Internal Revenue Service

Department of the Treasury

Index Number: 1362.04-00

Washington, DC 20224

Number: **200031046**
Release Date: 8/4/2000

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:2 - PLR-100597-00
Date:
May 9, 2000

X =

A =

B =

IRA =

D1 =

D2 =

D3 =

D4 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

a =

b =

Dear :

This letter responds to a letter dated December 31, 1999, and subsequent correspondence submitted by you as X's authorized representative on behalf of X, requesting a ruling under

§ 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated on D1 of Year 1. A, the vice-president of X, represents that X became an S corporation for federal income tax purposes effective for Year 1, its first taxable year.

By agreement with X, B became eligible to purchase shares of X at the beginning of Year 2. B's banker advised B to have B's IRA (IRA), rather than B directly, purchase the X stock. A represents that neither B's banker nor the custodian of IRA ever indicated to B that IRA might not be an eligible S corporation shareholder. A further represents that no one working with or for X recognized the potential problem, and X's employees followed B's instructions to issue X stock to IRA in exchange for cash from IRA.

On D2 of Year 2, X transferred a certificate for a shares of X stock to IRA. On D3 of Year 3, X transferred a certificate for b shares of X stock to IRA.

During negotiations regarding a potential sale of X, outside attorneys discovered that X stock was held by an IRA. On D4 of Year 4, all of the shares of X stock that had been transferred to IRA were redeemed and canceled in the company records of X.

The president of X represents that the termination of its election to be taxed as an S corporation was inadvertent and was not motivated by tax avoidance intent.

For Year 2 and all subsequent taxable years, B has reported all corporate items of allocable income and loss on B's individual income tax returns. X and its shareholders consent to adjustments consistent with the treatment of X as an S corporation.

Section 1362(a) of the Code 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) of the Code 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.

For taxable years beginning on or before December 31, 1997, § 1361(b)(1)(B) provided 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 and other than a trust described in § 1361(c)(2)) who is not an individual.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall 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. Section 1362(d)(2)(B) provides that any termination under § 1362(d)(2)(A) shall be effective on and after the date of cessation.

Section 1362(f) of the Code provides that if (1) an election under § 1362(a) by any corporation (A) 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 (B) 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 (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 of the corporation at any time during the period specified pursuant to § 1362(f), agrees 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 shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts submitted, and the representations made, we conclude that the termination of X's S corporation election occurred on D2 of Year 2. We further conclude that the termination was an "inadvertent termination" within the meaning of § 1362(f).

In addition, we conclude that X's S corporation election would have terminated on D3 of Year 3. This potential termination would have been inadvertent within the meaning of § 1362(f).

We further hold that under the provisions of § 1362(f) of the Code, X will be treated as continuing to be an S corporation from D2 of Year 2 to D4 of Year 4, and thereafter, provided that X's S corporation election was valid and provided that the election was not otherwise terminated under § 1362(d). During the period from D2 of Year 2 to D4 of Year 4, B will be treated as a shareholder of X. As a shareholder of X, B must report B's pro rata share of the separately and nonseparately computed items of X as provided in § 1366, make any adjustments to stock basis

as provided in § 1367, and take into account any distributions made by X as provided in § 1368. If X or its shareholders fail to treat X as described above, this ruling will 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 that requested it. Section 6110(k)(3) of the Code 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 forwarded to X.

Sincerely yours,

J. THOMAS HINES
Acting Branch Chief
Branch 2
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
Copy of a letter
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