Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:3
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Date:
November 22, 2004

LEGEND

X =

Y =

Z =

D1 =

D2 =

D3 =

D4 =

State =

A =

B =

C =

D =

E =

F =

G =

H =

m =

Dear :

We received your letter dated June 18, 2004, and subsequent correspondence on behalf of X, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code. This letter responds to your request.

FACTS

X was incorporated on D1 in State and elected to be treated as an S corporation effective D2. Prior to D3, X was owned by six individual shareholders, A, B, C, D, E, and F.

On D3, X sold shares of its stock to limited partnership Y, an ineligible shareholder of an S corporation. The general partner of Y was Z, an S corporation that owned an m% interest in Y. The limited partners of Y were A, E, G, and H. The shareholders of Z were A and H.

Effective D4, the shareholders of X sold 100% of their stock to a separate company that does not plan to operate X as an S corporation. Immediately before the sale to that company, X's shareholders were A, B, C, E, G, and Y.

X represents that it was unaware that selling shares of its stock to a limited partnership would terminate its S corporation election. X also represents that the termination of its S corporation election was inadvertent, unintended, and not the result of tax avoidance or retroactive tax planning.

X requests a ruling that the termination of its S corporation election was inadvertent within the meaning of § 1362(f). X and its shareholders agree to make any adjustments required by the commissioner consistent with the treatment of X as an S corporation.

LAW AND ANALYSIS

Section 1361(a) 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)(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 that except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1362(d)(2)(A) provides 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(d)(2)(B) provides that any termination under § 1362(d)(2) shall be effective on and after the date of cessation.

Section 1362(f) provides, in part, that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2), (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 such termination, steps were taken so that the corporation is a small business corporation, (4) the corporation, and each person who was a shareholder in 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 termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(d) of the Income Tax Regulations provides that the Commissioner may require any adjustments that are appropriate. In general, the adjustments 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).

CONCLUSIONS

Based solely upon the facts submitted and the representations made, we conclude that X's S corporation election terminated on D3, when X sold shares of its stock to Y, an ineligible shareholder of an S corporation. We further find that the termination was inadvertent within the meaning of § 1362(f).

Therefore, under the provisions of § 1362(f), X will continue to be treated as an S corporation for the period from D3 until D4, provided that X's S corporation election is valid, and not otherwise terminated under § 1362(d). Accordingly, X and its shareholders who were shareholders during the termination period must include the pro-rata share of the separately and nonseparately computed items attributable to those shares in their income as provided 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. Also during this period from D3 to D4, the shares of X held by Y must be treated as owned directly by Y's owners. The shareholders of Z, an S corporation that is the general partner of Y, shall be treated as directly owning the shares of X attributed to Z. If X or any of X's shareholder fail to treat X as described above, this ruling will be null and void. This ruling is contingent on X and X's shareholders filing amended returns consistent with this paragraph within 60 days of the date of this letter.

Except as specifically ruled above, we express or imply no opinion concerning the federal income tax consequences of the facts described above under any other provision of the Code. Specifically, we express or imply no opinion on whether Company is otherwise qualified to be an S corporation.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to X.

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

Sincerely yours,

/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