Internal Revenue Service

Number: **200851008**
Release Date: 12/19/2008

Index Number: 1362.04-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B03
PLR-114450-08
Date:
September 15, 2008

Legend:

X =

LLC =

A =

B =

C =

State =

D1 =

D2 =

D3 =

D4 =

D5 =

Dear :

This letter responds to a letter dated February 27, 2008, and subsequent correspondence, written on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

Facts

According to the information submitted, X was incorporated under the laws of State on D1 and elected under § 1362(a) to be an S corporation, effective D1. On D2, shares of X stock were issued to LLC, an ineligible S corporation shareholder. The members of LLC during the period D2 to D3 were individuals B and C. Between D3 and D4, when all of the shares of X stock held by LLC were redeemed, the sole member of LLC was B.

On D5, X was informed by its tax advisor that LLC was an ineligible S corporation shareholder and that X's S corporation election had terminated as of D2. X filed for a private letter ruling soon afterward.

X and its shareholders represent that the termination of X's S corporation election was inadvertent and unintended. X was unaware that LLC was an ineligible S corporation shareholder. From D2 onward, X and its shareholders have consistently treated X as an S corporation and X's shareholders have consistently included their distributive shares of X's income on their respective federal income tax returns. X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation that the Secretary may require.

Law and Analysis

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 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 one class of stock.

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) 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. 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 that if (1) an election under § 1362(a) or § 1361(b)(3)(B)(ii) 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 paragraph (2) or (3) of § 1362(d) or § 1361(b)(3)(C), (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 such ineffectiveness or termination, steps were taken (A) so that the corporation for which the election was made or the termination occurred is a small business corporation or a qualified subchapter S subsidiary, as the case may be, or (B) to acquire the required shareholder consents, and (4) the corporation for which the election was made or the termination occurred, and each person who was a shareholder in such corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of such corporation as an S corporation or a qualified subchapter S subsidiary, as the case may be) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such ineffectiveness or termination, such corporation shall be treated as an S corporation or a qualified subchapter S subsidiary, as the case may be, during the period specified by the Secretary.

Section 1.1362-4(b) of the Income Tax Regulations provides that, for purposes of § 1.1362-4(a), 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.

Conclusion

Based solely on the facts submitted and representations made, we conclude that X's S corporation election terminated on D2 when shares of X stock were issued to LLC. We also conclude that this termination was inadvertent within the meaning of § 1362(f). Consequently, we rule that X will continue to be treated as an S corporation from D2, and thereafter, provided X's S corporation election was valid, and provided that the election is not otherwise terminated under § 1362(d).

During the termination period of D2 to D4, B and C shall be treated as the owners of X stock in proportion to their ownership interests in LLC. Accordingly, all of the shareholders of X, including A, in determining their respective income tax liabilities for the period beginning D2 and thereafter, must include their pro rata share of the separately and nonseparately computed items 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 as provided in § 1368.

LLC must not be treated as a shareholder for any period it held an interest in X. Accordingly, this ruling is conditioned on the members of LLC treating themselves as shareholders of X, directly owning the X stock they owned indirectly through LLC, as represented by their LLC ownership percentages. If X or its shareholders fail to treat themselves as described above, this ruling shall be null and void.

Except as specifically set forth above, 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 or implied as to whether X otherwise qualifies as a subchapter S corporation under § 1361.

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

This ruling is directed only to the taxpayer requesting it. Pursuant to § 6110(k)(3) of the Code, this ruling may not be used or cited as precedent.

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 Associate Chief Counsel
(Passthroughs & Special Industries)

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

cc: