

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:2-PLR-161689-01
Date:
March 13, 2002

Legend

- X =
- A =
- B =
- C =
- D =
- E =
- Trust =
- GRAT =

- a =
- D1 =
- D2 =
- D3 =
- D4 =
- D5 =
- D6 =
- D7 =

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D8 =D9 =

Dear :

This letter responds to a letter dated November 4, 2001 and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated on and elected to be treated as an S corporation effective D1. On D2, Trust was created by A for the benefit of B and B's issue. The Trust instrument provides for income and principal to be distributed in the discretion of the independent trustee to B and B's issue. B, C, (a sibling of B) and D, the independent trustee, are trustees of Trust.

On D3, A created GRAT and transferred a shares of X stock to GRAT. According to the agreement of GRAT, the assets of GRAT were to be distributed in equal portions to B, C, and E on D4. On D4, A, as sole trustee of GRAT, transferred one-third of the X stock held in GRAT, to each of B, C, and E.

Shortly before D4, C, the president of X, contacted X's counsel, and asked whether X's S corporation status would be affected if B's X stock that was held in GRAT was transferred to Trust instead of directly to B. The attorney assured C that the transfer would not affect X's S corporation status.

B wrote a letter to X's attorney directing that B's shares in X be transferred on D4 from GRAT directly to Trust. This made B the grantor of a portion of Trust. Therefore, B should have been treated as the owner of the portion of Trust that held X stock under section 677. However, B would not have been treated as the owner of all of Trust under sections 671 to 678. Therefore, Trust was not a grantor trust eligible to hold S corporation stock under section 1361(c)(2)(A)(i), because it was not a wholly-owned grantor trust. Accordingly, X's S election terminated on D4.

In D5, while preparing Trust's income tax return, D determined that perhaps X's S election terminated on D4 as a result of the transfer of the X stock to Trust, since Trust was not an eligible S corporation shareholder. D immediately took steps to remove X stock from Trust. On D6, D transferred the X stock certificate issued to Trust to B's personal agency account. On D7, D transferred amounts equal to the X distributions received by Trust during the time Trust held X stock to B's personal agency account. In D8, X retained counsel to submit this request. In order to perfect B's ownership in X stock, on D9, the X stock certificate issued to Trust that was being held in B's personal agency account was surrendered, and a new X stock certificate was issued to B.

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X represents that the circumstances resulting in the termination of X's election to be an S corporation were inadvertent. X also represents that X and its shareholders did not intend to engage in tax avoidance or retroactive tax planning. X and each person who was or is a shareholder of X at any time since D4 agree to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary with respect to such period.

Section 1362(a) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

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)(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 purposes of section 1361(b)(1)(B), a trust may be a shareholder if all of it is treated (under subpart E of part I of subchapter J of chapter 1 of title 26) as owned by an individual who is a citizen or resident of the United States.

Section 1362(d)(2) 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 a corporation is an S corporation) such corporation ceases to be a small business corporation. 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) or (3); (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 under § 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.

Based solely on the facts and the representations made, we hold that X's election to be an S corporation effective D1 terminated on D4 because Trust was an

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ineligible shareholder. We hold also that the termination of X's S corporation election was inadvertent within the meaning of § 1362(f). Therefore, X will be treated as continuing to be an S corporation from D4 through D9 and afterwards, provided that X's S election was valid and was not otherwise terminated. In addition, from D4 through D9, B will be treated as the owner of the X stock held by Trust. Accordingly, from D4 through D9, B, must include Trust's pro rata share of the separately and nonseparately computed items of X under § 1366, make any adjustments to stock basis under § 1367, and take into account any distributions made by X to Trust under § 1368. If X or X's shareholders fail to comply with the requirements of this paragraph, this ruling shall be null and void.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code. Specifically, we express no opinion regarding whether X is otherwise eligible to be an S corporation.

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 forwarding a copy of this letter to X's authorized representative.

Sincerely yours,
J. Thomas Hines
Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2

Copy of this letter
Copy for 6110 purposes