

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

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Date:

May 25, 1999

Number: **199933035**
Release Date: 8/20/1999

X =

A =

B =

IRA =

Firm =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Trust 5 =

Trust 6 =

D1 =

D2 =

D3 =

D4 =

D5 =

Year 1 =

Year 2 =

Dear :

This letter responds to X's letter signed November 23, 1998, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting relief under § 1362(f) of the Internal Revenue Code.

The information submitted states that in Year 1, X, then a C corporation, received advice from Firm on the shareholder requirements for an S corporation. At that time, X chose not to elect to be an S corporation due to the holding of X stock by an employee stock ownership plan (ESOP), an ineligible S corporation shareholder at that time. Subsequently, on D1, IRA, an individual retirement account for the benefit of A, acquired shares of X.

In the beginning of Year 2, X reconsidered S corporation status. On D3, B, X's Vice-President of Finance, met with a member of Firm who discussed the opportunity for corporations whose shareholders included ESOPs to elect S corporation status. At that meeting, B, unaware that an individual retirement account was not a permitted shareholder of an S corporation, expressed confidence that all of X's shareholders would be permitted shareholders of an S corporation. However, in D4, when X began preparing Form 2553, Election by a Small Business Corporation, and questioned Firm to find out who should sign the shareholder consent for IRA, Firm learned IRA was a shareholder of X and X discovered that an individual retirement account is not a permitted shareholder of an S corporation. In order to correct the problem, on D5, X entered into a redemption agreement, which

is represented to be effective D5, for its shares held by IRA. Subsequently, X timely filed a Form 2553, with an effective date of D2. B represents that when X filed the Form 2553, X met the qualifications of a small corporation under § 1361(b).

Additionally, in the course of this request for relief, it was determined that, with regard to Trusts 1 to 6, improper shareholder consents were provided on X's Form 2553. In each of these cases B represents that the trust was a grantor trust. However, for Trusts 1 to 5, the respective grantor of each trust signed the Form 2553 as trustee, and for Trust 6, the trustee, who was not the same person as the grantor, signed the Form 2553.

B represents that the circumstances resulting in the invalidity of X's election to be an S corporation were inadvertent. As to IRA's holding of X stock, X believed all shareholders were qualified to hold S Corporation stock and only realized IRA was not a qualified shareholder when it proceeded preparing Form 2553 in D4. As to the improper consents, X's tax advisors did not include specific instructions to the shareholders concerning their signatures and due to the limited amount of time between the time X received the shareholders' signatures and the due date of the Form 2553, X's tax advisors did not review the form prior to X mailing it to the Service. Additionally, X and each person who was or is a shareholder of X at any time since D2 agree to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary with respect to such period.

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 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.

Rev. Rul. 92-73, 1992-2 C.B. 224, holds that a trust that qualifies as an individual retirement account under § 408(a) of the Code is not a permitted shareholder of an S corporation under § 1361.

Section 1362(a)(2) provides that an election under § 1362(a) shall be valid only if all persons who are shareholders in such

corporation on the day on which such election is made consent to such election.

Section 1.1362-6(b)(1) of the Income Tax Regulations provides that except as provided in § 1.1362-6(b)(3)(iii), the election of the corporation is not valid if any required consent is not filed in accordance with the rules contained in § 1.1362-6(b).

Section 1.1362-6(b)(2)(iv) of the regulations provides that in the case of a trust described in § 1361(c)(2)(A) (including a trust treated under § 1361(d)(1)(A) as a trust described in § 1361(c)(2)(A)(i)), only the person treated as the shareholder for purposes of § 1361(b)(1) must consent to the election.

Section 1361(c)(2)(A)(i) provides that for purposes of § 1361(b)(1)(B), a trust all of which is treated (under subpart E of part I of subchapter J of Chapter 1) as owned by an individual who is a citizen or resident of the United States may be a shareholder. Section 1361(c)(2)(B)(i) provides that for purposes of § 1361(b)(1), in the case of a trust described in § 1361(c)(2)(A)(i), the deemed owner shall be treated as the shareholder.

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.

Based solely on the facts submitted and the representations made, we hold that X's election to be an S corporation effective D2 was ineffective because, from D2 until D4, IRA, which was not a permitted shareholder of an S corporation, held shares in X and because improper shareholder consents were provided on X's Form

2553. We hold also that the ineffectiveness 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 effective D2 and thereafter, provided X's election to be an S corporation was not otherwise invalid and provided that the election was not terminated under § 1362(d). During the period from D2 to D4, A, for whose benefit IRA held X stock, will be treated as the owner of the X stock held by IRA. Accordingly, this individual and X's other shareholders 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. Additionally, this ruling is conditioned upon the relevant shareholders filing within 60 days following the date of this letter, proper shareholder consents to be associated with X's original Form 2553. If X, IRA, A, or any of X's other shareholders, fail to treat themselves as described above, this ruling shall be null and void.

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.

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's authorized representatives.

Sincerely yours,

H. GRACE KIM
Assistant to the Chief
Branch 2
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes

