

Number: **201527009**
Release Date: 7/2/2015
Index Number: 1362.04-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact: _____, ID No. _____

Telephone Number:

Refer Reply To:
CC:PSI:B03
PLR-128711-14
Date:
January 22, 2015

Legend

$$\underline{X} =$$

State =

D1 =D2 =D3 =D4 =

D5 =

D6 =

Period1 =

Period2 =

Shareholder =

Income Beneficiary =

Trust1 =

Trust2 =

Years =

n =

Dear :

This letter responds to a letter dated July 25, 2014, and subsequent correspondence submitted on behalf of X by its authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code (Code).

FACTS

The information submitted states that X was organized under the laws of State on D1 and elected to be an S corporation effective D1. Shareholder transferred shares in X to Trust1 on D2. Shareholder died on D3. On D4, Trust1 transferred the shares in X to Trust2 for the benefit of Income Beneficiary. On D5, Income Beneficiary died.

During the years between D4 and D5, X represents that Trust2 was eligible to be a qualified subchapter S trust (QSST) within the meaning of § 1361(d), but the Income Beneficiary did not timely file a QSST election. X also represents that Trust2 was eligible to be an electing small business trust (ESBT) within the meaning of § 1361(e) on D5 and thereafter, but the trustee did not timely file an ESBT election. Therefore, on D4, X's S corporation election terminated.

X represents that the termination was not motivated by tax avoidance or retroactive tax planning. X further represents that it has filed consistently as an S corporation since D1. 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.

Finally, during Period1, X made disproportionate distributions to one of its shareholders. X represents that under State law, all of X's stock has identical rights to distribution and liquidation proceeds. No provision in X's articles of incorporation, bylaws, or any other governing instruments altered those rights. X further represents that there is no agreement, written or oral, that any shareholder would be entitled to a preference regarding X's distribution or liquidation proceeds. X represents that during Period 2, corrective measures were taken to eliminate the cumulative amount of the disproportionate distributions.

LAW AND ANALYSIS

Section 1362(a) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be 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) provides that the term “small business corporation” means a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (B) 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, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

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 1 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 1361(c)(2)(A)(v) provides that for purposes of § 1361(b)(1)(B) an ESBT may be a shareholder.

Section 1361(d)(1) provides that a QSST whose beneficiary makes an election under § 1361(d)(2) will be treated as a trust described in § 1361(c)(2)(A)(i), and the beneficiary of such trust shall be treated as the owner (for purposes of § 678(a)) 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 1361(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 where 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 1361(e) defines an ESBT. Section 1361(e)(1)(A) provides that, except as provided in § 1361(e)(1)(B), an ESBT means any trust if (i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in § 170(c)(2), (3), (4), or (5), or (IV) an organization described in § 170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary,

(ii) no interest in such trust was acquired by purchase, and (iii) an election under § 1361(e) applies to such trust. Section 1361(e)(3) provides that an election under § 1361(e) shall be made by the trustee.

Section 1.1361-1(m)(2)(i) provides that the trustee of an ESBT must make the ESBT election by signing and filing, with the service center where the S corporation files its income tax return, a statement that meets the requirements of § 1.1361-1(m)(2)(ii).

Section 1362(d)(2)(A) provides that an election under § 1362(a) will be terminated whenever (at any time on or after the first day of the first 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) is effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under § 1362(a) or § 1361(b)(3)(B)(ii) 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) or § 1361(b)(3)(C), (2) the Secretary determines that the circumstances resulting in the ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were taken (A) so that the corporation for which the election was made or the termination occurred is a small business corporation or a qualified subchapter S subsidiary (QSub), as the case may be, or (B) to acquire the shareholder consents, and (4) the corporation for which the election was made or the termination occurred, 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 or a QSub, as the case may be) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation will be treated as an S corporation or a QSub, as the case may be during the period specified by the Secretary.

Section 1.1361-1(l)(1) provides, in part, that a corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in § 1.1361-1(l)(4) (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting stock among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock.

Section 1.1361-1(l)(2)(i) provides, in part, that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws,

applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

In § 1.1361-1(l)(2)(vi), Example 2 (Distributions that differ in timing), S, a corporation, has two equal shareholders, A and B. Under S's bylaws, A and B are entitled to equal distributions. S distributes \$50,000 to A in the current year, but does not distribute \$50,000 to B until one year later. The circumstances indicate that the difference in timing did not occur by a binding agreement relating to distribution or liquidation proceeds. The example concludes that under § 1.1361-1(l)(2)(i), the difference in timing of the distributions to A and B does not cause S to be treated as having more than one class of stock. However, § 7872 or other recharacterization principles may apply to determine the appropriate tax consequences.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election terminated on D4 when X had an ineligible shareholder. In addition, had X's S corporation election not terminated on D4, it would have terminated on D5. We conclude that the circumstances resulting in the termination were inadvertent within the meaning of § 1362(f). Accordingly, under § 1362(f), X will be treated as an S corporation from D4 and thereafter, provided X's S corporation election was otherwise valid and has not otherwise terminated under § 1362(d) for reasons not addressed in this letter.

This ruling is conditioned on 1) the estate of Income Beneficiary filing, on behalf of Income Beneficiary, a QSST election for Trust2, effective D4, with the appropriate service center within 120 days of the date of this letter, and 2) the trustee of Trust2 filing an ESBT election, effective D5, with the appropriate service center within 120 days of the date of this letter. A copy of this letter should be attached to the QSST and ESBT elections.

In addition, this ruling is conditioned on Trust2 filing any amended returns and making adjustments that are necessary to properly reflect the treatment of Trust2 as an ESBT for Years taxable years.

Furthermore, as an adjustment under § 1362(f), a payment of \$n and a copy of this letter ruling must be sent to the following address: Internal Revenue Service, Cincinnati Service Center, 201 West Rivercenter Blvd., Covington, KY 41011, Stop 31, Terri Lackey, Manual Deposit. The payment and a copy of this letter must be sent no later than D6.

If all of the above conditions are not met, then this ruling is null and void. Furthermore, if these conditions are not met, X must send a notification that its S corporation election has terminated to the service center with which X's S corporation election was filed.

Moreover, based solely on the facts submitted and representations made, we conclude that because X has identical distribution and liquidation rights under its governing provisions, the difference in timing between X's disproportionate distributions and the corrective measures made do not cause X to be treated as having more than one class of stock for purposes of § 1361(b)(1)(D). However, X's disproportionate distributions and the corrective measures must be given appropriate tax effect. Under these circumstances, we conclude that X's S corporation election did not terminate as a result of the disproportionate distributions and the corrective measures made.

Except as specifically ruled above, we express or imply no opinion concerning the federal tax consequences of the facts described above under any other provisions of the Code. Specifically, we express or imply no opinion regarding X's eligibility to be an S corporation.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with a power of attorney on file with this office, we are sending a copy of this letter to X's authorized representative.

Sincerely,

Mary Beth Carchia
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2):

Copy of this letter
Copy for § 6110 purposes