Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

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Number: **200013027**
Release Date: 3/31/2000

Date:
January 5, 2000

Company:

State:

Shareholders:

M:

N:

a:

b:

c:

d:

e:

f:

g:

h:

i:

Dear

This letter responds to a letter from your authorized representative dated September 28, 1999, as well as subsequent correspondence, submitted on behalf of Company, requesting a ruling under § 1362(f) of the Internal Revenue Code that the termination of Company's S corporation election was inadvertent. Company represents the following facts.

Company was incorporated under the laws of State on a and elected under § 1362(a) to be an S corporation effective b. Company's S election terminated on c when M purchased Company shares and caused them to be issued in the name of N, an ineligible shareholder under § 1361(b).

Company's accounting firm ("old firm") initially misidentified M as the owner of the shares in question for d, notwithstanding that ownership of these shares was in the name of N. In preparing Company's tax returns for e, old firm correctly identified N as the shareholder of record, but failed to inform either Company or M that N was an ineligible shareholder.

In late f, Company hired another accounting firm ("new firm") to prepare its financial statements and tax returns. In early g, while finalizing Company's returns, new firm discovered the ineligible shareholder and notified both Company and M. Company and M then contacted legal counsel and initiated a series of actions that culminated in Company issuing a substituted stock certificate in M's name, effective h.

According to Company, had it been properly advised by its accountants, it never would have permitted Company shares to be held by N. Company represents that N's stock ownership was in no manner part of a plan to terminate Company's S election.

Except as provided in § 1362(g), § 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1361(b)(1)(B) provides that, for purposes of subchapter S, the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not, among other things, 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) terminates whenever the corporation ceases to be a small business corporation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in 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 § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as might be required by the Secretary regarding this period, then, notwithstanding the circumstances resulting in termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) of the Income Tax Regulations provides that the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent.

According to the legislative history of § 1362(f)--

> 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. For example, if a corporation, in good faith, determined that it had no earnings and profits, but it is later determined on audit that its election terminated by reason of violating the passive income test for three consecutive years because the corporation in fact did have accumulated earnings, if the shareholders were to agree to treat the earnings as distributed and include the dividends in income, it may be appropriate to waive the terminating events, so

> that the election is treated as never terminated. 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 (1982); 1982-2 C.B. 718, 723.

After applying the applicable law and regulations to the facts and representations of this ruling request, we conclude that the termination of Company's S corporation election due to having an ineligible shareholder was inadvertent within the meaning of § 1362(f).

Consequently, we rule that Company will be treated as continuing to be an S corporation from c to the present, unless Company's S election otherwise is terminated under § 1362(d). As a condition for this ruling, for income tax reporting purposes, N is to be treated as the owner of the shares in question for tax year d, and M is to be treated as the owner of these shares for tax years e, f, and i.

Except for the specific ruling above, no opinion is expressed or implied concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding Company's eligibility to be an S corporation.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

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

Sincerely,
WILLIAM P. O'SHEA, Chief, Branch 3
Office of Assistant Chief Counsel
(Passthroughs and Special Industries)

enclosure: copy for § 6110 purposes