

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:B03 PLR-151665-02
Date:
March 21, 2003

X =

A =

B =

C =

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E =

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G =

H =

I =

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J =

K =

L =

M =

N =

O =

P =

Q =

R =

S =

T =

U =

Trust 1 =

Sub-Trust 1 =

Trust 2 =

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Trust 3 =

Trust 4 =

Trust 5 =

Trust 6 =

Trust 7 =

Trust 8 =

State =

d1 =

d2 =

d3 =

d4 =

d5 =

d6 =

d7 =

Dear _____ :

This letter responds to a letter dated September 12, 2002, and subsequent correspondence, submitted on behalf of X, by its authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

The information submitted provides that X was incorporated under the laws of State on d1. During d3, X was advised by its CPA to elect to be an S corporation. X retained an attorney to determine X's eligibility to elect to be an S corporation and

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prepare a Form 2553, Election by a Small Business Corporation. On d4, X filed a Form 2553 with the Internal Revenue Service to be effective d5.

The attorney retained by X determined that Trust 3 and Trust 7 were eligible to be shareholders of X because each trust met the definition of an electing small business trust (ESBT) pursuant to § 1361(c)(2)(A)(v). However, the attorney failed to file conforming ESBT elections.

The attorney retained by X determined that Trust 1 was eligible to be a shareholder of X pursuant to § 1361(c)(2)(A)(i). However, on d2, without the knowledge of X, Trust 1's X stock had been allocated to Sub-Trust 1, which was not eligible to be an S corporation shareholder.

X retained a new CPA in d6. The CPA determined that Sub-Trust 1 was not eligible to be a shareholder of X. The CPA also determined that the ESBT elections of Trust 3 and Trust 7 were not conforming.

On d7, the X stock held by Sub-Trust 1 was distributed to R and U.

X and X's historic shareholders, Trust 1, Sub-Trust 1, Trust 2, Trust 3, Trust 4, Trust 5, Trust 6, Trust 7, Trust 8, A, B, C, D, E, F, G, H, I, J, K, L, M, N, O, P, Q, R, S, T, U, agree to make any adjustments as required by § 1.1362-4(e). X represents that the termination of its S election was inadvertent and not the result of tax avoidance or retroactive tax planning. X further represents that for all relevant taxable years it has filed its income tax returns as an S corporation and its shareholders have included on their tax returns their proportionate share of X's income and loss.

LAW AND ANALYSIS

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) provides that the term small business corporation means a domestic corporation that is not an ineligible corporation and that does not (A) have more than 75 shareholders; (B) 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; (C) have a nonresident alien as a shareholder; and (D) have more than 1 class of stock.

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

Section 1361(c)(2)(A)(v) provides that for the purposes of § 1361(b)(1)(B), an ESBT may be a shareholder in an S corporation.

Section 1361(e)(1)(A) provides that an ESBT is any trust if (i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in § 170(c)(2), (3), (4) or (5) or (IV) an organization described in § 170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary; (ii) no interest in such trust was acquired by purchase; and (iii) an election under § 1361(e) applies to such trust.

Section 1.1361-1(m)(2)(i) of the Income Tax Regulations provides that the trustee must make the ESBT election by signing and filing, with the service center where the S corporation files its income tax return, a statement meeting the requirements of § 1.1361-1(m)(2)(ii). Section 1.1361-1(m)(2)(ii) provides that the election statement must include (A) the name, address and taxpayer identification number of the trust, the potential current beneficiaries, and the S corporation in which the trust currently owns stock; (B) an identification of the election as an ESBT election made under § 1361(e)(3); (C) the first date on which the trust owned stock in each S corporation; (D) the date on which the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed) and (E) representations signed by the trustee stating that the trust meets the requirements of § 1361(e)(1) and all potential current beneficiaries of the trust meet the shareholder requirements of § 1361(b)(1).

Section 1.1361-1(m)(3)(i) provides that if a trust makes a valid ESBT election, the trust will be treated as an ESBT for purposes of chapter 1 of the Internal Revenue Code as of the effective date of the ESBT election.

Section 1362(f) provides that (1) if 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 § 1362(d)(2) or (3), (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), 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, such corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the 1st day of the 1st 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 such termination shall be effective on and after the date of cessation.

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Section 1.1362-4(b) provides that the determination of whether a termination was inadvertent is made by the Commissioner. It further provides that 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 in the corporation's control and was not part of a plan, 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 inadvertence.

Section 1.1362-4(d) provides that the Commissioner may require any adjustments that are appropriate. In the case of a transfer of stock to an ineligible corporation that causes an inadvertent termination, the Commissioner may require the ineligible shareholder to be treated as an S corporation shareholder during the period the ineligible shareholder actually held stock. Moreover, § 1.1362-4(d) provides that the Commissioner may require protective adjustments to prevent any loss of revenue due to a transfer of stock to an ineligible shareholder.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election was ineffective for the taxable year beginning d5. We also conclude that the ineffectiveness of X's S corporation election constituted an inadvertent invalid election within the meaning of §1362(f).

Consequently, X shall be treated as an S corporation for the taxable year beginning d5, provided that X files a new Form 2553 and Trust 3 and Trust 7 file ESBT elections meeting the requirements of § 1.1361-1(m), effective d5, with the appropriate service center within 60 days of this letter. A copy of this letter should be attached to the Form 2553 and to each ESBT election.

This ruling is contingent on X's shareholders treating X as an S corporation for all periods beginning d5. Accordingly, X's shareholders in determining their respective income tax liabilities for the period beginning d5, must include their pro rata share of the separately and non-separately stated income of X pursuant to § 1366, make any basis adjustments pursuant to § 1367 and take into account any distributions pursuant to § 1368. Trust 1, Sub-Trust 1, Trust 3, and Trust 7 shall be treated as shareholders of X for all periods during which they actually held stock of X.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed on whether X is otherwise eligible to be an S corporation or whether Trust 3 or Trust 7 are otherwise eligible to be ESBTs.

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.

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

Sincerely yours,

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

Enclosures (2)

A copy of this Letter

A copy for §6110 purposes

cc: