

## Internal Revenue Service

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Third Party Communication: None

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Date:

October 16, 2006

X =

Trust =  
1

Trust =  
2

Trust =  
3

Trust =  
4

State =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

Dear :

This responds to a letter dated May 25, 2006, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated under the laws of State and elected to be an S corporation effective D1. On D2, Trust 1, Trust 2, and Trust 3 ("Trusts") owned all of the issued and outstanding shares of X. Trusts were treated as grantor trusts under subpart E of part I of subchapter J of chapter 1 of the Code. On D3, Trust 3 transferred all of its shares of X stock to Trust 4. Trust 4, a charitable remainder unitrust, is an impermissible S corporation shareholder under § 1361(b)(1)(B). Accordingly, X's S corporation election was terminated on D3. X was not aware that the transfer of stock to Trust 4 would terminate X's S corporation election.

X's S corporation election would also have terminated (if it had not already terminated on D3) on D4 when Trust 2 transferred half of its shares of X stock to Trust 4 (as well as half of its shares of X stock to Trust 1) and ceased to be a shareholder of X.

On D5, an accountant for Trust 4 notified X that X's S election had terminated. Effective D6, Trust 4 transferred all of its shares of X back to Trust 3.

During the period that Trust 4 held the stock of X, X and its shareholders, including Trust 4, filed returns treating X as if it were an S corporation.

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 such adjustments as the Service may require with respect to all periods since D3.

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)(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 Chapter 1) as owned by an individual who is a citizen or resident of the United States may be a shareholder.

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 D3, under § 1362(d)(2), because shares were transferred to Trust 4, a charitable remainder unitrust. We also conclude that the termination of X's S corporation election was inadvertent within the meaning of § 1362(f). Accordingly, we hold that under the provisions of § 1362(f), X will be treated as if it were an S corporation from D3 and thereafter, provided that X's S corporation election was valid and not otherwise terminated under § 1362(d). During the termination period, Trust 3 shall be treated as owning the stock that it transferred to Trust 4. In addition, Trust 3 shall be treated as owning the stock that was transferred to Trust 4 by Trust 2 since D4. Accordingly, Trust 3, in determining its respective income tax liabilities during the termination period and thereafter, must include its pro rata share of the separately 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. If X or Trust 3 fail to treat themselves as described above, this ruling shall be null and void.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed on whether X was otherwise eligible to be treated as an S corporation. Furthermore, we express no opinion on the consequences to Trust 4 of the above transactions under § 664.

This ruling is directed only to the taxpayer on whose behalf it was requested. 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 X's authorized representative.

Sincerely,

Bradford R. Poston  
Senior Counsel, Branch 2  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

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