

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:2-PLR-105412-02
Date:
May 30, 2002

Legend

- X =
- A =
- B =
- Trust 1 =
- Trust 2 =
- Trust 3 =
- Trust 4 =
- Trust 5 =
- Trust 6 =
- Trust 7 =
- Trust 8 =
- Sub 1 =
- Sub 2 =
- Sub 3 =
- Sub 4 =
- D1 =
- D2 =

Dear :

This letter responds to a letter dated November 6, 2001, 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 X was incorporated on D1. X has the following shareholders: A, Trust 1, Trust 2, Trust 3, Trust 4, Trust 5, Trust 6, Trust 7, and Trust 8. B, and subsequent to B's death, B's estate, were also shareholders of X until X redeemed the X stock held by B's estate. X has the following subsidiaries: Sub 1, Sub 2, Sub 3, and Sub 4. Effective D2, X elected to be an S corporation. X's

PLR-105412-02

attorney filed qualified subchapter S trust (QSST) elections on behalf of Trusts 1 through 7, effective D2. The information submitted states that Trust 8 is a grantor trust, and therefore, an eligible S corporation shareholder. In addition, effective D2, X's attorney filed qualified subchapter S subsidiary (QSSS) elections on behalf of Subs 1 through 4.

Upon the death of X's attorney, X obtained a new attorney who discovered that the subchapter S election made by X was ineffective because (1) Trusts 1 through 3 did not qualify as QSSTs but rather qualified as electing small business trusts (ESBTs), (2) Trusts 1 through 3 did not make the proper election under § 1361(e)(3) to be treated as ESBTs, and (3) the QSST elections made by Trusts 4 through 7 were made by the trusts' trustees and not the trusts' income beneficiaries. These deficiencies caused X's S election to be ineffective.

A, as president of X, represents that since D2, X, its shareholders, and its subsidiaries have filed tax returns under the assumption that these elections were filed properly and were effective D2. A also represents that the circumstances resulting in the ineffectiveness of X's election to be an S corporation were inadvertent and that X and X's 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" means a domestic corporation that is not an ineligible corporation and that 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(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

PLR-105412-02

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(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 “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), or (IV) an organization described in section 170(c)(1) which holds a contingent interest in such trust 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.

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.

Section 1.1361-1(m)(2) of the Income Tax Regulations 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 elections (generally within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust).

Section 1361(d)(1) provides that in the case of a QSST with respect to which a beneficiary makes an election under § 1361(d)(2), such trust shall be treated as a trust described in § 1361(c)(2)(A)(i) and, for purposes of § 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in

PLR-105412-02

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 (or his 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) 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(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 section 1362(b)(2)) by reason of failure to meet the requirements of section 1361(b) or to obtain shareholder consents, or was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in such termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the termination, steps were taken so that the corporation is a small business corporation; and (4) the corporation, and each person who was a shareholder of the corporation at any time during the period specified under § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary for that period, then, notwithstanding the circumstances resulting in such 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 D2. 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 an S corporation effective D2, and thereafter, provided that X's election to be an S corporation was not otherwise invalid and not terminated, thereafter, under § 1362(d). Subs 1 through 4 will be treated as QSSSs effective D2, and thereafter, provided that each of the QSSS elections for Subs 1 through 4 were not otherwise invalid and not terminated under § 1361(b)(3)(C).

In addition, Trusts 1 through 7 will be treated as shareholders of X, effective D2, and thereafter. Trusts 1 through 3 will be treated as ESBTs under § 1361(e), effective D2, and thereafter; the trusts and their respective beneficiaries must amend their tax returns accordingly. Effective D2, and thereafter, Trusts 4 through 7 will be treated as QSSTs described in § 1361(d)(3), and the respective beneficiaries of Trusts 4 through 7 will be treated, for purposes of § 678, as the respective owners of the X stock held by Trusts 4 through 7.

X's shareholders must include their pro rata share of the separately and

PLR-105412-02

nonseparately computed items of X as provided in § 1366, make any adjustments to stock basis as provided in section § 1367, and take into account any distributions made by X to shareholders as provided in § 1368. If X or X's 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 D2. An ESBT election for each of Trusts 1 through 3 pursuant to the procedures set forth in § 1.1361-1(m)(2) must be filed, effective D2, with the appropriate Service Center within 60 days of the date of this letter ruling. Furthermore, the respective beneficiaries of each of Trusts 4 through 7 must make a QSST election for each Trust, effective D2, with the appropriate Service Center within 60 days following the date of this letter. A copy of this letter should be attached to the new Form 2553, the ESBT elections and the QSST elections.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code, including whether X is otherwise eligible to be an S corporation, whether Trusts 1 through 3 are valid ESBTs, whether Trusts 4 through 7 are valid QSSTs, whether Trust 8 is a grantor trust, and whether Subs 1 through 4 are valid QSSSs.

This ruling is directed only to the taxpayer(s) requesting 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 and X's second 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