

## Internal Revenue Service

## Department of the Treasury

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Date:

July 2, 2001

X =

Y =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

State =

A =

B =

M =

a =

b =

This responds to a letter dated April 13, 2001, submitted on behalf of X, requesting a ruling under section 1362(f) of the Internal Revenue Code.

### Facts

According to the information submitted, X is a corporation organized under the laws of State on Date 1. X elected to be treated as an S corporation effective Date 2. On Date 3, the shareholders of X sold M shares of X stock to Y, a corporation,

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terminating X's S election. Y's shareholders were A and B. A and B held a% and b% of Y stock, respectively. On Date 4, counsel for A discovered that X's S election had terminated on Date 3 as a result of Y's acquiring X stock.

In order to restore X's eligibility to be treated as an S corporation, Y distributed all of its X stock to Y's shareholders, A and B, on Date 5.

X represents that during the termination period it has timely and consistently filed its tax returns consistent with its treatment as an S corporation. Further, X represents that at all times since Date 1, X and all of its shareholders treated X as a valid S corporation. The termination was inadvertent, and no tax avoidance would result from treating X's S election as having never been terminated.

X and each person who was a shareholder of X during the termination period agree to make any adjustments (consistent with X's treatment as an S corporation) that are required by the Secretary with respect to the termination period. In addition, X represents that A and B will report their pro rata share of Y's share of X's items of income, loss, deduction and credit.

### Law and Analysis

Section 1361(a)(1) defines an S corporation as a small business corporation for which an election under section 1362(a) is in effect. Section 1361(b)(1) defines "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate, other than a trust described in section 1361(c)(2), and other than an organization described in (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(d)(2)(A) of the Code provides that an election to be treated as an S corporation terminates whenever (at any time on or after the first day of the first 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 date the S corporation ceases to meet the requirements of a small business corporation. Section 1362(d)(2)(B).

Section 1362(f) of the Code provides that if (1) an election to be treated as an S corporation was terminated under section 1362(d) (2) or (3), (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 such 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 of the corporation at any time during the period specified pursuant to this subsection, agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be

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required by the Secretary with respect to that 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 upon the information submitted and the representations set forth above, we conclude that the termination of X's S corporation election was inadvertent within the meaning of section 1362(f).

Pursuant to section 1362(f), X will be treated as continuing to be an S corporation from Date 3 through Date 5, and thereafter, provided that X's subchapter S election is not otherwise terminated under section 1362(d). During the period from Date 3 to Date 5, A and B will be treated as shareholders of X. Accordingly, A and B must include in income Y's pro rata share of the separately and nonseparately stated items of X as provided in section 1366, make any adjustments to stock basis as required in section 1367, and take into account any distributions made by X as provided in section 1368. If X or any of X's shareholders fail to treat X as described above, this ruling shall be null and void.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the above-described facts under any other provision of the Code. In particular, no opinion is expressed or implied concerning whether X's S election was valid under section 1362.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code 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 letter is being sent to your authorized representative.

Sincerely,  
Matthew Lay  
Assistant to the Branch Chief, Branch 1  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)  
Copy of this letter  
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