

Internal Revenue Service

Department of the Treasury

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LEGEND

X =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

D1 =

D2 =

D3 =

m =

n =

o =

p =

This letter responds to a letter dated December 22, 1999, written on X's behalf, requesting inadvertent termination relief under section 1362(f) of the Internal Revenue Code.

FACTS

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X elected to be treated as an S corporation effective D1. On D2, two shareholders transferred stock in X to four trusts (the Trusts) in the following amounts: m shares to Trust 1, n shares to Trust 2, o shares to Trust 3, and p shares to Trust 4. Although the trustees of the Trusts were required to make Electing Small Business Trust (ESBT) elections within two and one-half months of the transfers to qualify as shareholders of X, they failed to timely file the elections. X was unaware that the failure to file ESBT elections terminated X's S election. On D3, it was discovered that transfers of X stock to the Trusts terminated X's S election.

X represents that the transfers to the Trusts were not motivated by tax avoidance or retroactive tax planning. In addition, X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary with respect to the period specified by section 1362(f).

X represents that the Trusts comply with the requirements under section 1361(e), which defines an ESBT. The trustees for the Trusts intend to file ESBT elections under Notice 97-12, 1997-1 C.B. 385, to be effective D2, once X receives this private letter ruling from the Service. The elections, however, will not be timely filed.

LAW AND ANALYSIS

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under section 1362(a) is in effect.

Effective for tax years beginning after December 31, 1996, section 1361(c)(2)(A)(v) provides that an ESBT (as defined in section 1361(e)) is a permitted S corporation shareholder. Generally, an ESBT is any trust if: (1) the trust does not have as a beneficiary any person other than an individual, an estate, or an organization described in section 170(c)(2), (3), (4), or (5); (2) no interest in the trust was acquired by purchase; and (3) an election to be an ESBT has been filed with respect to the trust.

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

Section 1362(d)(2)(A) provides that an S election under section 1362(a) shall be terminated whenever (at any time on or after the first day of the taxable year for which the corporation is an S corporation) the corporation ceases to be a small business corporation. The termination is effective on and after the day of cessation.

Section 1362(f) provides that if: (1) an election under section 1362(a) by any corporation (A) was not effective for the taxable year for which made (determined without regard to section 1362(b)(2)) by reason of a failure to meet the requirements of

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section 1361(b) or to obtain shareholder consents, or (B) was terminated under paragraph (2) or (3) of section 1362(d); (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 effectiveness 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 this subsection, 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, the corporation shall be treated as an S corporation during the period specified by the Secretary.

The committee reports accompanying the Subchapter S Revision Act of 1982, in discussing section 1362(f) as it relates to inadvertent terminations, state, in part, as follows:

If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.

The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped the taxpayers and the government will work out agreements that protect the revenues without undue hardship to taxpayers It is expected that the waiver may be made retroactive for all years, or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24.

CONCLUSIONS

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election under § 1362(a) was terminated on D2 when the Trusts acquired X stock. We also conclude that the termination constituted an inadvertent termination within the meaning of § 1362(f). Pursuant to § 1362(f), X will be treated as continuing to be an S corporation from D2, and thereafter, and the trustees of the Trusts will be treated as having filed timely ESBT elections on behalf of the Trusts, effective D2, provided that X's S election is not otherwise terminated under § 1362(d),

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and, provided further, that the trustees file ESBT elections for all of the Trusts with the service center, effective as of D2, within 60 days of the date of this letter. A copy of this letter should be attached to the elections.

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. Specifically, no opinion is expressed concerning whether X is an S corporation for federal tax purposes or whether the Trusts are ESBTs under section 1361(e).

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.

Under a power of attorney on file in this office, a copy of this letter will be sent to your authorized representative.

Sincerely yours,

Signed/Dianna K. Miosi

Dianna K. Miosi
Branch Chief, Branch 1
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes