Internal Revenue Service

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Legend

Company =

State =

A =

Corp X =

a =

b =

c =

This letter responds to a letter dated May 7, 1999, requesting a ruling on behalf of Company under § 1362(f) of the Internal Revenue Code.

The information submitted discloses that Company was incorporated on a under the laws of State. Company made an election to be an S corporation effective for its tax year beginning on b. Company currently has several shareholders, all of whom, Company represents, are eligible S corporation shareholders.

On c, Company acquired in a taxable purchase all of the assets of Corp X for a purchase price set in the corporations' Asset Purchase Agreement. In addition to the stated purchase price, Section 3.7 of the Agreement provided that 100 shares of Company stock are to be issued to Corp X's controlling shareholder, A, "as additional consideration for the purchase of the Assets." Accordingly, Company transferred 100 shares of its stock to the individual shareholder of Corp X as part of the asset purchase

price.

In connection with a recent refinancing transaction, Company learned of the effect of the transfers on its S election. Company then began preparing its request for inadvertent termination relief. Company represents that there was no tax avoidance or retroactive tax planning involved in the termination. In addition, Company represents that the termination occurred because of the lack of knowledge of the shareholder eligibility rules for S corporations.

Section 1361(a)(1) defines the term "S corporation" as, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect.

Section 1361(b)(1) defines a "small business corporation" as a domestic corporation that is not an ineligible corporation and that, among other requirements, does not have as a shareholder a person (other than an estate and other than a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual.

Section 1362(d)(2) provides that an election to be an S corporation 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) the corporation ceases to be a small business corporation. Section 1362(d)(2)(B) provides that the termination shall be effective on or after the date of cessation.

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 such 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 of the corporation at any time during the period specified pursuant to § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary for that period, then, notwithstanding the circumstances resulting in termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

After applying the relevant law to the facts submitted and the representations made, we conclude that Company's S corporation election terminated on c as a result of the transfer of Company stock to Corp X. We also conclude that the termination was inadvertent within the meaning of § 1362(f).

We further conclude that under the provisions of § 1362(f), Company will be treated as an S corporation on c and thereafter, provided Company had a valid S

corporation election and that election was not otherwise terminated under § 1362(d). A will be treated as the shareholder of Company for the shares held momentarily by Corp X during the termination period. Accordingly, all shareholders of Company, in determining their respective income tax liabilities, must take into account their pro rata shares of the separately and nonseparately computed items of Company under § 1366, makes adjustments to stock basis under § 1367, and take into account any distributions made by Company under § 1368. If Company or the shareholders fail to treat Company as described above, this ruling shall be null and void.

Except as specifically set forth above, we express no opinion concerning the federal tax consequences of the foregoing facts. Specifically, we express no opinion on whether Company otherwise qualifies as an S corporation.

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,

JEFF ERICKSON
Assistant to the Chief, Branch 3
Office of the Assistant
Chief Counsel
(Passthroughs and Special
Industries)

Enclosure:
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