

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:

November 17, 1998

Legend

X =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

Y1 =

Y2 =

Trust1 =

Trust2 =

Trust3 =

Trust4 =

Trust5 =

Trust6 =

:

This responds to your letter dated October 14, 1998, written on behalf of X, requesting a ruling that the termination of X's S corporation status was an inadvertent termination under § 1362(f) of the Internal Revenue Code.

FACTS

X elected S corporation status effective D1 . At the time X elected S corporation status, X was owned by A and Trust1. On D2, A transferred X stock to Trust2. On D3, X transferred X stock to Trust3. Trusts 1, 2, and 3 were established for the benefit of each of A's minor children. On D4, A established three additional trusts, each for the benefit of one of his minor children (Trusts 4, 5, and 6). The terms and conditions of Trusts 4, 5, and 6 are identical to those of Trusts 1,2, and 3, respectively, except for the provisions relating to successor trustees. On D5, the trustees of Trusts 1,2, and 3 distributed all of the X stock contained in those trusts to Trusts 4, 5, and 6, respectively.

X represents that Trusts 1, 2, 3, 4, 5, and 6 (collectively the "Trusts") qualify as qualified subchapter S trusts under § 1361(d)(3) and that each trust filed timely an election under § 1361(d)(2) to be treated as one.

During D6, A's attorney discovered that none of the accounting income of any of the Trusts had been distributed to the beneficiaries since the Trusts' inception. Additionally, A's attorney learned that the Trusts' accountants filed fiduciary income tax returns for the Trusts consistent with the accumulation of the Trusts' income. A's attorney then advised A and X that the Trusts' status as qualified subchapter S trusts and valid S corporation shareholders had terminated as of D7, as a result of their failure to pay their income to the Trusts' beneficiaries. Thus, X's S corporation status also terminated as of D7, because of the ineligible shareholders.

After discovering the error, on or about D8, the Trusts' distributed all accumulated income to their respective beneficiaries. Around the same time the Trusts also filed amended returns for the years Y1 to Y2 and amended individual returns for their respective beneficiaries consistent with the Trusts acting as qualified subchapter S trusts for the relevant time periods. X also submitted this request for inadvertent termination relief.

X represents that the trusts' failures to pay out the trusts' incomes were inadvertent and not the result of tax avoidance, retroactive tax planning, or an intention to revoke X's S election. Moreover, X and its shareholders (A and the trusts) agree to make any adjustments (consistent with the treatment of X as an S corporation) that the Secretary may require for the period of termination.

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.

Section 1361(b)(1) defines "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate, other than a trust described in § 1361(c)(2), and other than an organization described in (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 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 qualified subchapter S trust whose beneficiary makes an election under § 1361(d)(2) will be treated as a trust described in § 1361(c)(2)(A)(i), and the trust's beneficiary will be treated as the owner (for purposes of § 678(a)) of that portion of the trust's S corporation stock to which the election under § 1361(d)(2) applies. For purposes of this subsection, the term "qualified subchapter S trust" means a trust 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 U.S. and the terms of which require that (i) during the life of the current income beneficiary, there is only 1 income beneficiary of the trust; (ii) any corpus distributed during the life of the income beneficiary must be distributed to that beneficiary; (iii) the income interest of the current income beneficiary terminates on the earlier of the beneficiary's death or the trust's termination; and, (iv) upon the trust's termination during the income beneficiary's life the trust distributes all of its assets to the income beneficiary.

Under § 1361(d)(2)(A), the beneficiary of a qualified subchapter S trust 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.

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

With respect to § 1362(f), the committee reports to the Subchapter S Revision Act of 1982 provide, 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.

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.

CONCLUSIONS

Based solely on the facts submitted and representations set forth above, we conclude that the termination of X's subchapter S election, as of D7, was inadvertent within the meaning of § 1362(f).

Pursuant to § 1362(f), X will be treated as continuing to be an S corporation from D7, and thereafter, unless X's election is otherwise terminated.

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 the Trusts are qualified subchapter S trusts within the meaning of § 1361(d)(3).

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

Sincerely,

Signed/David R. Haglund

DAVID R. HAGLUND
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Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)