

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:2-PLR-133919-03
Date:
October 1, 2003

X =

Y =

Z =

A =

B =

C =

D =

E =

F =

G =

H =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year 1 =

Dear :

This is in reply to a letter dated May 29, 2003, submitted on behalf of X by X's authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that Y incorporated on Date 1 and filed a timely S corporation election effective Date 1. At the time of the S corporation election, all of Y's stock was owned by A. On Date 4, Y converted from an S corporation to a State limited liability company, X, via a state law merger. X, Y's successor entity, is treated as a partnership for federal tax purposes.

On Date 2, Y issued shares to Z, an ineligible shareholder, thereby terminating Y's S corporation election on Date 2. From Date 2 to Date 3, Y's shareholders were A, B, C, D, E, and Z. Neither Y's management nor its shareholders were aware that Z was an ineligible shareholder.

In Year 1, Y's management discovered that Z was an ineligible shareholder. Effective Date 3, Z distributed pro rata its stock of Y to its shareholders, F, G, and H. After Z's distribution of its shares of Y stock, Y no longer had an ineligible shareholder.

X represents that the transfer of Y stock to Z, an ineligible shareholder, was not motivated by tax avoidance or retroactive tax planning. For all taxable years Y and Y's shareholders' income was reported consistent with Y qualifying as an S corporation.

All the relevant shareholders of X and Y agree to make any adjustments (consistent with the treatment of Y as an S corporation) that the Secretary may require.

Section 1361(a)(1) of the Internal Revenue Code defines an "S corporation" as a small business corporation for which an 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 and other than a trust described in § 1361(c)(2) or an organization described in § 1361(c)(6)) who is not an individual.

Section 1362(d)(2) 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 a corporation is an S corporation) such corporation ceases to be a small business corporation. A termination of an S corporation election under § 1362(d)(2) is effective on and after the date of cessation.

Section 1362(f) provides 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 to obtain shareholder consents, or (B) was terminated under paragraph (2) or (3) of § 1362(d), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, 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 of 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 or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the information submitted and the representations made, we conclude that Y's S corporation election was terminated on Date 2 when Z, an ineligible shareholder, acquired Y stock. We also conclude that this termination was inadvertent within the meaning of § 1362(f).

We further hold that under the provisions of § 1362(f), Y will be treated as an S corporation from Date 2, and thereafter, provided that Y's S election was valid and was not otherwise terminated. From Date 2 to Date 3, E, G, and H will be treated as if they held their shares in Y directly.

Accordingly, all of the shareholders of Y, 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 Y as provided in § 1366, make any adjustments to basis provided in § 1367, and take into account any distributions made by Y as provided in § 1368. If Y 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 Y was otherwise eligible to be treated as 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 the power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,

J. Thomas Hines
Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: (2)
Copy of this letter
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