

Internal Revenue Service

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Washington, DC 20224

Person To Contact:

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Refer Reply To:

CC:PSI:B01

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Date: 5/30/2008

Legend

X =

C =

H =

Trust A =

Trust B =

Trust C =

Trust D =

Trust E =

Trust F =

Trust K =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Dear :

This responds to a letter dated March 17, 2008, and subsequent correspondence, submitted on behalf of X, requesting inadvertent invalid S corporation election relief pursuant to § 1362(f) of the Internal Revenue Code. In addition, your letter is also seeking relief allowing Trust A, Trust E, and Trust K to file late elections to be treated as electing small business trusts (ESBTs). In addition, your letter is also seeking relief allowing Trust B and Trust D to file late elections to be treated as qualified subchapter S trusts (QSSTs).

Facts

Based on the information submitted and representations made therein, we understand the relevant facts to be as follows. X was incorporated under the laws of State on Date 1, and elected to be treated as an S corporation effective Date 2.

On Date 2, Trust A, Trust B, Trust C, Trust D, Trust E, Trust F, and Trust K, among others, were shareholders of X.

The trust agreements for Trust A, Trust E, and Trust K each contained provisions that permitted distributions of corpus to be made other than to the income beneficiary of each trust. Further, Trust E requires income to be distributed to more than one beneficiary, to C and to her children. Trust A, Trust E, and Trust K are all eligible to file ESBT elections pursuant to § 1361(e)(3) to be treated as ESBTs. Nevertheless, Trust

A, Trust E, and Trust K did not elect to be treated as ESBTs. At the time of its S corporation election, X and its shareholders were unaware that Trust A, Trust E, and Trust K did not meet the requirements of § 1361(d)(3)(A) and, therefore, were ineligible shareholders of an S corporation.

Trust B and Trust D are both eligible to file QSST elections pursuant to § 1361(d)(2) to be treated as QSSTs. The income beneficiaries of Trust B and Trust D each reported the beneficiary's distributable share of X's items of income, loss, deductions, and credits, if any, as if Trust B and Trust D each had a valid QSST election in effect. Nevertheless, no election was made to treat Trust B and Trust D as QSSTs.

Trust C was a grantor trust under subpart E of part I of subchapter J of chapter 1 of the Code, with all income from Trust C payable to C.

H was a general partnership formed by employees of the institutional trustee of Trust A, Trust B, Trust C, Trust D, Trust E, and Trust F, to act as a nominee holder of closely-held securities held in accounts of trusts for which the institutional trustee acted as trustee.

X timely filed Form 2553, Election by a Small Business Corporation, prior to Date 3. However, the trustee of Trust K did not execute the Form 2553 filed by X, and thereby did not properly consent to X's election to be an S corporation. Further, Trust A, Trust B, Trust D, Trust E, and Trust K were not, or were not deemed to be, eligible shareholders of an S corporation under § 1361(b)(1)(B). Further, H executed the Form 2553 filed by X for Trust A, Trust E, and Trust F, rather than each trust's trustee, and therefore Trust A, Trust E, and Trust F did not properly consent to X's election to be an S corporation. Further, H executed the Form 2553 filed by X for Trust B and Trust D, rather than each trust's beneficiary, and therefore Trust B and Trust D did not properly consent to X's election to be an S corporation. Further, H executed the Form 2553 filed by X for Trust C, rather than its grantor, and therefore Trust C did not properly consent to X's election to be an S corporation. Neither X nor X's shareholders were aware that these circumstances would cause X's S corporation election to be invalid.

In Date 4, X learned of the invalidity of X's S corporation election. X represents that X and its shareholders have reported their income consistently with X being an S corporation beginning on Date 2. X represents that it promptly engaged counsel to investigate and to seek to correct the circumstances. X represents that there was no tax avoidance involved in the inadvertent invalid election. 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

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)(B) provides that, for purposes of subchapter S, 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, 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 the purposes of § 1362(b)(1)(B), a trust, all of which is treated (under title 26, subtitle A, chapter 1, subchapter J, part I, subpart E of the United States Code) as owned by an individual who is a citizen or resident of the United States, may be an S corporation shareholder.

Section 1361(c)(2)(A)(v) provides that, for the purposes of § 1362(b)(1)(B), an ESBT may be an S corporation shareholder.

Section 1361(d)(1) provides that, in the case of a QSST with respect to which a beneficiary makes an election under § 1361(c)(2), (A) such trust will be treated as a trust described in § 1361(c)(2)(A)(i), and (B) 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)(3)(A) provides that a QSST is a trust, the terms of which require that (i) during the life of the current income beneficiary, there shall be only 1 income beneficiary of the trust, (ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary, (iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust, and (iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary. In addition, § 1361(d)(3)(B) requires that the trust distribute (or require to be distributed) all of its income (within the meaning of § 643(b)) currently to 1 individual who is a citizen or resident of the United States.

Section 1361(e) defines an ESBT. Section 1361(e)(1)(A) provides that, except as provided in § 1362(e)(2)(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)(1)(B) provides that the term “electing small business trust” shall not include (i) any qualified subchapter S trust (as defined in § 1361(d)(3)) if an election under § 1361(d)(2) applies to any corporation the stock of which is held by such trust, (ii) any trust exempt from tax under subtitle A, and (iii) any charitable remainder annuity trust or charitable remainder unitrust (as defined in § 664(d)).

Section 1361(e)(3) provides that an election under § 1361(e) shall be made by the trustee. Any such election shall apply to the taxable year of the trust for which made and all subsequent taxable years of such trust unless revoked with the consent of the Secretary.

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

Section 1.1361-1(j)(6)(iii) provides that, if S corporation stock is transferred to a trust, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust. If a C corporation has made an election under § 1362(a) to be an S corporation (S election) and, before that corporation's S election is in effect, stock of that corporation is transferred to a trust, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust.

Section 1.1361-1(j)(7)(i) provides that the income beneficiary who makes the QSST election and is treated (for purposes of § 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of §§ 1361(b)(1), 1366, 1367, and 1368.

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 1.1361-1(m)(2)(iii) provides that the trustee of an ESBT must file the ESBT election within the time requirements prescribed in § 1.1361-1(j)(6)(iii) for filing a QSST election (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) provides that an election under § 1362(a) shall 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. The termination is effective on and after the day of the termination.

Section 1362(f) provides, in part, 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 § 1362(d)(2); (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 so that the corporation for which the election was made or the termination occurred is a small business corporation, or to acquire the required shareholder consents; and (4) the corporation for which the election was made or the termination occurred, and each person who was a shareholder in such corporation at any time during the period specified pursuant to § 1362(f), agrees to make such adjustments (consistent with the treatment of such 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, such corporation shall be treated as an S corporation during the period specified by the Secretary.

Conclusion

Based solely on the information submitted and the representations made, we conclude that X's S corporation election was ineffective for the taxable year beginning Date 2 because X had several ineligible shareholders and several shareholders did not properly consent to X's election to be an S corporation. We further conclude that the ineffectiveness of X's S corporation election constituted an inadvertent invalid election within the meaning of § 1362(f). Accordingly, pursuant to the provisions of § 1362(f), X will be treated as an S corporation from Date 2 and thereafter, provided that, apart from the inadvertent invalid election ruling and the rulings for relief from late ESBT and QSST elections herein, X's S corporation election was otherwise valid and has not otherwise terminated under § 1362(d).

This ruling is contingent on X and all of its shareholders treating X as having been an S corporation for the period beginning Date 2, and thereafter. Accordingly, in determining their respective income tax, all the shareholders of X must include their pro-rata share of the separately stated items of income (including tax-exempt income), loss, deduction, or credit and nonseparately computed items of income and loss of X as provided in § 1366, make adjustments to basis as 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 is null and void.

This ruling is contingent on Trust B and Trust D each making valid QSST elections, effective Date 2, with the appropriate service center within 60 days of this

letter. This ruling is also contingent on Trust A, Trust E, and Trust K each making valid ESBT elections, effective Date 5, with the appropriate service center within 60 days of this letter. Provided that these elections are made, from Date 2 and thereafter, the beneficiaries of Trust B and Trust D will be treated as the shareholders of X, and from Date 5 and thereafter, Trust A, Trust E, and Trust K will be treated as ESBTs under § 1361(e). A copy of this letter should be attached to each of these trusts' QSST and ESBT elections. A copy of this letter has been provided for this purpose.

Except as specifically ruled above, we express or imply no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code. Specifically, we express or imply no opinion regarding whether X is otherwise eligible to be an S corporation, whether Trust A, Trust E, and Trust K, are eligible ESBTs under § 1361(e), and whether Trust B and Trust D are eligible QSSTs under § 1361(d).

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

In accordance with a power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,

David R. Haglund

David R. Haglund
Senior Technician Reviewer, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

Copy for §6110 purposes