Internal Revenue Service

Department of the Treasury

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Telephone Number:

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X =

A =

B =

C =

D =

E =

F =

G =

Trust 1 =

Sub-Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Trust 5 =

Trust 6 =

State =

d1 =

d2 =

d3 =

d4 =

d5 =

d6 =

d7 =

Dear :

This letter responds to a letter dated September 12, 2002, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

The information submitted provides that X was incorporated on d1 in State and elected to be an S corporation effective d2. On d3, X stock was transferred to Trust 1, which was eligible to be an S Corporation shareholder pursuant to § 1361(c)(2)(A)(i). During d4, Trust 1 was divided into three separate trusts. On d5, without the knowledge of X, the X stock held in Trust 1 was allocated to Sub-Trust 1, which was not eligible to be an S corporation shareholder.

X retained a new CPA in d6. The CPA determined that Sub-Trust 1 was not eligible to be a shareholder of X. On d7, the stock of X held by Sub-Trust 1 was distributed to B and G.

X and X's historic shareholders, A, B, C, D, E, F, G, Trust 1, Sub-Trust 1, Trust 2, Trust 3, Trust 4, Trust 5 and Trust 6, agree to make any adjustments as required by § 1.1362-4(e). X represents that the termination of its S election was inadvertent and not the result of tax avoidance or retroactive tax planning. X further represents that for all relevant taxable years X has filed its income tax returns as an S corporation and its shareholders have included on their tax returns their proportionate share of X's income and loss.

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) provides that the term small business corporation means a domestic corporation that is not an ineligible corporation and that does not (A) have more than 75 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.

For taxable years prior to 1996, § 1361(b)(1)(A) provided that the term small business corporation means a domestic corporation which is not an ineligible corporation and which does not (A) have more than 35 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 the purposes of § 1361(b)(1)(B), a trust all of which is treated (under subpart E of part I subchapter J of chapter 1 of the Internal Revenue Code) as owned by an individual who is a citizen or resident of the United States may be a shareholder in an S corporation.

Section 1362(f) provides that (1) if 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) or (3), (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 is a small business corporation or to acquire the required shareholder consents, and (4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to § 1362(f), agrees to make such adjustments (consistent with the treatment of the 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.

Section 1362(d)(2)(A) 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(d)(2)(B) provides that such termination shall be effective on and after the date of cessation.

Section 1.1362-4(b) provides that the determination of whether a termination was inadvertent is made by the Commissioner. It further provides that 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 in the corporation's control and was not part of a plan, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish inadvertence.

Section 1.1362-4(d) provides that the Commissioner may require any adjustments that are appropriate. In the case of a transfer of stock to an ineligible corporation that causes an inadvertent termination, the Commissioner may require the ineligible shareholder to be treated as an S corporation shareholder during the period the ineligible shareholder actually held stock. Moreover, § 1.1362-4(d) provides that the Commissioner may require protective adjustments to prevent any loss of revenue due to a transfer of stock to an ineligible shareholder.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election was terminated on d5. We also conclude that the termination of X's S corporation election constituted an inadvertent termination within the meaning of § 1362(f).

Consequently, X shall be treated as an S corporation from d5 to d7, and thereafter, provided that X's S election was valid and not otherwise terminated under § 1362(d). Trust 1 and Sub-Trust 1 shall be treated as shareholders of X for all periods during which Trust 1 and Sub-Trust 1 actually held the stock of X. Accordingly, Trust 1 and Sub-Trust 1 must include their pro rata share of separately and non-separately computed items of X pursuant to § 1366, make adjustments to basis pursuant to § 1367, and take into account any distributions pursuant to § 1368.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed on whether X is otherwise eligible to be an S corporation.

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

Sincerely yours,

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

Enclosures (2)
A copy of this letter
A copy for §6110 purposes

cc: