

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B02

PLR-137033-07

Date:

January 15, 2008

Legend

X:

Trust 1:

Trust 2:

Trust 3:

State:

Court:

Date 1:

Date 2:

Date 3:

Date 4:

Date 5:

Dear :

This letter responds to a letter dated August 14, 2007, and subsequent correspondence, submitted on behalf of X, requesting rulings under § 1362(f) of the Internal Revenue Code.

X was incorporated under the laws of State. X elected under § 1362(a) to be an S corporation, effective Date 1. Trust 1, Trust 2, and Trust 3 (Trusts) became shareholders of X on Date 2, and the trustees of Trusts made elections for the trusts to be electing small business trusts (ESBTs). However, Article 6(i) of Trusts Agreement authorized the trustees to make distributions by payment to a corporation, partnership or limited liability company 90% or more of the interest in the stock or capital of which is owned by a beneficiary or is held in trust for a beneficiary's benefit or by payment to a trust for a beneficiary's benefit. Therefore, X's S corporation election terminated on Date 2, when Trusts became X shareholders because Trusts Agreement allowed distributions to ineligible potential current beneficiaries,.

On Date 3, X was informed by its legal counsel that Article 6(i) of the Trusts Agreement may cause the Trusts to be ineligible shareholders. On Date 4, X filed petitions to modify Trusts Agreement to eliminate the ability of the trustees to make payments to any corporations, partnerships or limited liability companies. On Date 5, State Court accepted and approved Trusts Agreement to incorporate this amendment.

X represents that the terminating event was not motivated by tax avoidance or retroactive tax planning. X also represents that no distributions were ever made from Trusts to anyone other than the individual beneficiary of each trust. X represents that since Date 1, X and its shareholders have filed federal income tax returns consistent with X's S corporation election. Furthermore, X and each person who is or was a shareholder of X at any time since Date 2, have filed their income tax returns consistent with the treatment of X as an S corporation.

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 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)(v) provides that, for purposes of § 1361(b)(1)(B), an ESBT may be a shareholder of an S corporation. Section 1361(c)(2)(B)(v) provides that in the case of an ESBT, each potential current beneficiary (PCB) of such trust shall be treated as a shareholder for purposes of § 1361(b)(1); except that, if for any period there is no PCB of such trust, such trust shall be treated as the shareholder during such period.

Section 1361(e)(1)(A) provides that for purposes of § 1361, except as provided in § 1361(e)(1)(B), the term "electing small business trust" means any trust if -- (i) the trust does not have as a beneficiary any person other than an individual, an estate, an organization described in § 170(c)(2), (3), (4), or (5), or an organization described in § 170(c)(1) that holds a contingent interest in the trust and is not a potential current beneficiary; (ii) no interest in the trust was acquired by purchase; and (iii) an election under § 1361(e) applies to the trust.

Section 1361(e)(2) provides that for purpose of § 1361, the term "potential current beneficiary" means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust (determined without regard to any power of appointment to the extent such power remains unexercised at the end of such period).

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 the trust unless revoked with the consent of the Secretary.

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 the termination 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 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 § 1362(d)(2) or (3), (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 in 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, such corporation shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the representations made and the information submitted, we conclude that X's S corporation election terminated on Date 2, under § 1362(d)(2), when X issued its stock to ineligible Trusts, and that this termination of X's S election was inadvertent within the meaning of § 1362(f). Accordingly, pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from Date 2 through Date 5, provided X's S corporation election was valid and was not otherwise terminated under § 1362(d). All of X's shareholders in determining their respective income tax liabilities during the termination period and thereafter, must include their pro rata share of the separately stated items of income (including tax-exempt income), loss, deduction, or credit and non-separately stated computed items of income or loss of X as provided in § 1366, make any adjustments to basis provided in § 1367, and take into account any distributions made by X as provided in § 1368.

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, no opinion is expressed on whether X is otherwise eligible to be treated as an S corporation or Trusts' eligibility to be ESBTs.

This ruling letter 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 the power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,

Bradford R. Poston
Senior Counsel, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes