

INTERNAL REVENUE SERVICE  
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29 July 1999

X =

A =

B =

C =

D =

E =

Trust =

F =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Year 1 =

State Y =

Dear :

This is in reply to your letter dated March 12, 1999, and subsequent correspondence submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code.

The information submitted states that X is a corporation organized under the laws of State Y. X elected to be an S corporation effective Date 1. The current shareholders of X are A, B, C, D, E, and Trust. On Date 2, F died. As part of the administration of F's estate, the shares of X owned by F were transferred to Trust. On Date 3, sixty days after the date the shares of X were transferred to Trust, Trust ceased to be an eligible shareholder of X, but continued to hold shares of X, resulting in the termination of X's S corporation election. Since the date of F's death, Trust's share of X's taxable income has been passed through to B and B has included the income on B's individual tax return. In Year 1, X retained a tax attorney in connection with the evaluation of a potential corporate transaction. In connection with that review it was discovered that Trust was not a qualified S corporation shareholder and that the S election for X had terminated on Date 3. X seeks relief under § 1362(f) that X's S election be reinstated as of Date 3. Furthermore, Trust would now like to file an election under § 1361(e), effective Date 4, and is requesting permission to file the election.

X and the shareholders of X have filed consistent with the treatment of X as an S corporation.

A represents that the terminating event was 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.

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 and other than a trust described in § 1361(c)(2)) who is not an individual.

For taxable years beginning on or before December 31, 1996, § 1361(c)(2)(A) provided that, for purposes of § 1361(b)(1)(B),

trusts that may be shareholders include a trust with respect to stock transferred to it pursuant to the terms of a will, but only

for the 60 day period beginning on the day on which such stock is transferred to it.

Section 1361(e)(1)(A) provides that an "electing small business trust" (ESBT) 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), or (5) of § 170(c); (ii) no interest in such trust was acquired by purchase, and (iii) an election under § 1361(e) applies to such trust.

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 any termination under § 1362(d)(2)(A) shall be effective on and after the date of cessation.

Section 1362(f) provides, in part, 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 termination was inadvertent, (3) no later than a reasonable period of time after the discovery of the circumstances resulting in the termination, steps were taken so that the corporation is a small business 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 such the termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Based on the information provided and the representations made, we hold that the termination of X's S corporation election occurred on Date 3, as a result of the failure of Trust to continue to qualify as a qualified S corporation shareholder under § 1361(c) and that the termination constituted an "inadvertent termination" within the meaning of § 1362(f).

We further hold that, pursuant to the provisions of § 1362(f), X will be treated as an S corporation from Date 3, to Date 4, provided that X's election was valid and not otherwise terminated under § 1362(d). In addition, from Date 4, and thereafter, Trust will be treated as an ESBT under § 1361(e)

provided that Trust files an ESBT election effective for Date 4, with the appropriate service center within 60 days following the date of this letter. Therefore, 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 any adjustments to basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368. For the period from Date 3, through Date 5, B must report the items allocated to Trust as if Trust was a Qualified Subchapter S Trust under § 1361(d)(3). If X or its shareholders fail to treat X as described above, this ruling will be null and void.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provisions of the Code.

This ruling is directed only to the taxpayers 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.

Sincerely yours,

J. THOMAS HINES  
Senior Technician Reviewer  
Branch 2  
Office of the Assistant  
Chief Counsel  
(Passthroughs and  
Special Industries)

Enclosures: 2  
Copy of this letter  
Copy for § 6110 purposes