

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

March 22, 2001

X =

A =

B =

Trust =

D1 =

D2 =

D3 =

Dear :

This letter responds to a letter, dated November 16, 2000, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting a ruling under §§ 1361(d)(3) and 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated on D1. X elected to be an S corporation effective D2. On D3, Trust acquired 12,500 shares of X stock. B is the sole beneficiary of Trust. B represents that Trust is eligible to be a Qualified Subchapter S Trust (QSST). However, B inadvertently failed to file an election under § 1361(d)(2) to qualify Trust as a QSST.

A further represents that neither X nor any of its shareholders engaged in tax avoidance or retroactive tax planning and that X intended to maintain its status as an S corporation at all times.

X, and X's shareholders agree to make any adjustments (consistent with the treatment of X as an S corporation) that the Secretary may require for the period of termination.

Article 6.1.1 of the governing instrument of Trust provides that all income of Trust must be distributed to B. Article 6.1.2 provides that all principal distributions must be distributed to B. Article 6.1.3 provides that B's income interest terminates on the earlier of B's death or the termination of Trust. Article 8.1.3 provides that if the Trust terminates during the life of B, the Trust assets must be distributed to B. B represents that B is a citizen of the United States.

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(d)(1) provides that in the case of a qualified subchapter S trust (QSST) with respect to which a beneficiary makes an election under § 1361(d)(2), such trust shall be treated as a trust described in § 1361(c)(2)(A)(i) and, for purposes of § 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under § 1361(d)(2) is made.

Section 1361(d)(2)(A) provides that a beneficiary of a QSST (or his legal representative) may elect to have § 1361(d) apply. Section 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 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 1362(d)(2) of the Code 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 1361(d)(3) defines the term QSST as a trust whose terms require that: (i) during the life of the current income beneficiary, there will be only one income beneficiary of the trust; (ii) any corpus distributed during the life of the current income beneficiary may be distributed only to that beneficiary; (iii) the income interest of the current income beneficiary in the trust will terminate on the earlier of the beneficiary's death or the termination of the trust; and (iv) upon the termination of the trust during the life of the current income beneficiary, the trust will distribute all of its assets to the beneficiary. Section 1361(d)(3)(B) further defines a QSST as a trust all of the income of which is distributed (or required to be distributed) currently to one individual who is a citizen or resident of the United States.

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 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 representations submitted, we hold that X's S corporation election terminated on D3 when Trust, an ineligible S corporation shareholder, acquired X stock. We also conclude that the termination was inadvertent within the meaning of § 1362(f).

We further hold that under the provisions of § 1362(f), X will be treated as continuing to be an S corporation on D3, and thereafter, provided X's S election was valid and not otherwise terminated. Accordingly, the shareholders of X must include their pro rata share of the separately stated and nonseparately computed items of X as provided in § 1366, make any adjustments to basis provided in § 1367, and take into account any distributions made by X as provided in § 1368. If X or its shareholders fail to treat X as described above, this ruling will

be null and void.

We also conclude that Trust satisfies the requirements to qualify as a QSST under § 1361(d)(3) and will be a permitted S corporation shareholder provided that within 60 days from the date of this letter B files with the appropriate service center an election for Trust to be a QSST under § 1362(d)(3) with an effective date of D3. A copy of this letter should be attached to this election filed with the service center.

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, including whether X was or is a small business corporation under § 1361(b) of the Code.

This ruling is directed only to the taxpayer(s) 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, a copy of this letter is being sent 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