

## Internal Revenue Service

## Department of the Treasury

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Telephone Number:

Refer Reply To:

CC:PSI:B01-PLR-123837-03

Date:

June 27 2003

X =

Y =

A =

Date 1 =

Date 2 =

Date 3 =

Trust 1 =

Dear :

This responds to the letter dated March 24, 2003, and additional correspondence, submitted on behalf of X, requesting a ruling under section 1362(f) of the Internal Revenue Code.

### Facts

X was organized on Date 1. On Date 2, A, a shareholder of X, transferred shares of X to Trust. X elected to be treated as an S corporation effective Date 3. The income beneficiary intended to file an election for Trust to be treated as a "qualified subchapter S trust" (QSST) under section 1361(d). However, the income beneficiary of Trust did not timely file the appropriate election under 1362(d)(2).

Since Date 3 X and X's shareholders have reported their share of X's income as though X were an S corporation and the income beneficiary of Trust has included Trust's share of income items on their personal returns. X represents that there was no

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intent to terminate X's S election and that the failure to file timely the QSST election for Trust was not motivated by tax avoidance or retroactive tax planning. X and its shareholders agree to make any adjustments required by the Secretary consistent with the treatment of X as an S corporation.

#### Law and Analysis

Section 1361(a)(1) 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) defines a "small business corporation" as a domestic corporation which is not an ineligible corporation and which does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in section 1361(c)(2), or an organization described in section 1361(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1361(c)(2)(A)(i) provides that for purposes of section 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 section 1361(b)(1), in the case of a trust described in section 1361(c)(2)(A)(i), the deemed owner shall be treated as the shareholder.

Section 1361(d)(1) provides that a QSST whose beneficiary makes an election under section 1362(d)(2) will be treated as a trust described in section 1361(c)(2)(A)(i), and the QSST's beneficiary will be treated as the owner (for purposes of section 678(a)) of that portion of the QSST's S Corporation stock to which the election under section 1361(d)(2) applies. Under section 1361(d)(2)(A), a beneficiary of a QSST may elect to have section 1361(d) apply. Under section 1361(d)(2)(D), this election will be effective up to 15 days and two months before the date of the election.

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 beneficiary in the trust shall terminate on the earlier of the 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 that beneficiary; and (B) all of the income (within the meaning of section 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.

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Section 1362(f) provides, in relevant part, that if (1) an election under section 1362(a) by any corporation was not effective for the taxable year for which made (determined without regard to section 1362(b)(2)) by reason of a failure to meet the requirements of section 1361 (b) or to obtain shareholder consents, (2) the Secretary determines that the circumstances resulting in such termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in ineffectiveness, steps were taken so that the corporation is once more 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 section 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 the period, then, notwithstanding the circumstances resulting in the ineffectiveness, the corporation shall be treated as continuing to be 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 section 1362(f) of the Code, provides, in part, 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 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.

## Conclusion

Based solely on the information submitted and the representations made, we conclude that X's subchapter S election was invalid because Trust was an ineligible shareholder. In addition, we conclude that the election was inadvertently invalid within the meaning of section 1362(f). Therefore, X will be treated as an S corporation from the date of termination, and thereafter, provided that the beneficiary of Trust files a QSST election with the appropriate service center within 60 days from the date of this letter. A copy of this letter should be attached to the QSST election.

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Except as specifically set forth above, we express no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X is otherwise eligible to be treated as an S corporation or whether Trust is eligible to be treated as a QSST.

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.

Pursuant to a power of attorney on file with this office, a copy of this letter is being forwarded to the taxpayer and the second listed authorized representative.

Sincerely,

**/s/ David R. Haglund**

David R. Haglund  
Senior Technician Reviewer, Branch 1  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)  
Copy of this letter  
Copy for § 6110 purposes