

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:

May 5, 1999

X =

A =

B =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Trust 5 =

Trust 6 =

Trust 7 =

Trust 8 =

Trust 9 =

Trust 10 =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

Dear :

This letter responds to the letter, dated October 15, 1998, and subsequent correspondence submitted by X's authorized representative on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated on D1. X made an election to be an S corporation effective D2. On D3, A, at that time X's sole shareholder, transferred a number of shares to Trusts 1 through 3. On D4, A transferred additional shares of X to Trusts 1 through 10. B, as X's president, represents that Trusts 1 through 10 were intended to be qualified subchapter S trusts (QSSTs) as described in § 1361(d)(3) of the Code and that they qualify as QSSTs. A died on D5.

After A's death, B became president of X and made inquiries as to the status of X's S corporation election. Various meetings were held between X, X's and shareholders' attorneys, and X's accountants regarding whether the elections under § 1361(d)(2) had been filed for the trusts. The meetings confirmed that the elections had not been filed. B represents that one public accounting firm prepared A's individual tax returns, another prepared X's corporate tax returns, a law firm handled A's estate planning, and a second law firm handled X's corporate matters. A did not inform any of these legal and accounting advisors as to the activities of any of the others. Each worked under the assumption that one of the others was responsible for preparing and filing the appropriate elections under § 1361(d)(2) for Trusts 1 through 10. In addition, the necessity for filing the elections was never communicated to the QSSTs' beneficiaries or to X. Therefore, no elections were filed for Trusts 1 through 10, and X's S corporation election terminated as of D3.

X and its shareholders have agreed to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary. B represents that X and its shareholders have reported their income consistent with S corporation status, and that the failure to timely file elections under § 1361(d)(2) for the trusts was not motivated by tax avoidance or retroactive tax planning. In D6, X engaged its accountants to prepare a ruling request to obtain relief for the termination of X's S corporation election. On D7, elections under § 1361(d)(2) were filed for the trusts.

Section 1361(a)(1) of the Code 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) of the Code, as in effect for taxable years beginning on or before December 31, 1997, provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not have as a shareholder a person (other than an estate and other than a trust described in § 1361(c)(2)) who is not an individual.

Section 1361(c)(2)(A)(i) of the Code provides that for purposes of § 1361(b)(1)(B), a trust all of which is treated (under subpart E of part I of subchapter J of chapter 1) as owned by an individual who is a citizen or resident of the United States may be a shareholder.

Section 1361(d)(1) of the Code provides that in the case of a qualified subchapter S trust with respect to which a beneficiary makes an election under § 1361(d)(2), (A) such trust

shall be treated as a trust described in § 1361(c)(2)(A)(i), and (B) for purposes of § 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust consisting of stock in an S corporation with respect to which the election under § 1361(d)(2) is made.

Section 1.1361-1(j)(6)(ii) of the Income Tax Regulations provides that the current income beneficiary of the trust must make the election under § 1361(d)(2) by signing and filing with the service center with which the corporation files its income tax return the applicable form or a statement including the information listed in § 1.1361-1(j)(6)(ii).

Section 1361(d)(2)(A) of the Code provides that a beneficiary of a qualified subchapter S trust (or a beneficiary's legal representative) may elect to have § 1361(d) apply. § 1361(d)(2)(D) provides that an election under § 1361(d)(2) shall be effective up to 15 days and 2 months before the date of the election.

Section 1362(d)(2)(A) of the Code provides that an election under § 1362(a) will 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(d)(2)(B) provides that any termination under § 1362(d)(2) shall be effective on and after the date of cessation.

Section 1362(f) of the Code provides that if (1) an election under § 1362(a) by any corporation (A) 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 (B) was terminated under paragraph (2) or (3) of § 1362(d), (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 (A) so that the corporation is a small business corporation, or (B) 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 § 1362(f), 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 such ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the representations made and the information submitted, we conclude that X's S corporation election terminated on D3, under § 1362(d)(2) of the Code, because the respective beneficiaries of each of Trusts 1 through 10 failed to timely file an election under § 1361(d)(2). Furthermore, X's S corporation election would have terminated D4 because of the transfer of X shares to Trusts 1 through 10.

We further conclude that the termination of X's S corporation election was an inadvertent termination within the meaning of § 1362(f) of the Code. We also conclude that the potential termination of X's S corporation election on D4 would have been inadvertent within the meaning of § 1362(f). Accordingly, pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation during the period, D3 through D7, provided that X's S corporation election was valid and is not otherwise terminated under § 1362(d). During the period, D3 through D7, Trusts 1 through 10 will be treated as trusts described in § 1361(c)(2)(A)(i), and the respective beneficiary of Trusts 1 through 10 will be treated, for purposes of § 678, as the owner of that portion of the respective trust that consists of X stock. The shareholders of X must, in determining their federal income tax liabilities, include their respective shares of the separately and non-separately computed items of X as provided in § 1366, make any adjustments to stock basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368. If X or its shareholders fail to treat themselves as described above, this ruling letter will be null and void.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code.

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. In particular, no opinion is expressed or implied concerning whether Trusts 1 through 10 are, or ever were, QSSTs within the meaning of § 1361(d)(3) of the Code.

Pursuant to a power of attorney on file with this office, copies of this letter will be sent to X's authorized representatives.

Sincerely yours,

H. GRACE KIM
Assistant to the Chief
Branch 2
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
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