Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B03
PLR-170748-03
Date:
September 29, 2004

In Re:

X =

State =

Shareholders =

a =

B =

c =

IRA =

d1 =

d2 =

d3 =

d4 =

d5 =

Dear :

This responds to your letter dated December 1, 2003, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

Facts

According to the information submitted, X was incorporated under the laws of State on d1. X elected to be an S corporation, effective d1.

On d2, X authorized the issuance of a shares of X stock to B. On d3, in accordance with B's instructions, X issued a shares to B's individual retirement account, IRA, in exchange for c. IRA is not an eligible shareholder of an S corporation under § 1361(b)(1)(B). Neither X nor X's shareholders were aware that the transfer of stock to IRA would terminate X's S corporation election.

On d4, X learned of the termination of X's S corporation election due to the transfer of stock to an ineligible shareholder. In order to correct this, X redeemed the shares of X stock held by IRA on d5. X represents that there was no tax avoidance or retroactive tax planning involved in the termination. In addition, X and Shareholders agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary with respect to the period specified by § 1362(f).

Law and Analysis

Except as provided in § 1362(g), § 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1361(b)(1)(D) provides that, for purposes of subchapter S, the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not, among other requirements, 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.

Rev. Rul. 92-73, 1992-2 C.B. 224, provides that a trust that qualifies as an IRA under § 408(a) is not a permitted shareholder of an S corporation under § 1361. In addition, Rev. Rul. 92-73 notes that, when an S corporation inadvertently terminates due to the transfer of S stock to an IRA, relief may be requested pursuant to § 1362(f).

Section 1362(d)(2)(A) provides that an election under § 1362(a) terminates whenever the corporation ceases to be a small business corporation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in termination, 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), agree to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary regarding this period, then, notwithstanding the circumstances resulting in termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) of the Income Tax Regulations provides that 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.

Section 1.1362-4(d) provides that the Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified by the Commissioner. In the case of a transfer of stock to an ineligible shareholder that causes an inadvertent termination under § 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of an S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent any loss of revenue due to a transfer of stock to an ineligible shareholder (e.g. a transfer to a nonresident alien).

Conclusion

Based solely on the facts submitted and representations made, we conclude that the termination of X's S corporation election due to the transfer of X stock to IRA was inadvertent within the meaning of § 1362(f). Consequently, we rule that X will continue to be treated as an S corporation from d3 to d5, and thereafter, unless X's S election otherwise terminates under § 1362(d).

As a condition for this ruling, for the tax period from d3 to d5 in which X reported a net loss, IRA will be treated as the shareholder of the a shares of stock. Otherwise, B must be treated as the shareholder of the a shares of stock for the tax period from d3 to d5. Accordingly, all shareholders of X must include the pro rata share of the separately

and nonseparately computed items attributable to those shares in their income as provide in § 1366, make adjustments to the stock basis of those shares as provided in § 1367, and take into account any distributions with respect to those shares as provided in § 1368. If X or its shareholders fail to treat X as described above, this ruling will be null and void.

Except for the specific ruling above, no opinion is expressed or implied concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed or implied regarding X's eligibility to be an S corporation.

Under a power of attorney on file with this office, we are sending a copy of this letter to X.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

/s/

James A. Quinn
Senior Counsel, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

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