



Trust =

Share A =

Share B =

Share C =

Share D =

\$n =

Dear :

This letter responds to a letter dated September 22, 2023, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting relief under § 1362(f) of the Internal Revenue Code.

### FACTS

According to the information submitted and representations made, X was incorporated on Date 1 under the laws of State. X elected to be treated as an S corporation effective Date 2.

Prior to Date 3, shares of X stock were held by Trust. Trust was treated as a grantor trust (under subpart E of part I of subchapter J of chapter 1 of the Code) owned by Settlor until Date 3. Effective Date 3, the Trust agreement was modified in accordance with State law to remove certain provisions of the agreement that caused Trust to be treated as a grantor trust that was wholly-owned by Settlor. X represents that beginning on Date 3, Trust met the requirements of an Electing Small Business Trust (ESBT) within the meaning of § 1361(e)(1)(A). However, the trustee of Trust failed to file an election under § 1361(e)(3) for the trust to be an ESBT effective Date 3. Consequently, Trust was an ineligible shareholder of X and X's S corporation status was terminated on Date 3.

Subsequently on Date 4, pursuant to the terms of the Trust agreement, Trust was divided into four equal shares, Share A for the benefit of A, Share B for the benefit of B, Share C for the benefit of C, and Share D for the benefit of D. Share A, Share B, Share

C, and Share D are each treated as separate shares under § 663(c). X represents that Share A, Share B, Share C, and Share D have at all times met the requirements of an ESBT within the meaning of § 1361(e), except that the trustees of Share A, Share B, Share C, and Share D failed to file ESBT elections under § 1361(e)(3) effective Date 4. Consequently, Share A, Share B, Share C, and Share D were ineligible shareholders of X and X's S corporation status would have terminated on Date 4, had it not already terminated on Date 3.

X further represents that the circumstances resulting in the termination of X's S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning. Additionally, X represents that X and its shareholders have filed income tax returns consistent with having a valid S corporation election in effect for all taxable years since its election on Date 2. X and its shareholders consent to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Commissioner.

#### 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 the 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 one class of stock.

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

Section 1361(e)(1)(A) 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 an ESBT does 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) of the Income Tax Regulations provides, in part, 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 1361(d)(3) provides that a substantially separate and independent share of a trust within the meaning of § 663(c) shall be treated as a separate trust for purposes of § 1361(d) and (c).

Section 663(c) provides that for the sole purpose of determining the amount of distributable net income in the application of §§ 661 and 662, in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts. The existence of such substantially separate and independent shares and the manner of treatment as separate trusts, including the application of subpart D, shall be determined in accordance with regulations prescribed by the Secretary.

Section 1.663(c)-1(a) provides that if a single trust has more than one beneficiary, and if different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts for the sole purpose of determining the amount of distributable net income allocable to the respective beneficiaries under §§ 661 and 662 (the separate share rule). The regulations further provide, in § 1.663(c)-1(c), that the separate share rule may be applicable even though separate and independent accounts are not maintained and are not required to be maintained for each share on the books of account of the trust, and even though no physical segregation of assets is made or required. Section 1.663(c)-3(a) provides that the applicability of the separate share rule generally depends on whether trust distributions are to be made in substantially the same manner as if separate trusts had been created.

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. A termination of an S corporation election under § 1362(d)(2) shall be effective on and after the date of cessation.

Section 1362(f) provides, in relevant part, that if (1) an election under § 1362(a) by any corporation 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 was terminated under § 1362(d)(2), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken so that the corporation for which the election was made or the termination occurred is a small business corporation or to acquire the required shareholder consents, and (4) the corporation for which the election was made or 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 ineffectiveness or 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 terminated on Date 3 when Trust became an ineligible shareholder. We also conclude that X's S corporation election would have terminated on Date 4 when Share A, Share B, Share C, and Share D, became ineligible shareholders, had it not already terminated on Date 3.

We further conclude that the circumstances resulting in the termination of X's S corporation election were inadvertent within the meaning of § 1362(f). Accordingly, pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation beginning on and after Date 3, unless X's S corporation election is otherwise terminated under § 1362(d) for reasons not addressed in this letter.

We additionally conclude that Trust will be treated as an ESBT from Date 3 until Date 4 and Share A, Share B, Share C, and Share D will each be treated as an ESBT effective Date 4 and thereafter. This letter is contingent on the following conditions that must occur within 120 days of the date of this letter (1) the trustees of Share A, Share B, Share C, and Share D must each file an election to treat Share A, Share B, Share C, and Share D as ESBTs, effective Date 4, with the appropriate service center, and (2) X and the trustees of Share A, Share B, Share C, and Share D, must file any original or amended returns and making adjustments to properly reflect the treatment of the shares as ESBTs for Year and all subsequent taxable years. A copy of this letter should be attached to each ESBT election and return.

Furthermore, as an adjustment under § 1362(f)(4), a payment of \$n and a copy of this letter must be sent to the following address:

Internal Revenue Service  
Kansas City Service Center  
333 W. Pershing Road  
Kansas City, MO 64108  
Stop 7777  
Attn: Manual Deposit

This payment and a copy of this letter must be sent no later than Date 5.

If the conditions are not met, this ruling is null and void. In addition, if these conditions are not met, X must notify the service center with which it filed its S corporation election that its election terminated on Date 3.

Except as specifically ruled above, we express or imply no opinion concerning the federal tax consequences of the facts 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 Share A, Share B, Share C, and Share D are otherwise eligible to be ESBTs.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the ruling request, it is subject to verification upon examination.

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.

In accordance with the power of attorney on file with this office, we are sending copies of this letter to X's authorized representative.

Sincerely,

Holly Porter  
Associate Chief Counsel  
(Passthroughs & Special Industries)

By: \_\_\_\_\_  
Jennifer Kenney  
Senior Counsel, Branch 1  
Office of Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosure

Copy of letter for § 6110 purposes

cc: