

Internal Revenue Service

Department of the Treasury

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Date:

October 13, 1999

Legend

X =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

State 1 =

Trust 1 =

Trust 2 =

Trust 3 =

This responds to your letter, dated September 23, 1999, submitted on behalf of X, requesting a ruling under section 1362(f) of the Internal Revenue Code.

Facts

The represented facts indicate that X, incorporated in State 1 on Date 1, elected to be treated as a Subchapter S corporation effective Date 2. At the time that X filed the election to be taxed as an S corporation X's shareholders included Trust 1, Trust 2 and Trust 3. It is represented that the three trusts possessed the elements of a qualified subchapter S trust ("QSST") described in section 1361(d)(3)(A).

On Date 3 X paid a dividend to its shareholders. Because the three trusts

PLR-115888-99

provided for the discretionary distribution of income, under Reg. section 1.1361-1(j)(1)(i), the trustee was required to distribute to each beneficiary the entire amount of the dividend by the last day of the taxable year; or, with an election under section 663(b), within 65 days after the end of the tax year. Through inadvertence, the trustee did not distribute amounts representing the dividends received by the three trusts from the S corporation to the respective beneficiaries within the required time. This failure to distribute the S corporation dividends resulted in the trusts losing their status as QSST's and their eligibility to hold S corporation stock thus causing X's S election to terminate as of Date 4.

X represents that at all relevant times, X and its shareholders treated X as an S corporation. X and its shareholders agree to make any adjustments necessary (consistent with the treatment of X as an S corporation) as may be required. X represents that the termination of X's S corporation election was inadvertent and was not part of a plan to terminate X's S corporation election nor was it motivated by tax avoidance.

Law and Analysis

Section 1361(a)(1) defines an S corporation as a small business corporation for which an election under section 1362(a) is in effect.

Section 1361(b)(1)(B) provides that one of the requirements for a taxpayer to be a small business corporation is that the taxpayer cannot 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(d)(1) states that a QSST whose beneficiary makes an election under section 1361(d)(2) will be treated as a trust described in section 1361(c)(2)(A)(i).

Section 1361(d)(3)(A) defines a QSST as a trust 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 that beneficiary; (iii) the income interest of the current income 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 the beneficiary.

Section 1361(d)(3)(B) further defines a QSST as a trust all of the income of which is distributed (or required to be distributed) currently to one individual who is a citizen or resident of the United States. Section 1361(d)(4)(B) provides that if any QSST ceases to meet any requirement of section 1361(d)(3)(B) but continues to meet the requirements of section 1361(d)(3)(A), the provisions of section 1361(d) will not apply to the trust as of the first day of the first taxable year beginning after the first taxable year

PLR-115888-99

for which it failed to meet the requirements of section 1361(d)(3)(B).

Section 1362(a) provides that a small business corporation may elect to be an S corporation. Under section 1362(d), an election to be an S corporation will 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) the corporation ceases to be a small business corporation.

Section 1362(f) provides that a corporation is treated as continuing to be an S corporation during the period specified by the Secretary if (1) an election under section 1362(a) by any corporation was terminated under paragraph (2) or (3) of section 1362(d), (2) the Secretary determines that the termination was inadvertent, (3) no later than a reasonable period of time after discovery of the terminating event, 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 that period.

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 [I]t may be appropriate to waive the terminating event when the one class of stock requirement was inadvertently breached, but no tax avoidance had resulted. 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 facts submitted and the representations made, we conclude

PLR-115888-99

that X's subchapter S election was terminated on Date 4 as a result of the failure to distribute currently all of the income of Trust 1, Trust 2 and Trust 3 to their respective income beneficiaries. We also conclude that the termination constituted an "inadvertent termination" within the meaning of section 1362(f) .

Pursuant to the provisions of section 1362(f) , X will be treated as continuing to be an S corporation from Date 4 and thereafter, provided that X's subchapter S election is not otherwise terminated under section 1362(d). In addition, so long as Trust 1, Trust 2 and Trust 3 otherwise qualify as QSSTs, they will be treated as trusts described in section 1361(c)(2)(A)(i).

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 or implied concerning whether Trust 1 Trust 2 and Trust 3 are, or ever were, "qualified subchapter S trusts" within the meaning of section 1361(d)(3), and no opinion is expressed or implied concerning whether X's S election was valid under section 1362.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

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

Enclosures (2)