

## Internal Revenue Service

## Department of the Treasury

Number: **200047028**  
Release Date: 11/24/2000  
Index Number: 1362.02-02  
1362.04-00

Washington, DC 20224

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Refer Reply To:

CC:PSI:B01 PLR-109212-00

Date:

August 24, 2000

### Legend

X =

Sub1 =

Sub2 =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

State =

n% =

:

This responds to the April 24, 2000, letter and additional information submitted on behalf of X, requesting rulings under § 1362(f) of the Internal Revenue Code.

### **FACTS**

X was incorporated on D1 under State law, and elected to be treated as an S corporation effective for its taxable year beginning D2. Also effective D2, X elected to treat Sub1 and Sub2 as qualified subchapter S subsidiaries (QSUBs).

As of D2, shares of X stock were owned by two individual retirement accounts (IRAs). X, however, was unaware that the two IRAs held X stock in that X's stock register listed the individual owners of the IRAs as the shareholders of record. Each IRA owned less than n% of X stock. In D3, X's accountants discovered that the two IRAs held shares of X stock. Effective D4, X redeemed all the stock held by the two IRAs.

Upon a further review of X's records, X's accountants discovered that shares of X stock had been transferred to another IRA on D5, after the effective date of the S corporation election. Like the above two IRAs, this IRA owned less than n% of X stock.

On D6, the X stock held by the IRA was distributed to the owner of the IRA in a taxable transaction.

### **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 1361(b)(3)(B) defines a QSUB as any domestic corporation which is not an ineligible corporation if 100 percent of the stock of the corporation is held by the S corporation, and the S corporation elects to treat the corporation as a QSUB.

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).

Section 1362(f) provides in relevant part 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 (B) was terminated under § 1362(d)(2); (2) the Secretary determines that the circumstances resulting in the 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 in the corporation at any time during the period specified pursuant to this subsection, 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 the ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Rev. Rul. 92-73, 1992-2 C.B. 224, holds that a trust qualified as an IRA under § 408 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(a), the shareholder may request relief under § 1362(f).

### **CONCLUSIONS**

Based solely on the facts submitted and representations made, we conclude that

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X's S corporation election was ineffective for the taxable year beginning D2 because the IRAs were ineligible shareholders of X. We conclude that the ineffectiveness of X's S corporation election constituted an inadvertent invalid election within the meaning of § 1362(f). We also conclude that X's S corporation election under § 1362(a) terminated on D5 when shares of X stock were transferred to an IRA. We conclude that the termination constituted an inadvertent termination within the meaning of § 1362(f). We further conclude that the inadvertent invalid S corporation election and subsequent inadvertent termination do not affect the status of Sub1 and Sub2 as QSUBs.

Under the provisions of § 1362(f), X will be treated as being an S corporation from D2, and thereafter, provided that, apart from the inadvertent termination ruling above, X's S corporation election was otherwise valid and has not otherwise terminated under § 1362(d). In addition, Sub1 and Sub2 will be treated as QSUBs from D2, and thereafter, provided that, apart from the inadvertent termination ruling above, X's S corporation election was otherwise valid and has not otherwise terminated under § 1362(d), and provided that the QSUB elections were otherwise valid and have not otherwise terminated.

This ruling is contingent upon X and all its shareholders treating X as having been an S corporation for the period beginning D2, and thereafter.

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. Specifically, no opinion is expressed regarding whether X is otherwise eligible to be an S corporation or whether Sub1 and Sub2 are otherwise eligible to be QSUBs.

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

Pursuant to the power of attorney on file with this office, a copy of this ruling is being sent to your authorized representatives.

Sincerely,  
**/s/ David R. Haglund**  
Senior Technician Reviewer, Branch 1  
Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)  
Copy of this letter  
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