

Internal Revenue Service

Department of the Treasury

Index Number: 1362.04-00

Washington, DC 20224

Number: **199944030**
Release Date: 11/5/1999

Person to Contact:

Telephone Number:

Refer Reply To:

CC:DOM:P&SI:1-PLR-111775-99

Date:

August 09, 1999

Legend

X =

A =

B =

D1 =

D2 =

D3 =

D4 =

D5 =

a =

State =

This responds to your representative's letter dated June 7, 1999, submitted on behalf of X, requesting a ruling under section 1362(f) of the Internal Revenue Code.

Facts

X is a corporation that was incorporated in State on D1. From D2 to D3, A was the sole shareholder in X. On D3, X issued a shares of X preferred stock to B (an owner of the business prior to D2) for no consideration as a purely ceremonial gesture.

PLR-111775-99

No dividends have been paid with respect to the preferred stock issued to B.

On D5, X filed an election to be treated as an S corporation effective D4. Also on D5, X's professional advisors realized that B held a shares of preferred stock, and that X's S corporation election was not valid. On D5, X converted the a shares of X preferred stock into X common stock.

X, A and B represent that the failure to qualify as a small business corporation was not motivated by tax avoidance or hindsight, and agree to make any adjustments (consistent with the treatment of X as an S corporation) that the Secretary may require for the period that the S election was ineffective.

Law and Analysis

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

Section 1361(b) defines a "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in section 1361(c)(2), or an organization described in section 1361(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Under section 1362(d)(2), an election under section 1362(a) is terminated whenever the corporation ceases to be a small business corporation.

Section 1362(f) provides that if: (1) an election under section 1362(a) by any corporation (A) was not effective for the taxable year for which made (determined without regard to section 1362(b)(2)) by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents, or (B) was terminated under paragraph (2) or (3) of section 1362(d); (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken (A) so that the corporation is a small business corporation, or (B) to acquire the required shareholder consents; and (4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to this subsection, 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 such period, then notwithstanding the circumstances resulting in such ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

PLR-111775-99

Conclusions

Based solely on the facts submitted and representations set forth above, we conclude that X's election to be an S corporation beginning on D4 was ineffective because, at the time of the election, X had more than one class of stock. We also conclude that the ineffectiveness of X's S corporation election was inadvertent within the meaning of section 1362(f).

Pursuant to section 1362(f), X will continue to be treated as an S corporation during the period from D4 to D5, and thereafter, unless X's S election is otherwise terminated under section 1362(d). In addition, during the period D4 to D5, A (and not B) will be treated as the owner of the preferred stock held by B. Therefore, A must include A's pro rata share of the separately stated and nonseparately computed items of X as provided in section 1366, make any adjustments to basis as provided in section 1367, and take into account any distributions made by X as provided in section 1368. If X or A fails to comply with the requirements of this paragraph, this ruling is null and void.

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.

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

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

Sincerely yours,

Signed/Daniel J. Coburn

DANIEL J. COBURN
Assistant to the Branch Chief, Branch 1
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter

Copy for section 6110 purposes

