Internal Revenue Service

Number: **200701028**
Release Date: 1/5/2007

Index Number: 1362.04-00

Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:3 PLR-163991-05
Date:
October 03, 2006

Company =

LLC =

Trust 1 =

Trust 2 =

Trust 3 =

State =

Warrants =

A =

a =

b =

c =

d =

e =

Dear :

This letter responds to a letter dated December 19, 2005, and subsequent correspondence, submitted on behalf of Company, requesting rulings under § 1362(f) of the Internal Revenue Code.

FACTS

Company was incorporated in a under the laws of State. Company later elected under § 1362(a) to be an S corporation by filing Form 2553, Election by a Small Business Corporation, with an effective date of b. However, several of Company's shareholders from community property states failed to obtain required consents to the S corporation election. In addition, Trust 1, Trust 2, and Trust 3, ("Trusts") are shareholders of Company. While the Trusts consented to the S corporation election, the trustees of the Trusts failed to make elections for the trusts to be electing small business trusts ("ESBTs"). Therefore, the Trusts were ineligible S corporation shareholders at the time of Company's S corporation election.

Company represents that the circumstances resulting in its ineffective S corporation election were inadvertent. Company submits that it was unaware of consent requirements for community property shareholders and believed all required consents necessary to make its S corporation election effective had been obtained. In addition, Company submits that it was unaware of a separate requirement that each of the Trusts makes an ESBT election.

On c, Company issued certain Warrants for the purchase of its common stock. The Warrants were issued to several persons.

Effective on d, A, a shareholder of Company through a grantor trust, transferred Company stock to LLC, an ineligible shareholder. The transfer was impermissible under Company's incorporating documents. A section of Company's articles of incorporation specifically prohibits the transfer of Company stock to any ineligible shareholder. The articles further provide that the transfer of Company stock to an ineligible shareholder shall be void ab initio. After Company's accounting firm became aware of the stock transfer and possible termination of Company's S corporation election, LLC transferred the shares of Company stock to A on e.

Company represents that the possible terminating events were not motivated by tax avoidance or retroactive tax planning. In addition, Company and its shareholders agree to make any necessary adjustments consistent with the treatment of Company as an S corporation.

LAW

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 1362(a)(2) provides that such an election shall be valid only if all of the persons who are shareholders in the corporation on the day on which the election is made consent to the election.

Section 1361(b)(1)(B) 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 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 1361(c)(2)(A)(v) provides that, for purposes of § 1361(b)(1)(B), an electing small business trust (ESBT) may be a shareholder.

Section 1361(e)(1)(A) provides that for purposes of § 1361, except as provided in § 1361(e)(1)(B), the term "electing small business trust" means any trust if – (i) the trust does not have as a beneficiary any person other than an individual, an estate, an organization described in § 170(c)(2), (3), (4), or (5), or an organization described in § 170(c)(1) that holds a contingent interest in the trust and is not a potential current beneficiary; (ii) no interest in the trust was acquired by purchase; and (iii) an election under § 1361(e) applies to the trust.

Section 1361(e)(3) provides that an election under § 1361(e) shall be made by the trustee. Any such election shall apply to the taxable year of the trust for which made and all subsequent taxable years of the trust unless revoked with the consent of the Secretary.

Section 1.1362-6(b)(1) of the Income Tax Regulations provides, in part, that except as provided in § 1.1362-6(b)(3)(iii), the S corporation election of the corporation is not valid if any required shareholder consent is not filed in accordance with the rules contained in § 1.1362-6(b).

Section 1.1362-6(b)(2)(i) provides that when stock of the corporation is owned by husband and wife as community property (or the income from the stock is community

property), or is owned by tenants in common, joint tenants, or tenants by the entirety, each person having a community interest in the stock's income therefrom and each tenant in common, joint tenant, and tenant by the entirety must consent to the election

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

For S corporation elections made and terminations occurring before January 1, 2005, § 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 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 the 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 with respect to this period, then, notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

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., a transfer to a nonresident alien).

Section 1361(a) provides that an S corporation is a small business corporation for which an election under § 1362(a) is in effect. Section 1361(b)(1) sets forth the requirements for a small business corporation. Section 1361(b)(1)(D) provides that the corporation may not have more than one class of stock.

Section 1.1361-1(l)(4)(i) provides, in pertinent part, that instruments, obligations, or arrangements are not treated as a second class of stock for purposes of § 1.1361-1(l)

(the single-class-of-stock requirement) unless they are described in § 1.1361-1(l)(4)(ii) or (iii).

Section 1.1361-1(l)(4)(iii) provides, in part, that except as otherwise provided in § 1.1361-1(l)(4)(iii), a call option**,** warrant, or similar instrument (collectively, call option**)** issued by a corporation is treated as a second class of stock of the corporation if, taking into account all the facts and circumstances, the call option is substantially certain to be exercised (by the holder or a potential transferee) and has a strike price substantially below the fair market value of the underlying stock on the date that the call option is issued, transferred by a person who is an eligible shareholder under § 1.1361-1(b)(1) to a person who is not an eligible shareholder under § 1.1361-1(b)(1), or materially modified.

CONCLUSIONS

Based solely on the facts submitted and the representations made, we conclude that Company's S corporation election was ineffective for the taxable year beginning b. We also conclude that the ineffectiveness of Company's S corporation election was inadvertent within the meaning of § 1362(f).

In addition, we conclude that under § 1362(f), Company will be treated as an S corporation from b, and thereafter, provided Company's S corporation election is otherwise valid and is not, except as addressed below, otherwise terminated under § 1362(d). In addition, Trust 1, Trust 2, and Trust 3 will be treated as trusts described in § 1361(e)(1) from b, and thereafter, provided the Trusts satisfy the requirements to be ESBTs. Accordingly, the shareholders of Company must include their pro rata shares of the separately and nonseparately 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 take into account any distributions with respect to those shares as provided in § 1368.

We further conclude that to the extent Company's S corporation election terminated due to the issuance of the Warrants on c, the termination was inadvertent within the meaning of § 1362(f). Consequently, we rule that Company will continue to be treated as an S corporation from c, and thereafter, provided Company's S election is not otherwise terminated under § 1362(d). We also conclude that Company's S corporation election terminated due to the transfer of Company stock to LLC on d, and that the termination was inadvertent within the meaning of § 1362(f). Consequently, we rule that Company will continue to be treated as an S corporation from d, and thereafter, provided Company's S election is not otherwise terminated under § 1362(d).

As a condition for this ruling, LLC must not be treated as shareholder for any time it held Company stock. Accordingly, for the time LLC did hold Company stock, A must include the pro rata shares of the separately and nonseparately computed items attributable to those shares in A's income as provided in § 1366, make adjustments to the stock basis of those shares as provided in § 1367, and take into account any distributions with respect to those shares as provided in § 1368.

These rulings are also conditioned on Company, within 60 days of the date of this letter, filing a new Form 2553 that contains the proper consents, with an effective date of b, with the appropriate service center. Furthermore, the trustees of the Trusts must make valid ESBT elections for the Trusts, effective b, with the appropriate service center within 60 days of the date of this letter. A copy of this letter should be attached to the new Form 2553 and to the ESBT elections.

Except for the specific rulings above, we express or imply no opinion concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion regarding Company's eligibility to be an S corporation or the Trusts' eligibility to be ESBTs.

Under a power of attorney on file with this office, we are sending a copy of this letter to Company's 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/

MARY BETH COLLINS
Senior Technician Reviewer, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

enclosures: copy of this letter
copy for § 6110 purposes

cc: