

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:2 - PLR-131675-02

Date:

October 9, 2002

Legend

A =

B =

X =

Y =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Dear :

This letter responds to your letter dated May 9, 2002, together with subsequent correspondence, submitted on behalf of X requesting relief under § 1362(f) of the Internal Revenue Code.

Facts

A, the President of X, represents that X was incorporated on Date 1 and that X has been treated as an S corporation since Date 1. On Date 2, B, a shareholder of X, transferred shares of X to Y, a corporation. On Date 3, the accountant for X informed the attorney for X that the transfer of the X shares to Y had terminated X's election to be an S corporation. On Date 4, the shares issued to Y were cancelled on X's corporate books and reissued to B.

X and its shareholders represent that the circumstances resulting in the termination of X's election to be an S corporation were inadvertent. X and its shareholders also represent that X and its shareholders did not intend to engage in tax

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avoidance or retroactive tax planning. X and each of its shareholders agree to make adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary.

Law and Analysis

Section 1362(a) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

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 such 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)(A) provides that an election under § 1362(a) will be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation. Section 1362(d)(2)(B) provides that the termination shall be 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 § 1362(d)(2) or (3), (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 who was a shareholder in 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, such corporation shall be treated as an S corporation during the period specified by the Secretary.

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Conclusion

Based solely on the representations made and the information submitted, we conclude that X's election to be an S corporation terminated on Date 2 because B transferred shares to an ineligible shareholder on that date. We also conclude that the termination of X's election to be an S corporation was an inadvertent termination within the meaning of § 1362(f). Under the provisions of § 1362(f), X will be treated as continuing to be an S corporation during the period Date 2 to Date 4 and thereafter, provided that X's election to be an S corporation was valid and was not otherwise terminated under § 1362(d). From Date 2 to Date 4, B must be treated as having held the shares originally issued to Y. Accordingly, B must include the prorata share of the separately and nonseparately computed items attributable to those shares in B's income as provided in § 1366, make adjustments to the stock basis of those shares as provided in § 1367, and take into account any distributions with respect to those shares, as provided in § 1368.

Except as specifically ruled above, we express no opinion concerning the federal income tax consequences of the transactions described above under any other provision of the Code. Specifically, we express no opinion regarding whether X is otherwise eligible to be an S corporation.

This ruling letter is directed only to the taxpayer who requested it and may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, we are forwarding a copy of this letter to X.

Sincerely yours,

MATTHEW LAY
Senior Technician Reviewer,
Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
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