

**Internal Revenue Service**

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:3 PLR-110071-03

Date:

June 19, 2003

Company:

Trust A:

Trust B:

State:

a:

b:

c:

Dear \_\_\_\_\_ :

This letter responds to a letter from your authorized representative dated February 11, 2003, as well as additional correspondence, submitted on behalf of Company, requesting a ruling under § 1362(f) of the Internal Revenue Code that Company's S corporation election was inadvertently invalid.

**FACTS**

Company was incorporated under the laws of State. It elected under § 1362(a) to be treated as an S corporation effective a. At the time of the election, Trust A held Company shares but was not an eligible shareholder under § 1361(c)(2). Trust B acquired Company shares on b but, like Trust A, was not an eligible shareholder under § 1361(c)(2).

Company filed an S corporation income tax return (Form 1120S) for its c tax year. For the same year, Company's shareholders filed their individual income tax returns consistent with Company being an S corporation. The invalid shareholders were discovered during an audit of Company by the Internal Revenue Service. The c tax year audit is still open pending the issuance of this letter ruling.

## LAW AND ANALYSIS

Section 1361(a)(1) provides that, for purposes of the Code, the term "S corporation" means, with respect to any tax year, a small business corporation for which an election under § 1362(a) is in effect for the year.

Section 1361(b)(1)(B) 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 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.

Section 1361(c)(2)(A)(v) provides that, for purposes of § 1361(b)(1)(B), an electing small business trust (ESBT) may be a shareholder. Section 1361(c)(2)(B)(v) provides that, for purposes of § 1361(b)(1), each potential current beneficiary of an ESBT is to be treated as a shareholder, unless for any period there is no potential current beneficiary, then the trust is to be treated as the shareholder during that period.

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) the trust does not have as a beneficiary any person other than an individual, an estate, or an organization described in § 170(c)(2), (3), (4), or (5); (ii) no interest in the trust was acquired by purchase; and (iii) an election under § 1361(e) applies to the trust.

Section 1361(e)(3) provides that such an election is to be made by the trustee and is to apply to the tax year of the trust for which made and all subsequent tax years unless revoked with the consent of the Service.

Section 1.1361-1(m)(2)(i) of the Income Tax Regulations provides that the trustee of the trust must make the ESBT election by signing and filing, with the service center where the S corporation files its income tax return, a statement that meets the requirements of § 1.1361-1(m)(2)(ii). Section 1.1361-1(m)(2)(iii) provides that the trustee must file the ESBT election within the period of time prescribed by § 1.1361-1(j)(6)(iii) for filing qualified subchapter S trust (QSST) elections (generally within the 16-day-and-2-month period beginning on the day the stock is transferred to the trust).

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was not effective for the tax year for which made (determined without regard to § 1362(b)(2)) by reason of a failure to meet the requirements of § 1361(b); (2) the Secretary determines that the circumstances resulting in the ineffectiveness were

inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness, 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 the ineffectiveness, the corporation shall be treated as an S corporation during the period specified by the Secretary.

The conference report on the Small Business Job Protection Act of 1996 (P.L. 104-188) provides that the Service should be reasonable in exercising this authority and apply standards that are similar to those applied under present law to inadvertent subchapter S terminations. H. Rep. No. 737, 104th Cong., 2d Sess. 222 (1996); 1996-3 C.B. 741, 962.

Section 1.1362-4(b) provides that, for purposes of § 1.1362-4(a), 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.

Company represents that Trusts A and B satisfy the requirements for an ESBT except that, unknown to Company, the trustees inadvertently failed to make the required elections under § 1361(e)(1)(A)(iii). Company represents also that at all times since its filing of the S corporation election, all of its shareholders have reported their respective shares of Company's income as though Company were an S corporation.

Company and its shareholders agree to make any adjustments, consistent with the treatment of Company as an S corporation, as might be required by the Service.

Based solely on the facts and representations submitted by Company, we conclude that Company's S corporation election was inadvertently invalid within the meaning of § 1362(f). Consequently, we conclude that Company will be treated as an S corporation beginning a, and thereafter, unless Company's S election otherwise terminates under § 1362(d). We conclude, also, that the Trustees will be deemed to have filed timely ESBT elections for Trusts A and B, provided that such elections, effective as of a and b, respectively, are filed no later than 60 days from the date of this letter, and provided that the Trusts' tax returns for the c tax year reflect, or are amended to reflect, the status of the Trusts as ESBTs. A copy of this letter should be attached to the ESBT elections.

Except for the specific rulings above, we express or imply no opinion concerning the federal income tax consequences of the facts of this case under any other provision

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of the Code. Specifically, we express or imply no opinion regarding the eligibility of Company to have elected under § 1362(a) to be an S corporation.

Under a power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

CHRISTINE ELLISON  
Chief, Branch 3  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

enclosures: copy of this letter  
copy for § 6110 purposes