Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Legend

X =

Y =

Z =

LLC1 =

LLC2 =

A =

B =

C =

State =

n =

D1 =

D2 =

D3 =

D4 =

D5 =

Dear :

This letter responds to a letter dated June 9, 2003, submitted by X's authorized representative on behalf of X, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

According to the information submitted, Y was incorporated under the laws of State on D1, and elected to be as an S corporation, effective D2.

On D3, Y converted to a State limited partnership. To effect the conversion, A and B, two shareholders of Y, each formed a State law single-member limited liability company, LLC1 and LLC2, respectively. A contributed n shares of Y stock to LLC1 in exchange for all the interests in LLC1. B contributed n shares of Y stock to LLC2 in exchange for all the interests in LLC2. After the conversion, LLC1 and LLC2 were the general partners of Z. A, B, and C were the limited partners of Z.

At the time of the conversion, Z simultaneously filed an election under § 301.7701-3 of the Procedure and Administration Regulations to be treated as an association taxable as a corporation. Although Z believed that the conversion would be treated for federal income tax purposes as a reorganization under § 368(a)(1)(F), and thus, a continuation of the original S corporation, Z filed a protective Form 2553, Election by a Small Business Corporation.

On or about D4, A, B, and C were advised by counsel that Y's conversion to a State limited partnership may have terminated its S corporation election. See generally § 5.03 of Rev. Proc. 2003-3, 2003-1 I.R.B. 113, 120 (providing that the Internal Revenue Service will not rule on whether a state law limited partnership electing to be classified as an association for federal tax purposes has more than one class of stock under § 1361(b)(1)(D)).

A, B, and C took the following remedial actions. On D5, A, B, and C formed X, a State limited liability partnership. In State, a limited liability partnership is a partnership formed under State's version of the Uniform Partnership Act and is treated as a general partnership. Under State law, a limited liability partnership does not present the distinctions in equity interests (limited vs. general) presented by a typical limited partnership. A, B, and C transferred all of their limited partnership interest in Z to X in exchange for an interest in X in the same proportion that A, B, and C had previously owned Y. A and B transferred their interests in their respective LLCs to X. X made an election to be classified as an association and an election to be treated as an S corporation, effective D5. Additionally, X made an election for Z to be a qualified subchapter S subsidiary (QSub), effective D5.

X represents that its motive for the conversion was the reduction of its State

franchise tax and not avoidance of federal tax. Moreover, X represents that it had no intention of terminating its S corporation election. X and its shareholders have agreed to make such adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary.

LAW AND ANALYSIS

Section 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1361(b)(1)(D) 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, among other things, have more than one class of stock.

Section 1362(d)(2)(A) provides that an election under § 1362(a) terminates whenever the corporation ceases to be a small business corporation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in termination, steps were taken so that the corporation is a small business corporation, 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 the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary regarding this period, then, notwithstanding the circumstances resulting in termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) of the Income Tax Regulations provides that the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent.

The Service is studying the issue of whether a state law limited partnership electing under § 301.7701-3 to be classified as an association taxable as a corporation has more than one class of stock for purposes of § 1361(b)(1)(D). Until the Service resolves this issue through published guidance, letter rulings will not be issued. The Service will treat any request for a ruling on whether a state law limited partnership is eligible to elect S corporation status as a request for a ruling on whether the partnership complies with § 1361(b)(1)(D). Rev. Proc. 2003-3, § 5.03, 2003-1 I.R.B. 113, 120 based on Rev. Proc. 99-51, 1999-2 C.B. 760.

CONCLUSIONS

Based solely on the facts represented, we conclude that if X's conversion from a State corporation to a State limited partnership did create a second class of stock, the consequent termination of X's S corporation election was inadvertent within the meaning of § 1362(f).

Therefore, we rule that X will continue to be treated as an S corporation for the period from D3 to D5, and thereafter, unless X's S election otherwise terminates under § 1362(d).

Except as specifically ruled above, we express no opinion concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding X's eligibility to be an S corporation or the validity of its S corporation election.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to your authorized representatives.

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

Sincerely yours,

Audrey W. Ellis
Reviewer, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
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cc: