

**Internal Revenue Service**

Department of the Treasury

Number: **200250009**  
Release Date: 12/13/2002  
Index Number: 1362.04-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

PLR-125606-02 CC:PSI:3

Date:

August 27, 2002

LEGEND

Company =

State =

ESOP =

Shareholders =

a =

b =

c =

d =

e =

Dear :

This letter responds to a letter dated April 19, 2002, and subsequent correspondence, submitted on behalf of Company requesting a ruling under § 1362(f) of the Internal Revenue Code.

According to the information submitted, Company was organized under the laws of State on a. Company elected to be treated as an S corporation, effective as of b.

On c, Company's employee stock ownership plan, the ESOP, transferred shares of Company stock to a participant's individual retirement account ("IRA") upon termination of the participant's employment. Pursuant to terms of the ESOP, Company intended immediately to repurchase the Company stock on the same date that the stock was transferred to the IRA. However, circumstances related to financing prevented Company from repurchasing the stock from the IRA until d. The failure to effect the intended simultaneous transfer and repurchase of Company stock was not discovered until e by Company's new accounting firm.

Company represents that it has been consistently treated as an S corporation at all times after its S corporation election. In addition, Company and its Shareholders agree to make any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Service.

Section 1361(a)(1) provides that the term "S corporation" means, with respect to any taxable 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 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 IRA 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 (or at any time on or after the first day of the first taxable year for which the corporation is an S corporation) the corporation ceases to be a small business corporation. Under § 1362(b)(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) to be treated as an S corporation was terminated under § 1362(d); (2) the Secretary determines that the termination was inadvertent; (3) no later than a reasonable period of time after discovery of the event resulting in the termination, steps were taken so that the corporation is once more 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 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 terminating event, the corporation shall be treated as continuing to be an S corporation during the period specified by the Secretary.

Based solely on the facts submitted and the representations made, we conclude that Company's subchapter S election was terminated on c, when Company's stock was transferred by the ESOP to an ineligible shareholder. We further conclude that the termination of Company's S corporation election was inadvertent within the meaning of § 1362(f).

Consequently, under § 1362(f) Company will be treated as an S corporation from c to d, and thereafter, provided that Company's S corporation election is otherwise valid and is not otherwise terminated under § 1362(d). During the period from c to d, the ESOP will be treated as owner of the Company stock held by the IRA. Accordingly, the ESOP and Company's other shareholders, in determining their income tax liabilities for the period from c to d, and thereafter, must include their pro rata shares of the separately and nonseparately computed items of Company under § 1366, make any adjustments to stock basis under § 1367, and take into account any distributions made by Company to shareholders under § 1368. If Company or any of Company's shareholders fail to treat Company as described above, this ruling will be null and void.

Except for the specific ruling above, we express or imply no opinion concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion regarding whether Company is otherwise qualified to be an S corporation.

This ruling is directed only to the taxpayer requesting it. Under § 6110(k)(3), it 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 Company's authorized representative.

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

Enclosures (2):  
Copy of this letter  
Copy for § 6110 purposes

cc: