

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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CC:PSI:3 PLR-137134-02
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November 7, 2002

LEGEND

Company =

A =

B =

C =

D =

E =

State =

Trust =

Trust 1 =

Trust 2 =

Date 1 =

Date 2 =

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Date 3 =

Date 4 =

Date 5 =

Date 6 =

m =n =o =

Dear :

This letter responds to a letter dated July 25, 2002, and subsequent correspondence, requesting inadvertent invalid election relief under § 1362(f) of the Internal Revenue Code.

Facts

Company incorporated on Date 1 under the laws of State, and elected to be an S corporation effective Date 4.

As of Date 2, the shareholders of Company were A, B, C, D, and E, with an aggregate ownership of m shares of Company stock (A and B each owning n shares and C, D, and E each owning o shares). On Date 2, assisted by an independent accountant and attorney, A and B created Trust, which was then divided into Trust 1 and Trust 2 for the benefit of C and D. A transferred n shares of Company stock to Trust 1, and B transferred n shares of Company stock to Trust 2. It was intended that A be the grantor owner of Trust 1 and B be the grantor owner of Trust 2.

On Date 3, C transferred o shares of Company stock to Trust 1, and D transferred o shares of Company stock to Trust 2.

On Date 5, Company learned that Trust 1 and Trust 2 were ineligible shareholders, and, thus, its S corporation election was invalid. Shortly thereafter, on Date 6, Trust 1 transferred o shares of Company stock to C, and Trust 2 transferred o shares of Company stock to D. It is represented that Trust 1 and Trust 2 are now eligible shareholders under § 1361(c)(2)(A)(i).

Company and its shareholders represent that the invalid S corporation election was inadvertent and was not motivated by tax avoidance or hindsight. Company and its shareholders agree to make any adjustments, consistent with the treatment of Company as an S corporation, that the Secretary may require with respect to the period

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specified by § 1362(f).

Applicable Law

Section 1361(a)(1) generally 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) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not (A) have more than 75 shareholders, (B) 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, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1362(a) provides, in part, that a small business corporation may elect to be an S corporation.

Section 1362(d)(2)(A) provides that an election under § 1362(a) is terminated 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. Section 1362(d)(2)(B) provides that such termination is effective on and after the date the S corporation ceases to be a small business corporation.

Section 1362(f) provides 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)(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 such ineffectiveness were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness, steps were taken so that the corporation is a small business corporation, or 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, such corporation shall be treated as an S corporation during the period specified by the Secretary.

Conclusion

Based on the facts submitted and the representations made, we conclude that Company's S corporation election was ineffective for the taxable year beginning Date 4 because Trust 1 and Trust 2 were ineligible shareholders of Company. We also conclude that the ineffectiveness of Company's S corporation election constituted an inadvertent invalid election under § 1362(f). Therefore, under § 1362(f), we rule that Company will be treated as an S corporation beginning Date 4 and thereafter, unless

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Company's S corporation election otherwise terminates under § 1362(d).

This ruling is contingent on Company and all its shareholders, including Trust 1 and Trust 2, treating Company as an S corporation effective Date 4, and on Company treating C, D, E, Trust 1, and Trust 2 as the shareholders of Company as of Date 4. Accordingly, Company's shareholders, in determining their respective income tax liabilities must include their pro rata share of the separately and nonseparately computed items of Company under § 1366, make adjustments to stock basis under § 1367, and take into account any distributions made by Company under § 1368.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above 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.

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

Sincerely yours,
Mary Beth Collins
Senior Technician Reviewer,
Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2):

Copy of this letter
Copy for § 6110 purposes

cc: