Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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Date:
January 25, 2002

X =

Y =

LP =

LLC =

A =

B =

C =

D1 =

D2 =

D3 =

D4 =

D5 =

State =

Dear :

This letter responds to a letter dated June 25, 2001, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting rulings under §§ 1361 and 1362(f) of the Internal Revenue Code.

The information submitted states that LLC was chartered in State on D1. At that time, A and B received membership interests in LLC. Also, at that time, A and B, the shareholders of X, an S corporation, transferred an aggregate of 1% of X to LLC. Additionally, X filed Articles of Conversion under State law, pursuant to which X

converted from a State corporation to a State limited partnership effective D2. X changed its name to LP. For federal tax purposes, LP elected to be classified as an association taxable as a corporation effective D2. LP represents that it was intended for LP to remain an S corporation.

A, B, X, and LP believed that pursuant to § 301.7701-3, LLC would be a disregarded entity for federal tax purposes. However, A and B remained the owners of LLC. Therefore, LLC was a partnership for federal tax purposes and not a disregarded entity. The shareholders of LP were not aware that a two member LLC is not a disregarded entity for federal tax purposes and therefore, not an eligible shareholder of an S corporation.

In D3, while reviewing LP's records, LP's accountant questioned whether LLC was an eligible shareholder of an S corporation. LP consulted with a law firm and discovered that LLC was not a disregarded entity and therefore, was not an eligible shareholder. Upon learning that a two member LLC was not an eligible shareholder of an S corporation, A transferred his ownership interest in LLC to B. As part of this transaction, C, B's spouse, became a 1% direct owner as a limited partner owner of LP.

B, LP's president, represents that the circumstances resulting in the termination of X's election to be an S corporation were inadvertent. B represents also that LP and its shareholders did not intend to engage in tax avoidance or retroactive tax planning. LP and each person who was or is a shareholder of LP 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.

Under LP's partnership agreement, LLC is the general partner and A, B, and C are the limited partners. On D4, LP requested a ruling under § 1362(f). However, due to the structure of LP, at that time, the Service could not rule as Rev. Proc. 2001-3, § 5.26 provided that the Service would not rule on whether a state law partnership electing to be classified as an association taxable as a corporation has more than one class of stock for purposes of § 1361(b)(1)(D).

On D5, LP was reorganized. Y, a corporation, was formed under State law. A, B, and C transferred all the limited partnership interests in LP to Y in exchange for common stock in Y. B transferred all of the outstanding member interest in LLC to Y. B represents that the transaction qualified as an exchange under § 351. Y filed Form 2553, an election to be an S corporation, effective D5. Y filed Form 8869, Qualified Subchapter S Subsidiary Election, for LP to treated as qualified subchapter S subsidiary. Following this restructuring, A, B, and C are the shareholders of Y, an S corporation. LP became a QSub of Y (99% direct ownership and 1% through LLC, a disregarded entity).

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 that is not an ineligible corporation and that does not have as a shareholder a person (other than an estate and other than a trust described in § 1361(c)(2) or an organization described in § 1361(c)(6)) 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) 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.

Section 301.7701-2(a) provides that for purposes of § 301.7701-3, a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code.

Section 301.7701-3(b)(1) provides guidance on the classification of domestic eligible entities for federal tax purposes. Generally, a domestic eligible entity with two or more members is classified as a partnership unless the entity elects otherwise; while a domestic eligible entity with a single owner is disregarded as a separate entity unless the entity elects otherwise.

Section 301.7701-2(b)(2) provides that for federal tax purposes, the term

corporation means an association (as determined under § 301.7701-3).

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7) or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in § 301.7701-3. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Section 1361(b)(3)(A) provides that a corporation which is a qualified subchapter S subsidiary shall not be treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and such items of the S corporation.

Section 1361(b)(3)(B) provides that for purposes of § 1361(b)(3), the term "qualified subchapter S subsidiary" means any domestic corporation which is not an ineligible corporation (as defined in § 1361(b)(2)) if (i) 100 percent of the stock of such corporation is held by the S corporation, and (ii) the S corporation elects to treat such corporation as a qualified subchapter S subsidiary.

Section 1.1361-4(a)(4) provides that except for purposes of § 1361(b)(3)(B) and § 1.1361-2(a)(1), the stock of a QSub shall be disregarded for all federal tax purposes.

Under § 1361(b)(3)(A) and § 1.1361-4, the separate existence of a QSub is disregarded for federal tax purposes such that all assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and items of income, deduction, and credit of the S corporation. In addition, § 1.1361-4 states that except for purposes of § 1361(b)(3)(B)(i) and § 1.1361-2(a)(1) (determining if the parent S corporation owns the requisite stock to make the QSub election), the stock of a QSub shall be disregarded for all Federal tax purposes.

For purposes of § 301.7701-3, a state law partnership is an eligible entity. Consequently, a state law limited partnership may elect to be classified as a corporation for federal tax purposes.

Accordingly, based on the information and representations provided, we conclude that LP is an association taxable as corporation pursuant to § 301.7701-3(c), and therefore, Y may elect to treat LP as a QSub under § 1361(b)(3).

Additionally, based solely on the facts submitted and the representations made, we hold that X's election to be an S corporation terminated on D1 because A and B transferred shares of X to an ineligible shareholder on that date. We hold also that the termination of X's S corporation election was inadvertent within the meaning of § 1362(f).

We further hold that under the provisions of § 1362(f), LP will be treated as an S corporation from D1 to D5, provided that X's election (X's original election which applies to LP) to be an S corporation was not invalid and provided that the election was not otherwise terminated under § 1362(d). From D1 to D5, A, B, and C (community property interest) will be treated as though they held their shares in LP directly, rather than through LLC. Additionally, from D1 to D5, A, B, and C 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 any of the shareholders fail 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. Specifically, we express no opinion regarding whether LP or Y is otherwise eligible to be an S corporation.

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) 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,
J. THOMAS HINES
Chief, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

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