Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200439007**
Release Date: 9/24/04
Index Number: 1362.04-00

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B01 – PLR-103000-04
Date:
May 28, 2004

Legend:

X =

Y =

a =
b =
D1 =
D2 =
D3 =
D4 =
D5 =

Dear :

This responds to your letter dated December 30, 2003, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

Facts

According to the information submitted and representations therein, X was organized on D1. Y, a wholly owned subsidiary of X, was organized on D2. X elected to be an S corporation effective D3. X also made an election to treat Y as a qualified subchapter S subsidiary (QSub) effective D3.

It was discovered that at the time of both elections, a of the shareholders of X held a portion of their shares in their individual retirement accounts (IRAs), which were

ineligible shareholders. On or about D4, X was informed by its accountants of the invalid election. To rectify the situation, all b shares owned by the IRAs were sold to eligible shareholders on D5.

X and its shareholders have agreed to make any adjustments that the Commissioner may require consistent with the treatment of X as an S corporation and Y as a QSub.

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 such year.

Section 1361(b)(1)(B) provides that a small business corporation cannot have 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. Section 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 D3 because b shares of X were held by a ineligible shareholders. 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 Y as a QSub of X.

Under the provisions of § 1362(f), X will be treated as an S corporation from D3, and thereafter, provided that X's S election was otherwise valid and has not otherwise terminated under § 1362(d) and provided that the QSub election was otherwise valid and has not otherwise terminated.

Furthermore, during the period from D3 to D5, each individual whose IRA held shares of X will be treated as the owner of the X shares held by the respective individual's IRA.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provisions of the Code. Specifically, no opinion is expressed regarding whether X is otherwise eligible to be an S corporation or whether Y is otherwise eligible to be a QSub.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) 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
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures(2):
Copy of this letter
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cc: