Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200430022**
Release Date: 7/23/04
Index Number: 1362.04-00

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:2 – PLR-169164-03
Date:
April 2, 2004

Legend

X:

Y:

A:

State:

D1:

D2:

D3:

D4:

D5:

Dear :

This responds to a letter dated December 4, 2003, and additional correspondence, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The represented facts are as follows: X was incorporated under State law on D1. X filed an election to be treated as an S corporation under § 1362 for its taxable year beginning D1. From D1 until D2, A, was the sole shareholder of X. On D3, A transferred some X stock to Y. None of the parties involved in the transfer of stock were aware that Y, an S corporation, was an impermissible S corporation shareholder.

On or around D4, X discovered that Y was an impermissible shareholder. On D5, Y agreed to transfer its X stock to A. X and its shareholders then requested inadvertent invalid election relief under § 1362(f) of the Code.

X represents that the circumstances resulting in the termination of X's S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning. X and its shareholders agree to make any adjustments required by the Secretary consistent with the treatment of X as an S corporation.

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) defines a "small business corporation" as a domestic corporation which is not an ineligible corporation and which does not (A) have more than 75 shareholders, (B) 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, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1362(f) provides, in relevant part, 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 § 1362(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 termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in ineffectiveness, 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 § 1362(f), agrees to make any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to the period, then, notwithstanding the circumstances resulting in the ineffectiveness, the corporation shall

be treated as continuing to be an S corporation during the period specified by the Secretary.

Based solely on the information submitted and the representations made, we conclude that A's transfer of X stock to Y on D3 terminated X's S election. We also conclude that the termination of X's S election was inadvertent within the meaning of § 1362(f). Accordingly, pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from D3 to D5 and thereafter, provided X's S election was valid and was not otherwise terminated under § 1362(d). Therefore, the shareholders of X, including Y, in determining their federal tax liability from D3 to D5, must include their pro rata share of the separately and nonseparately computed items of X as provided in § 1366, make any adjustments to stock basis as provided in § 1367, and take into account any distributions made by X to shareholders as provided § 1368. This ruling shall be null and void if the requirements of this paragraph are not met.

Except as specifically set forth above, we express no opinion concerning the federal tax consequences of the above-described facts under any other provision of the Code. Specifically, no opinion is expressed on whether X is otherwise eligible to be treated as an S corporation.

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

Sincerely,

Carolyn Hinchman Gray
Senior Counsel, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

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