

Internal Revenue Service

Department of the Treasury

Number: **200127015**
Release Date: 7/6/2001
Index Number: 1362.04-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:2 - PLR-125459-00

Date:

April 3, 2001

X =

A =

B =

C =

D =

E =

D1 =

D2 =

D3 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Trust 5 =

Dear :

This letter responds to a letter dated November 7, 2000, submitted by X's authorized representative on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated on D1. C, the president of X, represents that X became an S corporation for federal income tax purposes effective for Year 1. Initially, all of the stock of X was held by A and B, as community property, and by C and D, as community property.

On D2 of Year 2, A and B transferred one share of X stock each to Trust 1 and to Trust 2. On D3 of Year 3, A and B transferred an additional one share of X stock each to Trust 1 and to Trust 2.

On D2 of Year 2, C and D transferred one share of X stock each to Trust 3, Trust 4, and Trust 5. On D3 of Year 3, C and D transferred an additional one share of X stock each to Trust 3, Trust 4, and Trust 5.

C further represents that Trust 1, Trust 2, Trust 3, Trust 4, and Trust 5 (collectively, the Trusts) each satisfy the requirements to be a qualified subchapter S trust as described in § 1361(d)(3). At the time that the Trusts were established and the X stock was transferred to the Trusts, X had instructed its lawyer to ensure that the stock transfers would not terminate X's S corporation election. However, X's lawyer failed to prepare or file elections described under § 1361(d)(2) for the Trusts. Subsequently, X consulted another lawyer, who reviewed X's records and determined that X's S election terminated on D2 of Year 2.

C represents that during Year 4, under the terms of Trust 1, Trust 1 became a trust described in § 1361(c)(2)(A)(i), treated as owned by E under § 678.

C represents that the termination of X's election to be taxed as an S corporation was inadvertent and was not motivated by tax avoidance intent.

X and its shareholders consent to adjustments consistent with the treatment of X as an S corporation. C represents that X and its shareholders have treated X as an S corporation and the Trusts as QSSTs, except for that period during which Trust 1 was treated as owned by E under § 678, and have reported all of X's income consistent with this treatment.

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) 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(d)(1) provides that in the case of a qualified subchapter S trust with respect to which a beneficiary makes an election under § 1361(d)(2), (A) such trust shall be treated as a trust described in § 1361(c)(2)(A)(i), and (B) for purposes of § 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust consisting 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 qualified subchapter S trust (or a beneficiary's legal representative) may elect to have § 1361(d) apply. Section 1361(d)(2)(D) provides that an election under § 1361(d)(2) shall be effective up to 15 days and 2 months before the date of the election.

Section 1.1361-1(j)(6)(ii) of the Income Tax Regulations provides that the current income beneficiary of the trust must make the election under § 1361(d)(2) by signing and filing with the service center with which the corporation files its income

tax return the applicable form or a statement including the information listed in § 1.1361-1(j)(6)(ii).

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 the termination of X's S corporation election occurred on D2 of Year 2. We further conclude that the termination was an "inadvertent termination" within the meaning of § 1362(f).

In addition, we conclude that X's S corporation election would have terminated on D3 of Year 3. This potential termination would have been inadvertent within the meaning of § 1362(f).

We further hold that under the provisions of § 1362(f) of the Code, X will be treated as continuing to be an S corporation from D2 of Year 2 to the date that is 60 days after the date of this letter (inadvertent termination period) provided that X's S corporation election was valid and provided that the election was not otherwise terminated under § 1362(d). During the inadvertent

termination period, the Trusts will be treated as trusts described in § 1361(c)(2)(A)(i), and the respective beneficiaries of the Trusts will be treated, for purposes of § 678, as the owners of that portion of the respective trust that consists of X stock. The shareholders of X must, in determining their federal income tax liabilities, 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. This ruling is further conditioned on the beneficiaries of Trusts 2, 3, 4 and 5 making elections described in § 1361(d)(2) effective within 60 days following the date of this letter with respect to such trusts. A copy of this letter should be attached to the elections. 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) provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter is being forwarded to X's authorized representatives.

Sincerely yours,
JEANNE M. SULLIVAN
Assistant to the Chief
Branch 2
Office of the Associate
Chief Counsel
(Passthroughs and
Special Industries)

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