

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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LEGEND:

X =

Trust =

A =

B =

C =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

m =

n =

o =

Dear

This letter responds to a letter dated July 10, 1998, and subsequent correspondence, written on X's behalf, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, X was incorporated on D1 and elected to be an S corporation effective D2. At incorporation, A and B, the only shareholders of X, each received m shares of X's stock.

B died on D3, and his shares of X's stock were transferred to his estate. On D4, B's estate distributed n shares of X's stock to A and o shares of X's stock to Trust, which was established under the terms of B's will. A is the income beneficiary of Trust until A's death or her remarriage. Under the terms of Trust, A may also receive a certain amount of principal. Upon or after A's death or remarriage, the trustee will distribute the principal and accumulated interest thereon to B's daughter, C, her heirs and assigns.

In D5, X's new tax counsel discovered that Trust did not qualify as an eligible shareholder under § 1361(c)(2) and X's S corporation election had terminated on D6. X represents that the termination was inadvertent. X and A relied on an accountant and were unaware that Trust was an ineligible shareholder after it had owned X's stock for more than 60 days. X represents that it did not intend to terminate its S corporation election. X further represents that since D6, Trust has reported its share of X's income on its tax return, and A paid tax on the amounts distributed from the Trust. Trust and A are in the same tax bracket. X and its shareholders agree to make any adjustments (consistent with the treatment of X as an S corporation) that may be required.

X represents that Trust complies with the requirements under § 1361(e), which defines an Electing Small Business Trust (ESBT). The Trust intends to file an ESBT election under Notice 97-12, 1997-1 C.B. 385, to be effective D7, once it receives this private letter ruling from the Service. The election, however, will not be timely filed.

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.

Section 1361(b)(1)(B) provides that one of the requirements for a taxpayer to be a small business corporation is that the taxpayer cannot have as a shareholder a person (other than an estate and other than a trust described in § 1361(c)(2)) who is not an individual.

In the relevant year, § 1361(c)(2)(A)(iii) provided that an otherwise ineligible trust would be a permitted shareholder of a subchapter S corporation with respect to stock transferred to it under the terms of a will during a 60-day period beginning with the day of the transfer.

Section 1361(e)(1)(A) provides that for purposes of § 1361 and except as provided in § 1361(e)(1)(B), the term "electing small business trust" means any trust if-- (i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, or (III) an organization described in paragraph (2), (3), (4), or (5) of § 170(c), (ii) no interest in such trust was acquired by purchase, and (iii) an election under § 1361(e) applies to such trust.

Section 1361(e)(3) provides that an election to be an ESBT under § 1361(e) is made by the trustee. Any election applies to the taxable year of the trust for which made and all subsequent taxable years of the trust unless revoked with the consent of the Secretary.

Notice 97-12 provides a temporary procedure for making an ESBT election. Under Notice 97-12, the trustee of an ESBT makes an ESBT election by signing and filing with the appropriate Service Center a statement containing specified information. The trustee of the ESBT must file the ESBT election within the time requirements prescribed in § 1.1361-1(j)(6)(iii) of the Income Tax Regulations for filing Qualified Subchapter S Trust elections (generally within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust). The effective date of the election cannot be earlier than 15 days and 2 months before the date the election is filed.

Section 1362(d)(2) provides that an election to be an S corporation will be terminated whenever the corporation ceases to be a small business corporation.

Section 1362(f) provides that, (A) if an election under § 1362(a) by any corporation was terminated under § 1362(d)(2), (B) the Secretary determines that the termination was inadvertent, (C) no later than a reasonable period of time after discovery of the circumstances resulting in such termination, steps were taken so that the corporation is a small business corporation, and (D) 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 any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to the period, then, notwithstanding the terminating event, the corporation

shall be treated as an S corporation during the period specified by the Secretary.

The committee reports accompanying the Subchapter S Revision Act of 1982 Act explain § 1362(f) as follows:

If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.

The Committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped that taxpayers and the government will work out agreements that protect the revenues without undue hardship to taxpayers. . . . It is expected that the waiver may be made retroactive for all years, or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24; H.R. Rep. No. 826, 97th Cong., 2d Sess. 12 (1982), 1982-2 C.B. 730, 735.

CONCLUSIONS

X's S corporation election terminated on D6 when Trust, an ineligible S corporation shareholder, continued to hold X stock beyond the period provided in § 1361(c)(2)(A)(iii). Based solely on the facts submitted and representations made, we conclude that the termination of X's subchapter S election on D6, was inadvertent within the meaning of § 1362(f).

Under § 1362(f), X will be treated as continuing to be an S corporation during the period from D6, to D7, and thereafter, provided that X's S corporation election is valid and is not otherwise terminated under § 1362(d). However, this ruling is contingent on X filing an ESBT election, with an effective date of D7, with the appropriate Service Center within 60 days from the date of this ruling. The ESBT election should be made by following the procedure set forth in Notice 97-12.

In addition, if X files an ESBT election with an effective date of D7, with the appropriate Service Center within 60 days from the date of this ruling, Trust will be treated as a shareholder of X during the period from D6, until D7. Trust will be treated as an ESBT under § 1361(e) beginning on D7, assuming it otherwise meets the ESBT

requirements. Accordingly, Trust and A must include their pro rata share of the separately and nonseparately computed items of X under § 1366, make any adjustments to stock basis under § 1367, and take into account any distributions made by X to shareholders under § 1368. If X or its shareholders fail to treat X as described above, this ruling will be null and void.

A copy of this letter should be attached to the ESBT election that is filed with the Service Center.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X is an S corporation for federal tax purposes or whether Trust is an ESBT under § 1361(e).

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.

Under a power of attorney on file in this office, a copy of this letter will be sent to your authorized representative.

Sincerely yours,

Donna M. Young
Senior Technician Reviewer,
Branch 3
Office of the Assistant Chief
Counsel
(Passthroughs and Special
Industries)

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