

Internal Revenue Service

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Number: **200235015**

Release Date: 8/30/2002

Index Number: 1362.04-00

Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:3 PLR-144369-01

Date:

May 29, 2002

LEGEND

X =

Y =

Z =

A =

B =

d1 =

d2 =

d3 =

d4 =

State =

Shareholders =

Dear _____ :

This letter responds to a letter, dated August 2, 2001, and subsequent correspondence from your authorized representative, requesting, on behalf of X, inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

FACTS

On d1, X was incorporated in State, and elected under § 1362 to be treated as an S corporation effective d1. Shareholders of X are comprised of individuals and trusts. X represents that Shareholder trusts were all eligible S corporation shareholders and has not requested a ruling on their status.

In d2, the Shareholders engaged in a series of transactions to recapitalize X. As part of the recapitalization, X's debt was paid off and its debt-holders were given X stock. In addition, shares of X stock were transferred to Y and Z, two family limited partnerships on d3. At the time of the transfer, X and its shareholders were unaware that Y and Z were ineligible shareholders of an S corporation and that transferring shares to them would terminate X's S corporation election. In d4, after discovering that X's shares were held by ineligible shareholders, Y and Z transferred their shares to A and B, respectively.

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.

Section 1362(a) provides that except as provided in § 1362(g), a small business corporation may elect to be an S corporation.

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(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), in part, provides 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 was inadvertent, (3) no later than a reasonable period of time after discovery of the event resulting in such termination, steps were taken (A) 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 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 termination, the corporation shall be treated as continuing to be an S corporation during the period specified by the Secretary.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that X's election to be treated as an S corporation was terminated on d3, when X's shares were transferred to Y and Z, ineligible S corporation shareholders. We also conclude that the termination was inadvertent within the meaning of § 1362(f). Pursuant to § 1362(f), X will be treated as continuing to be an S corporation from d3, and thereafter, provided that X's S corporation election was otherwise valid and is not otherwise terminated under § 1362 (d).

This ruling is contingent on X and all of its shareholders treating X as having been an S corporation for the period beginning d3 and thereafter. Accordingly, all of the shareholders in X, in determining their respective income tax liabilities for the period beginning d3, and thereafter, must include their pro rata share of the separately and nonseparately computed items of X as provided in § 1366, make adjustments to stock basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368. During the period of termination, the S corporation items attributable to the ineligible shareholders will be deemed to be that of A and B.

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, we express or imply no opinion on whether X is otherwise eligible to be an S corporation.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,
Christine Ellison
Chief, Branch 3
Office of Chief Counsel
Passthroughs and Special Industries

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