the owner of the IRA's shares of stock.

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 X's S corporation election 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 the power of attorney on file with this office, a copy of this ruling is being sent to your authorized representative.

Sincerely,

Signed/Dianna K. Miosi

Dianna K. Miosi
Chief, Branch 1
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
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