

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Legend

X =

A =

Trust 1 =

Trust 2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year 1 =

Dear :

This responds to a letter dated December 26, 2007, and subsequent correspondence, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

Facts

The information submitted states that X elected to be an S corporation effective Date 1. Trust 1, a trust that was treated (under subpart E of part 1 of subchapter J of chapter 1) as owned by A, was a shareholder of X. Also, Trust 2, a qualified subchapter S trust (QSST) under § 1361(d)(1) for which A was the sole income beneficiary, was a shareholder of X.

On Date 2, A died. Trust 1 continued to qualify as a permissible S corporation shareholder under § 1361(c)(2)(A)(ii) for the 2-year period beginning on the day of the deemed owner's death and ending on Date 3. Trust 2 continued to qualify as a permissible S corporation shareholder under § 1.1361-1(j)(7)(ii) of the Income Tax Regulations for the 2-year period beginning on the day of the income beneficiary's death and ending on Date 3.

On Date 3, Trust 1 and Trust 2 each became an ineligible shareholder of X and X's election to be an S corporation terminated. On Date 4, the trustees of each of Trust 1 and Trust 2 distributed each Trust's stock in X to the beneficiaries of each of the respective trusts, pursuant to the terms of each Trust. X represents that the beneficiaries are individuals eligible to be S corporation shareholders. X represents that the circumstances resulting in the termination of X's S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning.

X and its shareholders have agreed to make any adjustments that the Commissioner may require, consistent with the treatment of X as an S corporation.

Law and Analysis

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, for purposes of subchapter S, 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)(i) provides that, for the purposes of § 1362(b)(1)(B), a trust all of which is treated (under title 26, subtitle A, chapter 1, subchapter J, part I, subpart E of the United States Code) as owned by an individual who is a citizen or resident of the United States may be a shareholder of an S corporation.

Section 1361(c)(2)(A)(ii) and § 1.1361-1(h)(1)(ii) of the Income Tax Regulations provide that, for purposes of § 1361(b)(1)(B), a trust that is described in § 1361(c)(2)(A)(i) immediately before the death of the deemed owner and that continues in existence after such death is a permitted shareholder, but only for the two-year period beginning on the day of the deemed shareholder's death.

Section 1.1361-1(h)(3)(i)(B) provides that, if stock is held by a trust described in § 1.1361-1(h)(1)(ii), the estate of the deemed owner is generally treated as the shareholder as of the day of the deemed owner's death.

Section 1361(d)(1) provides that, in the case of a qualified subchapter S trust with respect to which a beneficiary makes an election under § 1361(c)(2), (A) such trust will be treated as a trust described in § 1361(c)(2)(A)(i), and (B) 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 an S corporation with respect to which the election under § 1361(d)(2) is made.

Section 1.1361-1(j)(7)(i) provides that the income beneficiary who makes the QSST election and is treated (for purposes of § 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of §§ 1361(b)(1), 1366, 1367, and 1368.

Section 1.1361-1(j)(7)(ii) provides that if, upon the death of an income beneficiary, the trust continues in existence, continues to hold S corporation stock but no longer satisfies the QSST requirements, is not a qualified subpart E trust, and does not qualify as an ESBT, then, solely for purposes of § 1361(b)(1), as of the date of the income beneficiary's death, the estate of that income beneficiary is treated as the shareholder of the S corporation with respect to which the income beneficiary made the QSST election. The estate ordinarily will cease to be treated as the shareholder for purposes of § 1361(b)(1) upon the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day of the income beneficiary's death. During the period that the estate is treated as the shareholder for purposes of § 1361(b)(1), the trust is treated as the shareholder for purposes of §§ 1366, 1367, and 1368. If, after the 2-year period, the trust continues to hold S corporation stock and does not otherwise qualify as a permitted shareholder, the corporation's S election

terminates. If the termination is inadvertent, the corporation may request relief under § 1362(f).

Section 1362(d)(2) 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. The termination is effective on and after the day of the termination.

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; (2) the Secretary determines that the circumstances resulting in such ineffectiveness were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness, steps were taken so that the corporation for which the election was made is a small business corporation, or to acquire the required shareholder consents; and (4) the corporation for which the election was made, and each person who was a shareholder in such corporation at any time during the period specified pursuant to § 1362(f), agrees to make such adjustments (consistent with the treatment of such 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, such corporation shall be treated as 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 corporation election was terminated on Date 3, when Trust 1 and Trust 2 became ineligible shareholders. We further conclude that the termination of X's S corporation election was an inadvertent termination within the meaning of § 1362(f). Accordingly, pursuant to the provisions of § 1362(f), X will be treated as an S corporation from Date 3 and thereafter, provided that X's S corporation election was otherwise valid and has not otherwise terminated under § 1362(d).

The shareholders of X must include their pro-rata share of the separately stated and nonseparately computed items of X as provided in § 1366, make adjustments to basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368. If X or its shareholders fail to treat themselves as described above, this ruling is null and void.

Except as specifically ruled above, we express or imply no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code. Specifically, we express or imply no opinion regarding whether X is otherwise eligible to be an S corporation.

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

Sincerely,

/s/

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

Enclosures (2)

Copy of this letter

Copy for §6110 purposes

cc: