

## Internal Revenue Service

## Department of the Treasury

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Refer Reply To:  
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February 17, 1999

### Legend

X =

State =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

This responds to your representative's August 18, 1998 letter, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

### **FACTS**

X was incorporated under State law on D1, and elected subchapter S status, effective D2. On D3, one of X's shareholders gifted options to purchase stock of X to various trusts. On D4, all of the options to purchase were exercised. In addition, during D5, several other shareholders of X gifted stock of X to various trusts.

Although the trustees of the trusts were required to make Electing Small

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Business Trust (ESBT) elections within two and one-half months of the transfers to qualify as shareholders of X, they failed to timely file the elections. X was unaware that the failure to file ESBT elections terminated X's S election. In D6, X's accountants discovered that transfers of X stock to the trusts terminated X's S election. Shortly after this discovery, the trustees filed ESBT elections.

X represents that the transfers to the trusts were not motivated by tax avoidance or retroactive tax planning. 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 1361(a)(1) defines an "S corporation", with respect to any taxable year, as a small business corporation for which an S election under § 1362(a) is in effect for that year.

Effective for tax years beginning after December 31, 1996, § 1361(c)(2)(A)(v) provides that an ESBT (as defined in §1361(e)) is a permitted S corporation shareholder. Generally, an ESBT is any trust if: (1) the trust does not have as a beneficiary any person other than an individual, an estate, or an organization described in § 170(c)(2), (3), (4), or (5); (2) no interest in the trust was acquired by purchase; and (3) an election to be an ESBT has been filed with respect to the trust.

In Notice 97-12, 1997-3 I.R.B. 11, the Service provided guidance regarding ESBT elections. In particular, the trustee of an ESBT must file the ESBT election within the time requirements prescribed in regulation § 1.1361-1(j)(6)(iii) for filing Qualified Subchapter S Trust elections (generally within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust).

Section 1362(d)(2)(A) provides that an S election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the taxable year for which the corporation is an S corporation) the corporation ceases to be a small business corporation. The termination is effective on and after the day 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 paragraph (2) or (3) of § 1362(d); (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 effectiveness 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

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corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to this subsection, 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, the corporation shall be treated as an S corporation during the period specified by the Secretary.

The committee reports accompanying the Subchapter S Revision Act of 1982, in discussing § 1362(f) as it relates to inadvertent terminations, state, in part, as follows:

If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.

The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped the taxpayers and the government will work out agreements that protect the revenues without undue hardship to taxpayers . . . . It is expected that the waiver may be made retroactive for all years, or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24.

### **CONCLUSIONS**

Based solely on the facts submitted and representations made, we conclude that X's subchapter S election terminated when the trusts acquired X stock. We also conclude that the termination was inadvertent under § 1362(f). Therefore, under the provisions of § 1362(f), X will be treated as an S corporation from the date the trusts acquired X stock and thereafter, and the trustees will be treated as having filed timely ESBT elections on behalf of the trusts, effective on the date the trusts acquired X stock and thereafter, provided that X's S corporation election did not otherwise terminate under § 1362(d).

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

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Code. Specifically, no opinion is expressed concerning whether X's S corporation election was a valid election under § 1362.

This ruling is directed only to the taxpayer 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 copies of this ruling are being sent to your authorized representatives.

Sincerely,

Signed/Daniel J. Coburn  
Daniel J. Coburn  
Assistant to the Branch Chief, Branch 1  
Office of the Assistant Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)  
Copy of this letter  
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