

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

Number: **200438034**

Release Date: 9/17/04

Index Number: 1362.04-00

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:2 – PLR-168520-03

Date:

May 11, 2004

Legend

X:

A:

B:

C:

Trust:

Accounting Firm:

D1:

D2:

D3:

D4:

D5:

PLR-168520-03

Dear :

This letter responds to a letter dated November 24, 2003, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting relief under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated on D1. Effective D1, X elected to be an S corporation. On D2, Trust was created. A and B, as the co-trustees of Trust, represent that Trust was qualified to be an electing small business trust ("ESBT") effective D2. However, A and B inadvertently failed to make the ESBT election. Trust also became a shareholder of X on D2. However, Trust was an ineligible shareholder and therefore, X's S corporation election was terminated.

Sometime during D3, the beneficiaries of Trust requested that each separate equal share of Trust be accounted for separately for federal income tax purposes. Beginning with the tax year beginning D4, separate K-1 forms were issued to separate trusts established for the each of the Trust beneficiaries. On D5, Accounting Firm discovered the failure to timely make the ESBT election for Trust. X promptly submitted this request for a ruling in order to qualify Trust as an ESBT from D2 and to seek inadvertent termination relief under § 1362(f) for X.

A and B represent that Trust has filed federal income tax returns consistent with Trust being an ESBT from D2 to D4. All of X's shareholders represent that they have filed federal income tax returns consistent with the treatment of X as an S corporation. C, X's president, 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. X and its shareholders have agreed to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary.

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

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 the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not have

PLR-168520-03

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 an “electing small business trust” may be a shareholder in an S corporation.

Section 1361(e)(1)(A) provides that 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 paragraph (2), (3), (4), (5) of § 170(c), 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 “electing small business trust” shall not include (i) any qualified subchapter S trust (as defined in section 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.

In Notice 97-12, 1997-1 C.B. 385, the Service provided guidance regarding ESBT elections. In particular, the Notice provided that the trustee of an ESBT must file the ESBT election within the time requirements prescribed in regulation § 1.1361-1(j)(6)(iii) for filing QSST elections (generally within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust).

Section 1.1361-1(m)(8) of the Income Tax Regulations, Example 1(i), ESBT election with § 663(c) separate shares, provides that on January 1, 2003, M contributes S corporation stock to Trust for the benefit of M's three children A, B, and C. Pursuant to § 663(c), each of Trust's separate shares for A, B, and C will be treated as separate trusts for purposes of determining the amount of distributable net income (DNI) in the application of §§ 661 and 662. On January 15, 2003, the trustee of Trust files a valid ESBT election for Trust effective January 1, 2003. Trust will be treated as a single ESBT and will have a single S portion taxable under § 641(c).

Section 1362(f) provides that if—(1) an election under § 1362(a) by any corporation—(A) 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

PLR-168520-03

§ 1361(b) or to obtain shareholder consents, or (B) 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—(A) so that the corporation is a small business corporation, or (B) 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.

Based solely on the representations made and the information submitted, we conclude that X's S corporation election terminated on D2, under § 1362(d)(2), because A and B, the co-trustees of Trust, failed to timely file the required ESBT election under § 1361(e)(3). We further conclude that the termination of X's S election was 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 from D2 and thereafter, provided X's S corporation election was valid and was not otherwise terminated under § 1362(d). All of X's shareholders in determining their respective income tax liabilities during the termination period and thereafter, must include their pro rata share of the separately stated items of income (including tax-exempt income), loss, deduction, or credit and non-separately stated computed items of income or loss of X as provided in § 1366, make any adjustments to basis provided in § 1367, and take into account any distributions made by X as provided in § 1368.

Additionally, from D2 to the present, Trust will be treated as a shareholder of X and as a single ESBT with separate shares under § 1361(e), provided that A and B, file an ESBT election effective D2 for Trust with the appropriate service center within 60 days following the date of this letter. If Trust, X, or X's shareholders fail to treat X as described above, this ruling shall be null and void. A copy of this letter should be attached to the ESBT election.

Except as specifically ruled above, we express no opinion concerning the Federal tax consequences of the transactions described above under any other provision of the Code. Specifically, no opinion is expressed on whether X is otherwise eligible to be treated as an S corporation or whether Trust is an eligible ESBT under § 1361(e).

This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

PLR-168520-03

Pursuant to the powers of attorney on file with this office, a copy of this letter is being sent to Trust, X and X's other authorized representative.

Sincerely,

Carolyn Hinchman Gray  
Senior Counsel, Branch 2  
Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter

Copy for § 6110 purposes