

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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November 16, 1998

Legend

X =

Trust =

A =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

This responds to a letter submitted on behalf of X requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

FACTS

X elected to be treated as an S corporation effective Date 1. At that time, Trust was an eligible shareholder of X. On Date 2, A died and all of Trust's assets were included in A's estate. On Date 3, two years after A's death, Trust ceased to be an eligible shareholder of X but continued to hold shares of X stock. Trust filed an election under §1361(e) of the Internal Code effective Date 4.

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.

Section 1361(b)(1) defines a "small business corporation" as a domestic corporation which is not an ineligible corporation which 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 subsection (c)(2)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than 1 class of stock.

Section 1361(c)(2)(A) provides that, for purposes of § 1361(b)(1)(B), trusts that may be shareholders include (i) a trust all of which is treated (under subpart E of part I of subchapter J) as owned by an individual who is a citizen or resident of the United States, and (ii) such a trust, if it continues in existence after the death of the deemed owner, but only for the 2-year period beginning on the day of the deemed owner's death.

Section 1361(e)(1)(A) provides that an "electing small business trust" (ESBT) means any trust if (i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, or (III) an organization described in paragraph (2),(3),(4), or (5) of section 170(c); (ii) no interest in such trust was acquired by purchase, and (iii) an election under this subsection applies to such trust.

Section 1362(d)(2)(A) provides that an election under section 1362(a) shall be terminated 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) the Secretary determines that the circumstances resulting in the termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the 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 of inadvertent termination of the S election, 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 the termination, the corporation is treated as an S corporation during the period specified by the Secretary.

Section 1.1361-1(h)(ii) provides that a trust which was a qualified subpart E trust immediately before the death of the deemed owner and which continues in existence after the death of the deemed owner, and the entire corpus of the trust is includible in

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the gross estate of the deemed owner, the trust is a permitted shareholder for the 2-year period beginning on the day of the deemed owner's death.

The committee reports accompanying the Subchapter S Revision Act of 1982 explain § 1362(f) 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 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; H.R. Rep. No. 826, 97th Cong., 2d Sess. 12 (1982), 1982-2 C.B. 730, 735.

CONCLUSION

Based solely on the representations made, we conclude that X's subchapter S election terminated on Date 3, when Trust became an ineligible shareholder by continuing to hold X stock beyond the two year period after A's death. We also conclude that the termination was inadvertent. Therefore, X will be treated as continuing to be an S corporation from Date 3 through Date 4, and thereafter, provided X's S corporation election is not otherwise terminated under § 1362(d).

In addition, from Date 3 to Date 4, Trust will be considered a shareholder of X and will be taxed as if it were an ESBT from Date 3. If X, Trust, or the other shareholders of X fail to make any adjustments necessary to treat Trust as an ESBT from Date 3, this ruling is null and void.

Except as specifically set forth above, no opinion is expressed or implied as to the federal income tax consequences of the transaction described under any other provision of the Code. In particular, no opinion is expressed as to whether X made a valid subchapter S election under section 1362 or whether Trust is otherwise qualified

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as an ESBT.

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. As provided by a power of attorney on file in this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

signed/David R. Haglund
DAVID R. HAGLUND
Senior Technician Reviewer
Branch 1
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
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