Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Number: **200344013**
Release Date: 10/31/2003
Index Number: 1362.04-00

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:B03 PLR-104722-03
Date:
July 31, 2003

X =

Y =

A =

B =

C =

D =

E =

F =

G =

H =

a =

b =

c =

d =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Trust 5 =

Trust 6 =

Trust 7 =

Trust 8 =

Trust 9 =

Trust 10 =

Trust 11 =

d1 =

d2 =

d3 =

d4 =

d5 =

State =

Dear :

This letter responds to a letter dated January 15, 2003, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

Y was incorporated in d1 under the laws of State and its shareholders filed an election to treat Y as an S corporation effective d2. On d3, A, one of Y's shareholders, transferred Y stock to Trust 1. Pursuant to Article 3, Paragraph A of Trust 1, the trustees established four identical subtrusts, one for each of the four beneficiaries of Trust 1. Each of the four subtrusts was treated as owned by the beneficiary of that subtrust under § 678(a). However, the subtrusts did not qualify to be treated as wholly owned by their respective beneficiaries.

On d4, the shareholders of Y incorporated X as a shell corporation, elected to treat X as an S corporation, contributed the Y stock to X, and caused X to file an election to treat Y as a qualified subchapter S subsidiary (QSub). X represents that the formation of X followed by the contribution of the Y stock, coupled with a QSub election for Y, satisfied the requirements for a reorganization under § 368(a)(1)(F).

On d5, X discovered that the subtrusts established by the trustee of Trust 1 were

ineligible to be shareholders of an S corporation.

X represents that since d3, it has reported income consistent with its S election and that the beneficiaries of Trust 1 have reported the appropriate share of the income of Trust 1 consistent with each subtrust qualifying as a grantor trust. X represents that, consistent with the governing instrument of Trust 1, the trustee of Trust 1 will establish four additional subtrusts, one for each beneficiary of Trust 1, from the portion of the existing subtrusts that do not qualify under § 678(a) and that each of the new subtrusts will qualify and elect to be treated as a qualified subchapter S trust (QSST). Moreover, X and its shareholders, A, B, C, D, E, F, G, H, Trust 1, Trust 2, Trust 3, Trust 4, Trust 5, Trust 6, Trust 7, Trust 8, Trust 9, Trust 10, Trust 11, agree to make any adjustments consistent with the treatment of X and Y as S corporations as may be required by the Secretary.

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) defines the term small business corporation as 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 and other than a trust described in § 1362(c)(2), or an organization described in § 1361(c)(6)), and (D) have more than one 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 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 1361(d)(1) provides that in the case of a QSST with respect to which a beneficiary makes an election under § 1362(d)(2), the trust shall be treated as a trust described in § 1361(c)(2)(A)(i) and for the purposes of § 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which 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 the beneficiary of a QSST may elect to have § 1361(d) apply.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the first taxable year for which the corporation is an S Corporation) such corporation ceases to be a small business 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 § 1362(d)(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 this subsection, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as maybe 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 1.1361-1(j)(3) provides that for purposes of § 1361(c) and (d), a substantially separate and independent share of a trust, within the meaning of § 663(c) and the regulations thereunder is treated as a separate trust. For a separate share which holds S corporation stock to qualify as a QSST, the terms of the trust applicable to that separate share must meet the QSST requirements stated in § 1.1361-1(j)(1)(i) and (ii).

Section 1.1362-4(b) of the Income Tax Regulations 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 event was not 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 shareholder 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 representations made, we conclude that the S election of Y (later known as X) terminated on d3 and that the termination was inadvertent. As a result, we rule that X will be treated as an S corporation from d3 to the date that is 60 days from the date of this letter, and thereafter, provided its S election is not otherwise invalid and provided that each of the subtrusts of Trust 1 files a

QSST election with the appropriate service center not later than 60 days after the date of this letter.

During the period from d3 to the date that is 60 days from the date of this letter, and thereafter, the shareholders of X must include their pro rata share of separately and non-separately computed items of income, loss, deduction or credit pursuant to § 1366, make adjustments to basis pursuant to § 1367, and take into account any distributions pursuant to § 1368. Moreover, each of the beneficiaries of the subtrusts of Trust 1 must treat their share of Trust 1 as though that share were a wholly-grantor trust. If X or any of its shareholders fail to treat X as described above, this ruling is null and void.

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 as to whether X or Y is otherwise eligible to be an S corporation or whether the subtrusts of Trust 1 otherwise qualify as QSSTs.

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, we are sending a copy of this letter to the authorized representative of X.

Sincerely yours,

Jeanne Sullivan
Senior Technician Reviewer, 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: