



Dear \_\_\_\_\_ :

This responds to a letter dated September 14, 2007, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

#### FACTS

The information submitted states that X was incorporated on Date 1 in accordance with the laws of State. X elected to be an S corporation effective Date 1. On Date 2, shares of X's stock were transferred to Trust 1, Trust 2, and Trust 3. X represents that Trust 1, Trust 2, and Trust 3 were each qualified to be an electing small business trust (ESBT), within the meaning of § 1361(e), and that it was intended that an ESBT election be filed for each of the three trusts. However, the trustees of each of Trust 1, Trust 2, and Trust 3 failed to make an ESBT election. In Month, X's counsel discovered that there were no records of ESBT elections having ever been filed for Trust 1, Trust 2, or Trust 3.

Every taxable year since X's inception, except Year, X has made distributions to its shareholders on a pro rata basis. During Year, X made a number of distributions that were not in proportion to the ownership interests of the shareholders. In particular, actual distributions were made in Year to shareholder A, but not to any other shareholder of X. In addition, federal income tax payments were made in Year on behalf of Trust 1, Trust 2, and Trust 3 that were mistakenly reflected on A's Schedule K-1 as distributions to A. In Month, X's counsel discovered that distributions had been made in Year that were not in accordance with the shareholders' ownership interests in X.

On Date 3, X made remedial distributions to certain shareholders to correct the effect of the disproportionate distributions in Year. Interest payments were also made to account for the timing difference between the disproportionate and remedial distributions.

X represents that, under X's articles of incorporation and by-laws and State law, all of the issued and outstanding shares of capital stock of X have identical rights to distribution and liquidation proceeds, and that X has never had any written or oral agreement, or any other type of understanding, with any shareholder that would entitle any shareholder to a preference regarding distribution and liquidation proceeds.

X represents that the circumstances resulting in the termination of the election were not motivated by tax avoidance or retroactive tax planning. X further represents that X and each of its shareholders have filed federal income tax returns consistent with the treatment of X as an S corporation at all times since Date 1, and that Trust 1, Trust 2, and Trust 3 each have filed federal income tax returns consistent with their treatment as ESBTs. Finally, X and each of X's shareholders agree to make any adjustments required by the Secretary consistent with the treatment of X as an S corporation.

## LAW AND ANALYSIS

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) defines a "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not (A) have more than 100 shareholders, (B) 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, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1361(e)(1)(A) defines an ESBT as any trust if (i) the trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in § 170(c)(2), (3), (4), or (5), or (IV) 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 1.1361-1(m)(2)(i) provides that the trustee of an ESBT must make the ESBT election by signing and filing, with the service center where the S corporation files its income tax return, a statement that meets the requirements of § 1.1361-1(m)(2)(ii).

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that a corporation is generally treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

Section 1.1361-1(l)(2)(i) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the "governing provisions"). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Section 1362(d)(2) provides that (A) in general, 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 and (B) any termination under § 1362(d)(2) 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 terminated under paragraph (2) or (3) of § 1362(d), (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 termination, steps were taken so that the corporation is once more 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 pursuant to § 1362(f), agrees to make any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to the period, then, notwithstanding the circumstances resulting in the termination, the corporation will be treated as continuing to be an S corporation during the period specified by the Secretary.

## CONCLUSION

Based solely on the information submitted and the representations made, we conclude that X's S election terminated on Date 2 because ESBT elections were not filed for Trust 1, Trust 2, or Trust 3. In addition, we conclude that the termination was inadvertent within the meaning of § 1362(f). Furthermore, even if X's S corporation election had not terminated on Date 2, X's S corporation election may have terminated during Year because X may have had more than one class of stock due to the distributions made during Year. However, we conclude that, if X's S election was so terminated, such termination was inadvertent within the meaning of § 1362(f).

Therefore, X will be treated as continuing to be an S corporation from Date 2, and thereafter, provided that: (1) The trustees for Trust 1, Trust 2, and Trust 3 each file an ESBT election with the appropriate service center, effective Date 2, within 60 days of the date of this letter; and (2) X's S election is not otherwise terminated under § 1362(d). A copy of this letter must be attached to the ESBT elections. 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 and non-separately 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 expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed concerning whether X is otherwise eligible to be treated as an S corporation, or whether Trust 1, Trust 2, and Trust 3 are eligible to be treated as ESBTs.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

/s/

Audrey W. Ellis  
Senior Counsel, Branch 1  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)