Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

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LEGEND

Corporation =

Partnership =

X =

Y =

IRA 1 =

IRA 2 =

A =

B =

C =

D =

E =

F =

G =

Trust =

Shareholders =

State =

Year 1 =

Date 1 =

Date 2 =

Date 3 =

Dear :

This letter responds to a letter dated July 31, 2002, and subsequent correspondence, requesting inadvertent invalid election relief under § 1362(f) of the Internal Revenue Code.

Facts

Corporation was incorporated on Date 1 under State law and elected to be an S corporation effective Date 2.

In Date 3, Corporation learned that its S election was not valid because it had ineligible shareholders, IRA 1, IRA 2, X, Y, and Partnership, as of Date 2. When Corporation made its S corporation election, it was unaware that it had ineligible shareholders. During Year 1 but before Date 3, IRA 1 transferred Corporation stock to Trust, IRA 2 transferred Corporation stock to A, X transferred Corporation stock to B, C, D, and E, and Y transferred Corporation stock to Partnership. Once Corporation learned that its S election was invalid, Partnership transferred Corporation stock to F and G. It is represented that Trust, A, B, C, D, E, F, and G are eligible S corporation shareholders.

Corporation and its shareholders represent that the invalid S corporation election was inadvertent and was not motivated by tax avoidance or retroactive tax planning. Corporation represents that since Date 2, Corporation and its shareholders have treated Corporation as an S corporation. Corporation and its shareholders agree to make any adjustments, consistent with the treatment of Corporation as an S

corporation, that the Secretary may require with respect to the period 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 Corporation's S corporation election was ineffective for the taxable year beginning Date 2 because IRA 1, IRA 2, X, Y, and Partnership were ineligible shareholders of Corporation. We also conclude that the ineffectiveness of Corporation's S corporation election constituted an inadvertent invalid election under § 1362(f). Therefore, we rule that Corporation will be treated as an S corporation beginning Date 2 and thereafter, unless Corporation's S corporation election otherwise terminates under § 1362(d).

This ruling is contingent on Corporation treating A, B, C, D, E, F, and G as owning Corporation stock as of Date 2 and on Corporation and its shareholders treating Corporation as an S corporation effective Date 2. Accordingly, Corporation's shareholders, in determining their respective income tax liabilities must include their pro rata share of the separately and nonseparately computed items of Corporation under § 1366, make adjustments to stock basis under § 1367, and take into account any distributions made by Corporation 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 Corporation 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 the original of this letter to you, Corporation's authorized representative, and a copy to Corporation and Corporation's other 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