**Internal Revenue Service**

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B01
PLR-139261-05
Date:
August 23, 2005

Legend

X =

SH1 =

SH2 =

M =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

#a =

#b =

State =

Dear :

This responds to a letter from your authorized representative dated July 19, 2005, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code that the termination of X's S corporation election was inadvertent.

## FACTS

According to the information submitted and representations therein, X incorporated under the laws of State on D1, and elected S corporation status effective D2. On D3, SH1 and SH2 transferred by gift #a shares of X stock to M, an ineligible shareholder under § 1361(b)(1)(C), thereby terminating X's S corporation election. On D4, X made distributions with respect to its stock to its shareholders, including a distribution of #b to M.

The termination of X's S corporation election on D3 was discovered by X in D5. In response to this discovery, X, SH1, SH2, and M took steps so that X would be a small business corporation on D6.

X represents that at all times it has filed consistently with its belief that it was an S corporation. As soon as X discovered the terminating events, it initiated corrective action in order to once again become a small business corporation. Finally, X and each person who was a shareholder in X agree to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary.

## LAW AND ANALYSIS

Except as provided in § 1362(g), § 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1361(b)(1)(C) provides that, for purposes of subchapter S, the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not, among other things, have a nonresident alien as a shareholder.

Section 1362(d)(2)(A) provides that an election under § 1362(a) terminates whenever the corporation ceases to be a small business corporation.

Section 1362(f) provides in relevant part that if: (1) an election under § 1362(a) 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 for which the termination occurred, and each person who was a shareholder in such corporation at any time during the period specified pursuant to § 1362(f), agrees to make such adjustments (consistent with the treatment of such 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.

## CONCLUSION

Based solely upon the facts submitted and the representations set forth above, we conclude that the termination of X's S corporation election due to the transfer of X stock to M was inadvertent within the meaning of § 1362(f). Accordingly, we conclude that, pursuant to Section 1362(f), X will be treated as continuing to be an S corporation from D2 and thereafter, assuming X's S corporation election is valid and not otherwise terminated under § 1362(d).

As a condition for this ruling, M must not be treated as a shareholder for any time from D3 onward. Accordingly, for the time during this period that M did hold X shares, SH1 and SH2 must include the pro rata share of the separately and nonseparately stated computed items attributable to those shares in their income as provided in § 1366, make adjustments to the stock basis of those shares as provided in § 1367, and X must issue new Schedules K-1 for this period, and SH1 and SH2 must file amended income tax returns accordingly.

Except for the specific rulings above, no opinion is expressed or implied concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed or implied regarding X's eligibility to be an S corporation.

Under the power of attorney on file with this office, we are sending copies of this letter to your authorized representatives.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

/s/ Dianna K. Miosi

Dianna K. Miosi
Chief, Branch 1
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
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cc: