Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
June 5, 2002

Legend

X =

LP =

LLC =

Corp 1 =

Corp 2 =

A =

B =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

State 1 =

State 2 =

a% =

b% =

c% =

Dear

This letter responds to your letter dated October 11, 2001, submitted on behalf of X requesting a ruling under §1362(f) of the Internal Revenue Code.

FACTS

The facts state that X was incorporated on Date 1 and elected to be treated as an S corporation, effective on Date 1. A and B were equal shareholders of X. On Date 2, A and B each transferred a% of total X stock to LP, a State 1 limited partnership. LP was owned by A and B and Corp 1. Corp 1, in turn, was owned by A and B.

On Date 3, X converted from a State 1 corporation, to a State 1 limited partnership. X filed a Form 8832, Entity Classification Election, requesting that X be treated as an association taxable as a corporation under federal law, effective Date 3. It was X's intent that the conversion from a State 1 corporation to a State 1 limited partnership would qualify as a reorganization under §368(a)(1)(F) and have the S election continue.

On Date 4, X was notified that LP was an ineligible shareholder. Shortly thereafter, on or about Date 5, X's ownership was restructured so that LP was removed as an owner of X. LLC, a State 1 limited liability company that was wholly owned by A and treated as a disregarded entity, replaced LP and held b% of X. Therefore, X was equally owned by A and B.

On Date 6, X retained attorneys to submit a request for a ruling under §1362(f) that the transfer of the stock to LP caused an inadvertent termination, and that X would be treated as an S corporation since Date 2. X was advised that, pursuant to §5.26 of Rev. Proc. 2000-3, the Service would not rule on whether a state law limited partnership has more than one class of stock for purposes of §1361(b)(1)(D), and thus would not grant §1362(f) relief to a limited partnership asserting S corporation status.

Before making a request for this ruling under §1362(f), X took the following remedial measures on Date 7. A and B formed Corp 2 under State 2 law. A transferred all of his interest in both X and LLC to Corp 2, solely in exchange for common stock. B transferred all of his interest in X to Corp 2, solely in exchange for common stock. Therefore, X became wholly owned by Corp 2 (c% directly and b% through Corp 2's wholly owned LLC). Corp 2 filed a Form 2553, Election by a Small Business Corporation, to be treated as an S corporation, effective Date 7. Corp 2 filed a Form 8869, Qualified Subchapter S Subsidiary Election, electing to treat X as a Qualified Subchapter S Subsidiary (QSub), effective Date 7.

X represents that X and its shareholders did not intend to engage in tax avoidance or retroactive tax planning. X requests a ruling under § 1362(f), that A and B's transfers of shares to LP caused an inadvertent termination that was corrected within a reasonable amount of time after discovery. X further requests under § 1362(f) that X be treated as an S corporation since the date of the termination on Date 2.

LAW AND ANALYSIS

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

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 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 have as a shareholder a person (other than an estate and other than 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 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)(A) shall be effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation 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 to obtain shareholder consents, or was terminated under paragraph (2) or (3) of § 1362(d), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken so that the corporation is a small business corporation, or to acquire the required shareholder consents, and (4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to § 1362(f), agree 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 such ineffectiveness or termination, the corporation will be treated as an S corporation during the period specified by the Secretary.

Section 301.7701-2(a) of the Procedure and Administration Regulations provides that for purposes of § 301.7701-3, a business entity is any entity recognized for federal

tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code.

Section 301.7701-3(b)(1) provides guidance on the classification of domestic eligible entities for federal tax purposes. Generally, a domestic eligible entity with two or more members is classified as a partnership unless the entity elects otherwise; while a domestic eligible entity with a single owner is disregarded as an entity separate from its owner unless the entity elects otherwise.

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7) or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in § 301.7701-3. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Section 1361(b)(3)(A) provides that a corporation which is a qualified subchapter S subsidiary shall not be treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and such items of the S corporation.

Section 1361(b)(3)(B) provides that for purposes of § 1361(b)(3), the term “qualified subchapter S subsidiary” means any domestic corporation which is not an ineligible corporation (as defined in § 1361(b)(2)) if (i) 100 percent of the stock of such corporation is held by the S corporation, and (ii) the S corporation elects to treat such corporation as a qualified subchapter S subsidiary.

Section 1.1361-4(a)(4) of the Income Tax Regulations provides that except for purposes of § 1361(b)(3)(B) and § 1.1361-2(a)(1), the stock of a QSub shall be disregarded for all federal tax purposes.

Under § 1361(b)(3)(A) and § 1.1361-4, the separate existence of a QSub is disregarded for federal tax purposes such that all assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and items of income, deduction, and credit of the S corporation. In addition, § 1.1361-4 states that except for purposes of § 1361(b)(3)(B)(i) and § 1.1361-2(a)(1) (determining if the parent S corporation owns the requisite stock to make the QSub election), the stock of a QSub shall be disregarded for all Federal tax purposes.

For purposes of § 301.7701-3, a state law partnership is an eligible entity. Consequently, a state law limited partnership may elect to be classified as a corporation for federal tax purposes.

CONCLUSION

Based solely on the facts submitted and the representations made, we hold that X's election to be an S corporation terminated on Date 2 because A and B transferred shares of X to an ineligible shareholder on that date. We hold also that the termination of X's S corporation election was inadvertent within the meaning of § 1362(f).

We further hold that under the provisions of § 1362(f), X will be treated as an S corporation from Date 2 to Date 7, provided that X's original election to be an S corporation was valid and did not otherwise terminate. From Date 2 to Date 7, A and B will be treated as though they held their shares in X directly. Additionally, from Date 2 to Date 7, A and B must include their pro rata share of the separately and non-separately computed items as provided in § 1366, make adjustments to stock basis as provided in § 1367, and take into account any distributions made by X as provided by § 1368.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code. Specifically, we express no opinion regarding whether X was otherwise eligible to be an S corporation or whether Corp 2 is otherwise eligible to be an S corporation.

This ruling is directed only to the taxpayer who requested 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, we are forwarding a copy of this letter to X.

Sincerely yours,
J. Thomas Hines
Chief, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes