

Internal Revenue Service

Department of the Treasury

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Date:

January 30, 2001

LEGEND

Company =

State =

d1 =

d2 =

d3 =

d4 =

x =

y =

z =

SH1 =

SH2 =

Trust 1 =

Trust 2 =

Shareholders =

Dear

This letter responds to a letter dated July 31, 2000, and subsequent correspondence, written on behalf of Company by its authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, Company incorporated on d1 under State law, and filed an election under § 1362(a) to be treated as an S corporation on d2. On d3, SH1, a Company shareholder, transferred x shares of Company's stock to Trust 1. On d4, SH1 transferred an additional y shares to Trust 1. Also on d4, SH2, another Company shareholder, transferred z shares of Company's stock to Trust 2.

Company represents that Trust 1 was intended to be a Qualified Subchapter S Trust (QSST) as defined by § 1361(d), and Trust 2 was intended to be an Electing Small Business Trust (ESBT) as defined by § 1361(e). After changing tax preparers however, Company discovered that the beneficiary of Trust 1 failed to make a timely QSST election as required by § 1361(d)(2), and the trustee of Trust 2 failed to make a timely ESBT election as required by § 1361(e)(3). Both Trust 1 and Trust 2 were ineligible shareholders of an S corporation. Consequently, Company's S corporation election terminated on d3, the date of the first transfer.

Company represents that the termination of its S corporation election was inadvertent, unintended, and not the result of tax avoidance or retroactive tax planning. Company further represents that at all times subsequent to d3, Trust 1 reported as though it was a QSST and at all times subsequent to d4, Trust 2 reported as though it was an ESBT.

Company requests a ruling that the termination of its S corporation election was inadvertent under § 1362(f). Company and all of its Shareholders who were shareholders during the termination period consent to make any necessary adjustments consistent with the treatment of Company as an S corporation.

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 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.

Section 1361(c)(2)(A)(i) provides that for the purposes of § 1361(b)(1)(B), a trust all of which is treated (under subpart E of part I of subchapter J of this chapter) 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(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 an election under § 1361(d)(2) may be effective up to 15 days and two months before the date of the election.

Section 1361(c)(2)(A)(v) provides that an ESBT (as defined in § 1361(e)) may be a shareholder of an S corporation for purposes of § 1361(b)(1)(B). Notice 97-12, 1997-1 C.B. 385, provides that the trustee of the ESBT must file the ESBT election within the time requirements prescribed in § 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(d)(2)(A) provides that an election under § 1362(a) terminates whenever the corporation ceases to be a small business corporation.

Section 1362(f) provides 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 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 regarding this period, then, notwithstanding the circumstances resulting in the 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 the representations made, we conclude that Company's S corporation election was terminated on d3, when shares of Company's stock were first transferred to an ineligible shareholder. We also find that this termination was inadvertent within the meaning of § 1362(f). Thus, under the provisions of § 1362(f), Company will be treated as an S corporation from d3 and thereafter, provided, that the beneficiary of Trust 1 and the trustee of Trust 2 file the respective QSST and ESBT elections, with an effective date of d3 and d4, respectively, with the appropriate service center within 60 days from the date of this letter, and that Company's S corporation election is valid and is not otherwise terminated under § 1362(d). A copy of this letter should be attached to the QSST and ESBT elections.

During the termination period and thereafter, Trust 1 will be treated as if it was a QSST and Trust 2 will be treated as if it was an ESBT. Accordingly, the Shareholders of Company must include their pro rata share of the separately and nonseparately computed items of Company under § 1366, make any adjustments to stock basis under § 1367, and take into account any distributions made by Company to shareholders under § 1368. If Company, the trusts, or any of Company's shareholders fail to treat Company as described above, this ruling will 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, no opinion is expressed regarding whether Company is otherwise qualified to be an S corporation, whether Trust 1 is a valid QSST, or whether Trust 2 is a valid ESBT.

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

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,
Mary Beth Collins
Assistant to the Chief, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2):

Copy of this letter

Copy for § 6110 purposes