Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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September 20, 2007

Legend

X =

Y =

A =

B =

C =

D =

State =

Date1 =

Date2 =

Date3 =

Date4 =

Dear :

This responds to a letter dated May 8, 2007, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting relief pursuant to § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated under the laws of State on Date1, and elected to be treated as an S corporation effective Date1. On Date2, A, B, C, and D formed Y, a limited liability company under the laws of State treated as a partnership for federal tax purposes. On Date3, Y purchased all of the outstanding stock of X from A. At the time of transfer, Y was an ineligible S corporation shareholder, thereby terminating X's election as an S corporation on Date3. At the time of transfer, neither X nor its shareholders realized that Y was an ineligible S corporation shareholder and that the transfer of X stock to Y would terminate X's S corporation election under § 1362(d)(2). Upon discovery of the terminating event, Y agreed to transfer all of the X stock that it held to its members in the same proportion as their ownership interests in Y. This transfer of stock from Y to its members was completed on Date4. X represents that all of the members of Y that received transfers of X stock from Y on Date4 are eligible S corporation shareholders.

X represents that the circumstances resulting in the termination of X's S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning. 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.

Section 1361(a)(1) 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 1362(a) 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) will 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. Section 1362(d)(2)(B) provides that the termination 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 consent, or (B) was terminated under § 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the termination, steps were taken (A) so that the corporation is a small business corporation, or (B) to acquire the required 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 such termination, such 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 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., transfer to a nonresident alien).

Based solely upon the information submitted and the representations made, we conclude that X's S corporation election terminated on Date3, when shares of stock of X were transferred to Y. We further conclude that the termination was an inadvertent termination within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X

will be treated as continuing to be an S corporation on Date3, and thereafter, provided that X's S corporation election was not otherwise terminated under § 1362(d) for other reasons.

All of X's shareholders, in determining their respective income tax liabilities during the termination period and thereafter, must include their pro rata share of the separately stated items of income, loss, deduction or credit and nonseparately stated computed items of income or loss 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 to its shareholders as provided in § 1368. For this purpose, A, B, C, and D shall be treated as if they directly owned the outstanding shares of X owned by Y in the same proportion as each member's ownership interest in Y from Date3 through Date4. X and its shareholders shall make any adjustments as may be necessary, for federal tax purposes, consistent with this treatment. If X or its shareholders fail to treat themselves as described above, this ruling is null and void.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed regarding whether X otherwise qualifies as a small business corporation under § 1361.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) 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 X's authorized representative.

Sincerely,

James A. Quinn
Senior Counsel, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

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

cc: