

INTERNAL REVENUE SERVICE
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11/18/98

X =

A =

B =

C =

D =

E =

F =

G =

H =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

State Y =

Dear :

This is in reply to a letter dated July 23, 1998, and subsequent correspondence submitted on behalf of X by X's authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

X was incorporated under the laws of State Y on Date 1. In Date 2, X filed an election to be an S corporation for the fiscal year beginning Date 3. A owned all the stock of X until Date 4. On Date 4, A transferred 100 shares of X to each of C, D, and E. A, as the president of X, represents that C, D, and E each qualified as a trust eligible to make an election to be a qualified subchapter S trust (QSST) under § 1361(d)(3) of the Code.

Counsel for X did not inform X that the transfer of stock in X to C, D, and E would cause X's S corporation election to terminate unless an election was made for each trust to be a QSST. No election was filed for C, D, and E, to be treated as QSSTs. It is represented that C, D, and E, and not the beneficiaries of C, D, and E, paid the federal income tax on their respective share of X's income. Accordingly, the subchapter S election of X was terminated on Date 4. In Date 5, it was determined that the QSST election for each trust had not been made. In order to correct the problem, effective Date 6, C, D, and E distributed the X stock to its beneficiary, each of whom is an eligible shareholder. The current shareholders of X are A, B, F, G, and H.

A represents that the terminating event was not part of a plan to terminate the S election or for tax avoidance purposes, and took place without the knowledge of X. 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) 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(c)(2)(B)(i) provides that for purposes of § 1361(b)(1), in the case of a trust described in § 1361(c)(2)(A)(i), the deemed owner shall be treated as the 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 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) of the Code provides that a beneficiary of a QSST (or his legal representative) may elect to have § 1361(d) apply.

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)(A) of the Code provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be small business corporation.

Section 1362(f) of the Code provides that if (1) an election under § 1362(a) by any corporation 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 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 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 such ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts submitted and the representations made, we hold that X's election to be an S corporation terminated on Date 4, as a result of A's transfer of shares of X to C, D, and E. We also hold that the termination was inadvertent within the meaning of § 1362(f) of the Code.

We further hold that, pursuant to the provisions of § 1362(f) of the Code, X will be treated as an S corporation from Date 4 to Date 6, and thereafter, provided that X's election to be an S corporation was otherwise valid and was not terminated under § 1362(d). During the period from Date 4 to Date 6, C, D, and E will each be treated as a shareholder of X but they will not be treated as QSSTs under § 1361(d)(3). Therefore, 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 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 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 provisions 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.

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

Sincerely yours,

ARTHUR H. ERNST
Chief, Branch 2
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
Copy of this letter
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