Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

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Date:
June 25, 2001

Company:

State:

Trustees:

Trust:

Shareholders:

a:

b:

c:

d:

This letter responds to a letter from your authorized representative dated February 9, 2001, 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 following facts.

FACTS

Company was incorporated on a under the laws of State and elected under § 1362(a) to be an S corporation effective the same date. The Trust was created on b, and Company shares were transferred to it on c.

Company's S election terminated on c when the Trustees, relying on professional tax advice, failed to timely elect under § 1361(e)(3) to treat the Trust as an electing small business trust (ESBT). The termination of Company's S corporation election was discovered on d when Company and Company's counsel were reviewing possible business transactions. Company's Shareholders since c are listed in the legend of this letter.

LAW AND ANALYSIS

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)(v) provides that an ESBT may be a shareholder of an S corporation for purposes of § 1361(b)(1)(B).

Section 1361(e)(1)(A) provides that, for purposes of § 1361, and except as provided in § 1361(e)(1)(B), the term "electing small business trust" means any trust if (i) the trust does not have as a beneficiary any person other than an individual, an estate, or an organization described in § 170(c)(2), (3), (4), or (5); (ii) no interest in the trust was acquired by purchase; and (iii) an election under § 1361(e) applies to the trust.

Section 1361(e)(3) provides that an election under § 1361(e) shall be made by the trustee. The election shall apply to the tax year of the trust for which made and all subsequent tax years of the trust unless revoked with the consent of the Secretary.

Pending the issuance of final regulations, Notice 97-12, 1997-1 C.B. 385, provides procedures for making an ESBT election. The trustee of an otherwise qualifying trust makes the ESBT election by filing with the appropriate service center a signed statement containing the information specified in Notice 97-12. The trustee must file the ESBT election within the period of time prescribed by § 1.1361-1(j)(6)(iii) of the Income Tax Regulations for filing qualified subchapter S trust (QSST) elections (generally within the 16-day-and-2-month period beginning on the day the stock is transferred to the 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.

According to the legislative history of § 1362(f)--

> 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 that 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.

Company represents that the transfer of shares to the Trust was not motivated by tax avoidance or retroactive tax planning.

Company and the Trustees represent that they were unaware that the Trust had to make an ESBT election to avoid termination of Company’s S election. They represent also that the Trust meets the requirements of § 1361(e), defining an ESBT, except for the filing of an ESBT election.

The Trustees and the Shareholders represent that they at all times have filed

their income tax returns (Form 1041, U.S. Income Tax Return for Estates and Trusts, and Form 1040, U.S. Individual Income Tax Return) consistent with Company being an S corporation. The returns for the Trust, however, have not been filed consistent with ESBT status.

Based solely on the facts as represented by Company in this ruling request, we conclude that the termination of Company's S corporation election due to the failure of the Trustees to elect under § 1361(e) to treat the Trust as an ESBT was inadvertent within the meaning of § 1362(f).

Consequently, we rule that Company will continue to be treated as an S corporation from c, and thereafter, unless Company's S election otherwise terminates under § 1362(d). We rule, also, that the Trustees will be deemed to have filed a timely ESBT election for the Trust, provided that such election, effective as of c, is filed no later than 60 days from the date of this letter, and provided that the Trust's tax returns filed for the period of time since c are amended to reflect the status of the Trust as an ESBT. A copy of this letter should be attached to the ESBT election.

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, the eligibility of the Trust to be an ESBT, or the validity of the S corporation and ESBT elections.

Under a power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

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,
MARY BETH COLLINS
Assistant to the Chief, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

enclosure: copy of this letter
copy for § 6110 purposes