Internal Revenue Service

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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
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Date:
August 21, 2007

Legend

X =

LLC =

A =

B =

C =

D =

E =

F =

G =

State =

d1 =

d2 =

d3 =

d4 =

Dear :

This letter responds to your letter dated April 18, 2007, and subsequent correspondence, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

Facts

X was incorporated under the laws of State on d1 and elected to be an S corporation effective d1. On d2, A and B, the sole shareholders of X, sold their shares of X stock to LLC, an ineligible S corporation shareholder. Consequently, X's S corporation election terminated on d2. In d4, X learned that LLC was ineligible to own S corporation stock. Immediately thereafter, on d3, LLC distributed X stock to its members, C, D, E, F, and G, all of whom are individuals, in accordance with their ownership percentages in LLC.

X represents that there was no tax avoidance or retroactive tax planning involved in the sale of its stock to LLC. X was unaware that LLC was an ineligible S corporation shareholder. X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary with respect to the period specified by § 1362(f).

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)(B) provides, in part, 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 requirements, 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 1362(d)(2)(A) provides that an election under § 1362(a) is 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) is 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 the termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the 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 the corporation at any time during the period specified pursuant to § 1362(f), agree 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 such period, then, notwithstanding the circumstances resulting in the termination, the corporation shall be treated as an S corporation 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.

Conclusion

Based solely on the facts submitted and representations made, we conclude that X's S corporation election terminated on d2 when LLC, an ineligible shareholder, acquired X stock. We also conclude that this termination was inadvertent within the meaning of § 1362(f). Consequently, we conclude that X will continue to be treated as an S corporation from d2 and thereafter, provided that X's S corporation election was valid and was not otherwise terminated.

During the termination period of d2 to d3, C, D, E, F, and G shall be treated as the owners of X stock in accordance with their ownership percentages in LLC. Accordingly, C, D, E, F, and G, in determining their respective income tax liabilities during the termination period and thereafter, must include their pro rata share of the separately and nonseperately computed items of X under § 1366, make any adjustments to stock basis under § 1367, and take into account any distributions made by X under § 1368.

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

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

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 the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2):
Copy of this letter
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