

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:2 - PLR-118637-00
Date:
August 29, 2001

X =

A =

B =

C =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Trust 5 =

D1 =

D2 =

D3 =

D4 =

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D5 =

D6 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Dear :

This letter responds to a letter dated September 22, 2000, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting relief under § 1362(f) of the Internal Revenue Code.

The information submitted states that effective D1, X elected to be an S corporation. On D2, A transferred shares of X to Trust 1 and B transferred shares of X to Trust 2, Trust 3, Trust 4, and Trust 5 (Trusts).

A and B, the grantors of Trusts, intended for each of the Trusts to be treated as an Electing Small Business Trust (ESBT). A and B relied on their attorneys to file elections on behalf of Trust 1, Trust 2, Trust 3, Trust 4, and Trust 5 to be treated as ESBTs. However, the Service Center has no evidence of receiving elections to be treated as ESBTs from any of the Trusts.

Additionally, in D3, although none of the Trusts met the requirements to be a qualified subchapter S trust (QSST), Trust 2, Trust 3, Trust 4, and Trust 5 each received correspondence from the Service, accepting an election to be a QSST. Upon receiving acceptance as QSSTs, C, X's chief financial officer, questioned X's attorneys concerning the correspondence from the Service. According to C's representations, X's attorneys promised to correct the mistaken election acceptance to ensure that each of the Trusts was a valid ESBT. Until D4, C continued to question X's attorneys regarding the elections; however, X's attorneys failed to respond to inquiries.

In D5, C met with new attorneys and expressed concern about the Trusts' elections. Shortly after this meeting, the new attorneys began working with C to try to resolve the situation. In D6, the new attorneys concluded that X's S election terminated on D2 as a result of the transfer of the X stock to Trusts, which were not eligible shareholders, because no timely filed ESBT elections on behalf of Trusts were received by the Service Center. For Year 1, Year 2, Year 3, and Year 4, Trusts, X, and X's shareholders filed their federal income tax returns incorrectly.

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C represents that the circumstances resulting in the termination of X's election to be an S corporation were inadvertent. C represents also that X and its shareholders did not intend to engage in tax avoidance or retroactive tax planning. X and each person who was or is a shareholder of X at any time since D2 agree to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary with respect to such period.

Section 1362(a) 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 a "small business corporation" cannot 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)(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), (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 section 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

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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) 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) provides that if (1) an election under § 1362(a) by any corporation 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 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 so that the corporation is a small business corporation, or to acquire the required shareholder consents, and (4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to § 1362(f), agree 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 will be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts submitted and the representations made, we hold that X's election to be an S corporation effective D1 terminated on D2 because Trust 1, Trust 2, Trust 3, Trust 4, and Trust 5 failed to file ESBT elections and were therefore, ineligible shareholders. We hold also that the termination of X's S corporation election was inadvertent within the meaning of § 1362(f).

We further hold that under the provisions of § 1362(f), X will be treated as an S corporation effective D2 and thereafter, provided X's election to be an S corporation was not invalid and provided that the election was not otherwise terminated under § 1362(d). Trusts 1 through 5 will be treated as "electing small business trusts" under § 1361(e) beginning on D2. For Year 1, Year 2, Year 3, and Year 4, the items of income, deduction, and credit attributable to any portion of the Trusts treated as owned by a person under the grantor trust rules of subpart E, including S corporation stock and other property (the grantor portion), must be taken into account on that individual's tax return pursuant to the rules applicable to grantor trusts under subpart E of subchapter J. Other items of income, deduction, and credit must be attributed to either the S portion, which includes the S corporation stock, or the non-S portion, which includes all other assets of the trust. The S portion is subject to tax under the special rules of § 641(c), while the non-S portion is subject to the trust taxation rules of subparts A through D of subchapter J. The grantor or another person who is treated as the owner

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of a portion of Trusts includes in computing taxable income, items of deduction, and credits against tax attributable to that portion of Trusts under § 671. Additionally, X's shareholders must include their pro rata share of the separately and non-separately computed items as provided in § 1366, make adjustments to stock basis as provided in § 1367, and take into account any distributions made by X as provided by § 1368.

Additionally, this ruling is conditioned upon the Trusts filing within 60 days, following the date of this letter, ESBT elections, pursuant to the procedures set forth in Notice 97-12, with an effective date of D2, with the appropriate Service Center. A copy of this letter should be attached to the ESBT elections. If X, Trusts, or any of X's other shareholders, fail to treat themselves as described above, this ruling shall 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. Specifically, we express no opinion regarding whether X is otherwise eligible to be an S corporation, or whether Trusts are valid ESBTs.

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

In accordance with the power of attorney on file with this office, we are forwarding a copy of this letter to X's authorized representative.

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

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