

Internal Revenue Service

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Person to Contact:

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April 28, 2000

Legend

X =

TRUST =

PRS =

A =

D1 =

D2 =

D3 =

D4 =

D5 =

STATE =

This responds to your representative's letter dated November 22, 1999, and subsequent correspondence, submitted on behalf of X requesting relief under § 1362(f) of the Internal Revenue Code for an invalid subchapter S election.

FACTS

X incorporated under STATE law on D1 and decided to elect subchapter S status as of D2. While completing the Form 2553, X determined that it had an ineligible shareholder, PRS. On D3, therefore, PRS transferred the X shares that it held to TRUST, which X represents was a qualified subchapter S shareholder under § 1361(c)(2). X's shareholders then filed Form 2553 on D4, electing subchapter S status for X as of D2. Unknown to X, its subchapter S election was invalid because X had an ineligible shareholder during the period D2 to D3.

On D5, A purchased the majority of X's stock. During A's due diligence of X's records, A discovered that X had an ineligible shareholder during the period D2 to D3, making its subchapter S election invalid.

LAW AND ANALYSIS

Section 1361(a)(1) provides that an "S corporation" is, with respect to a given year, a small business corporation for which an election under § 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 § 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 1361(c)(2)(A)(i) provides that, for purposes of § 1361(b)(1)(B), a trust all of which is treated (under subpart E of part I of subchapter J of chapter 1) as owned by an individual who is a citizen or resident of the United States, may be a shareholder.

Section 1362(f) provides, in part, that, if (1) an election under § 1362(a) by any corporation was not effective because of the failure of the corporation to meet the requirements of § 1361(b), (2) the Secretary determines that the circumstances resulting in the ineffective election were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness, steps were taken so that the corporation is 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 § 1362(f), agrees to make such adjustments (consistent with the treatment of the corporation as a subchapter S corporation) as may

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be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in the termination, the corporation will be treated as a subchapter S corporation during the period specified by the Secretary.

CONCLUSION

Based upon the information submitted and representations made, we conclude that X's subchapter S status was ineffectively elected as of D2. Therefore, under § 1362(f), X will be treated as an S corporation from D2 and thereafter provided: 1) notwithstanding the ineligible shareholder, X was otherwise eligible to be an S corporation on D2, and its election was timely and validly filed; 2) X's election was not otherwise terminated under § 1362(d), and, 3) during the period D2 to D3, TRUST will be treated as if it owned X's stock instead of PRS. Accordingly, pursuant to § 1361(d)(1), TRUST, in determining its income tax liabilities during the period from D2 to D3 when PRS owned the X shares, must include the pro rata share of the separately and nonseparately computed items of X as provided in § 1367, and take into account any distributions made by X as provided by § 1368. If X, PRS, TRUST, or any of X's other shareholders fail to treat X as described above, this ruling shall be void.

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 concerning whether X is a subchapter S corporation for federal tax purposes.

Pursuant to a power of attorney on file with our office, we are sending a copy of this letter to X. This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Signed/Dianna K. Miosi

Dianna K. Miosi

Chief, Branch 1

Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter

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