



X was incorporated under the laws of State on Date 1, and elected to be treated as an S corporation effective Date 2.

On Date 3, a shareholder of X transferred w shares of X to A. A is not an eligible shareholder of an S corporation under § 1361(b)(1)(B). Neither X nor X's shareholders were aware that the transfer of stock to A would cause X's S corporation election to be terminated.

In Date 4, X learned of the termination of X's S corporation election due to the transfer of stock to an ineligible shareholder. As a corrective action, the shares of X were transferred to A's owners, all of whom were eligible shareholders.

X represents that, as of Date 3, the shareholders of X were not aware that A was prohibited from owning shares of X, and that such a transaction would terminate X's S corporation election. X also represents that the shareholders of X did not intend to terminate X's S corporation election.

### Law

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 1361(a)(1) 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, for purposes of subchapter S, 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) 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, and 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 for which the termination occurred

is a small business corporation, or to acquire the required shareholder consents; and (4) the corporation for which the termination occurred, and each person who was a shareholder in such corporation at any time during the period specified pursuant to § 1362(f), agrees to make such adjustments (consistent with the treatment of such 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.

### Conclusion

Based solely on the information submitted and the representations made, we conclude that X's S corporation election was terminated for the taxable year beginning Date 3 because A was an ineligible shareholder. We further conclude that the termination of X's S corporation election constituted an inadvertent termination within the meaning of § 1362(f). Accordingly, pursuant to the provisions of § 1362(f), X will be treated as an S corporation from Date 3 and thereafter, provided that X's S corporation election was otherwise valid and has not otherwise terminated under § 1362(d).

From Date 3 to Date 5, the former owners of A must be treated as directly owning a pro rata portion of the shares of X that were held by A, in addition to any other shares in X that they held during such period.

Accordingly, X's shareholders, in determining their respective income tax liabilities, must include their pro rata share of the separately and nonseparately computed items of X as provided in § 1366, make adjustments to basis as provided in § 1367, and take into account any distributions as provided in § 1368.

Except as specifically ruled above, we express or imply no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code.

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 a power of attorney on file with this office, a copy of this letter is being sent to X's authorized representatives.

Sincerely,

*David R. Haglund*

David R. Haglund

Chief, Branch 1

Office of the Associate Chief Counsel

(Passthroughs & Special Industries)

Enclosures (2)

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