

**Internal Revenue Service**

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:  
CC:PSI:2-PLR-108867-02  
Date:  
June 11, 2002

Legend

X =

A =

B =

Trust =

Trustee =

D1 =

D2 =

D3 =

D4 =

Dear :

This letter responds to a letter dated January 28, 2002, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting relief under section 1362(f) of the Internal Revenue Code.

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The information submitted states that effective D1, X elected to be an S corporation. A and B, shareholders of X, created Trust on D2. On D2 and D3, A and B transferred shares of X stock to Trust. Since Trust's creation, Trust has filed all of its returns as an electing small business trust (ESBT). A, as president of X, represents that Trust meets the requirements of an ESBT under section 1361(e)(1) but failed to make an ESBT election required by section 1361(e)(3). A, B and Trustee of Trust were unaware that Trustee was required to file an election under section 1361(e)(3) in order for Trust to be an ESBT. In D4, a tax advisor informed A, B, and Trustee that X's S election terminated on D2 as a result of the transfer of X stock to Trust, because Trust was not an eligible shareholder.

A represents that the circumstances resulting in the termination of X's election to be an S corporation were inadvertent. A also represents that X and its shareholders did not intend to engage in tax avoidance or retroactive tax planning. X and each person who was or is a shareholder of X at any time since D2 agree to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary with respect to such period.

Section 1362(a) provides that, except as provided in section 1362(g), a small business corporation may elect, in accordance with the provisions of section 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 section 1362(a) is in effect for such year.

Section 1361(b)(1)(B) provides that a "small business corporation" cannot have as a shareholder a person (other than an estate, a trust described in section 1361(c)(2), or an organization described in section 1361(c)(6)) who is not an individual.

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, or (III) an organization described in paragraph (2), (3), (4), (5) of section 170(c), (ii) no interest in such trust was acquired by purchase, and (iii) an election under section 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 section 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 section 664(d)).

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Section 1361(e)(3) provides that an election under section 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(m)(2) of the Income Tax Regulations, provides that the trustee of the ESBT must file the ESBT election within the time requirements prescribed in section 1.1361-1(j)(6)(iii) for filing qualified subchapter S trust 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) 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. Section 1362(d)(2)(B) provides that any termination under section 1362(d)(2)(A) shall be effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under section 1362(a) by any corporation was not effective for the taxable year for which made (determined without regard to section 1362(b)(2)) by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents, or was terminated under paragraph (2) or (3) of section 1362(d), (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 is a small business corporation, or 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 section 1362(f), agree 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, the corporation will be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts submitted and the representations made, we hold that X's election to be an S corporation effective D1 terminated on D2 because Trust failed to file an ESBT election and was therefore, an ineligible shareholder. We also hold that the termination of X's S corporation election was inadvertent within the meaning of section 1362(f).

Pursuant to section 1362(f), X will be treated as continuing to be an S corporation effective D2 and thereafter, provided that X's election to be an S corporation was not invalid and provided that the election was not otherwise terminated under section 1362(d). Trust will be treated as an "electing small business trust" under section 1361(e) beginning on D2. X's shareholders must include their pro rata share of

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the separately and nonseparately computed items of X as provided in section 1366, make any adjustments to stock basis as provided in section 1367, and take into account any distributions made by X to shareholders as provided in section 1368.

Additionally, this ruling is conditioned upon Trust filing within 60 days following the date of this letter, an ESBT election, pursuant to the procedures set forth in § 1.1361-1(m)(2), with an effective date of D2, with the appropriate Service Center. A copy of this letter should be attached to the ESBT election. If X, Trust, or any of X's other shareholders, fail to treat themselves as described above, this ruling shall be null and void.

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, we express no opinion regarding whether X is otherwise eligible to be an S corporation, or whether Trust is a valid ESBT.

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

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

Sincerely yours,  
J. Thomas Hines  
Chief, Branch 2  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures: 2

Copy of this letter

Copy for § 6110 purposes