Internal Revenue Service

Number: **200408011**
Release Date: 2/20/04
Index Number: 1362.04-00, 1362.00-00

Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B01 – PLR-143675-03
Date:
Nov 10 2003

Legend:

X =

D1 =

State =

D2 =

A =

B =

D3 =

D4 =

Y =

D5 =

Dear

This letter responds to the letter dated July 18, 2003, and related correspondence, written on behalf of X, requesting relief for inadvertent invalid subchapter S election under § 1362(f) of the Internal Revenue Code ("Code").

FACTS

The information submitted discloses that, X was incorporated on D1 under State law, and elected to be treated as an S corporation effective for its taxable year beginning D2. Also effective D2, X elected to treat A, a wholly owned subsidiary, as a qualified subchapter S subsidiary ("QSub"). X elected treat B, also a wholly owned subsidiary, as a QSub, effective D3.

As of D2, X was unaware that, on D4, a portion of X's stock was transferred to Y, a partnership. Subsequently, upon a review of corporate matters, X's accountant and legal counsel discovered that on D2 a portion of X's stock was held by Y, an ineligible shareholder. To rectify the error, X immediately initiated action to have the portion of stock then held by Y transferred back to X's eligible shareholder. Shortly thereafter, on D5, Y transferred the stock to back to X's eligible shareholder.

LAW AND ANALYSIS

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

Section 1361(b)(1)(B) provides that a small business corporation cannot 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) shall be terminated whenever (at any time on or after the first day of the taxable year for which the corporation is an S corporation) the corporation ceases to be a small business corporation. The termination is effective on and after the day of the cessation. § 1362(d)(2)(B).

Section 1361(b)(3)(B) defines a QSub as a domestic corporation that is not an ineligible corporation, if 100 percent of the stock of the corporation is owned by an S corporation, and the S corporation elects to treat the corporation as a QSub.

Section 1362(f), in relevant part, 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 (B) was terminated under § 1362(d)(2); (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 so that the corporation is once more a small business corporation; and (4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to this subsection, agrees to make such 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 ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

CONCLUSION

Based solely on the facts submitted and representations made, we conclude that X's S election was ineffective for the taxable year beginning on D2 because Y was an ineligible shareholder of X. We further conclude that the ineffectiveness of X's S election constituted an inadvertent invalid election within the meaning of § 1362(f). In addition, we conclude that the inadvertent invalid S election does not affect the status of A and B as QSubs.

Under the provisions of § 1362(f), X will be treated as an S corporation from D2, and thereafter, provided that, apart from the inadvertent invalid election ruling above, X's S election was otherwise valid and has not otherwise terminated under § 1362(d), and provided that the QSub elections were otherwise valid and have not otherwise terminated.

This ruling is contingent upon X and all its shareholders treating X as having been an S corporation for the period beginning D2, and thereafter.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed regarding whether X is otherwise eligible to be an S corporation or whether A and B are otherwise eligible to be QSubs.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being mailed to your authorized representative.

Sincerely,

/s/ David R. Haglund

David R. Haglund
Senior Technician Reviewer
Branch 1
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter
Copy for § 6110 purposes