

Internal Revenue Service

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Legend

A =

B =

C =

D =

E =

Trust 1 =

Trust 2 =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

D8 =

D9 =

Dear

This responds to a letter dated July 26, 2007, and subsequent correspondence, submitted on behalf of C (Taxpayer) by C's authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that C made an election to be treated as an S corporation effective D1, D made an election to be treated as an S corporation effective D2, and E made an election to be treated as an S corporation effective D3. On D7, a new corporation, B, was formed to own the stock of C, D, and E. The shareholders of C, D, and E transferred their stock to B in exchange for 100% of the stock of B and B made an election to be treated as an S corporation and elections to treat C, D, and E as qualified subchapter S subsidiaries (QSubs) effective D7.

On D8, a new corporation, A, was formed to own the stock of B. The shareholders of B transferred the stock of B to A in exchange for 100% of the stock of A and A made an election to be treated as an S corporation and elections to treat B, C, D, and E as QSubs effective D8.

The shareholders of A are two trusts, Trust 1 and Trust 2. Trust 1 acquired shares of C, D, and E on D6 and attempted to make an election to be treated as an electing small business trust (ESBT) effective D6. Trust 2 acquired shares of C, D, and E on D5 and attempted to make an election to be treated as an ESBT effective D4.

The trust instruments for both Trust 1 and Trust 2 included the following provisions: (1) the independent trustees have the power to make discretionary distributions to Qualified Charities defined as organizations described in §§ 170(c), 2055(a), and 2522(a); and (2) the trustees are authorized to make a contribution of all or any portion of the trust to a charitable remainder unitrust. Further, Trust 1 and Trust 2 did not identify all PCBs on their ESBT election and Trust 2 did not file its election within the

time requirements of § 1.1361-1(m)(2). As a result, C's election to be an S corporation terminated.

Trust 1 and Trust 2 were subsequently reformed to provide that only 20 Qualified Charities, defined as organizations described in § 1361(c)(6), may receive distributions from the trusts.

Taxpayer represents that the termination of C's S corporation election was inadvertent and was not motivated by tax avoidance or retroactive tax planning. Further, at all relevant times Taxpayer and Taxpayer's shareholders have continually treated Taxpayer as an S corporation. As such, all items of income, gain, loss and deduction recognized by Taxpayer have been allocated among the shareholders of Taxpayer and the shareholders have reported on their individual income tax returns for all relevant taxable years, their respective share of the income, gain, loss and deductions of Taxpayer. Taxpayer and its shareholders have agreed to make any adjustments the Commissioner may require with respect to all relevant tax periods.

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1361(b)(1) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (B) 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), (C) have a nonresident alien as a shareholder, and (D) no more than one class of stock.

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 234 of the 2004 Act amended § 1361(e)(2) by providing that in determining an ESBT's PCBs for any period, powers of appointment will be disregarded to the extent not exercised by the end of that period.

Section 1361(c)(6) provides that certain exempt organizations are permitted as shareholders, that is, an organization which is (A) described in § 401(a) or 501(c)(3), and (B) exempt from taxation under § 501(a).

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 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 such 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 under § 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 for that period, then, notwithstanding the circumstances resulting in such termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Based on the information submitted and the representations made, we conclude that C's S election terminated on D5 and we further conclude that the invalidity was inadvertent within the meaning of § 1362(f). Accordingly, pursuant to the provisions of § 1362(f), C will be treated as an S corporation from D5 to D7.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any provisions of the Code. In particular, we express no opinion on whether Trust 1 and Trust 2 otherwise qualify to be ESBTs and whether C qualifies to be an S corporation.

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

Pursuant to a power of attorney on file with this office, a copy of this letter is being forwarded to Taxpayer's authorized representative.

Sincerely,

Bradford R. Poston
Senior Counsel, Branch 2
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

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

cc: