Internal Revenue Service

Number: **200629017**
Release Date: 7/21/2006
Index Number: 1362.04-00

Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:3 PLR-154846-05

Date:
April 20, 2006

Company:

LLC:

M:

N:

P:

State:
a:

b:

c:

d:

Dear :

This letter responds to your letter dated September 12, 2005, as well as additional correspondence, submitted on behalf of Company, requesting a ruling under § 1362(f) of the Internal Revenue Code that the termination of Company's S corporation election was inadvertent. Company represents the following facts.

FACTS

Company was incorporated on a under the laws of State and elected under § 1362(a) to be an S corporation effective that same day.

M, the sole shareholder on the date of incorporation, sold b% of the shares of Company to N and P on c. P's attorney drafted the purchase documents showing LLC, an ineligible shareholder, as the initial shareholder of P's d% interest, thus causing Company's S corporation election to terminate on c.

Company represents that the termination of the S corporation election was inadvertent and not motivated by tax avoidance. It was the intent of the shareholders to operate Company as an S corporation. Contemporaneous documents identify P, rather than LLC, as one of the two purchasing shareholders. Company was unaware that it had an ineligible shareholder until an examination by the Internal Revenue Service. To correct the situation, Company has taken steps to conform documentation to the original intent of the shareholders. Company and its shareholders agree to make any adjustments during the termination period (consistent with the treatment of Company as an S corporation) as might be required by the Service.

LAW

Except as provided in § 1362(g), § 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)(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, among other things, 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 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 might 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.

Section 1.1362-4(d) provides that the Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified by the Commissioner. In the case of a transfer of stock to an ineligible shareholder that causes an inadvertent termination under § 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of an S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent any loss of revenue due to a transfer of stock to an ineligible shareholder (e.g., a transfer to a nonresident alien).

CONCLUSION

Based on the facts and representations submitted by Company, we conclude that the termination of Company's S corporation election due to the transfer of Company stock to LLC, an ineligible shareholder, was inadvertent within the meaning of § 1362(f). Consequently, we rule that Company will continue to be treated as an S corporation from c, and thereafter, unless Company's S election otherwise terminates under § 1362(d).

As a condition for this ruling, LLC must not be treated as a shareholder for any time it held Company shares. During the termination period when LLC held Company shares, P must be treated as the owner of those shares. Thus, P must include in his income the prorata share of the separately and nonseparately computed items attributable to the Company shares held by LLC during the termination period, as provided in § 1366, make adjustments to the stock basis of those shares as provided in

§ 1367, and take into account any distributions with respect to those shares as provided in § 1368.

Except for the specific ruling above, no opinion is expressed or implied concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed or implied regarding Company's eligibility to be an S corporation.

Under a power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

/s/

JAMES A. QUINN
Senior Counsel, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure: Copy of this letter
Copy for § 6110 purposes

cc: