Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact: 199916047

Telephone Number:

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LEGEND

Company =

Shareholder 1 =

Shareholder 2 =

Trust 1 =

Trust 2 =

d1 =

d2 =

d3 =

d4 =

d5 =

d6 =

x =

y =

Dear:

This responds to your letter dated September 9, 1998, and subsequent correspondence written on behalf of Company, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, Company was incorporated d1 and elected to be treated as an S corporation as defined in § 1361(a) effective d2. On d3, Shareholder 1, a Company shareholder, transferred x shares of nonvoting common stock to Trust 1. Trust 1, for which Shareholder 1 was both the grantor and trustee, was created with the intention that it would be a grantor retained annuity trust and an eligible shareholder of an S corporation under § 1361(c)(2)(A)(i).

On d4, Shareholder 2 transferred y shares of nonvoting common shares of Company's stock to Trust 2. Trust 2 was created with the intention that it would be either a grantor trust as described in § 1361(c)(2)(A)(i) or a qualified subchapter S trust (QSST) under § 1361(d). However, because of a miscommunication between Trust 2's accountants and attorneys, Trust 2 did not qualify as either a grantor trust or a QSST. Therefore, Trust 2 was an ineligible shareholder of an S corporation and Company's S status, if it had not already terminated on d3, terminated on d4. Shareholder 2 did not intend on terminating Company's S corporation election. On d5, the trustee of Trust 2, filed an Electing Small Business Trust (ESBT) election for Trust 2, effective d6.

Company and each of its shareholders who were shareholders during the period of termination agree to make any necessary adjustments consistent with the treatment of Company as an S corporation.

RULINGS REQUESTED

1. Company requests a ruling that Trust 1 was a trust as described in § 1361(c)(2)(A)(i) when it was created and, therefore, a permissible S corporation shareholder. Alternatively, if Trust 1 was not a permissible S corporation shareholder, Company requests inadvertent termination relief under § 1362(f) for the period in which it was an impermissible shareholder.

2. Company requests inadvertent termination relief under § 1362(f) for the period in which Trust 2 was an impermissible shareholder.

LAW AND ANALYSIS

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)(i) provides that for the purposes of § 1361(b)(1) a trust all of which is treated (under subpart E of part I of subchapter J of chapter 1 of the Code) as owned by an individual who is a citizen of the United States is a permitted shareholder of an S corporation.

Subpart E of part I of subchapter J of chapter 1 of the Code includes § 671 through § 679. Section 671 provides, in part, that where it is specified in subpart E that the grantor is treated as the owner of any portion of a trust, there must then be included in computing the taxable income and credits of the grantor those items of income, deductions, and credits against tax of the trust that are attributable to that portion of the trust to the extent that the items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 1.671-3(a)(1) of the Income Tax Regulations provides that if a grantor is treated as the owner of an entire trust (corpus as well as ordinary income), the grantor takes into account in computing the grantor's income tax liability all items of income, deduction, and credit (including capital gains and losses) to which the grantor would have been entitled had the trust not been in existence during the period the grantor is treated as the owner.

Effective for tax years beginning after December 31, 1996, § 1361(c)(2)(A)(v) provides that for purposes of § 1361(b)(1)(B), an ESBT is a permitted shareholder of an S corporation.

Section 1362(d)(2)(A) provides than an election under § 1362(a) shall be terminated whenever (at any time after the first day of the first taxable year for which corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(d)(2)(B) provides that a termination of an S corporation election under § 1362(d)(2) is effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2); (2) the Secretary determines that the circumstances resulting in such 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 specified pursuant to § 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.

Section 1.1362-4(d) provides that the Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified. In the case of a transfer of stock to an ineligible shareholder that causes an inadvertent termination under § 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of an S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent any loss of revenue because of the transfer of stock to an ineligible shareholder.

CONCLUSIONS

After applying the relevant law to the facts submitted and representations made, we have reached the following conclusions.

1. We conclude that Shareholder 1 is the owner of Trust 1 in its entirety within the meaning of § 671 until the earlier of the grantor's death or the termination of the trust. Thus, Trust 1 is an eligible shareholder of an S corporation under § 1361(c)(2)(A)(i) and Company's S corporation status did not terminate on d3, when Shareholder 1 transferred Company stock to Trust 1

2. Company's S corporation election terminated on d4, when Shareholder 2 transferred shares of Company stock to Trust 2. This termination was inadvertent within the meaning of § 1362(f). Under § 1362(f), Company will be treated as continuing to be an S corporation during the period from d4 until Trust 2's ESBT election was effective on d6 and thereafter, assuming Company's S corporation election was valid and was not otherwise terminated under § 1362(d). During that period, Trust 2, though an impermissible shareholder, will be treated as a shareholder of Company. Accordingly, Trust 2, Shareholder 2, and all the shareholders of Company during that period, in determining their respective income tax liabilities during the termination period and thereafter, must include the pro

rata share of the separately and nonseparately computed items of Company as provided in § 1367, and take into account any distributions made by Company as provided by § 1368.

If Company, the trusts, or all of Company's shareholders fail to treat Company and the trusts as described above, this ruling shall be null and void.

Except for the specific ruling above, no opinion is expressed or implied concerning the federal tax consequences of the facts of this case under any other provision of the Code. No opinion is expressed on whether Company is otherwise qualified to be an S corporation. Furthermore, we express no opinion on whether Trust 2 was eligible to make an ESBT election under § 1361(e) or whether the ESBT election was valid.

This ruling is directed only to the taxpayer requesting it. Under § 6110(k)(3), it may not be used or cited as precedent.

Sincerely,

(signed) Jeff Erickson

Jeff Erickson
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Enclosures (2)

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