

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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Date:
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LEGEND

X =

Y =

Z =

D1 =

D2 =

D3 =

Y1 =

State =

Shareholders =

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Dear _____ :

This letter responds to your letter dated March 20, 2001, and subsequent correspondence submitted on behalf of X, requesting inadvertent termination relief under section 1362(f) of the Internal Revenue Code.

FACTS

X is a State corporation that elected S corporation status under §1362(a) effective as of D1. On D2, X issued stock to Z, a nonresident alien. On D3, upon the acquisition of Y, additional stock was issued to nonresident aliens.

Accountants discovered that X's stock had been issued to nonresident aliens

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and notified X that nonresident aliens were ineligible to own stock in an S corporation. X immediately began negotiations to redeem the X stock that had been issued to these ineligible shareholders. X represents that it has repurchased the stock issued on D2 and D3.

X represents that it did not intend to terminate its S election. X also represents that for purposes of filing its return for Y1 and thereafter, the shares issued to the nonresident aliens were treated as not having been issued. Accordingly, all of the income and loss was reported only by the eligible shareholders. Shareholders have agreed to make any adjustments consistent with treatment of X as a S corporation as may be required by the Commissioner.

LAW AND ANALYSIS

Section 1361(b)(1) defines the term "small business corporation" to mean 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 and other than a trust described in § 1361(c)(2), or an organization described in § 1361(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(a) provides, in part, that a small business corporation may elect to be an S corporation.

Section 1362(d)(2)(A) provides that an election to be treated as a subchapter 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) such corporation ceases to be a small business corporation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2), (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 such termination, steps were taken so that the corporation is a small business corporation, and (4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified agrees to make adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to the termination period, then, notwithstanding the circumstances resulting in the termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) provides that, for purposes of § 1.1362-4(a), the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was

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inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent.

CONCLUSION

Based on the information submitted and the representations made, we conclude that X's election to be treated as an S corporation terminated on D2 when X issued stock to a nonresident alien. We further conclude that the termination was inadvertent within the meaning of § 1362(f).

Under § 1362(f), X will be treated as continuing to be an S corporation from D2 and thereafter, provided that X's S corporation election was valid and was not otherwise terminated under § 1362(d). In determining their respective income tax liabilities, Shareholders must include their pro rata share of the separately and nonseparately computed items of X as provided in § 1367, and must take into account any distributions X made as provided in § 1368. If X or any of X's Shareholders fail to treat X as described above, this ruling shall be void.

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, we express or imply no opinion concerning whether X is an S corporation for federal tax purposes.

Under a power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,
Christine E. Ellison,
Chief, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: (1)

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