

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:1-PLR-113430-00

Date:

September 26, 2000

Legend:

X =
A =
B =
State =
D1 =
D2 =
D3 =
D4 =

This responds to your letter dated July 10, 2000, submitted on behalf of X, requesting a ruling under section 1362(f) of the Internal Revenue Code.

FACTS

X incorporated under the laws of State on D1. X elected to be treated as an S corporation effective D2. Under a Shareholders' Agreement, no shareholder of X could sell or transfer any stock of X to an ineligible shareholder under subchapter S. Any purported transfer of shares in violation of this provision was declared null and void. The Shareholders' Agreement also provided that the company held a right to repurchase any shareholder's shares at the termination of that shareholder's employment. The purchase price for any shares sold pursuant to this provision would be the value per share as determined by the shareholders at the preceding annual meeting.

On D3, A, a shareholder and officer of X, transferred stock of X to B, an ineligible shareholder under subchapter S. On approximately D4, X discovered that B was an ineligible shareholder.

LAW AND ANALYSIS

Section 1361(a)(1) defines an S corporation as a small business corporation for which an election under section 1362(a) is in effect. Section 1361(b)(1) defines "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate, other than a trust described in section 1361(c)(2), and other than

PLR-113430-00

an organization described in (c)(6)) 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) of the Code provides that an election to be treated as an S corporation terminates whenever (at any time on or after the first day of the first 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 meet the requirements of a small business corporation. Section 1362(d)(2)(B).

Section 1.1361-1(l)(2)(iii)(A) provides that buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless (1) a principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D), and (2) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock. Section 1.1361-1(l)(2)(iii)(B) provides an exception to the above rule, stating that bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights.

Section 1362(f) of the Code provides that if (1) an election to be treated as an S corporation was terminated under section 1362(d) (2) or (3), (2) the Secretary determines that the termination was inadvertent, (3) no later than a reasonable period of time after discovery of the event resulting in such termination, steps were taken so that the corporation is once more a small business corporation, and (4) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to this subsection, agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to that period, then, notwithstanding the terminating event, the corporation shall be treated as continuing to be 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 section 1362(f) of the Code, provides, 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

PLR-113430-00

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.

CONCLUSION

Based upon the information submitted and the representations set forth above, we conclude that to the extent X's S corporation election terminated on D3, that termination was inadvertent within the meaning of section 1362(f).

Pursuant to the provisions of section 1362(f), X will be treated as continuing to be an S corporation through D3 and thereafter, provided that X's subchapter S election is not otherwise terminated under section 1362(d).

Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the above-described facts under any other provision of the Code. In particular, no opinion is expressed or implied concerning whether X's S election was valid under section 1362.

This ruling is directed only to the taxpayer that 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 the taxpayer.

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

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