

## Internal Revenue Service

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Third Party Communication: None

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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B02

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Date:

October 07, 2005

### Legend

X = EIN:

A =

B =

Trust 1 =

Trust 2 = TIN:

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Dear :

This letter responds to a letter dated May 19, 2005, together with subsequent correspondence, submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code.

The information submitted states that X, a State corporation, elected to be treated as an S corporation effective Year 1. Trust 1, a revocable trust treated as a

grantor trust under subpart E of part I of subchapter J of chapter 1 the Code was a shareholder of X. On Date 1, A, the grantor of Trust 1, died. Upon A's death, Trust 1 ceased to qualify as a grantor trust. Trust 1 continued to qualify as a subchapter S trust 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. On Date 2, X shares were transferred from Trust 1 to Trust 2, an ineligible shareholder. This transfer of X shares would have terminated X's S corporation election. But, pursuant to Section 3.2 of the Shareholder Agreement, the transfer was null and void, and therefore, Trust 1 continued to be the shareholder of X. However, Trust 1 failed distribute the shares of X on or before Date 3. Accordingly, Trust 1 ceased to qualify as an eligible shareholder on Date 3, and X's S corporation election was terminated on Date 3.

B, the president of X represents that the following remedial actions were taken. Trust 2 elected to be treated as a Qualified Subchapter S Trust (QSST) effective Date 4. On Date 4, Trust 1 transferred its shares of X to Trust 2.

X represents that neither the disqualified transfer of X shares to an ineligible shareholder nor the terminating event, Trust 1's failure to transfer the X shares prior to Date 3, were motivated by tax avoidance or retroactive tax planning. For all taxable years X's shareholders' income was reported consistent with X qualifying as an S corporation. For taxable Year 2, believing that there had been a valid transfer of the X stock from Trust 1 to Trust 2, X issued K-1's to both Trust 1 and Trust 2. For taxable Year 3, X issued a K-1 to Trust 1, and Trust 1 will report its share of X's income loss, deductions, and credits on its income tax return.

X and all of the relevant shareholders of X agree to make any adjustments (consistent with the treatment of X as an S corporation) that the Secretary may require.

Section 1361(a)(1) of the Code provides that an S corporation means a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1361(b)(1)(B) provides that the term small business corporation is 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) 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 I) as owned by an individual who is a citizen or resident of the United States may be a shareholder.

Section 1362(c)(2)(A)(ii) provides that a trust which was described in clause (i) immediately before the death of the deemed owner and which continues in existence after such death, but only for the 2 year period beginning on the day of the deemed owner's death may be a shareholder.

Section 1361(d)(1) provides that in the case of a QSST with respect to which a beneficiary makes an election under § 1361(d)(2), such trust shall be treated as a trust described in § 1361(c)(2)(A)(i) and, 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 1361(d)(2)(A) provides that a beneficiary of a QSST (or his legal representative) may elect to have § 1361(d) apply. Section 1362(d)(2)(D) provides that an election under § 1361(d)(2) shall be effective up to 15 days and 2 months before the date of the election.

Section 1.1361-1(j)(6)(ii) of the Income Tax Regulations provides that the current income beneficiary of the trust must make the election under § 1361(d)(2) by signing and filing with the service center, with which the corporation files its income tax return the applicable form or a statement including the information listed in § 1.1361-1(j)(6)(ii).

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the taxable year for which a corporation is an S corporation) such corporation ceases to be a small business corporation. A termination of an S corporation election under § 1362(d)(2) is 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 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 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, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts submitted and the representations made, we conclude that if on Date 2 the transfer of X shares to Trust 2, an ineligible shareholder, had not been null and void, X's S corporation election would have terminated on Date 2. This termination would have been an inadvertent termination under § 1362(f). We also conclude that X's S election was terminated on Date 3, the day after the two year period that began on Date 1, because Trust 1 was no longer an eligible shareholder of X. We

conclude that this termination was inadvertent within the meaning of § 1362(f). Accordingly, under the provisions of § 1362(f), X will be treated as continuing to be an S corporation from Date 2, and thereafter, provided that X's S election was valid and was not otherwise terminated under § 1362(d). This ruling is contingent on Trust 1, Trust 2, and Trust 2's beneficiary amending their taxable Year 2 returns to reflect that Trust 1 was the shareholder of X for all of taxable Year 2. Also, this ruling is contingent on Trust 1, Trust 2, and Trust 2's beneficiary reporting their share of X items as if Trust 1 was a shareholder of X for all of taxable Year 3. Accordingly, Trust 2's QSST election will be effective for taxable Year 4.

Accordingly, all of the shareholders of X, in determining their respective income tax liabilities for the period beginning Date 2 and thereafter must include their pro rata share of the separately stated and non-separately computed items of X as provided in § 1366, make any adjustments to basis 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 shall be null and void.

Except as specifically ruled upon above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provisions of the Code. Specifically, no opinion is expressed on whether X was otherwise eligible to be treated as an S corporation, or on whether there was a valid transfer of X shares from Trust 1 to Trust 2 on Date 2. Further, no opinion is expressed as to whether Trust 2 qualifies as a QSST.

This ruling is directed only to the taxpayer who requested it. Section § 6110(k)(3) of the Code 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's authorized representative.

Sincerely,  
J. Thomas Hines  
Chief, Branch 2  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

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