Internal Revenue Service

Department of the Treasury

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Washington, DC 20224
Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:B1-PLR-132970-03
Date:
July 28 2003

Legend

X =

State =

Year =

D1 =

Dear :

This responds to your letter dated, May 15, 2003, submitted on behalf of X, requesting relief for an inadvertent invalid election under §1362(f) of the Internal Revenue Code.

Facts

X was formed under the laws of State, during Year. X elected to be an S corporation, effective D1. On D1, X stock was held by Trust. Trust was not a permissible S corporation shareholder, and therefore, X's S corporation election was invalid. X represents that Trust is qualified to make an electing small business trust ("ESBT") election, and will make the election if X is granted relief for the inadvertent invalid election. X also represents that it filed Form 1120S, consistent with S corporation status, for all years involved in this request.

Law and Analysis

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

According to the legislative history of section 1362(f) –

> 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 revenues without undue hardship to taxpayers. For example, if a corporation, in good faith, determined that it had no earnings and profits, but it is later determined on audit that its election terminated by reason of violating the passive income test for three consecutive years because the corporation in fact did have accumulated earnings, if the shareholders were to agree to treat the earnings as distributed and include the dividends in income, it may be appropriate to waive the terminating events, so that the election is treated as never terminated.

> Likewise, it may be appropriate to waive the terminating event when the one class of stock requirement was inadvertently breached, but no tax avoidance had resulted. 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.

Conclusion

Based solely on the facts submitted and the representations set forth above, we conclude that X's subchapter S corporation election on D1 was an inadvertent invalid election within the meaning of § 1362(f). Pursuant to § 1362(f), X will be treated as continuing to be an S corporation from D1 and thereafter, provided that the beneficiary of Trust files an ESBT election with the appropriate service center, with a D1 effective date, within 60 days of the date of this ruling. A copy of this letter must be attached to the ESBT election.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed on whether X's qualifies to be an S corporation or whether Trust is an ESBT within the meaning of § 1361(c)(2)(A)(v).

This ruling is directly only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that if 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,

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

Enclosures (2)
Copy of this letter