Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Number: **200307079**
Release Date: 2/14/2003
Index Number: 1362.04-00

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:3 PLR-138900-02
Date:
November 14, 2002

LEGEND

X =

d1 =

d2 =

d3 =

d4 =

d5 =

State =

S1 =

S2 =

S3 =

S4 =

S5 =

S6 =

S7 =

Dear :

This letter responds to a letter dated July 3, 2002, and subsequent correspondence, submitted by X's authorized representative on behalf of X, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, X was incorporated under the laws of State on d1, and elected to be treated as an S corporation effective d2. X's shareholders from d3 to d5 were S1, S2, S3, S4, S5, S6, and S7. As of d5, S2 transferred all of its stock to S1.

On d3, X decided to convert to a State limited partnership under the State Revised Uniform Limited Partnership Act. On d3, with the intent to continue to be treated as an S corporation, X filed a Form 8832, Entity Classification Election, to be treated as an association taxable as a corporation.

On or about d4, X's attorneys became aware that X converted to a State limited partnership, and advised X that X's conversion to a State limited partnership may have caused X's S corporation election to terminate because a state law limited partnership may be treated as having more than one class of stock under § 1361(b)(1)(D). Realizing for the first time that X's conversion to a State limited partnership might have terminated its S corporation election, X converted back to a State corporation effective on d5.

X represents that its motive for the conversion to a State limited partnership was the reduction of its State franchise tax and not avoidance of federal tax. Moreover, X represents that it had no intention of terminating its S corporation election.

X represents that it has filed its tax returns (consistent with X being treated as an S corporation) for the period from d3 to d5.

X and X's shareholders have agreed in the form prescribed by § 1.1362-4(e) to make adjustments during the period from d3 to d5 consistent with the treatment of X as an S corporation as may be required by the Internal Revenue Service.

LAW AND ANALYSIS

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 1361(b)(1)(D) 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 more than one class of stock.

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

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in termination, steps were taken so that the corporation is a small business corporation, 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 regarding this period, then, notwithstanding the circumstances resulting in 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 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.

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).

The Service is studying the issue of whether a state law limited partnership electing under § 301.7701-3 to be classified as an association taxable as a corporation has more than one class of stock for purposes of § 1361(b)(1)(D). Until the Service resolves this issue through published guidance, letter rulings will not be issued. The Service will treat any request for a ruling on whether a state law limited partnership is eligible to elect S corporation status as a request for a ruling on whether the partnership

complies with § 1361(b)(1)(D). Rev. Proc. 2002-3, 2002-1 I.R.B. 117, § 5.04, based on Rev. Proc. 99-51, 1999-9 C.B. 760.

CONCLUSIONS

Based solely on the facts as represented by X in this ruling request, we conclude that if X's conversion from a State corporation to a State limited partnership did create a second class of stock, the consequent termination of X's S corporation election was inadvertent within the meaning of § 1362(f).

Therefore, we rule that X will continue to be treated as an S corporation for the period from d3 to d5, and thereafter, unless X's S election otherwise terminates under § 1362(d). Accordingly, X and its shareholders who were shareholders during the termination period must include the prorata share 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.

Except for the specific ruling above, no opinion is expressed or implied concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding X's eligibility to be an S corporation or the validity of its S corporation election.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to each of X's authorized representatives.

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.

Sincerely,
James A. Quinn
Senior Counsel, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

cc: