

Internal Revenue Service

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Date:

April 28, 2005

X =

A =

B =

C =

Sub 1 =

Sub 2 =

Sub 3 =

Sub 4 =

Sub 5 =

Sub 6 =

Sub 7 =

Sub 8 =

Sub 9 =

Sub
10 =

D1 =

D2 =

D3 =

Trust
1 =

Trust
2 =

Trust
3 =

Trust
4 =

Trust
5 =

Dear :

This letter responds to a letter dated January 28, 2005, submitted on behalf of X by its authorized representative, requesting relief under § 1362(f) of the Internal Revenue Code.

A, the vice president of X, represents that an election was made for X to be an S corporation effective D1. X has elected to treat ten of its subsidiaries, Subs 1 through 10 (collectively, the Subsidiaries) as qualified subchapter S subsidiaries (QSubs). The shareholders of X include Trusts 1 through 5 (collectively, the Trusts), each of which is represented to be an electing small business trust (ESBT) within the meaning of §§ 1361(c)(2)(A)(v) and 1361(e), and which is not an eligible S corporation shareholder under another provision of § 1361(c)(2)(A). Under the terms of each of the Trusts, B and B's spouse are eligible to receive current distributions of trust property pursuant to a

power of appointment held by the primary beneficiary of each Trust. B was not married at the time of the creation of the Trusts.

On D2 (which was in a taxable year beginning on or before December 31, 2004), B married C, a nonresident alien. B and C have not filed an election under § 6013(g) or (h) to treat C as a resident of the United States for any taxable year. As B's spouse, C became a potential current beneficiary of each of the Trusts. As a nonresident alien, C is not an eligible S corporation shareholder. Therefore, X's S corporation election terminated on D2.

When X discovered that the ability of C to receive distributions from the Trusts terminated X's S corporation election, it contacted the beneficiaries of the Trusts, who each executed a substantially identical release (represented as being valid under local law), providing that the beneficiary irrevocably and permanently released the right to exercise the power of appointment during that beneficiary's lifetime or upon that beneficiary's death in favor of any (i) non-resident alien within the meaning of § 1361(b)(1)(C), (ii) nonresident alien who has made an election pursuant to § 6013(g) or (h) to be treated as a resident of the United States, or (iii) other person who, if that person were a permissible appointee of the power of appointment would cause any S corporation in which the Trust owns stock to cease to be a small business corporation as defined in § 1361(b)(1). The last of the five releases was executed D3 (which was in a taxable year beginning on or before December 31, 2004).

A represents that the termination of X's S corporation election was not motivated by tax avoidance or retroactive tax planning. X and its shareholders have agreed to make any adjustments that the Commissioner may require, consistent with the treatment of X as an S corporation.

Section 1361(a)(1) of the Code 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 1362(d)(2)(A) provides that, in general, an election to be treated as an S corporation 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 1361(c)(2)(A)(v) provides that, for purposes of § 1361(b)(1)(B), an ESBT may be a shareholder of an S corporation. Section 1361(c)(2)(B)(v) provides that in the case of an ESBT, each potential current beneficiary (PCB) of such trust shall be treated

as a shareholder for purposes of § 1361(b)(1); except that, if for any period there is no PCB of such trust, such trust shall be treated as the shareholder during such period.

Section 1361(e) defines an ESBT. Section 1361(e)(2), prior to its modification by § 234 of the American Jobs Creation Act of 2004, P.L. 108-357, provided that, for purposes of § 1361(e), the term “potential current beneficiary” meant, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. This definition applied to taxable years beginning on or before December 31, 2004.

Section 1.1361-1(m)(4)(vi)(B) of the Income Tax Regulations provides that if the holder of a power of appointment permanently releases the power in a manner that is valid under the applicable local law, the persons that would be PCBs solely because of the power will not be PCBs after the effective date of the release.

Section 1361(b)(3)(A) provides that except as provided in regulations prescribed by the Secretary and in the case of information returns required under part III of subchapter A of chapter 61, for purposes of title 26 (i) a corporation which is a QSub shall not be treated as a separate corporation, and (ii) all assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and such items (as the cases may be) of the S corporation.

Section 1361(b)(3)(B) defines “QSub” for the purposes of § 1361(b)(3) as any domestic corporation which is not an ineligible corporation (as defined in § 1361(b)(2)), if (i) 100 percent of the stock of such corporation is held by the S corporation, and (ii) the S corporation elects to treat such corporation as a QSub.

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 the ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were taken (A) so that the corporation is a small business corporation or (B) to acquire the shareholder consents; 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 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 the ineffectiveness or termination, the corporation will be treated as an S corporation during the period specified by the Secretary.

Sections 6013(g) and (h) provide, in general, that a nonresident alien married to a citizen or resident of the United States may be treated as a resident of the United States for purposes of chapter 1 of subtitle A of title 26 if the nonresident alien and spouse so elect.

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election terminated on D2 when C became a PCB of the Trusts. We further conclude that the termination constituted an inadvertent termination within the meaning of § 1362(f).

We further hold that, pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from D2 to D3, and thereafter, provided X's S corporation election was otherwise valid and provided that the election was not otherwise terminated under § 1361(d). The Trusts will be treated as trusts described in §§ 1361(c)(2)(A)(v) and 1361(e) and the Subsidiaries will be treated as QSubs described in § 1361(b)(3)(B). C will not be treated as a PCB of any of the Trusts subsequent to the effective date of the releases executed by the Trust beneficiaries unless and until C becomes a United States citizen. The shareholders of X must include their pro-rata share of the separately stated and nonseparately computed items of X as provided in § 1366, make any 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.

We further rule that any election by B and C under §§ 6013(g) or (h), or any subsequent termination of such election will not have any effect on the relief granted above. No other opinion is expressed or implied concerning the effect or validity of any election under §§ 6013(g) or (h) or subsequent termination of such election.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provisions of the Code. Specifically, no opinion is expressed whether X is otherwise eligible to be an S corporation, whether the Subsidiaries are otherwise eligible to be QSubs, or whether the Trusts are otherwise eligible to be ESBTs.

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

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

Sincerely,

J. THOMAS HINES
Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes