

Internal Revenue Service

Department of the Treasury
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Person To Contact:

Telephone Number:

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Date:

August 18, 2005

LEGEND:

X =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Dear

This letter responds to a letter dated July 11, 2005, submitted on behalf of X, requesting relief for an inadvertent invalid subchapter S election under § 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, X was incorporated on Date 1 under the laws of State. X elected to be an S corporation effective on Date 2. At the time of the S corporation election and pursuant to the advice of X's accountant, a portion of the X stock was held by entities treated as partnerships for federal tax purposes (the

Partnerships). It was intended that these entities be the nominees of eligible shareholders (the Shareholders). After the election, X's accountant died. X's new accountant recommended that the Partnerships distribute their X stock to the Shareholders and that X obtain a letter ruling in the event that one or more of the Partnerships were not merely nominees thereby causing X's S election to be ineffective. Between Date 3 and Date 4, the Partnerships distributed their X stock to the Shareholders and X made this request shortly thereafter.

X and the Shareholders represent that if there was an invalid S corporation election, it was inadvertent and was not motivated by tax avoidance or retroactive tax planning. X represents that since Date 2, X and its Shareholders have treated X as an S corporation and treated Shareholders as owners. X and its Shareholders agree to make any adjustments, consistent with the treatment of X as an S corporation that the Secretary may require.

LAW AND ANALYSIS

Section 1361(a)(1) 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)(B) provides that an S 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) will be terminated whenever (at any time on or after the 1st day of the 1st 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 the termination shall be effective on and after the date of cessation.

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 subsection (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 (A) so that the corporation is a small business corporation or (B) 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 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 such ineffectiveness,

such corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1361-1(e)(1) of the Income Tax regulations provides that the person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation. For example, a partnership may be a nominee of S corporation stock for a person who qualifies as a shareholder of an S corporation. However, if the partnership is the beneficial owner of the stock, then the partnership is the shareholder, and the corporation does not qualify as a small business corporation.

CONCLUSION

Based solely on the information submitted and the representations made, we conclude that X's S corporation election may have been ineffective for the taxable year beginning Date 2 because X may have had ineligible shareholders. We also conclude that the ineffectiveness of X's S election constituted an inadvertent invalid election within the meaning of § 1362(f). Therefore, we rule that X will be treated as an S corporation from Date 2, and thereafter, provided that X's S election was valid and was not otherwise terminated.

Accordingly, all of the shareholders of X, in determining their respective income tax liabilities for the period beginning Date 2 and thereafter must include their pro rata share of the separately stated and non-separately 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 themselves as described above, this ruling shall be null and void.

Except as specifically ruled upon above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provisions of the Code. Specifically, no opinion is expressed on whether X was otherwise eligible to be treated as an S corporation.

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.

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,

Beverly Katz
Acting Chief, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes