Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
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Refer Reply To:
CC:PSI:B03
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Date:
September 6, 2007

LEGEND

Company 1 =

Company 2 =

State =

Date 1 =

Date 2 =

Date 3 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

A =

B =

C =

D =

E =

F =

Purchaser =

Dear :

This letter responds to a letter dated January 22, 2007, and additional communication, submitted on behalf of Company 1, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

Company 1 was incorporated under the laws of State on Date 1 and elected under § 1362(a) to be an S corporation, effective that same date. On Date 2, Company 1 issued F shares of its common stock to each of A, B, and C. The terms of this issuance were not documented in a stock purchase agreement or any other type of writing. No stock certificates representing these shares were prepared, and no entries in Company 1's stock ledger were made. In the case of A, Company 2 provided the funds necessary to acquire Company 1 stock. Company 2 is an S corporation wholly owned by A.

When the Year 1 tax return for Company 1 was being prepared, D prepared a Schedule K-1 in the name of Company 2 to reflect treating Company 2 as the owner of those shares of Company 1 stock.

E prepared the Year 2 tax return for Company 1 and reviewed the Year 1 return. E did not notice that Company 2 was an ineligible shareholder of Company 1 and the Year 2 tax return and Schedule K-1 reflected this same treatment. E noticed this

treatment while preparing the Year 3 return but believed it to be a clerical error and not indicative of a termination of Company 1's S corporation status. Further, A's personal income tax return ultimately reported each of the items of income, loss, deduction and credit attributable to ownership of the Company 1 shares.

In late Year 4, in connection with a potential purchase of Company 1, Purchaser noted that Company 1's S corporation election was potentially terminated because an ineligible shareholder owned Company 1 stock. Accordingly, Company 1 seeks relief pursuant to § 1362(f).

On Date 3, Purchaser completed the purchase of Company 1 and Company 1's S corporation election terminated.

LAW AND ANALYSIS

Section 1361(a) 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) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (B) 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, (C) have a nonresident alien as a shareholder, and (D) have more than 1 class of stock.

Section 1362(a)(1) 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 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the 1st day of the 1st 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) shall be effective on and after the date of cessation.

Section 1362(f) provides, in part, that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2); (2) the Secretary determines that the circumstances resulting in such termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in such termination, steps were taken so that the corporation for which the termination occurred 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 with respect to such period; then, notwithstanding the circumstances resulting in such termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(d) of the Income Tax Regulations provides that the Commissioner may require any adjustments that are appropriate. In general, the adjustments 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 solely on the facts submitted and the representations made, we conclude that the termination of Company 1's S corporation election due to the transfer of Company 1 stock to Company 2 was inadvertent within the meaning of § 1362(f). Consequently, we conclude that Company 1 will be treated as an S corporation from Date 1 to Date 3.

Therefore, under the provisions of § 1362(f), Company 1 will continue to be treated as an S corporation for the period from Date 1 to Date 3, provided that Company 1's S corporation election is valid and not otherwise terminated under § 1362(d). Accordingly, for the time that Company 2 held Company 1 stock, the shareholders A, B, and C must include their pro rata shares of the separately and nonseparately computed items attributable to these shares in their income 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 as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion regarding Company 1's eligibility to be an S corporation.

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 sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

/s/

Leslie H. Finlow
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes