

Internal Revenue Service

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Person to Contact:

Telephone Number:

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Legend

X =

A =

B =

C =

D =

D1 =

D2 =

D3 =

Year 1 =

IRA 1 =

IRA 2 =

IRA 3 =

IRA 4 =

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Dear _____ :

This letter responds to a letter, dated July 16, 2002, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that X elected to be an S corporation for its taxable year beginning D1 of Year 1. As of D1 of Year 1, all of the shares of X were owned by four individual shareholders A, B, C, and D, and four individual retirement accounts IRA 1, IRA 2, IRA 3, and IRA 4 (collectively, the IRAs). Each of the IRAs is owned by one of the individual shareholders.

For Year 1 and all subsequent taxable years, all of the items attributable to the shares of X owned by each of the IRAs were reported on the individual income tax returns of the owner of that IRA. The corporate income tax returns of X were filed consistent with all of the shares being owned by A, B, C, and D. On D2, X's attorney discovered that shares of X were held by the IRAs and advised X that its S corporation election was invalid because IRAs are not eligible S corporation shareholders. On D3, all of the shares of X owned by the IRAs were transferred to a § 401(a) trust, which is an eligible S corporation shareholder.

A, as president of X, represents that the circumstances resulting in the ineffectiveness of X's S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning. X and its shareholders agree to make any adjustments (consistent with the treatment of X as an S corporation) that the Secretary may require.

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) defines an "S corporation" 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 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.

Section 1361(c)(6) provides that, for purposes of § 1361(b)(1)(B), an organization which is (A) described in § 401(a) or § 501(c)(3), and (B) exempt from taxation under § 501(a), may be a shareholder in an S 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 failure to meet the requirements of § 1361(b) or to

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obtain shareholder consents, or 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 the ineffectiveness or termination, 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 under § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary for that period, then, notwithstanding the circumstances resulting in such termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts and representations submitted, we conclude that X's S corporation election was ineffective beginning on D1 of Year 1 because of the ownership of X stock by the IRAs, which are ineligible S corporation shareholders. We also conclude that the ineffectiveness of X's S corporation election was an "inadvertent invalid election" within the meaning of § 1362(f).

We further conclude that under the provisions of § 1362(f), X will be treated as being an S corporation from D1 of Year 1 to D3, and afterwards, provided X's S corporation election was otherwise valid and was not otherwise terminated.

In addition, A, B, C, and D will be treated as the owners of the X stock owned by IRA 1, IRA 2, IRA 3, and IRA 4, respectively, during the period from D1 of Year 1 to D3. The shareholders of X must include their pro rata share of the separately stated and nonseparately 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 X as described above, during the period from, this ruling will 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, including whether X was or is a small business corporation under § 1361(b).

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.

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

Sincerely yours,

CAROLYN HINCHMAN GRAY
Senior Counsel, Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
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