

Internal Revenue Service

Department of the Treasury

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Date:

November 15, 1999

X =

A =

B =

Trust =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Dear :

This letter responds to a July 12, 1999 ruling request and subsequent correspondence submitted on behalf of X by its

authorized representative, concerning relief under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated on Date 1 and elected to be an S corporation under § 1362(a) of the Code effective for Year 1. On Date 2 of Year 2, A, the chairman of X, created Trust for the benefit of B. A timely qualified subchapter S trust (QSST) election was filed for Trust. On Date 3 of Year 2, A transferred to Trust 23 shares of X stock. On Date 4 of Year 2, A transferred another 372 share of X stock to Trust. The X stock and cash are the only assets Trust has ever held.

B reported a pro rata share of X's tax items for Year 2, Year 3, and Year 4. Trust did not have any trust accounting income in Year 2 and therefore the trustee did not distribute any income to B for Year 2. Trust had trust accounting income for Year 3 but the trustee only distributed a portion of such income to B. The trustee distributed to B all of Trust's trust accounting income for Year 4.

During a review of the affairs of X and X's principal shareholders by X's new counsel, it was discovered in late Year 4 that Trust had not distributed all of its income for Year 3. Upon further investigation, it was discovered that the trustee was not advised nor aware of the QSST income distribution requirement. Thereafter, the trustee made distributions to B of all of Trust's Year 3 income (and earnings thereon) that had not been distributed. In addition, all of Trust's Year 4 income was distributed to B on or before Date 4 of Year 4. On Date 5, Trust filed an election to be treated as an electing small business trust (ESBT) effective for its 1999 taxable year under Notice 97-12, 1997-1 C.B. 385.

The shareholders of X represent that they were not aware that the failure to timely distribute all of Trust's income each year could terminate X's S corporation election. In addition, the shareholders represent that the termination was not for purposes of tax avoidance or any type of retroactive tax planning. X and its shareholders also represent that they have filed their respective tax returns consistent with the treatment of X as an S corporation. Further, X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary.

Section 1361(a) 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) of the Code defines the term "small business corporation" as 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) or an organization described in § 1361(c)(6)) 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), 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 consisting of stock in an S corporation with respect to which the election under § 1361(d)(2) is made.

Section 1361(d)(3)(B) of the Code defines a qualified subchapter S trust as a trust all of the income (within the meaning of § 643(b)) of which is distributed (or required to be distributed) currently to one individual who is a citizen or resident of the United States.

Section 1361(d)(4)(B) of the Code provides that if any qualified subchapter S trust ceases to meet any requirements of § 1361(d)(3)(B) but continues to meet the requirements of § 1361(d)(3)(A), the provisions of § 1361(d) shall not apply to such trust as of the first day of the first taxable year beginning after the first taxable year for which it failed to meet the requirements of § 1361(d)(3)(B).

Section 1362(f) of the Code provides, in part, that if (1) an election under § 1362(a) by any corporation was terminated under paragraph (2) or (3) of § 1362(d), (2) the Secretary determines that the circumstances resulting in the 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 this subsection, 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 the termination, the corporation will be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts and representations submitted, we conclude that X terminated its election to be an S corporation on the first day of its Year 4 taxable year as a result of the trustee's failure to distribute all of the trust accounting income to B for the Year 3 taxable year. We also hold that the termination was inadvertent within the meaning of § 1362(f) of the Code.

We further hold that under the provisions of § 1362(f) of the Code, X will be treated as continuing to be an S corporation from the first day of its Year 4 taxable year to Date 4 of Year 4 and thereafter provided that X's S corporation election was valid and provided that the election was not otherwise terminated under § 1362(d). If X or its shareholders fail to treat X as described above, this ruling will 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 concerning the qualification of Trust as an ESBT and the validity of the ESBT election.

This ruling is directed to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to the power of attorney on file, a copy of this letter is being sent to X's authorized representative.

Sincerely,

J. THOMAS HINES
Senior Technician Reviewer
Branch 2
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
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