

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact: _____, ID No.

Telephone Number:

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Date:
March 17, 2006

X =

A =

Trust =

D1 =

D2 =

D3 =

Year =

1

Dear _____ :

This responds to a letter dated October 27, 2005, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting rulings under § 1362 of the Internal Revenue Code.

The information submitted states that X was incorporated on D1. The shareholders of X intended X to be an S corporation effective D2, and a Form 2553, Election by a Small Business Corporation, was timely filed for X. However, Trust, a shareholder of X, was intended to have been an electing small business trust (ESBT) under § 1361(e) effective D2, but no ESBT election was properly filed by the trustee of Trust. Nevertheless, since D2, Trust has been treated as an ESBT.

The trustee of Trust and A, the beneficiary of Trust, intended to convert Trust, which they believed to be an ESBT, into a qualified subchapter S trust (QSST) under § 1361(d) effective for the Year 1 taxable year. In the process of seeking to convert Trust to a QSST, they discovered the failure to file the ESBT election. Because of the failure to file the ESBT election for Trust, the S corporation election for X was ineffective. A died on D3 of Year 1. Trust's governing instrument provides that Trust terminates at A's death, and the trust assets and accumulated income are distributed to named individual beneficiaries.

X represents that the failure to file the ESBT election for Trust was not motivated by tax avoidance or retroactive tax planning. X and its shareholders have agreed to make any adjustments that the Commissioner may require, consistent with the treatment of X as an S corporation.

Section 1361(a)(1) of the Code 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 the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which 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 § 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)(A)(v) provides that an ESBT may be a shareholder.

Section 1361(d)(1) provides that in the case of a QSST for 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 shall be 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 may elect to have § 1361(d)(1) apply.

Section 1361(d)(3)(B) provides that for purposes of § 1361(d), the term "qualified subchapter S trust" means a trust all of the income (within the meaning of § 643(b)) of which is distributed currently to one individual who is a citizen or resident of the United States.

Section 1361(e) defines an ESBT. Section 1361(e)(1)(A) provides that, except as provided in § 1362(e)(2)(B), an ESBT means 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 PCB, (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 under § 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 1.1361-1(j)(6)(ii) of the Income Tax Regulations provides that the current income beneficiary of a QSST must make the election under § 1361(d)(2) by signing and filing with the service center with which the corporation files its income tax returns the applicable form or a statement including the information listed in § 1.1361-1(j)(6)(ii).

Section 1.1361-1(m)(2)(i) provides that the trustee of the ESBT 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 1362(f) provides that if (1) an election under § 1362(a) by any corporation (A) 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 (B) was terminated under § 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in the ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were taken (A) so that the corporation is a small business corporation or (B) to acquire the shareholder consents; 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 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 the ineffectiveness or termination, the corporation will be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts and representations submitted, we conclude that any S corporation election by X intended to be effective D2 would have been ineffective because of the failure of Trust to file an ESBT election, and that this ineffectiveness was inadvertent within the meaning of § 1362(f).

We hold that, pursuant to the provisions of § 1362(f), X will be treated as an S corporation from D2 and thereafter, provided X was otherwise eligible to make an S corporation election and provided that any such election would not have otherwise been

terminated under § 1361(d). Trust will be treated as an ESBT from D2 until the end of the taxable year immediately prior to the Year 1 taxable year. Trust will be treated as a QSST effective for the Year 1 taxable year until D3 of Year 1. The shareholders of X must include their pro-rata share of the separately stated and nonseparately computed items of X as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368. If X or its shareholders fail to treat themselves as described above, this ruling is null and void.

This ruling is conditioned upon the executor of A's estate filing an appropriately completed QSST election for Trust on behalf of A effective as of the beginning of the Year 1 taxable year, and filing A's final Form 1040, U.S. Individual Income Tax Return, consistent with A being treated as the owner of the X stock held by Trust. The election must be made within 60 days following the date of this letter and a copy of this letter should be attached to the election.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provisions of the Code. In particular, we express no opinion on whether Trust is otherwise eligible to be an ESBT or QSST.

This ruling is directed only to the taxpayer that requested it. Section 6110(j)(3) provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file, a copy of this letter is being sent to X's authorized representative.

Sincerely,

J. THOMAS HINES
Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes