

Internal Revenue Service

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February 18, 2004

Legend

X =

A =

B =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

State =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

Dear :

This letter responds to a letter dated November 4, 2003, submitted by you on behalf of X as its authorized representative, requesting relief under § 1362(f) of the Internal Revenue Code.

X was incorporated on D1 under the laws of State. X elected to become an S corporation, effective D2. On D3, A and B, shareholders of X, created Trust 1, Trust 2, Trust 3, and Trust 4 ("the Trusts"). Each trust's beneficiary qualified, under § 678(a), to be treated as the owner of the entire trust. On D4, A and B contributed shares of X stock to the Trusts. As trusts treated (under subpart E of part I of subchapter J of chapter 1 of title 26) as entirely owned by an individual who is a citizen or resident of the United States, the Trusts were eligible S corporation shareholders under § 1361(c)(2)(A)(i).

On D5, each trust's beneficiary no longer qualified under § 678(a) to be treated as the owner of the entire trust. Therefore, the Trusts were no longer eligible S corporation shareholders under § 1361(c)(2)(A)(i). Accordingly, X's S election terminated on D5. In D6, A and B's accountant discovered that the Trusts ceased to qualify as eligible S corporation shareholders on D5. To qualify as eligible S corporation shareholders, the Trusts elected under § 1361(e)(3) to be treated as electing small business trusts, effective D7. In addition, X submitted this ruling request for inadvertent termination relief under § 1362(f).

X represents that for the period beginning after D5, the beneficiaries of the Trusts filed their individual income tax returns consistent with the Trusts qualifying as eligible S corporation shareholders under § 1361(c)(2)(A)(i) and consistent with X's S election remaining in effect. Accordingly, the beneficiaries of the Trusts included in their individual income tax returns, X's items of income, deduction, and credits allocated to the shares of X stock held in the Trusts in which they are beneficiaries. In addition, X represents that all shareholders of X, for the period beginning after D5, filed their tax returns consistent with X's S election remaining in effect.

X represents that the circumstances resulting in the termination of X's S election to be an S corporation were inadvertent. X also represents that X and X's shareholders

did not intend to engage in tax avoidance or retroactive tax planning. X and each person who was or is a shareholder of X at any time since D5 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” means a domestic corporation that is not an ineligible corporation and that does not 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)(i) provides that for purposes of section 1361(b)(1)(B), a trust may be a shareholder if all of it is treated (under subpart E of part I of subchapter J of chapter 1 of title 26) as owned by an individual who is a citizen or resident of the United States.

Section 1361(c)(2)(A)(v) provides that an “electing small business trust” may be a shareholder in an S corporation.

Section 1361(e)(1)(A) provides that 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 section 170(c), or (IV) an organization described in section 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 section 1361(e) applies to such trust.

Section 1361(e)(1)(B) provides that the term “electing small business trust” shall not include (i) any qualified subchapter S trust (as defined in section 1361(d)(3)) if an election under section 1361(d)(2) applies to any corporation the stock of which is held by such trust, (ii) any trust exempt from tax under subtitle A, and (iii) any charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)).

Section 1361(e)(3) provides that an election under section 1361(e) shall be made by the trustee. Any such election shall apply to the taxable year of the trust for which

made and all subsequent taxable years of such trust unless revoked with the consent of the Secretary.

Section 1362(d)(2) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the first taxable year for which a corporation is an S corporation) such corporation ceases to be a small business corporation. A termination of an S corporation election under § 1362(d)(2) is effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in such termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the termination, 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 under § 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 for that period, then, notwithstanding the circumstances resulting in such termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts and the representations made, we hold that X's S election to be an S corporation effective D2 terminated on D5 because the Trusts were ineligible shareholders. We hold also that the termination of X's S corporation election was inadvertent within the meaning of § 1362(f). Therefore, X will be treated as continuing to be an S corporation from D5 through D7 and afterwards, provided that X's S election was valid and was not otherwise terminated. In addition, from D5 through D7, the respective beneficiaries of the Trusts will be treated as the owners of the X stock held by the Trusts. Accordingly, from D5 through D7, the respective beneficiaries of the Trusts must include the Trusts' 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 the Trusts under § 1368. If X or X's shareholders fail to comply with the requirements of this paragraph, this ruling shall be null and void.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, we express no opinion regarding whether X is otherwise eligible to be an S corporation or whether the Trusts are valid electing small business trusts.

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This ruling is directed only to the taxpayer requesting 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 with this office, we are sending a copy of this letter to X and X's second representative.

Sincerely yours,

Carolyn Hinchman Gray
Senior Counsel, Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
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