

Internal Revenue Service

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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-127849-04

Date:

November 17, 2004

LEGEND

X =

A =

B =

C =

D =

Trust 1 =

Trust 2 =

Trust 3 =

State =

D1 =

D2 =

D3 =

D4 =

Dear :

This letter responds to your letter dated May 18, 2004, and subsequent correspondence on behalf of X, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, X was incorporated under the laws of State on D1, and elected under § 1362(a) to be taxed as an S corporation effective D2. At the time of its S corporation election, 100 percent of X's stock was owned by A.

Subsequent to X's S corporation election, A transferred all of A's shares in X to A's children, C and D, and also to Trust 1, a revocable trust treated as a grantor trust under subpart E of part I of subchapter J of chapter 1 the Code. A and B, A's spouse, were joint owners of the grantor trust.

A died on D3. Pursuant to the terms of Trust 1, Trust 1 was divided into two separate trusts upon A's death. Trust 2, a grantor trust with B as its sole owner, was created to hold B's share of the joint assets that were in Trust 1. Trust 3 was created to hold, for B's benefit, A's share of Trust 1's joint assets.

As a grantor trust, Trust 2 was an eligible shareholder of an S corporation. Trust 3 was intended to qualify as a qualified subchapter S trust (QSST) under § 1361(d). However, due to inadvertence, B, its sole income beneficiary, never filed a QSST election.

B died on D4. Pursuant to the terms of Trust 3, the stock in X was distributed to C and D free of trust. In administering B's estate, C and D discovered that B never filed a QSST election for Trust 3, and that X's S corporation election may have terminated. After B's death, Trust 2 made an election under § 645 to be treated as part of B's estate.

X represents that it did not intend to terminate its S corporation election, and that the termination was inadvertent and not motivated by tax avoidance or retroactive tax planning. X and its shareholders have agreed to make any necessary adjustments consistent with the treatment of X as an S corporation. X further represents that after

A's death and before B's death, B reported on B's individual income tax return all of the S corporation items attributable to the X stock held by the trusts.

LAW AND ANALYSIS

Section 1362(a)(1) provides that except as provided in § 1362(g), a small business corporation may elect to be an S corporation.

Section 1361(b)(1) defines a "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not (A) have more than 75 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 I of subchapter J of chapter 1 of the Code) (a grantor trust) as owned by an individual who is a citizen or resident of the United States may be a shareholder of an S corporation. Section 1361(c)(2)(B)(i) provides that for purposes of § 1361(b)(1), in the case of a trust described in § 1361(c)(2)(A)(i), the deemed owner shall be treated as the 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), the trust is treated as a trust described in § 1361(c)(2)(A)(i), and for purposes of § 678(a), the beneficiary of the trust is treated as the owner of that portion of the trust that 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 the beneficiary's legal representative) may elect to have § 1361(d) apply. Section 1361(d)(2)(D) provides that a QSST election shall be effective up to 15 days and 2 months before the date of the election.

Section 1362(d)(2) provides that (A) an election under § 1362(a) shall be terminated whenever (at any time on or after the 1st taxable year for which the corporation, is an S corporation) such corporation ceases to be a small business corporation and (B) any termination under § 1362(d)(2) 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 was terminated under § 1362(d)(2); (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 such 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 any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to the period, then, notwithstanding the circumstances resulting in the termination, the corporation shall be treated as continuing to be an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) provides that the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent.

Section 1.1362-4(d) provides that the Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified by the Commissioner. In the case of a transfer of stock to an ineligible shareholder that causes an inadvertent termination under § 1362(f), the Commissioner may require that ineligible shareholder to be treated as a shareholder of an S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover the Commissioner may require protective adjustments that prevent any loss of revenue due to a transfer of stock to an ineligible shareholder (e.g., a transfer to a nonresident alien).

CONCLUSIONS

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election terminated due to Trust 3's failure to file a QSST election. We find that this termination was inadvertent within the meaning of § 1362(f). Under the provisions of § 1362(f), X will continue to be treated as an S corporation from D3, the date of A's death until D4, the date of B's death (and the distribution of the stock from the ineligible trust to individuals C and D), and thereafter, provided that X's S election was valid and not otherwise terminated under § 1361(d).

B will be treated as the shareholder of X with respect to the stock held by Trust 3 from D3 until D4. The shareholders of X must include their pro rata share of the separately and nonseparately computed items of X under § 1366, make any adjustments to stock basis under § 1367, and take into account any distributions made by X to shareholders under § 1368. If X or its shareholders fail to treat X as described above, during the period from D3 to D4, this ruling shall be null and void.

Except for the specific ruling above, no opinion is expressed or implied concerning the federal tax consequences of the facts of this case under any other

provision of the Code. Specifically, we express or imply no opinion whether X is otherwise qualified to be an S corporation.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to X.

This ruling is directed only to the taxpayer requesting it. Under § 6110(k)(3), it may not be used or cited as precedent.

Sincerely yours,

/s/

James A. Quinn
Senior Counsel, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2):

Copy of this letter

Copy for § 6110 purposes

cc: