

## Internal Revenue Service

## Department of the Treasury

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### LEGEND

Company =

State =

d1 =

d2 =

d3 =

d4 =

H =

W =

T1 =

T2 =

T3 =

Grantor Trust Owners =

Dear

This responds to your letter dated September 20, 1999, and subsequent correspondence on behalf of Company, requesting rulings under §§ 1362(b)(5) and 1362(f) of the Internal Revenue Code.

### FACTS

According to the information submitted, Company was incorporated on d1 under State law by H and W. Although H and W intended for Company to be an S corporation from inception, an election to be an S corporation under § 1362 was not timely filed. Nevertheless, H and W have always acted as though Company was an S corporation.

On d2, H and W began gifting certain shares of Company's stock to six separate trusts. Each trust was for the benefit of one of H's six children. Company represents that three of the trusts were "grantor trusts," and thus, were eligible S corporation shareholders. At the time, the other three trusts, T1, T2, and T3 (collectively the Trusts) were ineligible shareholders of an S corporation. Thus, had Company timely filed its S election, it would have terminated on d2. At the time of the transfers, the Trusts were not eligible to be Electing Small Business Trusts (ESBTs).

During d3, Company's new accountants discovered that Company had ineligible shareholders and that the presumed S corporation election had never been filed. Company represents that as of d4, the Trusts were eligible to be ESBTs under § 1361(c)(2)(A)(v), and the trustees of the Trusts filed ESBT elections effective d4.

Company and its shareholders agree to make any adjustments consistent with the treatment of Company 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) 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 1362(a) provides that a small business corporation may elect to be an S corporation.

Section 1362(b) provides the rule on when an S election will be effective. If an S election is made within the first two and one-half months of a corporation's taxable year, then the corporation will be treated as an S corporation for the year in which the election is made. If an S election is made after the first two and one-half months of a corporation's taxable year, then the corporation will not be treated as an S corporation until the taxable year after the year in which the S election is made.

Section 1362(b)(5) provides that if (A) an election under § 1362 (a) is made for

any taxable year after the date prescribed by § 1362 for making the election or no election is made for any taxable year, and (B) the Secretary determines that there was reasonable cause for the failure to timely make the election, the Secretary may treat the election as timely made for that taxable year.

Section 1361(b)(1)(B) provided 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.

Effective for tax years beginning after December 31, 1996, § 1361(c)(2)(A)(v) provides that for the purposes of § 1361(b)(1)(B) an ESBT may be a shareholder of an S corporation.

Section 1362(d)(2)(A) provides that an S election under § 1362(a) shall terminate 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 date the S corporation ceases to be a small business corporation. Section 1362(d)(2)(B).

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 such termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the termination, steps were taken so that the corporation is a small business corporation, 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 the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary for that 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.

## CONCLUSIONS

After applying the relevant law to the facts submitted and representations made, we conclude that Company has established reasonable cause for not making a timely election and is eligible for relief under § 1362(b)(5). Additionally, we hold that the transfer of Company's shares to the Trusts on d2 was an inadvertent termination within the meaning of § 1362(f).

Therefore, Company must file a completed Form 2553, Election by a Small Business Corporation, with the appropriate service center within 60 days of the date of this letter. The election should specify an effective date of d1, and a copy of this letter should be attached to the election. Company shall be treated as an S corporation from d1 and thereafter, provided Company was otherwise eligible to be an S corporation on d1, and its election has not otherwise terminated under § 1362(d). The Trusts will be

treated as if they were ESBTs for the tax years beginning after December 31, 1996 and ending before d4, and must amend their tax returns accordingly.

Except as specifically set forth above, no opinion is expressed or implied as to the federal income tax consequences of the above transactions under any other provision of the Code. Specifically, we express no opinion regarding whether Company is otherwise eligible to be an S corporation, or whether the Trusts are valid ESBTs.

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.

Pursuant to a power of attorney on file with this office, a copy of this letter will be sent to the taxpayer.

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.

Sincerely yours,  
Robert Honigman  
Acting Assistant to the Chief, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)