

Internal Revenue Service

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Person To Contact: _____, ID No.

Telephone Number:

Refer Reply To:
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Date:
February 21, 2018

Legend

X =

Y =

Z =

State =

Trust 1 =

Trust 2 =

Trust 3 =

A =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Dear _____ :

This responds to a letter dated August 11, 2017, and subsequent correspondence submitted on behalf of Z by Z's authorized representative, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

FACTS

The information submitted states that X was incorporated under the laws of State on Date 1. X filed a timely election under § 1362(a) to be treated as an S corporation effective Date 2. On Date 2, Trust 1 and Trust 2 each owned shares of X stock.

Z represents that Trust 1 and Trust 2 each qualified to elect to be treated as electing small business trusts (ESBTs) under § 1361(e), however, the trustees for each of the trusts failed to make timely ESBT elections within the meaning of §1361(e)(1)(A)(v) thereby causing X's S corporation election to be ineffective due to X's failure to meet all the requirement of § 1361(a).

Y was incorporated on Date 3 and was wholly-owned by A. Y filed a timely election under § 1362(a) to be treated as an S corporation effective Date 4. On Date 5, X merged into Y in a § 368(a)(1)(A) statutory merger. As a result of the merger, the shares of X stock owned by Trust 1 and Trust 2 were converted by operation of law into share of Y. Z represents that Trust 1 and Trust 2 each qualified to elect to be treated as ESBTs under § 1361(e), however, the trustees for each of the trusts failed to make timely ESBT elections within the meaning of §1361(e)(1)(A)(v) thereby causing Y's S corporation election to terminate.

On Date 6, Trust 1 transferred its shares of Y stock to Trust 3. The trustee of Trust 3 timely filed an election pursuant to § 1361(e) to be treated as an ESBT effective Date 6. However, Y's S corporation election was not valid on Date 6, thus invalidating Trust 3's ESBT election.

According to the information submitted Z was organized under the laws of State on Date 7, and filed a timely election under § 1362(a) to be treated as an S corporation effective Date 8. On Date 8, incident to what Z represents was part of a reorganization under § 368(a)(1)(F), Y's shareholders contributed all of their stock in Y to Z, thereby causing Y to become a wholly-owned subsidiary of Z. Afterwards, Z made an election to treat Y as a qualified subchapter S subsidiary (QSub) effective Date 8. On Date 7, Y was owned by A and Trust 3.

Z represents that the circumstances resulting in the termination of X, Y, and Z's S corporation elections were inadvertent and not motivated by tax avoidance. Z further represents that X, Y, and Z filed returns consistent with their respective status as an S corporation. Z also represents that at all times Trust 1 and Trust 2 each qualified to be

an ESBT and continue to qualify as an ESBT. X further represents that Trust 1, Trust 2, and Trust 3 each filed returns consistent with rules applicable to ESBTs. Z and its shareholders agree to make such adjustments (consistent with the treatment of X, Y, and Z as an S corporation) as may be required by the Secretary.

LAW AND ANALYSIS

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 a shareholder.

Section 1361(e)(1)(A) provides that for purposes of § 1361, except as provided in § 1361(e)(1)(B), 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, (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)(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) of the Income Tax Regulations provides, in part, that the trustee of the trust 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 1362(d)(2) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

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 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.

Section 1.1362-4(b) provides, in relevant part, that for purposes of § 1.1362-4(a), the determination of whether a termination 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 was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and 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 an event or circumstance, tends to establish that the termination was inadvertent.

Section 1.1362-4(d) provides, in part, that the Commissioner may require any adjustments that are appropriate. In general, the adjustments should be consistent with the treatment of the corporation as an S corporation during the period specified by the Commissioner.

Rev. Rul. 2008-18, 2008-1 C.B. 674, situation 2, holds that, consistent with Rev. Rul. 64-250, a reorganization under § 368(a)(1)(F) did not cause the termination of an S corporation election under § 1362. In Rev. Proc. 2008-18, C, an individual, owned all of the stock of Z, an S corporation. In Year 1, Z formed Newco, which in turn forms Mergeco. Pursuant to a plan of reorganization, Mergeco merges with and into Z, with Z surviving and C receiving solely Newco stock in exchange for Z stock. Newco meets the requirements for qualification as a small business corporation and timely elects to treat Z as a QSub, effective immediately following the transaction. The transaction met the requirements of a reorganization under § 368(a)(1)(F) and Z's original S corporation election continued for Newco. Newco must obtain a new EIN. Z must retain its EIN even though a QSub election is made for Z and must use its original EIN any time the QSub is otherwise treated as a separate entity for federal tax purposes (including for employment and certain excise taxes) or if the QSub election terminates.

Rev. Rul. 64-250, 1964-2 C.B. 333, holds that a reorganization under § 368(a)(1)(F) did not cause a termination of an election under form § 1372, the predecessor to § 1362. In that revenue ruling, an electing small business corporation within the meaning of former § 1371(b) was reincorporated in another state through the corporation's shareholders organizing a new corporation in the other state and merging

the existing corporation into the new corporation. The revenue ruling states that the surviving corporation also met the requirements for qualification as a small business corporation.

CONCLUSION

Based solely on the facts submitted and representations made, we conclude that X's S corporation election terminated beginning on Date 2 because the trustees of Trust 1 and Trust 2 failed to timely file the required ESBT elections under § 1361(e)(1)(A)(v). The failure to timely file the required ESBT elections under § 1361(e)(1)(A)(v) on behalf of Trust 1 and Trust 2 also resulted in the termination of Y beginning on Date 5. We also conclude that because Y's S corporation election had terminated, the ESBT election made by Trust 3 was ineffective thus the S corporation election by Z was terminated on Date 8. We further conclude that these terminations were inadvertent within the meaning of § 1362(f) and (1) X will continue to be treated as an S corporation for the period from Date 2, (2) Y will continue to be treated as an S corporation for the period from Date 5, and (3) Z will continue to be treated as an S corporation for the period from Date 7, provided that X, Y, and Z's S corporation elections were valid and were not otherwise terminated under § 1362(d).

This ruling is conditioned upon the trustees of Trust 1 and Trust 2 filing ESBT elections effective upon Date 2 and Trust 3 file a new ESBT election effective as of Date 6. The elections must be filed with the appropriate service center within 120 days of the date of this ruling. A copy of this letter should be attached to the ESBT elections.

Accordingly, X, Y and Z's shareholders, in determining their respective income tax liabilities, must include their pro rata share of the separately stated and nonseparately computed items of X, Y, or Z, respectively, as provided in § 1366, make any adjustments to stock basis as provided in § 1367, and take into account distributions made by X, Y, or Z as provided by § 1368.

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion regarding whether X, Y or Z are otherwise eligible to be treated as an S corporation or whether Trust 1, Trust 2, or Trust 3 is eligible to be treated as an ESBT. This ruling is directed only to the taxpayer requesting 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, a copy of this letter is being sent to Z's authorized representative.

Sincerely,

Laura C. Fields

Laura C. Fields
Senior Technician Reviewer, Branch 1
(Passthroughs & Special Industries)

Enclosures (2)
Copy of Letter
Copy for 6110 purposes

cc: