

**Internal Revenue Service**

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Date:

May 13, 2004

X =

A =

B =

C =

Trust  
1 =

Trust  
2 =

D1 =

Year  
1 =

Year  
2 =

Dear :

This letter responds to a letter, dated October 25, 2003, and subsequent correspondence submitted on behalf of X by X's authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that X elected to be an S corporation for its taxable year beginning D1 of Year 1. As of D1 of Year 1, the shareholders of X included Trust 1 and Trust 2 (the Trusts). A, the grantor of the Trusts, represents that the Trusts qualified as electing small business trusts (ESBTs) as defined in § 1361(e), but that the trustees of the trusts failed to timely file ESBT elections for the Trusts, because they incorrectly believed that the Trusts were grantor trusts wholly owned by their respective beneficiaries, B and C, under § 678.

For Year 1 and all subsequent taxable years, all of the items attributable to the shares of X owned by each of the Trusts were reported on the individual income tax return of the beneficiary of that Trust. The corporate income tax returns of X were filed consistent with all of the shares being owned by the Trusts as wholly owned grantor trusts.

A, on behalf of X, represents that the circumstances resulting in the ineffectiveness of X's S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning. X and its shareholders agree to make any adjustments (consistent with the treatment of X as an S corporation) that the Secretary may require.

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) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1361(b)(1)(B) provides that a "small business corporation" means a domestic corporation that is not an ineligible corporation and that 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 purposes of § 1361(b)(1)(B), an ESBT may be a shareholder of an S corporation.

Section 1361(e)(1)(A) provides that an ESBT is 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 1362(f) provides 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 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 the ineffectiveness or 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 under § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary for that period, then, notwithstanding the circumstances resulting in such termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts and representations submitted, we conclude that X's S corporation election was ineffective beginning on D1 of Year 1 because of the ownership of X stock by the Trusts, which were ineligible S corporation shareholders. We also conclude that the ineffectiveness of X's S corporation election was an inadvertent invalid election within the meaning of § 1362(f).

We further conclude that under the provisions of § 1362(f), X will be treated as being an S corporation from D1 of Year 1, and afterwards, provided X's S corporation election was otherwise valid and was not otherwise terminated, provided that Trust 1 and Trust 2 file ESBT elections meeting the requirements of § 1.1361-1(m), effective for the Year 2 taxable year, with the appropriate Internal Revenue service center, within 60 days of the date of this letter. A copy of this letter should be attached to each ESBT election.

In addition, B and C will be treated as the owners of the X stock owned by Trust 1 and Trust 2, respectively, during the taxable year beginning D1 of Year 1, as if Trust 1 and Trust 2 were qualified subchapter S trusts (QSSTs) treated as owned by B and C under § 678. Trust 1 and Trust 2, as ESBTs, will be treated as the owners of the X stock beginning with the Year 2 taxable year. The shareholders of X must include their pro rata share of the separately stated and nonseparately computed items 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. If X or its shareholders fail to treat X as described above, during the period beginning D1 of Year 1, this ruling will be null and void.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code, including whether X was or is a small business corporation under § 1361(b) or whether the Trusts are otherwise eligible to be ESBTs.

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.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,

J. THOMAS HINES  
Chief, Branch 2  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures:

Copy of this letter  
Copy for § 6110 purposes