

According to the information submitted and representations within, X was incorporated on Date 1, under the laws of State. Effective Date 1, X elected to be taxed as an S corporation. Prior to Date 2, Trust was a grantor trust wholly owned by A and as such an eligible shareholder of X. On Date 2, A died and Trust ceased being a grantor trust. A timely election to treat Trust as an electing small business trust (“ESBT”) was not made, thus Trust became an ineligible shareholder of X, causing X’s S corporation election to terminate effective Date 3.

X represents that Trust has at all times met the requirements of an ESBT within the meaning of § 1361(e). X further represents that since Date 2, it has filed its federal income tax returns consistent with being an S corporation. X represents that its S corporation election termination was inadvertent and was not motivated by tax avoidance or retroactive tax planning. Further, X represents that X and its shareholders agree to make any adjustments required as a condition of obtaining relief under the inadvertent termination rule as provided under § 1362(f) of the Code that may be required by the Secretary.

LAW AND ANALYSIS

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) defines a “small business corporation” as 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)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than 1 class of stock.

Section 1361(c)(2)(A)(i) provides that, for purposes of § 1361(b)(1)(B), a trust all of which is treated (under subpart E of part I of subchapter J of chapter 1) as owned by an individual who is a citizen or resident of the United States may be an S corporation shareholder.

Section 1361 (c)(2)(A)(ii) provides that, for purposes of § 1361(b)(1)(B), a trust that was described in § 1361(c)(2)(A)(i) immediately before the death of the deemed owner and which continues in existence after such death, but only for the 2-year period beginning on the day of the deemed owner’s death.

Section 1361(c)(2)(A)(v) provides that, for purposes of § 1361(b)(1)(B), an electing small business trust (ESBT) may be an S corporation shareholder.

Section 1361(e) provides that 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 ESBT 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(f) provides, in relevant part, 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 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 the 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.

Section 1.1362-4(b) provides that for purposes of § 1.1362-4(a), the determination of whether a termination or invalid election was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination or invalid

election was inadvertent. The fact that the terminating event or invalidity of the election was not reasonably within the control of the corporation, and in the case of a termination, was not part of a plan to terminate the election, or the fact that the terminating event or circumstance took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such event or circumstance, tends to establish that the termination or invalidity of the election was inadvertent.

Section 1.1362-4(d) provides that the Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation or QSub during the period specified by the Commissioner. In the case of stock held by an ineligible shareholder that causes an inadvertent termination or invalid election for an S corporation under section 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of the S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent the loss of any revenue due to the holding of stock by an ineligible shareholder (for example, a nonresident alien).

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election inadvertently terminated within the meaning of § 1362(f) on Date 3 when Trust became an ineligible shareholder. Pursuant to the provisions of § 1362(f), X will be treated as an S corporation from Date 3 and thereafter, provided X's S corporation election is not otherwise terminated under § 1362(d).

This letter is contingent upon, within 120 days from the date of this letter, the trustee filing with the appropriate service center an election to treat Trust as an ESBT effective Date 3. Furthermore, Trust must file amended returns and make any adjustments that are necessary to properly reflect the treatment of Trust as an ESBT for Years taxable years. A copy of this letter should be attached to the ESBT election.

Except as specifically ruled upon above, we express or imply no opinion concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion regarding X's eligibility to be an S corporation or Trust's eligibility to be an ESBT.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Pursuant to the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

Sincerely,

James A. Quinn
Senior Counsel, Branch 3
Associate Chief Counsel
(Passthroughs and Special Industries)

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