

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:

January 6, 2003

Legend:

X =

State =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

#a =

#b =

A =

B =

IRA =

PRS =

Dear :

This responds to a letter dated October 1, 2002, together with subsequent correspondence, submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code.

FACTS

X was incorporated under the laws State on D1. X elected subchapter S status, effective, D2. On D3, A transferred #a shares of X stock to IRA, thereby terminating X's S corporation election. On D3, neither X, its officers, nor its shareholders were aware that the X stock was transferred to an ineligible shareholder. On or about D4, X's interim Chief Financial Officer discovered that shares of X stock had been issued to IRA. Upon a subsequent review of X's records, X's attorneys discovered that on D3, A also transferred #b shares of X stock to PRS, an ineligible shareholder. On D5, B, an individual shareholder, acquired the X stock held by PRS. On D6, X redeemed the X stock held by IRA.

X represents that the circumstances resulting in the termination of X's S corporation election on D3 were inadvertent. X also represents that X and its shareholders did not intend to engage in tax avoidance or retroactive tax planning. X and the shareholders of X agree to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary with respect to such period.

LAW AND ANALYSIS

Section 1361(a)(1) defines an "S corporation", with respect to any taxable year, as a small business corporation for which an S election under § 1362(a) is in effect for such year.

Section 1361(b)(1)(B) provides that a small business corporation cannot 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 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the taxable year for which the corporation is an S corporation) the corporation ceases to be a small business corporation. The termination is effective on and after the day of the cessation. Section 1362(d)(2)(B).

Rev. Rul. 92-73, 1992-2 C.B. 224, holds that a trust qualified as an individual retirement account under § 408(a) is not a permitted S corporation shareholder under § 1361. Rev. Rul. 92-73 further states that if a shareholder inadvertently causes a termination of an S corporation by transferring stock to a trust that qualifies as an IRA under § 408, the shareholder may request relief under § 1362(f).

Section 1362(f), in relevant part, provides that, if: (1) an election under § 1362(a) by any 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 in the corporation at any time during the period specified pursuant to § 1362(f), agrees to make any 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.

CONCLUSIONS

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election under § 1362(a) was terminated on D3, because ineligible shareholders held shares of X. We also conclude that the termination constituted an inadvertent termination within the meaning of § 1362(f). Therefore, pursuant to § 1362(f), X will be treated as an S corporation from D3, and thereafter, provided that X's subchapter S election is not otherwise terminated under § 1362(d). Accordingly, X's shareholders, in determining their federal tax liability, must include their pro rata share of the separately and nonseparately computed items of X under § 1366, make any adjustments to stock basis under § 1367, and take into account any distributions made by X to shareholders under § 1368. This ruling is null and void if the requirements of this paragraph are not met.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X is a valid S corporation.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

/s/ Dianna K. Miosi
Dianna K. Miosi
Chief, Branch 1
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
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