Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

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Number: **199909023**
Release Date: 3/5/1999

Date:
December 1, 1998

Legend

Company =

A =

B =

C =

D =

Limited Partnership =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

State =

Dear

This letter responds to your letter dated June 8, 1998, written on behalf of Company, requesting relief under § 1362(f) of the Internal Revenue Code for an inadvertent termination of Company's status as an S corporation.

FACTS

According to the information submitted, Company, was incorporated under the laws of State on Date 1. On Date 2, Company filed a Form 2553, Election by a Small Business Corporation, electing S corporation status as of Date 1. Company had two shareholders, A and B. On Date 3, Company issued shares of stock to C and D. Pursuant to instructions from C's wife, Company canceled C's shares and reissued them to Limited Partnership, the entity through which most of C's assets were held. Thus, shares in Company were issued to Limited Partnership on Date 4.

When Limited Partnership's tax adviser received a Form K-1 for its stock ownership in Company, he immediately notified Company that a limited partnership cannot be a shareholder of an S corporation and he returned the shares to Company. On Date 5, Company canceled the shares and reissued the certificates to C. It is represented that neither Company nor any of the shareholders were aware that the transfer of shares to Limited Partnership terminated Company's S corporation status and the transfer was not motivated by tax avoidance or retroactive tax planning. It is further represented that none of the parties involved intended to terminate Company's S corporation status. At all times Company and its shareholders have treated Company as if it were a valid S corporation.

In response to this termination, Company has requested relief under § 1362(f). Specifically, Company requests that the termination be waived and that C, and not Limited Partnership, be treated as a shareholder of Company from Date 4 until Date 5. All parties have agreed to make any adjustments that might be required as a condition of such relief.

DISCUSSION

Under § 1361(a)(1), an S corporation is a small business corporation for which an election under § 1362(a) is in effect. Section 1361(b) defines a small business

corporation, in part, as a domestic corporation that is not an ineligible corporation and that has as shareholders only individuals, estates, or trusts described in § 1361(c)(2). Partnerships are not among the eligible shareholders listed in § 1361(b).

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 first taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation. Section 1362(d)(2)(B) provides that any termination under § 1362(d)(2) shall be effective on and after the date of cessation.

Under § 1362(f), a corporation that has lost its S corporation status under § 1362(d)(2) shall be treated as continuing to be an S corporation during the period specified by the Secretary if: the Secretary determines that the termination was inadvertent; the corporation took steps to return to its status as a small business corporation within a reasonable time after the discovery of the termination; and the corporation and all persons who were shareholders during the specified period agree to make adjustments consistent with the treatment of the corporation as an S corporation as may be required by the Secretary for the period.

The committee reports accompanying the Subchapter S Revision Act of 1982 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 revenue without undue hardship to taxpayers ... [I]t 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.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude

that Company's S corporation election terminated on Date 4 when Company's stock was issued to Limited Partnership, an ineligible shareholder. We further conclude that the termination was inadvertent within the meaning of § 1362(f).

Pursuant to § 1362(f), Company will be treated as continuing to be an S corporation during the period from Date 4 to Date 5, and thereafter, provided Company's S corporation election was valid and is not otherwise terminated under § 1362(d). In addition, during the period from Date 4 to Date 5, C will be treated as the owner of the shares that were issued to Limited Partnership. Accordingly, in determining their federal tax liability for the period from Date 4 to Date 5, A, B, C, and D must include their pro rata share of the separately and nonseparately computed items of Company under § 1366, make adjustments to stock basis under § 1367, and take into account any distributions made by Company under § 1368. If Company, A, B, C, and D fail to treat Company as described above, this ruling shall be null and void.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether Company is otherwise a valid S corporation for federal tax purposes.

This letter is issued only to the taxpayer who requested it. Under § 6110(k)(3), it may not be used or cited as precedent.

Company should attach a copy of this letter to its next federal income tax return. We enclose a copy for that purpose.

Pursuant to a power of attorney on file with this office, a copy of this ruling is being sent to your representative.

Sincerely yours,

Donna M. Young
Senior Technician Reviewer,
Branch 3
Office of the Assistant Chief
Counsel
(Passthroughs and Special
Industries)

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