Internal Revenue Service

Number: **200438004**
Release Date: 9/17/04
Index Number: 1362.04-00

Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:3 PLR-102876-04

Date:
May 18, 2004

Company:

M:

N:

Trust:

State:

a:

b:

c:

d:

e:

Dear

This letter responds to a letter from Company's authorized representative dated May 30, 2002, as well as additional correspondence, submitted on behalf of Company, requesting a ruling under § 1362(f) of the Internal Revenue Code that the termination of

Company's S corporation election was inadvertent. Company represents the facts as follows.

FACTS

Company was incorporated in a under the laws of State and elected under § 1362(a) to be an S corporation effective b. M, Company's sole shareholder, formed Trust on c, to which he transferred all his shares in Company on d. M represents that Trust meets the requirements of § 1361(d)(3) for a qualified subchapter S trust (QSST), as he intended. However, N, the income beneficiary of Trust, failed to file timely the QSST election required by § 1361(d)(2).

Trust is not a permitted S corporation shareholder under § 1361(b)(1)(B). The termination of Company's S corporation election due to the transfer of stock to an ineligible shareholder was discovered in e by a legal advisor to Company as it was considering acquiring a certain asset.

From the date of termination to the present, Company, Trust, and N have filed their federal income tax returns (Forms 1120S, 1041, and 1040, respectively) consistent with Company being an S corporation. The transfer of the shares in Company to Trust was not motivated by retroactive tax planning or a desire for tax avoidance. Company, Trust, and N agree to make adjustments during the termination period (consistent with the treatment of Company as an S corporation) as may be required by the Service.

LAW

Except as provided in § 1362(g), § 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1361(b)(1)(B) provides that, for purposes of subchapter S, the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not, among other things, 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)(i) provides that a trust all of which is treated (under subpart E of part I of subchapter J of chapter 1 of the Code) as owned by an individual who is a citizen or resident of the United States may be a shareholder of an S corporation for purposes of § 1361(b)(1)(B). Section 1361(c)(2)(B)(i) provides that, in the case of a trust described in § 1361(c)(2)(A)(i), the deemed owner shall be treated as the shareholder.

Section 1361(d)(1) provides that, in the case of a QSST with respect to which a beneficiary makes an election under § 1361(d)(2)–

(A) the trust shall be treated as a trust described in § 1361(c)(2)(A)(i), and

(B) for purposes of § 678(a), the beneficiary of the trust shall be treated as the owner of that portion of the trust that consists of stock in an S corporation with respect to which the election under § 1361(d)(2) is made.

Section 1361(d)(2)(A) provides that a beneficiary of a QSST (or his legal representative) may elect to have § 1361(d) apply. Section 1361(d)(2)(D) provides that an election under § 1361(d)(2) shall be effective up to 15 days and 2 months before the date of the election.

Section 1361(d)(3) defines the term "qualified subchapter S trust".

Section 1362(d)(2)(A) provides that an election under § 1362(a) terminates whenever the 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 termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in termination, steps were taken so that the corporation is a small business corporation, and (4) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as might be required by the Secretary regarding this period, then, notwithstanding the circumstances resulting in termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) provides that 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 event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination 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 during the period

specified by the Commissioner. In the case of a transfer of stock to an ineligible shareholder that causes an inadvertent termination under § 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of an S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent any loss of revenue due to a transfer of stock to an ineligible shareholder (e.g., a transfer to a nonresident alien).

CONCLUSION

Based on the facts and representations submitted by Company, we conclude that the termination of Company's S corporation election due to the transfer of Company stock to Trust was inadvertent within the meaning of § 1362(f). Consequently, we rule that–

(1) Company will continue to be treated as an S corporation from d, and thereafter, unless Company's S election otherwise terminates under § 1362(d); and

(2) N will be deemed to have filed a timely QSST election, provided such election, effective as of d, is filed no later than 60 days from the date of this letter. A copy of this letter should be attached to the QSST election filed with the service center.

Except for the specific rulings above, no opinion is expressed or implied concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed or implied regarding Company's eligibility to be an S corporation or Trust’s qualifications as a QSST.

Under a power of attorney on file with this office, we are sending the original of this letter to you and a copy to Company.

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.

Sincerely,

/s/

JAMES A. QUINN
Senior Counsel, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

enclosure: copy of this letter
copy for § 6110 purposes

cc: