Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Number: **200205024**
Release Date: 2/1/2002
Index Number: 1362.04-00

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:3 PLR-123501-00
Date:
October 29, 2001

Company =

A =

B =

C =

D =

E =

F =

G =

H =

Partnership =

State =

Date 1 =

Year 1 =

Dear

This responds to your letter dated October 30, 2000, and subsequent correspondence, submitted on behalf of Company, requesting inadvertent termination relief under section 1362(f) of the Internal Revenue Code.

FACTS

On Date 1, Company was incorporated under the laws of State with eight shareholders (A, B, C, D, E, F, G, and H). Company filed a Form 2553 with the Internal Revenue Service Center to elect S corporation status under § 1362(a). The Service Center notified Company that its election had been accepted and was effective as of Date 1. Company filed a Form 1120S for Year 1.

When filing Form 2553, Company failed to attach certain shareholder consents. In addition, Company issued nonvoting shares to an ineligible shareholder, Partnership, instead of issuing the shares to shareholder A. After the matter was discovered, the corporate records were corrected to confirm A's ownership of the shares previously issued to Partnership. Consistent with A owning the stock, an amended Form 1120S and corresponding Schedule K-1's for Year 1 were filed with the Internal Revenue Service. The ratable portion of Company's items of income, loss, deduction or credit previously allocated to Partnership was reallocated to A. A included the reallocated items on A's individual federal income tax return. Company and each of its shareholders agree to make such adjustments or take such action (consistent with the treatment of Company as a S Corporation) as may be required by the Secretary with respect to the tax period in issue.

LAW AND ANALYSIS

Section 1361(b)(1) defines the term "small business corporation" to mean 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 and other than a trust described in § 1361(c)(2), or an organization described in § 1361(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(b)(1)(B) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not 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(a) provides, in part, that a small business corporation may elect to be an S corporation.

Section 1362(a)(2) provides that an election under § 1362(a) shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall 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(f) provides that if (1) an election under § 1362(a) by any corporation is 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 was terminated under § 1362(d)(2) or (3)), (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 so that the corporation is a small business corporation, or to acquire the required shareholder consents, (4) and 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 or termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) provides that, for purposes of § 1.1362-4(a), the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent.

CONCLUSIONS

Based on the facts submitted and representations made, we conclude that Company's S corporation election was inadvertently invalid for failure to attach certain shareholder consents to its election. If the election had been valid, Company's S

corporation status would have terminated when stock was issued to Partnership, an ineligible shareholder. Under § 1362(f), Company will be treated as if it were an S corporation from Date 1 and thereafter, provided Company's S corporation election was otherwise valid and not otherwise terminated under § 1362(d). A shall be treated as owning the stock transferred to Partnership. Accordingly A, and Company's other shareholders, in determining their respective income tax liabilities during the termination period and thereafter, must include their pro rata share of the separately and nonseparately computed items of Company as provided in § 1367, and take into account any distributions made by Company as provided by § 1368. If Company, or any of the shareholders fail to treat Company as described above, this ruling shall be void.

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed concerning whether Company is a S corporations for federal tax purposes.

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

A copy of this letter must be attached to any income tax return to which it is relevant.

Under a Power of Attorney on file with this office, we are sending a copy of this letter to the taxpayer and the second authorized representative.

Sincerely,
/s/
Christine Ellison
Chief, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

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