

**Internal Revenue Service**

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October 19, 2001

**LEGEND**

X =  
Shareholders =

State =

IRA =

A =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Dear

This letter responds to a letter dated March 26, 2001, and subsequent correspondence submitted on behalf of X, requesting inadvertent invalid election relief under § 1362(f) of the Internal Revenue Code.

**FACTS**

The following facts were represented. X was incorporated on Date 1 under the laws of State. X elected to be an S corporation, effective Date 2.

In Date 3, during a routine operational and planning meeting, it was discovered

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that some of the shares of X were owned by an Individual Retirement Account (IRA), an ineligible shareholder. Upon this discovery, X's management consulted with its accounting firm to ascertain a resolution to the shareholder eligibility problem. It was decided that a taxable IRA distribution was the most expeditious recourse. Thus, on Date 4, the X stock held by the IRA was distributed to A in a taxable transaction. Subsequently, X submitted this ruling request for inadvertent invalid election relief under § 1362(f).

X represents that it intended to be taxed as an S corporation effective for Date 2 and that the ineffectiveness of the S election was not motivated by tax avoidance or retroactive tax planning. X and its shareholders have agreed to make any adjustments that the Commissioner may require consistent with the treatment of X as an S corporation.

## **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)(B) provides that a "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not 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.

Rev. Rul. 92-73, 1992-2 C.B. 224, holds that a trust that qualifies as an individual retirement account under § 408(a) is not a permitted shareholder of an S corporation under § 1361.

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. Under § 1362(d)(2)(B), the termination is effective on and after the date the S corporation ceases to meet the requirements of a small business corporation.

Section 1362(f) provides, in relevant part, that, if (1) an election under § 1362(a) by any corporation was not effective for the taxable year for which made (determined without regard to § 1362(b)(3)) by reason of a failure to meet the requirements of § 1361(b), (2) the Secretary determines that the circumstances resulting in the effectiveness were inadvertent, (3) no later than a reasonable period of time after discovery of the ineffectiveness, 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 any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to the period, then,

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

## **CONCLUSION**

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election was ineffective for the taxable year beginning Date 2 because the IRA was an ineligible shareholder. We also conclude that the ineffectiveness of X's S corporation election constituted an inadvertent invalid election within the meaning of § 1362(f).

Consequently, under § 1362(f), X will be treated as being an S corporation effective Date 2 and thereafter, provided X's election to be an S corporation was not otherwise invalid and provided that the election was not terminated under § 1362(d). During the period from Date 2 to Date 4, A will be treated as the owner of the X stock held by IRA. Accordingly, this individual and X's other shareholders must include their pro rata share of the separately and non-separately computed items as provided in § 1366, make adjustments to stock basis as provided in § 1367, and take into account any distributions made by X as provided by § 1368. If X, IRA, A or any of X's other shareholders fails to treat themselves as described above, this ruling shall be null and void.

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 regarding the eligibility of X to have elected under § 1362(a) to be an S corporation.

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

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

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

Enclosure: Copy for section 6110 purposes