

Internal Revenue Service

Department of the Treasury

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January 21, 2000

LEGEND:

X =

I =

Q1 =

Q2 =

D1 =

D2 =

D3 =

D4 =

D5 =

This letter responds to your letter, dated October 11, 1999, written on behalf of X, requesting rulings under § 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, X was incorporated on D1 and filed an election to be an S corporation effective D2. At the time the election was filed, one of X's shareholders, I, a testamentary trust, was not an eligible shareholder under § 1361(c)(2). X and its shareholders relied on the advice of X's accountant and did not realize that this caused X's S election to be invalid until X consulted with an attorney on D4. Shortly after D4 all of the X shares held by I were distributed to the beneficiaries. For the period from D2 to D4 all of the income of X allocated to I was reported by a beneficiary of I.

In the period between D2 and D4, shares of X stock were transferred to two irrevocable trusts that are not eligible shareholders under § 1361(c)(2). X represents that the trusts, Q1 and Q2, were intended to be qualified subchapter S trusts (QSSTs) effective D3. However, the beneficiaries (or their legal representatives) did not make the QSST elections. X and its shareholders relied on the advice of X's accountant and did not realize that the transfer of X's stock to Q1 and Q2 was a termination event until X consulted with an attorney on D5.

X represents that as soon as the invalid election and termination were brought to its attention it took steps to obtain relief. X also represents that there was no intent to knowingly make an invalid S election or to terminate its S election and that the events that resulted in the invalid election and termination were not motivated by tax avoidance or retroactive tax planning. X and its shareholders have agreed to make any adjustments that the Secretary may require, consistent with the treatment of X as an S corporation.

The Service has been asked to rule that (1) X will be treated for federal tax purposes as a subchapter S corporation effective D2; (2) X's S election will not be treated as terminated because of transfers of X stock to Q1 and Q2 between D2 and D4; and (3) Q1 and Q2 meet the requirements of an QSST under § 1361(d)(3) and thus are permitted shareholders of X under § 1361(c)(2)(A)(i).

LAW AND ANALYSIS

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 section 1362(a) is in effect for such year.

Section 1361(b)(1)(B) of the Code 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 section 1361(c)(2)) 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 this chapter) 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 a qualified subchapter S trust with respect to which a beneficiary makes an election under § 1361(d)(2) shall be treated as a trust described in § 1361(c)(2)(A)(i).

Section 1361(d)(2) provides that a beneficiary of a qualified subchapter S trust (or his legal representative) may elect to have this subsection apply.

Section 1361(d)(3) defines a qualified subchapter S trust as a trust (A) the terms of which require that (i) during the life of the current income beneficiary, there shall be

only 1 income beneficiary of the trust, (ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary, (iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such 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 shall distribute all of its assets to such beneficiary, and (B) all of the income (within the meaning of § 643(b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States.

Section 1.1361-1(j)(6)(iii)(D) provides that if a corporation's S election terminates because of a late QSST election, the corporation may request inadvertent termination relief under § 1362(f).

Section 1362(f) of the Code 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 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.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24, in discussing § 1362(f) of the Code, states in part:

If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.

The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped that taxpayers and the government will work out agreements that protect the revenues without undue hardship to taxpayers. . . . It is expected that the waiver may be made retroactive for all years, or retroactive for the period in

which the corporation again became eligible for subchapter S treatment, depending on the facts.

CONCLUSIONS

After applying the law to the facts submitted and the representations made, we conclude that X's S corporation election was ineffective for the taxable year beginning D2 because I was an ineligible shareholder of X. We conclude that the ineffectiveness of X's S corporation election constituted an inadvertent invalid election within the meaning of § 1362(f) of the Code.

We also conclude that X's S corporation election under § 1362(a) was terminated when shares of X stock were transferred to Q1 and Q2 and the beneficiaries (or their legal representatives) of Q1 and Q2 did not make timely QSST elections under § 1361(d). We conclude that the termination constituted an inadvertent termination within the meaning of § 1362(f).

We conclude that Q1 and Q2 meet the requirements under § 1361(d)(3) to be QSSTs and will be treated as QSSTs under § 1361(d)(3) beginning on D3, provided that within 60 days from the date of this letter, the beneficiaries (or their legal representatives) of Q1 and Q2 file with the appropriate service center elections to be QSSTs under § 1362(d)(3) with an effective date of D3. A copy of this letter should be attached to each QSST filed with the service center.

Under the provisions of section 1362(f) of the Code, X will be treated as being an S corporation from D2, and thereafter, provided that, apart from the inadvertent termination ruling above, X's S corporation election was otherwise valid and is not otherwise terminated under § 1362(d).

This ruling is contingent on X and all of its shareholders treating X as having been an S corporation for the period beginning D2, and thereafter. Accordingly, all of the shareholders in X, in determining their respective income tax liabilities for the period beginning D2, and thereafter, must include their pro rata share of the separately and nonseparately computed items of X as provided in § 1366, make adjustments to stock basis as provided in § 1367, and take into account any distributions made by X as provided by § 1368.

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. Specifically, no opinion is expressed regarding the effects of the redemption. Further, no opinion is expressed regarding whether X is otherwise eligible to be an S corporation.

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

Under a power of attorney on file with this office, a copy of this letter will be sent to X.

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
Copy for § 6110 purposes