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FACTS

According to the information submitted, X was incorporated under the laws of State on D1. X timely elected subchapter S status, effective D2, by filing Form 2553 with the Service. Since D3, X has had a shareholder agreement which provides that any attempted transfer of shares to an ineligible shareholder shall be null and void. On D4, upon request of one of X's shareholders (transferor shareholder), X transferred a shares of X stock from the transferor shareholder to Z. On D5, X formed a subsidiary, Y, and timely filed a Form 8869 to treat Y as a QSub as of the date of its formation. Effective D6, X Spun off Y and distributed all of the shares of Y proportionately each of X's shareholders. Z did not actually receive stock in Y. However, on D6, Z was a shareholder of record of X. The Spin off terminated Y's QSub election. Y timely filed an election to be taxed as an S corporation effective D6.

On D7, upon request of the transferor shareholder, X transferred a shares of X stock from the transferor shareholder to Z. In addition, X made three distributions to Z, the shareholder of record at the time of the distributions. At the time of such transfers and distributions, Z was an ineligible S corporation shareholder. Neither X, nor any of its shareholders or employees intended to terminate X's S corporation status by making the transfer of shares to Z. Nor did they intend to make an invalid QSub election or subsequent S corporation election for Y. Immediately upon discovery of the fact that Z was an ineligible shareholder, X voided the shares issued to Z and issued replacement certificates to the transferor shareholder. In addition, Z repaid X the full amount of the distributions made to it and X redistributed such funds to the transferor shareholder.

LAW AND ANALYSIS

Section 1361(a)(1) of the Code provides that the term "S corporation" means, with respect to any taxable year, 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 for purposes of subchapter S, a "small business corporation" cannot have as a shareholder a person (other than an estate, a trust described in section 1361(c)(2), or an organization described in section 1361(c)(6)) who is not an individual.

Section 1361(b)(3)(B) defines a Qualified subchapter S subsidiary (QSub) as any domestic corporation which is not an ineligible corporation if 100 percent of the stock of the corporation is held by the S corporation, and the S corporation elects to treat the corporation as a QSub.

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Section 1362 (d)(2)(A) provides that an election under section 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 1362(f) of the Code provides that if (1) an election under section 1362(a) by any corporation was not effective for the taxable year for which it was made (determined without regard to section 1362(b)(2)) by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents or was terminated under paragraph (2) or (3) of subsection (d), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination was inadvertent, (3) no later than a reasonable period of time after discovery of the event resulting in the ineffectiveness, steps were taken (A) so that the corporation is a small business corporation, or (B) to acquire the required shareholder consents, and (4) the corporation, and each person who was a shareholder of 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 such ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

CONCLUSION

Based on the information submitted and the representations made, we conclude that to the extent X's S corporation election terminated on D4, Y did not meet the definition of a QSub as of D5 and, thus, its QSub election, effective D5, was invalid. In addition, Y did not meet the definition of a subchapter S corporation as of D6 and, thus, its S corporation election, effective D6, was invalid. We conclude, however, that the facts causing such termination and ineffectiveness were inadvertent within the meaning of section 1362(f) of the Code.

Consequently, Y will be treated as a QSub from D5 to D6 and an S corporation beginning D6, and thereafter, provided that, apart from the facts discussed above, X's S corporation election was otherwise valid and has not otherwise terminated under section 1362(d), and provided that Y's QSub and S corporation elections were otherwise valid and have not otherwise terminated under Section 1362(d).

Except as specifically ruled upon above, no opinion is expressed as to the federal income tax consequences of the facts described above under any other provision of the Code. In particular, no opinion is expressed or implied as to whether X

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otherwise qualifies as a Subchapter S Corporation or whether Y otherwise qualifies as a QSub or Subchapter S Corporation under section 1361.

This ruling is directed only to the taxpayers 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, a copy of this letter is being sent to the Taxpayers representatives.

Sincerely,

/s/ Dianna K. Miosi

Diana K. Miosi
Branch Chief, Branch 1
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

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

cc: