Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:
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Refer Reply To:
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Date:
April 27 2004

Legend:

X =

D1 =

State =

D2 =

D3 =

Dear

This letter responds to the letter dated December 11, 2003, and related correspondence, written on behalf of X, requesting relief for inadvertent termination of subchapter S election under § 1362(f) of the Internal Revenue Code ("Code").

FACTS

The information submitted discloses that, X was incorporated on D1 under State law, and elected to be treated as an S corporation effective D1. On D2, a portion of X's stock were issued to certain Individual Retirement Account trusts ("IRAs") that are ineligible shareholders under § 1361(c)(1)(A).

X represents that upon discovery of the inadvertent error, it took immediate remedial action and redeemed all of the stock issued to the IRAs on D3. X and each of

its shareholders have agreed to make any adjustments that the Commissioner may require consistent with the treatment of X as an S corporation.

LAW AND ANALYSIS

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under section 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.

Section 1.1361-1(f) of the Income Tax Regulations provides that except as otherwise provided in § 1.1361-1(e)(1) (relating to nominees and paragraph (h) relating to certain trusts), a corporation in which any shareholder is a corporation, partnership, or trust does not qualify as a small business corporation.

Section 1.1361-1(e)(1) provides that the person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation. For example, a partnership may be nominee of S corporation stock for a person who qualifies as a shareholder of an S corporation. However, if the partnership is the beneficial owner of the stock, the partnership is the shareholder, and the corporation does not qualify as a small business corporation.

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(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. The termination is effective on and after the day of the cessation. § 1362(d)(2)(B).

Section 1362(f), in relevant part, 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 (B) was terminated under § 1362(d)(2); (2) the Secretary determines that the circumstances resulting in the ineffectiveness or termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were taken so that the corporation is once more 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 ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

CONCLUSION

Based solely on the facts submitted and representations made, we conclude that X's S election terminated upon the issuance of a portion of its stock to the IRAs on D2, and the termination constituted an "inadvertent termination" within the meaning of § 1362(f).

We also conclude that, pursuant to § 1362(f), X will be treated as an S corporation from D2 and thereafter, provided that X's S election was otherwise valid and has not terminated under § 1362(d).

In addition, during the period from D2 to D3, the beneficiaries of the IRAs will be treated as the owners of the IRAs' shares of X stock. Accordingly, each beneficiary must include their respective IRA's percent of the separately and nonseparately stated 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. This ruling is null and void if X or the IRA beneficiaries fail to comply with these requirements.

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 X's orginal election to be an S corporation was a valid election under § 1362.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being mailed to your authorized representative.

Sincerely,

David R. Haglund
Senior Technician Reviewer
Branch 1
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter
Copy for § 6110 purposes

cc: