

Internal Revenue Service

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LEGEND

X =

Y =

Z =

State =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

Year 1 =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Trust 5 =

Shareholder =

a =

b =

Dear :

This letter responds to your letter dated October 21, 2008, and subsequent correspondence, submitted on behalf of X by X's authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

X was incorporated under the laws of State on D1 and elected to be an S corporation effective D2. Y and Z are wholly-owned subsidiaries of X. Y and Z were incorporated under the laws of State on D3 and D4, respectively. X filed valid elections to treat Y and Z as qualified subchapter S subsidiaries (QSubs) effective as of the date of X's S election, D2.

On D5, Shareholder transferred a shares of X stock to Trust 1. The taxpayer represents Trust 1 is a permissible S corporation shareholder under § 1361(c)(2)(A)(i). Trust 1 terminated on D6 whereupon b shares of X stock were transferred to Trust 2 and Trust 3. The taxpayer represents that Trust 2 and Trust 3 are each eligible to be an electing small business trust (ESBT) within the meaning of § 1361(e). However, no election was made under § 1361(e)(3) to treat Trust 2 or Trust 3 as an ESBT. The

primary beneficiaries of Trust 2 and Trust 3 also have withdrawal powers over their respective trusts that would cause them to be the owners of a portion of their respective trusts under §§ 671 and 678. Consequently, Trust 2 and Trust 3 were ineligible shareholders, and, as a result, X's S corporation election terminated on D6.

Upon learning that X may not qualify as an S corporation, X took steps to ensure that X qualified as an S corporation. On D7, Trust 2 transferred all of its shares of X stock to Trust 4, and Trust 3 transferred all of its shares of X stock to Trust 5. X represents Trust 4 and Trust 5 are permissible shareholders under § 1361(c)(2)(A)(i).

X represents the termination of X's S corporation election was inadvertent and not motivated by tax avoidance or retroactive tax planning. X represents that X and all of its shareholders have filed returns consistent with X's status as an S corporation since D1. In addition, X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary with respect to the period specified by § 1362(f).

LAW AND ANALYSIS

Section 678(a)(1) provides that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which the person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself.

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 which is not an ineligible corporation and which 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(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 this chapter) 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 for purposes of § 1361(b)(1)(B), an ESBT is a permissible shareholder.

Section 1361(e)(1)(A) provides that, except as provided in § 1362(e)(1)(B), an ESBT means any trust if (i) such 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) 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 the trust.

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)(i) of the Income Tax Regulations 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 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, in relevant part, that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in the ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were taken (A) so that the corporation is a small business corporation or (B) to acquire the shareholder consents; 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 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 the ineffectiveness or termination, the corporation will be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) provides that for purposes of § 1.1362-4(a) the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent.

Section 1.1362-4(d) provides that the Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified by the Commissioner.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that X's election to be treated as an S corporation terminated on D6 when stock in X was transferred to impermissible shareholders. We further conclude that the termination was inadvertent within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation on and after D6, and Y and Z will be treated as QSubs on and after D6, unless X's S corporation election is otherwise terminated under § 1362(d), and the QSub elections for Y and Z are otherwise valid and not terminated under § 1361(b)(3). Trust 2 and Trust 3 will be treated as ESBTs from D6 until D7. Accordingly, 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 nonseparately computed items of income or loss of X as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account any distributions made by X as provided by § 1368.

This ruling is conditioned upon the trustee of Trust 2 and Trust 3 filing appropriately completed ESBT elections with the appropriate service center effective D6. The ESBT elections must be filed within 60 days following the date of this letter and a copy of this letter should be attached to the elections. This ruling is additionally conditioned on Trust 2, Trust 3, and their beneficiaries filing within 60 days following the date of this letter amended returns for Year 1 and subsequent taxable years consistent with the treatment of Trust 2 and Trust 3 as ESBTs and the beneficiaries as the owners of their respective portions of Trust 2 and Trust 3 under §§ 671 and 678. A copy of this letter should be attached to each amended return. If X or its shareholders fail to treat themselves as described above, this ruling is null and void.

Except as specifically provided herein, no opinion is expressed or implied as to the federal tax consequences of the facts described above under any other provision of the Code. In particular, no opinion is expressed as to whether X is otherwise eligible to be an S corporation, whether Y or Z are otherwise eligible to be QSubs, whether Trust 2 or Trust 3 are otherwise eligible to be ESBTs, and whether Trust 1, Trust 4, or Trust 5 are otherwise permissible shareholders of X.

This ruling is directed only to the taxpayer 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, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

/s/

Leslie H. Finlow
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2):

A copy of this letter
A copy for § 6110 purposes

cc: