Internal Revenue Service

Department of the Treasury

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Legend

X =

Y =

State =

Business =

LP =

D1 =

D2 =

n =

This responds to the letter dated June 18, 1999, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

X is a professional service corporation incorporated under State law. X is engaged in the business of Business. X elected subchapter S corporation status, effective D1.

From D2 to the present, a LP has been the record owner of n shares of X stock. X represents that each LP has held such stock as a nominee of Y. Y is an organization that is described in § 501(c)(3) and is exempt from taxation under § 501(a).

Neither X nor its shareholders were aware that if Y was a shareholder of X stock

as of D2, X's S election terminated.

All of the shareholders of X agree to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Internal Revenue Service.

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 that year.

Effective for tax years beginning before December 31, 1997, § 1361(b)(1)(B) provided that a "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not 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.

Effective for tax years beginning after December 31, 1997, § 1361(c)(6) provides that for purposes of § 1361(b)(1)(B), an organization that is described in §§ 401(a) or 501(c)(3), and is exempt from taxation under § 501(a), may be a shareholder of an S corporation.

Section 1362(d)(2)(A) provides that an S election under § 1362(a) shall terminate 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 date the S corporation ceases to be a small business corporation. Section 1362(d)(2)(B).

Section 1362(f) provides that if: (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2); (2) the Secretary determines that the circumstances resulting in such termination were inadvertent; (3) 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 (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 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.

In granting relief pursuant to § 1362(f), § 1.1362-4(d) of the Income Tax Regulations provides that the Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified. In the case of transfer of stock to an ineligible shareholder that causes an inadvertent termination under § 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of an S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent any loss of revenue due to a transfer of stock to an ineligible shareholder (e.g. transfer to a nonresident alien).

CONCLUSIONS

Based solely upon the information submitted and the representations made, and specifically expressing no opinion as to the ownership of the n shares of X stock held by each LP as a nominee of Y, we conclude that if X's S election terminated on D2, the termination was inadvertent under § 1362(f). Therefore, under the provisions of § 1362(f), X will be treated as an S corporation from D2 and thereafter, provided that X's S corporation election did not otherwise terminate under § 1362(d).

In addition, from D2 until January 1, 1998, and without expressing any opinion as to the ownership of the n shares of X stock held by each LP as a nominee of Y, Y must take into account its pro rata share of the separately and nonseparately computed items of X as provided in § 1366, make any adjustments to stock basis as provided in

§ 1367, and take into account any distributions made by X as provided in § 1368. If X, Y, or any of X's shareholders fail to amend their federal tax returns, or make any necessary adjustments in order to comply with the above requirements, this ruling shall be null and void. A copy of this ruling should be submitted with the amended returns.

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.

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, the original and a copy of this ruling is being sent to X's authorized representatives, and a copy of this ruling is being sent to X.

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

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