**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

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LEGEND:

X =

A =

B =

C =

D =

E =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

Dear

This letter responds to your letter dated July 28, 2000, and subsequent correspondence written on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

## FACTS

According to the information submitted, X incorporated on D1 and elected to be an S corporation effective D1. On D2, entity B, an ineligible S corporation shareholder, converted its convertible debentures in X into shares of X common stock. On D3, B converted its warrants in X into X common stock.

On D4, corporation C, an ineligible S corporation shareholder, converted its convertible debentures in X into X common stock. On D5, C converted its warrants in X into X common stock. In the later part of D6, X's auditors noticed that X had issued its common stock to ineligible shareholders, and, thus, had terminated its S election on D2. Subsequently, beginning on D7, the X common stock that was held by B is held by A and the X common stock that was held by C is held by D and E. A, D, and E are eligible S corporation shareholders.

X represents that as soon as the termination was brought to its attention it took steps to obtain relief. X also represents that there was no intent to knowingly terminate its S election and that the events that resulted in the termination were not motivated by tax avoidance or retroactive tax planning. Also, X and its shareholders have agreed to make any adjustments that the Secretary may require, consistent with the treatment of X as an S corporation.

## LAW AND ANALYSIS

Section 1361(a)(1) 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) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not 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 S 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 termination.

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 the termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in 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 in the corporation at any time during the period specified under § 1362(f), 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.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24, in discussing § 1362(f) of the Code, states in part:

> 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.

## CONCLUSIONS

After applying the law to the facts submitted and the representations made, we conclude that X's S corporation election under § 1362(a) was terminated when shares of X stock were issued to B on D2. We conclude that the termination constituted an inadvertent termination within the meaning of § 1362(f). Therefore, under the provisions of § 1362(f), X will be treated as continuing to be an S corporation from D2 to D7, and thereafter, provided that X's S corporation election is not otherwise terminated under § 1362(d); and B and C will be treated as shareholders during the period from D2 to D7.

This ruling is contingent on X and all of its shareholders treating X as having been an S corporation from D2 to D7, and thereafter. Accordingly, all of the shareholders in X, in determining their respective income tax liabilities, must include their pro rata share of the separately and nonseparately computed items of X as

provided in § 1366, make adjustments to stock basis as provided in § 1367, and take into account any distributions made by X as provided by § 1368.

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 regarding the tax consequences of the transfer of X common stock from B to A and from C to D and E.

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

Sincerely yours,
Mary Beth Collins
Assistant to the Chief, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

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