

**Internal Revenue Service**

Department of the Treasury

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Date:

June 22, 2000

X =

Y =

Z =

Q =

A =

B =

C =

D =

E =

F =

G =

H =

I =

J =

K =

L =

M =

N =

P =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

D8 =

D9 =

D10 =

D11 =

D12 =

IRA 1 =

IRA 2 =

IRA 3 =

Partnership 1 =

Partnership 2 =

Partnership 3 =

Trust 1 =

Trust 2 =

Trust 3 =

LLC 1 =

LLC 2 =

Law Firm =

Dear :

This letter responds to a letter dated November 23, 1999, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting relief under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated D1 and its election to be an S corporation was accepted effective D1. C, as X's chairman and secretary, represents that due to the manner in which X maintained control over share issuances, a number of shares in X were issued to ineligible S corporation shareholders.

On D2, 10,000 shares were issued to IRA 1, an individual retirement account for the benefit of A. On D10, the 10,000 shares issued to IRA were transferred to A.

On D3, 2,500 shares of X were issued to Partnership 1, a family partnership. On D7, Partnership 1 purchased an additional 50,000 newly issued shares of X. On D10, Partnership 1 transferred all of its 52,500 shares of X to Trust 1, which is owned by and for the benefit of B. C represents that Trust 1 is a grantor trust, a permitted S corporation shareholder under § 1361(c)(2)(A)(i).

On D3, 2500 shares of X were issued to Partnership 2, a family partnership. On D10, Partnership 2 transferred all of its 2,500 shares of Taxpayer to Trust 2, which is owned by and for the benefit of D. C represents that Trust 2 is a grantor trust, a permitted S corporation shareholder under § 1361(c)(2)(A)(i).

On D3, Y, an S corporation, was issued 125,000 shares of X stock. These shares were issued to Y in two separate share certificates, numbers 66 and 67, each representing 62,500 shares. Subsequently, for reasons not known, the 62,500 shares represented by certificate number 67 have been treated as canceled and as treasury stock. C represents that these shares are not outstanding shares of Y. The 62,500 represented by certificate number 66 were shown on X's records as transferred to C (an eligible shareholder) on D9.

On D4, LLC 1, a limited liability company, purchased 50,000 shares of X. Of these shares, 25,000 shares were transferred to E (an eligible shareholder) and the remaining 25,000 shares transferred to F (an eligible shareholder).

On D4, Z, a corporation, acquired 54,000 newly issued shares of X. Z's shares of X were transferred to G (an eligible shareholder) on D10.

On D4, Partnership 3, a limited partnership, purchased 100,000 shares of X stock. The 100,000 shares were transferred to H (an eligible shareholder) on D10.

On D4, Q, a corporation, purchased 100,000 newly issued shares of X. These 100,000 shares were transferred to I (an eligible shareholder) on D10.

On D5, 30,000 shares of X were issued to IRA 2. The shares were transferred from IRA 2 to J (an eligible shareholder) on D12.

On D6, IRA 3 purchased 60,000 shares of X. These shares were purchased directly from X. On D10, the 60,000 shares issued to IRA 3 were transferred to K (an eligible shareholder).

On D7, LLC 3 purchased 100,000 shares of X stock. Of these shares, 47,500 were transferred to Trust 1, 2,500 were transferred to L, 10,000 were transferred to M, and 40,000 were transferred to Trust 2 on D10.

On D7, Trust 3 purchased 100,000 shares of X stock from X. This transaction was unwound through the purchase for cash by C of 100,000 shares from Trust 3. This purchase occurred on D10.

On D11, X increased its number of shareholders to exceed 75 and therefore, ceased to be an S corporation.

On D8, N purchased 40,000 shares of X from P. N is a nonresident alien. Following D11, when X ceased to be an S corporation, P (an eligible shareholder) repurchased the 40,000 shares from N.

C represents that X relied on its advisors to monitor the eligibility of its S shareholders. X was not aware that its advisors were not adequately reviewing the eligibility of X's shareholders. As a result, a number of ineligible shareholders were issued shares of X. Prior to approximately March of 1996, X maintained its stock book at its offices. According to C's representations, the incorrect issuances during this period resulted from inadequate staffing and incomplete oversight over

share issuances. From and after approximately March of 1996, X's lawyers, Law Firm, maintained the stock book. C represents that the issuances to ineligible shareholders during this period resulted from insufficient oversight and coordination between and X and Law Firm of share issuances.

C represents that the circumstances resulting in the termination of X's S corporation election on D3 and in the subsequent potential terminations of the S corporation election were inadvertent. C represents also that X and its shareholders did not intend to engage in tax avoidance or retroactive tax planning. X and each person who was or is a shareholder of X agree to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary with respect to such period.

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

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), as in effect for taxable years beginning on or before December 31, 1997, provided that a "small business corporation" cannot 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.

Section 1361(c)(2)(A)(i) provides that for purposes of § 1361(b)(1)(B), a trust all of which is treated (under subpart E of part I of subchapter J of Chapter 1) as owned by an individual who is a citizen or resident of the United States may be a shareholder.

Section 1361(c)(2)(B)(i) provides that for purposes of § 1361(b)(1), in the case of a trust described in § 1361(c)(2)(A)(i), the deemed owner shall be treated as the shareholder.

Section 1361(b)(1)(C) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not have a nonresident alien as a shareholder.

Rev. Rul. 92-73, 1992-2 C.B. 224, holds that a trust that qualifies as an individual retirement account under § 408(a) of

the Code is not a permitted shareholder of an S corporation under § 1361.

Section 1362(d)(2)(A) provides that an election under § 1362(a) will be terminated whenever (at any time on or after the 1<sup>st</sup> day of the 1<sup>st</sup> 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 the termination shall be effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation (A) was not effective for the taxable year for which made (determined without regard to § 1362(b)(2)) by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consents, or (B) was terminated under § 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken (A) so that the corporation is a small business corporation, or (B) 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 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 ineffectiveness or termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts submitted and the representations made, we hold that X's election was terminated on D3 because an ineligible shareholder held shares of X. We hold also that the termination of X's S corporation election was inadvertent within the meaning of § 1362(f). In addition, other circumstances described above would have resulted in the termination of X's S corporation election if the S corporation election had not been otherwise terminated when these events occurred and these potential terminations would have been inadvertent within the meaning of § 1362(f).

We further hold that under the provisions of § 1362(f), X will be treated as an S corporation effective D3 to D11, provided X's election to be an S corporation was not otherwise invalid and provided that the election was not otherwise terminated under § 1362(d). Accordingly, X's shareholders, in determining their federal tax liability, must include their pro rata share of the separately and nonseparately computed items of X under § 1366, make any adjustments to stock basis under § 1367, and take into

account any distributions made by X to shareholders under § 1368. If X or its shareholders fail to treat X 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 on whether the original election made by X to be an S corporation was a valid election under § 1362.

This ruling letter 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.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely yours,  
J. THOMAS HINES  
Acting Branch Chief, Branch 2  
Office of the Assistant Chief Counsel  
(Passthroughs and Special Industries)

Enclosures: 2  
Copy of this letter  
Copy for § 6110 purposes