**Internal Revenue Service**

Department of the Treasury

Washington, DC 20224

Number: **200242024**
Release Date: 10/18/2002
Index Number: 1362.04-00

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:3-PLR-153574-01
Date:
July 16, 2002

**LEGEND**

Company =

Shareholders =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Bank =

A =

B =

X =

Dear :

This letter responds to a letter dated August 29, 2001, and subsequent correspondence, submitted on behalf of Company, requesting relief under § 1362(f) of the Internal Revenue Code.

## FACTS

The following facts have been represented. Company was incorporated in State on Date 1. Company elected S corporation status under § 1362(a) effective Date 1. On Date 2, A's individual retirement account (IRA), through its custodian Bank, loaned $X to Company. At that time, A and A's IRA were not shareholders in Company. B, a shareholder in Company, secured the loan with a personal guaranty secured by a pledge of Company's stock. Company subsequently defaulted on the loan. On Date 3, pursuant to the guaranty, B transferred some of her shares of Company's stock to Bank as custodian of A's IRA. Company and its shareholders were unaware that Bank was holding the stock for the benefit of A's IRA and that the transfer would terminate Company's S corporation election. When Company realized that an IRA was an ineligible shareholder, Bank, on Date 4, transferred all of the IRA's shares of Company's stock to A in his individual capacity.

Company, Shareholders, and Bank represent that the termination of Company's S election when B transferred Company's stock to Bank on behalf of A's IRA was inadvertent. Company and Shareholders also represent that they did not intend to engage in tax avoidance or retroactive tax planning. Furthermore, all items of income, gain, loss, deduction, and credit of Company were or will be reported as if A directly owned all of the shares held by Bank during the period from Date 3 to Date 4. Company and its Shareholders, including A, agree to make any adjustments, consistent with the treatment of Company as an S corporation, as might be required by the Secretary.

## LAW AND ANALYSIS

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect.

Section 1361(b)(1)(B) provides that, in order to be a small business corporation, a taxpayer cannot have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual.

Section 1.1361-1(f) of the Income Tax Regulations provides that except as otherwise provided in § 1.1361-1(e)(1) (relating to nominees and paragraph (h) relating to certain trusts), a corporation in which any shareholder is a corporation, partnership, or trust does not qualify as a small business corporation.

Section 1.1361-1(e)(1) provides that the person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation. For example, a partnership may be a nominee of S corporation stock for a person who qualifies as a shareholder of an S corporation. However, if the partnership is the beneficial owner of the stock, then the partnership is the shareholder, and the corporation does not qualify as a small business corporation.

Rev. Rul. 92-73, 1992-2 C.B. 224, holds that a trust that qualifies as an individual retirement account under § 408(a) of the Code is not a permitted shareholder of an S corporation under § 1361.

Section 1362(d)(2)(A) provides that an election to be treated as a subchapter S corporation terminates whenever (at any time on or after the first day of the first taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation. Under § 1362(d)(2)(B), the termination is effective on and after the date the S corporation ceases to meet the requirements of a small business corporation.

Section 1362(f) provides, in relevant part, that, if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d), (2) the Secretary determines that the termination was inadvertent, (3) no later than a reasonable period of time after discovery of the event resulting in the 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), 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 terminating event, the corporation shall be treated as an S corporation during the period specified by the Secretary.

## CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that Company's election to be treated as an S corporation terminated on Date 3 when B transferred Company stock to Bank who held the stock on behalf of A's IRA. We also conclude that the termination constituted an "inadvertent termination" within the meaning of § 1362(f).

We further hold that under the provisions of § 1362(f), Company will be treated as continuing to be an S corporation from Date 3, and thereafter, provided that Company's S corporation election was valid and was not otherwise terminated under § 1362(d). This ruling is contingent upon Company and Shareholders treating Company as having been an S corporation for the period beginning Date 3, and thereafter. In addition, during the period from Date 3 to Date 4, A will be treated as the owner of the IRA's shares of Company stock. Accordingly, A must include the IRA's percent of the separately and nonseparately stated items of Company as provided in § 1366, make any adjustments to stock basis as provided in § 1367, and take into account any distributions made by Company as provided in § 1368. This ruling is null and void if Company or A fails to comply with these requirements.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed on whether the original election made by Company to be an S corporation was a valid election under § 1362.

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

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

Sincerely,

/s/

Jeanne M. Sullivan
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

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