INTERNAL REVENUE SERVICE
UIL 1362.00-00

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JANUARY 7, 1999

Re:

Legend:

X:

Y:

a:

b:

c:

d:

e:

f:

g:

m:

n:

date 1:

date 2:

date 3:

date 4:

Dear :

We received your letter, dated , , submitted on X's behalf, requesting a ruling under § 1362(f) of the Internal Revenue Code. This letter responds to that request.

The represented facts are as follows: X is a corporation that elected to be treated as an S corporation under § 1362 effective for its taxable year beginning date 1. On date 2, a and b, each sold m shares of X stock to Y, a C corporation. a and b did not consult with their tax advisors concerning the sale. The other shareholders and/or officers of X were either unaware of a and b's sale of X stock to Y, or did not know that such a sale would result in the termination of X's S corporation election.

On date 3, a, b and X became aware of the termination of X's S corporation election as result of the sale of X stock by a and b to Y when X's accounting firm discovered the termination while preparing X's tax return for the year beginning date 1 and the accounting firm notified the officers and shareholders of X. In order for X to again qualify as an S corporation, Y sold its shares of X stock to f and g on date 4.

For taxable years beginning on or before December 31, 1997, § 1361(b) defines a "small business corporation" as a domestic corporation which is not an ineligible corporation and which does not (A) have more than 75 shareholders, (B) 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, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

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

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was not effective for the taxable year for which made by reason of a failure to meet the requirements of § 1361(b) or to obtain the shareholder consents, (2) the Secretary determines that the circumstances resulting in the ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were taken so that the corporation is a small business corporation or to acquire the required shareholder consents, and (4) the corporation and each person who was a shareholder in the corporation at any time during the period specified pursuant to § 1362(f) agrees to make any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to the period, then, notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation is treated as an S corporation during the period specified by the Secretary.

With respect to § 1362(f), the committee reports accompanying the Subchapter S Revision Act of 1982 state the following:

> 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. . . . 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; H.R. Rep. No. 826, 97th Cong., 2d Sess. 12 (1982), 1982-2 C.B. 730, 735.

Based solely on the facts submitted and the representations made, we conclude: 1) that the termination of X's subchapter S election occurred on date 2, as a result of Y's ownership of X stock, and that the termination constituted an inadvertent termination within the meaning of § 1362(f); (2) no later than a reasonable period of time after discovery of the circumstances of the ineffective election or termination, steps were taken so that X was once more a small business corporation; and (3) no tax avoidance was intended nor will result from the continued treatment of X as a subchapter S corporation. Therefore, pursuant to § 1362(f), X's election to be an S corporation will be recognized as effective date 2 through date 4, and thereafter, provided that X's subchapter S election is not otherwise terminated under § 1362(d).

During the period from date 2 through date 4, Y will be treated as the owner of n shares of X stock. Accordingly, each of the shareholders of X from date 2 through date 4--Y, a, b, c, d, e, f and g--must include in income its pro rata share of X's separately and nonseparately computed items as provided in § 1366, make adjustments to stock basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368. This ruling shall be null and void if the requirements of this paragraph are not met.

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the above-described facts under any other provision of the Code. Specifically, no opinion is expressed on whether the election made by X to be treated as an S corporation was a valid election under § 1362, whether Y is a C corporation, or whether X's current shareholders are valid S corporation shareholders.

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.

Sincerely yours,

Joseph H. Makurath
Senior Technician Reviewer,
Branch 7
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)