Internal Revenue Service

Department of the Treasury

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LEGEND

Company =

State =

d1 =

d2 =

d3 =

d4 =

d5 =

Dear

This letter responds to a letter dated October 12, 1998, on behalf of Company, requesting relief under § 1362(f) of the Internal Revenue Code.

Facts

According to the information submitted, Company, a State corporation was incorporated on d1. On d2, Company filed a Form 2553, Election by a Small Business Corporation, effective for the taxable year beginning d3, to be treated as an S corporation as defined in § 1361(a).

At the time Company filed Form 2553, two Individual Retirement Accounts (IRAs) held shares in Company. Company's accountants had incorrectly advised Company that IRAs were permissible S corporation shareholders under § 1361(c)(6).

On d4, Company's accountants learned that IRAs are impermissible S corporation shareholders, and that Company's S corporation election was invalid. On d5, Company redeemed the stock from the IRAs.

Company and each of its shareholders who were shareholders during the period of invalidity agree to make any adjustments consistent with the treatment of Company as an S corporation.

Law and Analysis

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1361(b)(1)(B) provides that a "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not have as a shareholder a person (other than an estate and other than a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual.

Revenue Ruling 92-73, 1992-2 C.B. 224, holds that a trust qualified as an individual retirement account under § 408 is not a permitted shareholder of an S corporation under § 1361.

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 such 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 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 the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary for that period, then, notwithstanding the circumstances resulting in such ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

After applying the relevant law to the facts submitted and the representations made, we conclude that Company's election to be an S corporation beginning on d3 was ineffective because, at the time of the election, some of Company's shareholders were ineligible shareholders. We also hold that the ineffectiveness was inadvertent within the meaning of § 1362(f).

We further hold that under the provisions of § 1362(f), Company will be treated as an S corporation during the period of d3 through d5, and thereafter, provided

Company's S corporation election was not otherwise invalid and provided that the election was not terminated under § 1362(d). Additionally, during the period from d3 to d5, each individual whose IRA held Company stock will be treated as the owner of the Company stock held by the respective individual's IRA. Accordingly, those individuals and Company's other shareholders must include their pro rata share of the separately and nonseparately computed items of Company as provided in § 1366. If Company, the IRAs, the individuals whose IRAs held Company stock, or any of Company's other shareholders, fail to treat Company and the IRAs as described above, this ruling shall be null and void.

Except as specifically set forth above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provision in 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.

Sincerely yours,

William P. O'Shea
Chief, Branch 3
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

enclosures: copy of this letter
copy for § 6110 purposes