

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:  
CC:PSI:B02-PLR-112770-01  
Date:  
August 28, 2001

X =

Y =

A =

B =

C =

D =

E =

F =

Court =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

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Trust 5 =

Trust 6 =

Trust 7 =

Trust 8 =

Trust 9 =

Trust 10 =

Trust 11 =

Trust 12 =

Trust 13 =

Trust 14 =

Trust 15 =

State Z =

d =

e =

f =

Year 1 =

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Year 2 =

Year 3 =

g =

h =

i =

j =

Accountant =

business 1 =

business 2 =

Dear :

This is in reply to your letter dated February 14, 2001, and prior correspondence, submitted on behalf on X, requesting a ruling under section 1362(f) of the Internal Revenue Code.

The information submitted states that X, a State Z corporation, was incorporated on d. X is engaged in business 1. X owns 100 percent of the issued and outstanding stock of Y, a State Z corporation engaged in business 2.

The current shareholders of X are A, 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, Trust 14, and Trust 15.

Prior to e, X and Y joined in filing a consolidated federal income tax return. On f, X filed a timely Form 2553, Election by a Small Business Corporation, for the purpose of treating X as an S corporation effective e. Also on f, X timely filed a Form 966, Corporate Dissolution or Liquidation, pursuant to Notice 97-4, 1997-1 C.B. 351, for the purpose of treating Y as a qualified subchapter S subsidiary (QSub) within the meaning of § 1361(b)(3)(B), effective e.

Prior to Year 1, the shareholders of X included A, B, C and D and Trusts 1 - 7, which respectively benefitted seven members of A's family. In Year 1, X's counsel, D, drafted Trusts 8 - 14 for the same seven beneficiaries respectively. Trusts 8 -14 were funded with X stock in Year 1 and Year 2.

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Shortly before the filing of X's S corporation election and the QSub election for Y, Accountant and X asked, E, an attorney and advisor to X, to review the chart Accountant had prepared to verify that it represented E's understanding of the ownership of X as of both h (the day before the S corporation election was to be effective), and as of i, (the date such verification was requested). E verified in writing that the chart was accurate. As a result, when Accountant prepared the Form 2553 for X, it believed that there were only seven trusts that were shareholders in X. B, the trustee of Trusts 1 - 14, signed the Consent Statement to the Form 2553 seven times for the trusts, referencing only the beneficiary of each trust on the Consent Statement. In addition, seven Electing Small Business Trust (ESBT) elections were filed. X and its shareholders reviewed the election forms and believed them to be accurate.

As a result of having made the S corporation and ESBT elections, income tax returns were required to be filed for the trusts for X's taxable year ending g. This was the first time that these trusts were required to file income tax returns because X had never declared dividends while X was a C corporation and the trusts had no assets other than X stock. In April of Year 3, while preparing the tax returns for trusts, Accountant realized for the first time that the trusts had been drafted as separate entities and should file separate tax returns and advised X of this determination. A hired an attorney, E, to look at the trusts in light of this issue.

After a review of the trusts, E determined that Trusts 1 - 14 were separate legal entities under State Z law and discovered various scrivener errors with Trusts 8 - 14 that were in need of correction. On j, Court issued an order correcting the scrivener errors.

Upon further review of X's S corporation and ESBT elections, Accountant discovered various additional errors described in the request.

A, as X's president, represents that at all times since e, X has treated itself as an S corporation and treated Y as a QSub. A represents that the invalid S corporation election was inadvertent and was not motivated by tax avoidance or hindsight. A further represents that X intended to be an S corporation effective e, and that X intended for Y to be a QSub effective as of e.

X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary with respect to the period specified by § 1362(f).

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 for purposes of subchapter S, the term "small business corporation" means a domestic corporation that is not an ineligible

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corporation and that does not have as a shareholder a person (other than an estate and other than a trust described in § 1361(c)(2) or an organization described in § 1361(c)(6)) who is not an individual.

Section 1361(b)(2) provides that for purposes of § 1361(b)(1), the term "ineligible corporation" means any corporation which is (A) a financial institution which uses the reserve method of accounting for bad debts described in § 585, (B) an insurance company subject to tax under subchapter L, (C) a corporation to which an election under § 936 applies, or (D) a DISC or former DISC.

Section 1361(b)(3)(A) provides that except as provided in regulations prescribed by the Secretary, for purposes of title 26 (i) a corporation which is a qualified subchapter S subsidiary shall not be treated as a separate corporation, and (ii) all assets, liabilities, and items of income, deduction, and credit of a qualified subchapter S subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation.

Section 1361(b)(3)(B) provides that for purposes of § 1361(b)(3), the term "qualified subchapter S subsidiary" means any domestic corporation which is not an ineligible corporation (as defined in § 1361(b)(2)) if (i) 100 percent of the stock of such corporation is held by the S corporation, and (ii) the S corporation elects to treat such corporation as a qualified subchapter S subsidiary.

Section 1361(e)(1)(A) provides that for purposes of § 1361 and except as provided in § 1361(e)(1)(B), 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 (1), (2), (3), (4), or (5) of § 170(c), which holds a contingent interest and is not a potential current beneficiary, (ii) no interest in such trust was acquired by purchase, and (iii) an election under § 1361(e) applies to such trust.

In Notice 97-12, 1997-1 C.B. 385, the Service provided guidance regarding ESBT elections. In particular, the trustee of an ESBT must file the ESBT election within the time requirements prescribed in § 1.1361-1(j)(6)(iii) of the Income Tax Regulations for filing Qualified Subchapter S Trust 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) will be terminated whenever (at any time on or after the 1st day of the 1st 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) provides that if (1) an election under § 1362(a) by any corporation (A) was not effective for the taxable year for which made (determined

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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 was 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 information submitted, and the representations made, we conclude that X's S corporation election was ineffective for the taxable year beginning on e. We also conclude that the ineffectiveness of X's S corporation election was an "inadvertent invalid election" within the meaning of § 1362(f).

Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation effective e, and thereafter, and Y will be treated as a QSub effective e, and thereafter, provided that, apart from the events and errors described above, X's S corporation election was otherwise valid and is not otherwise terminated under § 1362(d) and the QSub election for Y was otherwise valid and not terminated under § 1361(b).

In addition, Trusts 1 through 14 will be treated as shareholders of X for the period effective e. Trusts 1 through 14 will be treated as "electing small business trusts" under § 1361(e) beginning on e. X's shareholders must include 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 to shareholders as provided in § 1368. If X or its shareholders fail to treat X as described above, this ruling will be null and void.

These rulings are conditioned on X, within 60 days of the date of this letter, filing a new Form 2553 with the appropriate Service Center with an effective date of e. Furthermore, an ESBT election for each of Trusts 1 - 14 pursuant to the procedures set forth in Notice 97-12 must be filed with the appropriate Service Center within 60 days of the date of this letter ruling. A copy of this letter should be attached to the new Form 2553 and the ESBT elections.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code.

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This ruling is directed only to the taxpayer who 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 will be sent to X's authorized representative.

Sincerely yours,  
Matthew Lay  
Senior Technician Reviewer, Branch 2  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures: 2  
Copy of this letter  
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