

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Telephone Number:

Refer Reply To:

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Date:

September 2, 1999

X =

A =

B =

IRA =

Firm =

D1 =

D2 =

D3 =

Year 1 =

Dear :

This letter responds to your letter dated May 4, 1999, submitted on behalf of X requesting relief under § 1362(f) of the Internal Revenue Code.

The information submitted states that in Year 1, X analyzed the benefits of being an S corporation. Following its analysis, X decided to elect to be an S corporation for its taxable year beginning on D1. In order to meet the qualifications required for an S corporation, X reduced its number of shareholders. Following this reduction in shareholders, X believed that it was

qualified to be an S corporation.

In D2, while preparing its S corporation election, X contacted Firm to discuss the procedural requirements for obtaining shareholder consents to the S corporation election. Firm requested that X reconfirm that all of its shareholders were qualified to hold stock in an S corporation. In reviewing its shareholder list, X discovered that IRA, an individual retirement account for the benefit of A, held X stock. X believed that an individual retirement account was a qualified shareholder and asked Firm to confirm this. At that point, Firm advised X that an individual retirement account is not a qualified shareholder of an S corporation. In order to correct the problem, on D3, X acquired the shares held by IRA. Subsequently, X timely filed a Form 2553, Election by a Small Business Corporation, with an effective date of D1. B represents that with the exception of the ownership of X stock held by IRA, X qualified as a small business corporation under § 1361(b) on D1, and that when X filed the Form 2553, X met the qualifications of a small business corporation under § 1361(b).

B, as X's president, represents that the circumstances resulting in the invalidity of X's election to be an S corporation were inadvertent. As to IRA's holding of X stock, X believed all shareholders were qualified to hold S Corporation stock and only realized IRA was not a qualified shareholder when X proceeded in preparing its shareholder list and was advised by Firm. Additionally, X and each person who was or is a shareholder of X at any time since D1 agree to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary with respect to such period.

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 a "small business corporation" cannot 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.

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(f) provides that if (1) an election under § 1362(a) by any corporation was not effective for the taxable year for which made (determined without regard to § 1362(b)(2)) by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consents, or was terminated under paragraph (2) or (3) of § 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 so that the corporation is a small business corporation, or 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 § 1362(f), agree to make such 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 will be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts submitted and the representations made, we hold that X's election to be an S corporation effective D1 was ineffective because, from D1 until D3, IRA, which was not a qualified shareholder of an S corporation, held shares in X. We hold also that the ineffectiveness of X's S corporation election was inadvertent within the meaning of § 1362(f).

We further hold that under the provisions of § 1362(f), X will be treated as an S corporation effective D1 and thereafter, provided X's election to be an S corporation was not otherwise invalid and provided that the election was not terminated under § 1362(d). During the period from D1 to D3, A, for whose benefit IRA held X stock, will be treated as the owner of the X stock held by IRA. Accordingly, this individual and X's other shareholders must include their pro rata share of the separately and non-separately computed items as provided in § 1366, make adjustments to stock basis as provided in § 1367, and take into account any distributions made by X as provided by § 1368. If X, IRA, A, or any of X's other shareholders fails to treat themselves as described above, this ruling shall be null and void.

Except as specifically ruled above, we express 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 who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, we are forwarding a copy of this letter to X.

Sincerely yours,

H. GRACE KIM  
Assistant to the Chief  
Branch 2  
Office of the Assistant  
Chief Counsel  
(Passthroughs and  
Special Industries)

Enclosures: 2  
Copy of this letter  
Copy for § 6110 purposes