Internal Revenue Service

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Third Party Communication: None
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Person To Contact:
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Telephone Number:

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Date:
October 10, 2007

X =

State =

A =

B =

C =

D =

E =

D1 =

D2 =

D3 =

D4 =

D5 =

Shareholders =

Dear :

This responds to a letter dated March 12, 2007, 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 made an election to be treated as an S corporation effective as of that date. On D2, shares of X were transferred to A. A was not an eligible S corporation shareholder as of the date of transfer, and X's S corporation election terminated on D2. Thereafter, X stock was also transferred to B, C and D on D3 and to E on D4, each of which were ineligible shareholders. The X stock held by all of the ineligible shareholders was reacquired by parties that are represented as being eligible S corporation shareholders in D5.

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 consent to make any 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) provides that the term "small business corporation" means a domestic corporation that is not an ineligible corporation and 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 1361(c)(2)(A)(i) provides that for purposes of § 1361(b)(1)(B), a trust all of which is treated (under subpart E of part I of subchapter J of chapter 1 of the Code) (a grantor trust) as owned by an individual who is a citizen or resident of the United States may be a shareholder of an S corporation. Section 1361(c)(2)(B)(i) provides that for purposes of § 1361(b)(1), in the case of a trust described in § 1361(c)(2)(A)(i), the deemed owner shall be treated as the shareholder.

Section 1362(d)(2) provides that 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. A termination of an S corporation election 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 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 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 any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to the period, then, notwithstanding the circumstances resulting in the termination, the corporation shall be treated as continuing to be an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) 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 that 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).

Based solely on the facts submitted and the representations made, we conclude that X's election to be treated as an S corporation terminated on D2 under § 1362(d)(2), because shares of X were transferred to an ineligible shareholder, and that this termination of X's S election was inadvertent within the meaning of § 1362(f).

We conclude that X's S election would have terminated on D3, under § 1362(d)(2), because shares of X were transferred to ineligible shareholders, and that this termination would have been inadvertent within the meaning of § 1362(f).

We also conclude that X's S election would have terminated on D4, under § 1362(d)(2), because shares of X were transferred to an ineligible shareholder, and that this termination would have been inadvertent within the meaning of § 1362(f).

Accordingly, pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from D2 to D5, and thereafter, provided X's S corporation election was valid and was not otherwise terminated under § 1362(d). 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 or loss 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.

Except as specifically provided herein, no opinion is expressed or implied as to the federal tax consequences of the facts described above under any other provisions of the Code. In particular, no opinion is expressed as to whether X is otherwise eligible to be an S corporation.

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.

Sincerely,

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

Enclosures: 2
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