

On Date 2, Trust acquired shares of X stock, and had been an eligible shareholder of X until Date 3. On Date 3, Trust ceased to qualify as an eligible S corporation shareholder, and X's subchapter S election terminated. X represents that, as of Date 3, Trust became eligible to be an electing small business trust (ESBT). However, the trustee of Trust failed to make an ESBT election effective Date 3 in a timely manner.

X represents that the failure to file the ESBT election for Trust was inadvertent and was not motivated by tax avoidance or retroactive tax planning. X and its shareholders have agreed to make any adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary with respect to the period specified by § 1362(f).

Law and Analysis

Section 1362(a) of the Code 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, for purposes of subchapter S, 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)(v) provides that, for the purposes of § 1362(b)(1)(B), an ESBT may be an S corporation shareholder.

Section 1361(e) defines an ESBT. Section 1361(e)(1)(A) provides that, except as provided in § 1362(e)(2)(B), an ESBT 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 § 170(c)(2), (3), (4), or (5), 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 § 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.

Section 1.1361-1(m)(2)(i) provides that the trustee of an ESBT must make the ESBT election by signing and filing, with the service center where the S corporation files its income tax return, a statement that meets the requirements of § 1.1361-1(m)(2)(ii).

Section 1.1361-1(m)(2)(iii) provides that the trustee of an ESBT must file the ESBT election within the time requirements prescribed in § 1.1361-1(j)(6)(iii) for filing a QSST election (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) 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. The termination is effective on and after the day of the termination.

Section 1362(f) provides, in part, that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2); (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 such termination, steps were taken so that the corporation for which the termination occurred is a small business corporation; and (4) the corporation for which the termination occurred, and each person who was a shareholder in such corporation at any time during the period specified pursuant to § 1362(f), agrees to make such adjustments (consistent with the treatment of such corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.

Conclusion

Based solely on the information submitted and the representations made, we conclude that X's S corporation election was terminated on Date 3, when Trust became an ineligible shareholder. We further conclude that the termination of X's S corporation election was an inadvertent termination within the meaning of § 1362(f). Accordingly, pursuant to the provisions of § 1362(f), X will be treated as an S corporation from Date 3 and thereafter, provided that X's S corporation election was otherwise valid and has not otherwise terminated under § 1362(d).

This ruling is contingent on Trust making a valid ESBT election, effective Date 4, with the appropriate service center within 60 days of this letter. Provided that this election is made, from Date 4 and thereafter, Trust will be treated as an ESBT under § 1361(e).

Except as specifically ruled above, we express or imply no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code. Specifically, we express or imply no opinion regarding whether X is otherwise eligible to be an S corporation, or whether Trust otherwise qualifies as a valid ESBT.

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

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

Sincerely,

David R. Haglund

David R. Haglund
Chief, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)
Copy of this letter
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cc: