

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:2-PLR-106384-02
Date:
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X =

Y =

A =

B =

C =

D =

Date 1 =

Date 2 =

Year 1 =

Year 2 =

Dear

This responds to a letter dated November 16, 2001, together with subsequent correspondence, requesting a ruling under §1362(f) of the Internal Revenue Code.

Facts

The information submitted states that X incorporated on Date 1 and filed a timely Subchapter S election effective for its Year 1 taxable year. At the time of the election, A was the sole shareholder of X.

On Date 2, additional shares of X stock were issued to Y, C, and D. Y was an S corporation with B as its sole shareholder. X represents that neither the attorneys nor the accountants advising the parties involved informed the parties that the transfer of X stock to Y, an ineligible S corporation shareholder, would terminate X's S election. In the later part of Year 2, X learned that the issuance of X stock to Y terminated X's S election. Upon discovery of the termination, the X stock held by Y was transferred to B.

X represents that all S corporation items allocated by X to Y were reported by B on his individual income tax return exactly as they would have been if B directly owned the X shares held by Y.

X represents that the circumstances resulting in the termination of X's S corporation election were inadvertent. X also represents that X and its shareholders did not intend to engage in tax avoidance or retroactive tax planning. For all taxable years, X and all of X's shareholder's have reported their income consistent with X being an S corporation. X and X's shareholders agree to make any adjustments (consistent with the treatment of X as an S corporation) that the Secretary may require.

Law and Analysis

Section 1361(a)(1) of the Internal Revenue Code defines an "S corporation" means, as a small business corporation for which an election under §1362(a) is in effect for the taxable year.

Section 1361(b)(1)(B) provides that the term "small business corporation" is a domestic corporation which is not an ineligible corporation and which 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 under §1362(a) shall be terminated whenever (at any time on or after the first day of the taxable year for which a corporation is an S corporation) such corporation ceases to be a small business corporation. A termination of an S corporation election under §1362(d)(2) is effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under §1362(a) by any corporation (A) was not effective for the taxable 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, or (B) was terminated under paragraph (2) or (3) of §1362(d), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, 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 was a shareholder of the corporation at any time during the period specified pursuant to §1362(f), agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such ineffectiveness or termination, 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 election was terminated on Date 2, when Y acquired X stock. We also conclude that this termination was inadvertent within the meaning of §1362(f). We further conclude that under the provisions of §1362(f), X will be treated as continuing to be an S corporation from Date 2, and thereafter, provided that X's S election was valid and was not otherwise terminated under §1362(d). Accordingly, all of the shareholders in X, in determining their respective income tax liabilities for the period beginning Date 2 and thereafter, must include their pro rata share of the separately stated and non-separately computed items of X as provided in §1366, make any adjustments to basis provided in §1367, and take into account any distributions made by X as provided in §1368. If X or its shareholders fail to treat themselves as described above, this ruling shall be null and void.

Except as specifically ruled upon above, we express no opinion concerning the Federal tax consequences of the transactions described above under any other provisions of the Code. Specifically, no opinion is expressed as to whether X or Y are S corporations under §1361(b).

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

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,
Matthew Lay
Senior Technician Reviewer, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: (2)
Copy of this letter
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