**Internal Revenue Service**

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Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:3 PLR-126438-04

Date:
January 25, 2005

Company:

M:

N:

Shareholders:

a:
b:
c:
d:
e:
f:
g:
h:

Dear :

This letter responds to a letter from your authorized representative dated May 12, 2004, as well as additional correspondence, submitted on behalf of Company, requesting a ruling under ' 1362(f) of the Internal Revenue Code that the termination of Company's S corporation election was inadvertent. Company represents the facts as follows.

FACTS

Company elected under ' 1362(a) to be an S corporation effective a. On b, Company issued shares of stock to M. On c, d, and e, Company issued shares of stock to N. Neither M nor N are permitted S corporation shareholders under § 1361(b)(1)(C). The termination of Company=s S corporation election on b due to the transfer of stock to an ineligible shareholder was discovered in f by an outside accountant as Company was in the preliminary stages of a potential transaction. In response to this discovery, Company canceled all of the shares it had issued to M and N and issued promissory notes to these ineligible shareholders for the amounts they had paid for the Company stock, effective e.

Company obtained new legal counsel in or around g, at which time Company was informed that its S corporation status had terminated and that it would have to file a request with the Service for a ruling granting relief for the termination.

Company represents that it had no intent of terminating its S corporation election, that the issuance of stock to M and N was not motivated by retroactive tax planning or the desire for tax avoidance, and that Company and its shareholders have continued to treat Company as an S corporation since the date of termination. Company and Shareholders agree to make adjustments during the termination period (consistent with the treatment of Company as an S corporation) as may be required by the Service.

LAW

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)(C) provides that, for purposes of subchapter S, the term Asmall business corporation@ means a domestic corporation that is not an ineligible corporation and that does not, among other things, have a nonresident alien as a shareholder.

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), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as might 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) 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 on the facts and representations submitted by Company, we conclude that the termination of Company's S corporation election due to the transfer of Company stock to M was inadvertent within the meaning of ' 1362(f). Consequently, we rule that Company will continue to be treated as an S corporation for all tax years for which the statute of limitations has not expired (presently, from h onward), unless Company's S election otherwise terminates under ' 1362(d) (taking no account of the inadvertent stock transfers to N on c, d, and e).

As a condition for this ruling, M and N must not be treated as shareholders for any time from h onward. Accordingly, for the time during this period that M and N did hold Company shares, Shareholders must include the prorata 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. Company must issue new Schedules K-1 for this period, and Shareholders must file amended income tax returns accordingly.

Except for the specific rulings above, no opinion is expressed or implied concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed or implied regarding Company'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 your authorized representative.

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 Associate Chief Counsel
(Passthroughs and Special Industries)

enclosure: copy of this letter
copy for ' 6110 purposes

cc: