Internal Revenue Service

Department of the Treasury

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LEGEND

Company =

State =
X =
d1 =
d2 =
d3 =
d4 =
d5 =
T1 =

T2 =

T3 =

T4 =

Shareholders =

Dear

This letter responds to your letter dated February 3, 1999, and subsequent correspondence, requesting that Company be granted inadvertent invalid election relief under § 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, Company was incorporated in State on d1, and elected to be treated as an S corporation as defined by § 1361 on d2. At the time Company filed its S election, it was owned by X shareholders, including two trusts. Company believed that each of these trusts was eligible to be a qualified subchapter S trust (QSST), as defined by § 1361(d). The current income beneficiaries of these trusts filed QSST elections on d2, simultaneously with Company's S election. However, each of these trusts had two beneficiaries, although in separately managed sub-trusts.

During the preparation of Company's tax return in d3, Company's accountant discovered that the separately managed sub-trusts may not have qualified under the flush language of § 1361(d)(3) as substantially separate and independent shares of trusts within the meaning of § 663(c), and therefore could not be treated as separate

trusts for the purposes of § 1361(c). Since trusts that have more than one current income beneficiary are ineligible to be QSSTs, the two trusts were ineligible to be shareholders of an S corporation. If Company had ineligible shareholders on the date of its election, then its election was ineffective.

On d4, the two original trusts distributed the shares in Company's stock to T1, T2, T3, and T4. Each of these trusts has only one current income beneficiary. The four trusts are identical, save for the named trustees and beneficiaries. Company represents that the four trusts contain all of the necessary provisions to be QSSTs, with the exception of a mandate that all of the income (within the meaning of § 643(b)) of the trusts be distributed currently to one individual who is a citizen or resident of the United States. However, Company represents that the trustee of each trust has distributed and will distribute all of the trusts' income currently to each beneficiary. The current income beneficiaries of T1, T2, T3, and T4 may have filed QSST elections on d5. However, if filed, the elections were not timely.

Company maintains it did not know that the two original trusts may have been ineligible shareholders of an S corporation on d2, and that the transactions involved were neither intentional, nor motivated by tax avoidance or retroactive tax planning. Company and all of the shareholders who were shareholders during the period of ineffectiveness (the Shareholders) agree to make any adjustments that the Commissioner may require consistent with treating Company as an S corporation.

LAW AND ANALYSIS

Section 1362(a)(1) 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(b)(1)(B) 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, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual.

Section 1361(d)(3)(A)(i) provides that the term QSST means, among other things, a trust the terms of which require that during the life of the current income beneficiary, there shall be only one income beneficiary of the trust. A substantially separate and independent share of a trust within the meaning of § 663(c) shall be treated as a separate trust for the purposes of §§ 1361(d) and (c).

Section 1361(d)(1) provides that in the case of a QSST that makes an election under § 1361(d)(2), (A) such trust will be treated as a trust described in § 1361(c)(2)(A)(i) and (B) for the purposes of § 678(a), the beneficiary of such trust will be treated as the owner of that portion of the trust which consists of stock in an S corporation.

Section 1361(c)(2)(A)(i) provides that for the 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 of the United States may be a shareholder of an S corporation.

Section 1361(d)(2)(D) provides that a QSST election shall be effective up to 15 days and 2 months before the date of the election.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was not effective for the taxable year for which made by reason of a failure to meet the requirements of § 1361(b), (2) the Secretary determines that the circumstances resulting in such ineffectiveness were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness, steps were taken so that the corporation is a small business corporation, (4) the corporation, and each person who was a shareholder in the corporation at any time during the period of the ineffectiveness agrees to make 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, the corporation shall be treated as an S corporation during the period specified by the Secretary.

CONCLUSIONS

After applying the relevant law to the facts submitted and the representations made, we conclude that Company's S corporation election on d2 was inadvertently ineffective under § 1362(f) because at the time of the election, Company's stock was owned by trusts that were ineligible to be shareholders of an S corporation. We also find that, had Company's S corporation been effective, it would have terminated on d4 because of the failure of the four new trusts to timely file QSST elections.

Therefore, under § 1362(f) Company will be treated as an S corporation from d2 and thereafter provided: 1) notwithstanding the ineligible shareholders, Company was otherwise eligible to be an S corporation on d2, and its election was timely and validly filed; 2) Company's election was not otherwise terminated under § 1362(d); 3) the current income beneficiaries of T1, T2, T3, and T4 timely file QSST elections with the appropriate Service Center within 60 days of the date of this letter; and 4) the trustees of T1, T2, T3, and T4, continue to distribute all of the income (within the meaning of § 643(b)) of the trust currently to one individual who is a citizen or resident of the United States during the life of the current income beneficiaries. During the period of ineffectiveness, the separately managed sub-trusts will be treated as if they were separate QSSTs under § 1361(d) and owners of Company's stock, and T1, T2, T3, and T4, will be treated as if they were QSSTs. Accordingly, pursuant to § 1361(d)(1), the beneficiaries of each trust and the other Shareholders, in determining their respective income tax liabilities during the period of ineffectiveness 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 and their beneficiaries, or any of Company's other Shareholders fail to treat Company as described above, this ruling shall be null and void.

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

Sincerely Yours,

William P. O'Shea
Chief, Branch 3
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2):
Copy of this letter
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