Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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Legend

X =

State =

Ineligible Shareholders =

Agreements =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

D8 =

$x =

This responds to a letter dated December 18, 2000, and subsequent correspondence, submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, X is a corporation organized under the laws of State. Effective D1, X elected to be treated as a subchapter S corporation.

X engaged in a series of private financing transactions that resulted in X issuing shares of stock to certain shareholders that were not eligible to hold S corporation stock (Ineligible Shareholders) from D2 through D6.

In addition, on or about D3, D4, and D5, and in anticipation of a contemplated initial public offering (IPO), X issued convertible subordinated debentures (Debentures) in the aggregate principal amount of $x. The IPO, however, never occurred.

On or about D7, X became aware that the Ineligible Shareholders were not permissible S corporation shareholders and that its S election had terminated on D2. X also became aware that the Debentures might constitute a second class of stock. As a result, X submitted this ruling request seeking relief under § 1362(f).

X represents that on or before D8, X took steps such that the Ineligible Shareholders no longer held shares of X stock. In addition, X represents that on or before D8, the Debentures were either converted to X stock or were surrendered for promissory notes.

X represents that it did not intend to terminate its S corporation status and that the acquisition of X stock by Ineligible Shareholders and the issuance of the Debentures was not motivated by tax avoidance or by retroactive tax planning. X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary with respect to the period specified by § 1362(f).

X seeks rulings that: (1) the termination of X's S election by virtue of the Ineligible Shareholders owning X stock constituted an "inadvertent termination" within the meaning of § 1362(f); and (2) to the extent the debentures constitute a second

class of stock, the termination of X's S election constituted an "inadvertent termination."

LAW AND ANALYSIS

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

Section 1361(b)(1) 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 § 1361(c)(2), or an organization described in § 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.

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 taxable year for which the corporation is an S corporation) the corporation ceases to be a small business corporation. Under § 1362(d)(2)(B), the termination is effective on and after the date the S corporation ceases to meet the requirements of a small business corporation.

Section 1362(f) provides, in relevant 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 the termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the termination, steps were taken so that the corporation is a small business corporation; 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 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 the termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

CONCLUSIONS

Based solely on the facts submitted and representations made, we conclude that X's S corporation election terminated as a result of the Ineligible Shareholders acquiring X stock. We conclude that the acquisition of stock by the Ineligible Shareholders constituted an "inadvertent termination" within the meaning of § 1362(f). We further conclude that, to the extent the Debentures constitute a second class of stock, any termination of X's S election as a result of the issuance of the Debentures also constituted an "inadvertent termination" within the meaning of § 1362(f). Accordingly, under the provisions of § 1362(f), X will be treated as being an S corporation from D2 and thereafter, provided that, apart from the inadvertent termination rulings above, X's S corporation election was otherwise valid and has not otherwise terminated under § 1362(d).

The shareholders of X must include their 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 to the shareholders as provided in § 1368.

The rulings in this letter are based on information and representations submitted by taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for ruling, it is subject to verification on examination.

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. Specifically, no opinion is expressed regarding whether the original election made by X to be treated as an S corporation was a valid election under § 1362(d).

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 the power of attorney on file with this office, a copy of this ruling is being sent to X and X's second listed authorized representative.

Sincerely,
Matthew Lay
Senior Technician Reviewer, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes