

**Internal Revenue Service**

Number: **200430023**

Release Date: 7/23/04

Index Number: 1362.04-00

Department of the Treasury  
Washington, DC 20224

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:2 – PLR-169219-03

Date:

April 9, 2004

Legend

X:

A:

Trust 1:

Trust 2:

Law Firm:

D1:

D2:

D3:

D4:

D5:

State:

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Dear \_\_\_\_\_ :

This letter responds to a letter dated November 3, 2003, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting relief under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated under the laws of State on D1. Effective D2, X elected to be an S corporation. On D3, Trust 1 and Trust 2 were created. A, as president of X and as trustee of Trust 1 and Trust 2, represents that Trust 1 and Trust 2 were each qualified to be an electing small business trust ("ESBT") effective D3. However, A, as trustee of Trust 1 and Trust 2, inadvertently failed to make the ESBT elections for the trusts. Trust 1 and Trust 2 became shareholders of X on D4. However, Trust 1 and Trust 2 were ineligible shareholders and therefore, X's S corporation election was terminated.

On D5, Law Firm discovered the failure to timely make the ESBT elections for Trust 1 and Trust 2. X promptly submitted this request for a ruling in order to qualify Trust 1 and Trust 2 as ESBTs effective D3 and to seek inadvertent termination relief under § 1362(f) for X.

A represents that Trust 1 and Trust 2 have filed federal income tax returns consistent with each trust being an ESBT. All of X's shareholders represent that they have filed federal income tax returns consistent with the treatment of X as an S corporation. A, as X's president, represents that the circumstances resulting in the termination of X's S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning. X and its shareholders have agreed to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary.

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 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.

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Section 1361(c)(2)(A)(v) provides that an “electing small business trust” may be a shareholder in an S corporation.

Section 1361(e)(1)(A) provides that the term “electing small business trust” 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 paragraph (2), (3), (4), (5) of § 170(c), 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 section 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.

In Notice 97-12, 1997-1 C.B. 385, the Service provided guidance regarding ESBT elections. In particular, the Notice provided that the trustee of an ESBT must file the ESBT election within the time requirements prescribed in regulation § 1.1361-1(j)(6)(iii) for filing QSST elections (generally within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust).

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 § 1362(d)(2) or (3), (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, such corporation shall be treated as an S corporation during the period specified by the Secretary.

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Based solely on the representations made and the information submitted, we conclude that X's S corporation election terminated on D4, under § 1362(d)(2), because A, the trustee of Trust 1 and Trust 2, failed to timely file the required ESBT elections under § 1361(e)(3). We further conclude that the termination of X's S election was inadvertent within the meaning of § 1362(f). Accordingly, pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from D4 and thereafter, provided X's S corporation election was valid and was not otherwise terminated under § 1362(d). All of X's shareholders in determining their respective income tax liabilities during the termination period and thereafter, must include their pro rata share of the separately stated items of income (including tax-exempt income), loss, deduction, or credit and non-separately stated computed items of income or loss 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.

Additionally, from D4 and thereafter, Trust 1 and Trust 2 will be treated as the shareholders of X, and Trust 1 and Trust 2 will be treated as ESBTs under § 1361(e), effective D3 and thereafter, provided that A files an ESBT election effective D3 for each of Trust 1 and Trust 2 with the appropriate service center within 60 days following the date of this letter. If Trust 1, Trust 2, X, or X's shareholders fail to treat X as described above, this ruling shall be null and void. A copy of this letter should be attached to each ESBT election.

Except as specifically ruled above, we express no opinion concerning the Federal tax consequences of the transactions described above under any other provision of the Code. Specifically, no opinion is expressed on whether X is otherwise eligible to be treated as an S corporation or whether Trust 1 or Trust 2 are eligible ESBTs under § 1361(e).

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

Pursuant to the powers of attorney on file with this office, a copy of this letter is being sent to Trust 1, Trust 2 and X.

Sincerely,

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

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