

**Internal Revenue Service**

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Washington, DC 20224

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Refer Reply To:

CC:PSI:3

PLR-118946-04

Date:

August 04, 2004

**LEGEND**

Corporation =

A =

B =

C =

State =

Trust 1 =

Trust 2 =

Grantor =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Dear :

This letter responds to a letter dated March 16, 2004, written on behalf of Corporation by its authorized representative, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

### Facts

According to the information submitted, Corporation incorporated on Date 1 under the laws of State, and elected to be an S corporation effective Date 2.

As of Date 5, the shareholders of Corporation were A, B, C, Trust 1, and Trust 2. Trust 1 and Trust 2 were established on Date 3 as grantor trusts. On Date 4, Grantor transferred Corporation stock into the corpus of Trust 1.

On Date 5, Grantor died, and Trust 1 ceased to be a grantor trust and became irrevocable. For two years following Date 5, however, Grantor's estate was treated as the deemed owner of the Corporation stock. This two-year period expired on Date 6.

As of Date 6, the shareholders of Corporation were A, B, Trust 1, and Trust 2.

It is represented that Trust 1 met the requirements to be a qualified subchapter S trust (QSST) as defined in § 1361(d)(3). Due to an oversight, however, a timely QSST election under § 1361(d)(2) was not filed on behalf of Trust 1, thereby terminating Corporation's S corporation election on Date 6. Following Date 7, Corporation discovered that a QSST election for Trust 1 was not made. After receiving legal advice and contemplating ways to remedy the failure to make the QSST election, Corporation submitted this private letter ruling request.

Corporation represents that the failure to file the QSST election was not motivated by tax avoidance or retroactive tax planning. It is represented that Corporation and its shareholders have treated Corporation as an S corporation since Date 2. Further, Corporation and its shareholders have agreed to make any adjustments that the Commissioner may require consistent with the treatment of Corporation as an S corporation.

### Applicable Law

Section 1361(a)(1) generally 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 which is not an ineligible corporation and which 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 one class of stock.

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

Section 1361(c)(2)(A)(ii) provides that a permitted S corporation shareholder includes a trust which was described in § 1361(c)(2)(A)(i) immediately before the death of the deemed owner and which continues in existence after such death, but only for the 2-year period beginning on the day of the deemed owner's death.

Section 1361(d)(1) provides that, in the case of a QSST with respect to which a beneficiary makes an election under § 1361(d)(2), the trust is treated as a trust described in § 1361(c)(2)(A)(i), and for purposes of § 678(a), the beneficiary of the trust is treated as the owner of that portion of the trust that consists of stock in an S corporation with respect to which the election under § 1361(d)(2) is made.

Section 1361(d)(2)(A) provides that a beneficiary of a QSST (or the beneficiary's legal representative) may elect to have § 1361(d) apply. Section 1361(d)(2)(D) provides that an election under § 1361(d)(2) may be effective up to 15 days and two months before the date of the election.

Section 1362(f) provides that, if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2); (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 such 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 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

circumstances resulting in the termination, the corporation shall be treated as continuing to be an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) of the Income Tax Regulations provides that 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.

Section 1.1362-4(d) provides that the Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified by the Commissioner. In the case of a transfer of stock to an ineligible shareholder that causes an inadvertent termination under § 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of an S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent any loss of revenue due to a transfer of stock to an ineligible shareholder.

### Conclusion

Based solely on the materials submitted and representations made, we conclude that Corporation's S corporation election terminated on Date 6 when the two-year period described in § 1361(c)(2)(A)(ii) expired. We further conclude that the termination was inadvertent within the meaning of § 1362(f).

Under 1362(f), Corporation will be treated as if it were an S corporation from Date 6 and thereafter, provided the required QSST election with an effective date of Date 6 is filed with the appropriate service center within 60 days from the date of this letter, and Corporation's S corporation election was otherwise valid and not otherwise terminated under § 1362(d). Accordingly, Corporation's shareholders, in determining their respective income tax liabilities during the termination period and thereafter, must include their pro rata share of the separately and nonseparately computed items of Corporation as provided in § 1367, and take into account any distributions made by Corporation as provided in § 1368. If Corporation, or any of Corporation's shareholders fail to treat Corporation as described above, this ruling shall be void. A copy of this letter should be attached to the QSST election.

Except as specifically ruled above, we express or imply no opinion concerning the federal tax consequences of the facts described above under any other provisions

of the Code. Specifically, we express or imply no opinion concerning whether Corporation is otherwise qualified to be an S corporation or whether Trust 1 is otherwise qualified to be a QSST.

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.

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

Sincerely yours,

*/s/*

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

Enclosures (2):

Copy of this letter  
Copy for § 6110 purposes

cc: