

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

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Date:  
May 16, 2000

X =

A =

B =

D1 =

D2 =

D3 =

D4 =

D5 =

Year 1 =

Year 2 =

Year 3 =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Trust 5 =

Trust 6 =

Trust 7 =

Trust 8 =

Trust 9 =

Trust 10 =

Trust 11 =

Trust 12 =

Trust 13 =

Dear :

This letter responds to a letter dated January 18, 2000, and subsequent correspondence submitted by you as X's authorized representative on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated on D1 of Year 1. X elected to be an S corporation beginning on D2 of Year 2. The shareholders of X on D2 of Year 2 were Trust 1, Trust 2, Trust 3, Trust 4, Trust 5, Trust 6, Trust 7, Trust 8, Trust 9, Trust 10, and Trust 11.

On X's Form 2553, Election by a Small Business Corporation, with respect to Trust 1, A, Trust 1's deemed owner and trustee, signed as trustee. Subsequently, in the course of this request for relief regarding the transfer of X shares to ineligible shareholders, it was determined that A should have signed as deemed owner, not as trustee.

A, the president of X, represents that, in connection with X's election to be an S corporation, Trusts 2 through 11 each filed an election to be treated as an electing small business trust (ESBT) beginning on D2 of Year 2.

B, a beneficiary of Trust 11, died on D3 of Year 2. Under Trust 11, upon the death of B, Trust 12 and Trust 13 (the Successor Trusts) were to be created for the benefit of B's issue and the assets of Trust 11, including X stock, were to be distributed to the Successor Trusts.

A represents that the trustees of Trust 11 did not realize that they were required to establish the Successor Trusts until D4 of Year 3. On D5 of Year 3, the trustees of Trust 11 established the Successor Trusts and transferred the assets of Trust 11, including X stock, to the Successor Trusts. The trustees of the Successor Trusts filed elections for the Successor Trusts to be treated as ESBTs beginning D5 of Year 3.

A further represents that for the period from D3 of Year 2 to D5 of Year 3, X continued to treat Trust 11 as a shareholder of X, consistent with the ESBT election filed by Trust 11.

A further represents that neither X nor any of its shareholders engaged in tax avoidance or retroactive tax planning and that X intended to maintain its status as an S corporation at all times.

X and its shareholders consent to make adjustments consistent with the treatment of X as an S corporation.

Section 1362(a) of the Code 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) 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.

For taxable years beginning on or before December 31, 1997, § 1361(b)(1)(B) provided 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 and other than a trust described in § 1361(c)(2)) who is not an individual.

Section 1361(c)(2)(A)(i) provides that 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 in an S corporation.

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 1362(a)(2) provides that an election under § 1362(a) shall be valid only if all persons who are shareholder in such corporation on the day on which such election is made consent to such election.

Section 1.1362-6(b)(1) of the Income Tax Regulations provides that, except as provided in § 1.1362-6(b)(3)(iii), the election of the corporation is not valid if any required consent is not filed in accordance with the rules contained in § 1.1362-6(b).

Section 1.1362-6(b)(2)(iv) provides that, in the case of a trust described in § 1361(c)(2)(A), only the person treated as the shareholder for purposes of § 1361(b)(1) must consent to the election.

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 § 170(c), (ii) no interest in such trust was acquired by purchase, and (iii) an election under § 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 § 1361(d)(3)) if an election under § 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 § 664(d)).

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.

Notice 97-12, 1997-1 C.B. 385, provides that the trustee of the ESBT must file the ESBT election within the time requirements prescribed in § 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 that the stock is transferred to the trust).

Section 1362(d)(2)(A) 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 the corporation is an S corporation) such corporation ceases to be a small business corporation. Section 1362(d)(2)(B) provides that any termination under § 1362(d)(2)(A) shall be effective on and after the date of cessation.

Section 1362(f) of the Code 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 paragraph (2) or (3) of § 1362(d), (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 (A) so that the corporation is a small business corporation, or (B) to acquire the required 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 such ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts submitted, and the representations made, we conclude that X's election to be an S corporation beginning on D2 of Year 2 was ineffective because the shareholder consent for Trust 1 provided on X's Form 2553 was improper. We hold also that the ineffectiveness of X's S corporation election was inadvertent within the meaning of § 1362(f). In addition, solely for purposes of this ruling request, the Successor Trusts will be treated as receiving X stock on D3 of Year 2, so there was a failure to timely file ESBT elections for the Successor Trusts. Such failure would have resulted in the termination of X's S corporation election on D3 of Year 2, had the S corporation election been effective when made. We further conclude that the potential termination would have been an "inadvertent termination" within the meaning of § 1362(f).

We further hold that under the provisions of § 1362(f) of the Code, X will be treated as an S corporation from D2 of Year 2 to D5 of Year 3, and thereafter, provided that X's S corporation election was otherwise valid and provided that the election was not otherwise terminated under § 1362(d). During the period from D3 of Year 2 to D5 of Year 3, with respect to the X stock eventually transferred to the Successor Trusts, Trust 11 will be treated as the shareholder of X and as a trust described in § 1361(c)(2)(A)(v). Trust 11 and X's other shareholders must report their pro rata share of the separately and nonseparately computed items of X as provided in § 1366, make any adjustments to stock 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 X as described above, this ruling will be null and void.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code.

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

Pursuant to a power of attorney on file with this office, copies of this letter are being forwarded to X and to X's other authorized representative.

Sincerely yours,  
H. GRACE KIM  
Assistant to the Chief Branch 2  
Office of the Assistant Chief Counsel  
(Passthroughs and Special Industries)

Enclosures: 2  
Copy of a letter  
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