

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact: _____, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B03
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Date:
September 26, 2007

LEGEND

Company =

State =

Employee =

IRA =

Shareholders =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

a =

b =

c =

x =

y =

z =

Dear :

This letter responds to your letter dated October 27, 2006, and subsequent correspondence, submitted on behalf of Company, requesting a ruling on the status of Company as an S corporation.

FACTS

Company incorporated under State law on Date 1, and made an S corporation election effective Date 2. During Company's c taxable year, Company was owned by Shareholders. Under Company's employee stock purchase program, Employee could buy shares of Company stock and Company would match Employee's stock purchase according to a matching formula. Under the program, Employee desired to have her IRA buy Company's stock. On Date 3, Company, Employee, and IRA executed a subscription agreement in which IRA was to purchase a shares of Company stock for x. Subsequently, IRA purchased the shares of Company stock on Date 4, for x. Due to a rounding error, Company refunded y to Employee as an adjustment to the purchase price of the a shares.

On Date 5, a clerical error caused Company to issue b shares of Company stock (amount of stock IRA purchased and amount of stock Company issued under its matching formula) to Employee (not to IRA). On Date 6, Company made a pro rata distribution to its shareholders, in which Company distributed z from Company's S corporation earnings to Employee. On or about Date 7, Company corrected the clerical error regarding the identity of the shareholder by issuing a new stock certificate to IRA dated Date 5, thereby voiding the prior stock certificate issued to Employee.

On Date 8, outside counsel for Company notified Company that an individual retirement account is ineligible to own S corporation stock. On Date 9, Company, Employee, and IRA entered into a rescission agreement. Under the rescission agreement, (1) Company voided the stock certificate issued to IRA and returned to IRA the purchase price of the shares of Company stock, and (2) Employee returned to Company the amount Company distributed to Employee and the amount Company refunded to Employee due to the rounding error. Company represents that no distributions were made to IRA.

LAW AND ANALYSIS

Section 1361(a) provides, in part, 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) provides, in part, 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) will be terminated 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.

The Service recognizes that a rescission may be given full effect in abrogating a transaction under certain conditions. When these conditions are met, the transaction is disregarded for federal income tax purposes. In this connection, Rev. Rul. 80-58, 1980-1 C.B. 181, states the general legal principles pertaining to the doctrine of rescission in the following terms:

The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.

The revenue ruling states that there are at least two conditions that must be satisfied for the remedy of rescission to apply to disregard a transaction for federal income tax purposes. First, the parties to the transaction must return to the status quo ante; that is, they must be restored to "the relative positions they would have occupied had no contract been made." Second, this restoration must be achieved within the taxable year of the transaction.

CONCLUSION

Company, Employee, and IRA were restored to the relative positions they would have occupied had Company's stock never been issued to IRA. In addition the restoration and the original transaction both occurred within Company's c taxable year. Therefore, the legal doctrine of rescission applies to (1) disregard Company's issuance

of Company stock to IRA and (2) prevent the termination of Company's S corporation status.

Based solely on the facts submitted and representations made, we rule that Company will be treated as continuing to be an S corporation during the period from Date 5 to Date 9, and thereafter, provided that Company's S corporation election was valid and was not otherwise terminated under § 1362(d). We further rule that during the period from Date 5 to Date 9, Shareholders will be treated as the shareholders of Company. Accordingly, Shareholders must include in income their pro rata shares of the separately and nonseparately stated items of Company under § 1366, make any adjustments to stock basis under § 1367, and take into account any distributions made by Company under § 1368. This ruling is null and void if Company or Shareholders fail to comply with these requirements.

Except as expressly provided herein, we express or imply no opinion concerning the federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion concerning whether Company is otherwise eligible to be an S corporation for federal tax purposes.

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

In accordance with a power of attorney on file with this office, a copy of this letter is being sent to Company's authorized representative.

Sincerely,

/s/

Mary Beth Collins
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2):

Copy of this letter
Copy for § 6110 purposes

cc: