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Person To Contact:
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Telephone Number:

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Date:
October 19, 2006

X =

Y =

A =

B =

n =

State =

D1 =
D2 =
D3 =
D4 =

Dear :

This responds to a letter dated July 17, 2006, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated in State on D1 and elected to be treated as an S corporation. At the time of incorporation, A and B were the sole shareholders of X. On D2, X converted from a State corporation to a State

limited partnership and elected to be treated as an association taxable as a corporation. Y was formed to act as the general partner in the limited partnership and was also wholly owned by A and B. A and B transferred an n general partnership interest to Y immediately after the conversion. Y was an ineligible S corporation shareholder, and X's S corporation status terminated on D2 when Y acquired an interest in the limited partnership.

On D3, after learning that Y was an ineligible shareholder, A and B liquidated Y and both received an equal share of Y's general partnership interest in X which they then both contributed to two separate newly formed single member limited liability companies that were both disregarded entities for federal tax purposes.

After D3, A and B were advised by their accountant that X's conversion to a State limited partnership may have also terminated its S corporation election. See generally section 5.06 of Rev. Proc. 2006-3, 2006-1 I.R.B. 122 (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 section 1361(b)(1)(D)). Once advised that the conversion may also have caused X's S election to terminate, X reorganized as a State corporation on D4.

X represents that its motive for the conversion was not avoidance of federal tax and that its shareholders were unaware of the consequences when the transfer of interests to Y were made. Moreover, X represents that it did not intend to terminate its S corporation election and that during the termination period it and its shareholders timely and consistently filed their tax returns consistent with the treatment of X as an S corporation. X and 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) of the Code 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 the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not 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 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 have more than one class of stock.

Section 1362(d)(2) provides that (A) in general, 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 and (B) any termination under § 1362(d)(2) 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 (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 to obtain shareholder consents or (B) was terminated under § 1362(d)(2) or (3), (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 (A) so that the corporation is a small business corporation or (B) to acquire the shareholder consents; 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 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 will be treated as an S corporation during the period specified by the Secretary.

The Service is studying the issue of whether a state law limited partnership electing under section 301.7701-3 to be classified as an association taxable as a corporation has more than one class of stock for purposes of section 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 section 1361(b)(1)(D). Rev. Proc. 2006-3, section 5.06, 2006-1 I.R.B. 122 based on Rev. Proc. 99-51, 1999-2 C.B.

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election terminated on D2 and that the termination was inadvertent within the meaning of § 1362(f). In addition, 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 section 1362(f). We further hold that, pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from D2 and thereafter, provided X's S corporation election was valid and provided that the election was not otherwise terminated under § 1361(d). The shareholders of X must include their pro-rata share of the separately stated and nonseparately computed items of X as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368. If X or its shareholders fail to treat themselves as described above, this ruling is null and void.

Specifically, this ruling is conditioned upon A and B being treated as the owners of the X interests held by Y effective D2, and thereafter. A and B must report their pro-rata shares of the items described above on their individual federal income tax returns. If they fail to do so, this ruling is 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 provisions of the Code.

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

Pursuant to a power of attorney on file, a copy of this letter is being sent to X's authorized representative.

Sincerely,

Bradford R. Poston
Senior Counsel, Branch 2
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

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