Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Number: **200109018**
Release Date: 3/2/2001
Index Number: 1362.00-00

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:3 PLR-114651-00

Date:
November 29, 2000

Company:

Subsidiaries:

Partnership X:

Partnership Y:

Trust M:

Trust N:

Trust P:

M:

N:

P:

State A:

State B:

a:

b:

c:

d:

Dear

This letter responds to a letter from your authorized representative dated July 12, 2000, submitted on behalf of Company, requesting a ruling under § 1362(f) of the Internal Revenue Code that Company's S corporation election was inadvertently invalid. Company represents the following facts.

FACTS

Company was incorporated in a under the laws of State A. Effective b, Company elected under § 1362(a) to be treated as an S corporation and elected under § 1361(b)(3)(B) to treat Subsidiaries as qualified subchapter S subsidiaries (QSubs).

Partnership X was formed in c, with Trust M, Trust N, and P contributing Company stock and Partnership Y (with M, N, and P as partners) contributing real property. P subsequently transferred his interest in Partnership X to Trust P. Under the partnership agreement, any partner could demand the return of its capital contribution. The sole function of Partnership X was to hold bare record title to the shares of Company stock that, if held by partners who were domiciliaries of State B, would be subject to that state’s intangible personal property tax.

At the time of Company’s S corporation election, Partnership X and Trust P held shares of Company stock. We decline to rule on whether Partnership X held the Company shares as a nominee or agent, with no beneficial interest in those shares. Thus, for purposes of this ruling, Company’s S election was invalid because on b Company had an ineligible shareholder.

LAW AND ANALYSIS

Section 1361(a)(1) provides that, for purposes of the Code, the term "S corporation" means, with respect to any tax year, a small business corporation for which an election under § 1362(a) is in effect for the year.

Section 1361(b)(1)(B) provides that, for purposes of subchapter S, the term "small business corporation" means a domestic corporation that is not an ineligible

corporation and that does not, among other things, have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual. A partnership is not a permitted shareholder.

Section 1362(f) provides that if–

(1)(A) an election under § 1362(a) by any corporation was not effective for the tax 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;

(2) the Secretary determines that the circumstances resulting in the ineffectiveness were inadvertent;

(3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness, 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 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 might be required by the Secretary regarding this period,

then, notwithstanding the circumstances resulting in the ineffectiveness, the corporation shall be treated as an S corporation during the period specified by the Secretary.

The conference report on the Small Business Job Protection Act of 1996 (P.L. 104-188) provides that the Service should be reasonable in exercising this authority and apply standards that are similar to those applied under present law to inadvertent subchapter S terminations. H. Rep. No. 737, 104th Cong., 2d Sess. 222 (1996); 1996-3 C.B. 741, 962.

According to the legislative history of § 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.

Section 1.1362-4(b) of the Income Tax Regulations 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 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.

Company represents that M, N, and P (whether as trustees or in their individual capacities) did not intend to provide Partnership X with beneficial ownership of Company stock. On personal financial statements provided to various financial institutions, M, N, and P treated themselves as the owners of the Company stock held by Partnership X as shareholder of record from b to d. On d, Company stock held by Partnership X was re-registered in the name of Trusts M, N, and P. Company represents that these trusts satisfy the requirements of § 1361(c)(2). Company and its

shareholders agree to make any adjustments, consistent with the treatment of Company as an S corporation, as might be required by the Secretary.

Based solely on the facts as represented by Company in this ruling request, we conclude that Company's S corporation election was inadvertently invalid within the meaning of § 1362(f). Consequently, we rule that Company will be treated as an S corporation beginning b and thereafter, unless Company's S election otherwise terminates under § 1362(d).

This ruling is contingent on Company and its shareholders, Trusts M, N, and P , treating Company as an S corporation for the period beginning b and thereafter.

Except for the specific ruling above, no opinion is expressed or implied concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding the eligibility of Company to have elected under § 1362(a) to be an S corporation or of Subsidiaries to be QSubs.

Under 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 who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

/s/

MARY BETH COLLINS
Assistant to the Chief, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

enclosure: copy for § 6110 purposes