

Internal Revenue Service

Number: **200628014**

Release Date: 7/14/2006

Index Number: 1362.04-00

Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B02

PLR-160833-05

Date:

March 31, 2006

X =

Trust =

1

Trust =

2

Trust =

3

Trust =

4

Trust =

5

Trust =

6

Trust =

7

Trust =

8

D1 =

D2 =

D3 =

D4 =

Year =

1

Year =

2

Year =

3

Dear :

This responds to a letter dated November 30, 2005, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

X was incorporated on D1 and made an election to be treated as an S corporation effective D1. On D2, individual shareholders of X transferred X stock to Trust 1, Trust 2, Trust 3, Trust 4, Trust 5, Trust 6, Trust 7, and Trust 8 (collectively, the Trusts), each of which has a different primary beneficiary. These transfers were intended to take effect for purposes of determining the Trusts' pro rata share of all tax items of X on the first day of Year 1. The terms of the Trusts provide that any S corporation stock owned by a Trust is automatically transferred to a separate trust for the benefit of the Trust's primary beneficiary (the New Trust), which is intended to be a qualified subchapter S trust (QSST) under § 1361(d), which will be an eligible S corporation shareholder if the beneficiary of the New Trust makes the appropriate election.

The trustee of the Trusts failed to create the New Trusts and the beneficiaries did not make any QSST elections. For Year 1 and subsequent taxable years, the Trusts were treated as the owners of the X stock and the Trusts did not distribute all of the income (within the meaning of § 643(b)) of the Trusts to the respective beneficiaries. Individual shareholders transferred additional X stock to the Trusts on D3 of Year 1 and D4 of Year 2.

X's S corporation election terminated on D2 when the Trusts became shareholders. X's S corporation election would also have terminated (if it had not already terminated on D2) on D3 of Year 1 and D4 of Year 2 (because of the additional transfers of X stock) as well as on the first day of Year 2 and of Year 3 (because of the Trusts' failure to distribute all of their income to their respective beneficiaries).

X represents that the failure to create the New Trusts and file QSST elections for them, and the failure to distribute all of the income, were not motivated by tax avoidance or retroactive tax planning. X and its shareholders have agreed to make any adjustments that the Commissioner may require, consistent with the treatment of X as an S corporation.

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) 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(c)(2)(A)(i) 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) provides that in the case of a QSST for which a beneficiary makes an election under § 1361(d)(2), the trust is treated as a trust described in § 1361(c)(2)(A)(i), and for purposes of § 678(a), the beneficiary of the trust shall be treated as the owner of that portion of the trust that 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 may elect to have § 1361(d)(1) apply.

Section 1361(d)(3)(B) provides that for purposes of § 1361(d), the term “qualified subchapter S trust” means a trust all of the income (within the meaning of § 643(b)) of which is distributed currently to one individual who is a citizen or resident of the United States.

Section 1361(d)(4) provides that if any QSST ceases to meet any requirement of § 1361(d)(3)(B) but continues to meet the requirements of § 1361(d)(3)(A) (regarding the terms of the trust), 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 1.1361-1(j)(6)(ii) of the Income Tax Regulations provides that the current income beneficiary of a QSST must make the election under § 1361(d)(2) by signing and filing with the service center with which the corporation files its income tax returns the applicable form or a statement including the information listed in § 1.1361-1(j)(6)(ii).

Section 1362(d)(2) provides that (A) in general, 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 the corporation is an S corporation) such corporation ceases to be a small business corporation and (B) any termination under § 1362(d)(2) shall be effective on and after the date of cessation.

Section 1362(f) 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 § 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in the ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were taken (A) so that the corporation is a small business corporation or (B) to acquire the shareholder consents, and (4) the corporation and each person who was a shareholder of 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 the ineffectiveness or termination, the corporation will be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts submitted and the representations made, we conclude that the termination of X's S corporation election was inadvertent within the meaning of § 1362(f). We further hold that, pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from D2 and thereafter, provided X's S corporation election was valid and provided that the election was not otherwise terminated under § 1361(d). The New Trusts will be treated as QSSTs from D2 and thereafter. The shareholders of X identified below must satisfy the conditions below with respect to Year 1 and Year 2 and, thereafter, 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 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 is null and void.

This ruling is conditioned upon (1) the Trusts transferring their X stock to the New Trusts pursuant to their governing instruments, (2) the beneficiaries of the New Trusts filing appropriately completed QSST elections for the New Trusts effective D2, (3) the Trusts distributing all of the income which would have been attributable to the New Trusts for Year 1 and all subsequent taxable years to their respective beneficiaries, and (4) X, the Trusts, the New Trusts, and the beneficiaries of the Trusts and the New Trusts filing any returns or amended returns necessary to conform to this letter. Specifically, the Trusts, the New Trusts, and the beneficiaries of the Trusts and the New Trusts must file returns or amended returns consistent with the treatment of the New Trusts as QSSTs and the beneficiaries as the deemed owners of the portions of the respective New Trusts consisting of X stock for Year 1 and all subsequent years. The QSST elections and any returns or amended returns must be filed within 60 days following the date of this letter and a copy of this letter should be attached to any such elections or returns.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provisions of the Code. In particular, we express no opinion on whether the New Trusts are otherwise eligible to be QSSTs.

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

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

Sincerely,

J. THOMAS HINES
Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes