

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

July 10, 2001

LEGEND:

X	=
State	=
D1	=
D2	=
D3	=
D4	=
D5	=
A	=
Trust	=
B	=

Dear

This letter responds to a letter dated November 14, 2000, submitted on behalf of X, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

FACTS

X was incorporated on D1 under the laws of State. X elected to be an S corporation, effective D2.

A, a shareholder of X, died on D3 and his shares of X stock were transferred to his estate. On D4, A's estate distributed all of the X stock to a Trust. It was intended that the Trust be treated as a qualified subchapter S trust (a QSST) as defined in § 1361(d)(3). However, due to an oversight, B, the beneficiary of the Trust, did not make a timely QSST election under § 1361(d)(2), thereby terminating X's S corporation election on D4. In D5, X's counsel discovered that B had not made a QSST election for Trust. Subsequently, X submitted this ruling request for inadvertent termination relief under § 1362(f).

X and B represent that the transfer of stock to the Trust and the subsequent failure to file the QSST election were not motivated by tax avoidance or retroactive tax planning. Further, X and its shareholders represent that from D4 until the present, X,

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the beneficiary of the Trust, and the other shareholders have all filed, or will file, returns consistent with X's status as an S corporation. 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.

LAW AND ANALYSIS

Section 1361(a)(1) defines an "S" corporation as a small business corporation for which an election under § 1362(a) is in effect for such 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(c)(2)(A)(i) provides that 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 subchapter S corporation shareholder.

Section 1361(d)(1) states that a QSST whose beneficiary makes an election under § 1361(d)(2) will be treated as a trust described in § 1361(c)(2)(A)(i), and the QSST's beneficiary will be treated as the owner (for purposes of § 678(a)) of that portion of the QSST's S corporation stock to which the election under § 1361(d)(2) applies.

Section 1361(d)(3) defines a QSST as a trust (A) the terms of which require that (i) during the life of the current income beneficiary, there shall 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 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 one individual who is a citizen or resident of the United States.

Under § 1361(d)(2)(A), the beneficiary of a QSST may elect to have § 1361(d) apply. Under § 1361(d)(2)(D), this election will be effective up to 15 days and two months before the date of the election.

Under § 1362(d)(2), an election to be an S corporation will be terminated whenever the corporation ceases to be a small business corporation.

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Section 1.1361-1(j)(6)(iii)(D) of the Income Tax Regulations 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), in relevant part, provides that, if: (1) an election under § 1362(a) by any corporation was terminated under § 1362(d); (2) the Secretary determines that the termination was 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 in the corporation at any time during the period specified pursuant to § 1362(f), agrees to make any 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 shall be treated as an S corporation during the period specified by the Secretary.

The Committee reports accompanying the Subchapter S Revision Act of 1982 explain § 1362(f) as follows:

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 the 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.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24; H.R. Rep. No. 826, 97th Cong., 2d Sess. 12 (1982), 1982-2 C.B. 730, 735.

CONCLUSION

Based on the facts presented and representations made, we conclude that X's S corporation election terminated on D4, because B failed to make a timely QSST

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election under § 1361(d)(2). We also conclude that the termination was inadvertent within the meaning of § 1362(f). Therefore, under § 1362(f), X will be treated as an S corporation from D4 and thereafter, assuming X's S corporation election is valid and is not otherwise terminated under § 1362(d). However, this ruling is contingent on B filing a QSST election, with an effective date of D4, with the appropriate service center within 60 days of the date of this ruling. A copy of this letter must be attached to the QSST election.

If Trust files a valid QSST election Trust will be treated as a trust described in § 1361(c)(2)(A)(i), and B will be treated under § 678 as the owner of the portion of Trust consisting of X stock during the period from D4 and thereafter assuming Trust satisfies the QSST requirements. Accordingly, the shareholders of X must include their pro rata share of the separately and nonseparately computed items of X under § 1366, make any adjustments to stock basis under § 1367, and take into account any distributions made by X to shareholders under § 1368. If X, Trust, or any of X's shareholders fail to treat X as described above, this ruling will be null and void.

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 on whether X's original election to be an S corporation was a valid election under § 1362 or whether Trust is a QSST within the meaning of § 1361(d)(3).

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

Under a power of attorney on file with this office, we are sending a copy of this letter to X.

Sincerely,
Mary Beth Collins
Assistant to the Chief, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:
Copy for section 6110 purposes