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Washington, DC 20224

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Date:  
September 28, 2018

### Legend

$$\underline{X} =$$
A =
$$\underline{B} =$$
State =

Trust 1 =

Share 1A =

Share 1B =

Share 1C =

Share 1D =

Share 1E =

Share 1F =

Trust 2 =

Share 2A =

Share 2B =

Share 2C =

Share 2D =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Dear :

This responds to a letter dated March 9, 2018, and subsequent correspondence, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

## Facts

The information submitted states that X was incorporated under the laws of State on Date 1 and elected to be treated as an S corporation effective Date 2. As of Date 2, A's shares of X were held through Trust 1, a grantor trust that was treated (under subpart E of part 1 of subchapter J of chapter 1) as entirely owned by A.

On Date 3, A died and Trust 1 ceased to be a grantor trust. Nevertheless, Trust 1 continued to qualify as a permissible S corporation shareholder under § 1361(c)(2)(A)(ii) for the 2-year period beginning Date 3. Trust 1's trust agreement provided that upon the death of A, the X stock held by Trust 1 is to be held by six shares, Share 1A, Share 1B, Share 1C, Share 1D, Share 1E, and Share 1F (collectively Trust 1 Shares). Each Trust 1 share is treated as a separate share under § 663(c).

X represents that each of the Trust 1 shares would have qualified as a qualified subchapter S trust (QSST) under § 1361(d)(1) on Date 4 except for the fact that the sole beneficiary of each share failed to make an election under § 1361(d)(2) to treat the share as a QSST. Accordingly, the Trust 1 shares became ineligible shareholders of X and X's S corporation election terminated effective Date 4.

On Date 5, B, a shareholder of X died. Pursuant to B's last will and testament, B's estate transferred B's X stock to Trust 2 on Date 6. Trust 2 qualified as a permissible S corporation shareholder under § 1361(c)(2)(A)(iii) for the 2-year period beginning on Date 6, the day on which the X stock was transferred to it. Effective Date 6, trustees held Trust 2 in five shares. Four shares, Share 2A, Share 2B, Share 2C, and Share 2D (Trust 2 Shares), held X stock and were administered as QSSTs, effective Date 7. Although the Trust 2 Shares were administered as QSSTs no election under § 1362(d)(2) was made to treat the Trust 2 shares as QSSTs effective Date 7 and the governing document of Trust 2 did not satisfy the requirements to qualify the Trust 2 shares as QSSTs.

On Date 7, the Trust 2 Shares became ineligible shareholders of X. On Date 8, the beneficiaries the Trust 2 Shares and the trustees of Trust 2 entered into a binding non-judicial settlement agreement under State law effective as of Date 6 to qualify the Trust 2 shares as QSSTs.

X represents that all income has been reported on all affected returns consistent with the treatment of X as an S corporation for Date 2 and thereafter. X further represents that the beneficiaries of the Trust 1 shares and the Trust 2 Shares have filed their federal income tax returns consistent with the Trust 1 shares and Trust 2 shares being treated as QSSTs. X represents that the circumstances resulting in the termination of X's S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning.

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 1362(a) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

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

Section 1361(b)(1)(B) provides that, for purposes of subchapter S, 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, 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, for the purposes of § 1362(b)(1)(B), a trust all of which is treated (under title 26, subtitle A, chapter 1, subchapter J, part I, subpart E of the United States Code) as owned by an individual who is a citizen or resident of the United States may be a shareholder of an S corporation.

Section 1361(c)(2)(A)(ii) and § 1.1361-1(h)(1)(ii) of the Income Tax Regulations provide that, for purposes of § 1361(b)(1)(B), a trust that is described in § 1361(c)(2)(A)(i) immediately before the death of the deemed owner and that continues in existence after such death is a permitted shareholder, but only for the two-year period beginning on the day of the deemed shareholder’s death.

Section 1361(c)(2)(A)(iii) and § 1.1361-1(h)(1)(iv)(A) of the Income Tax Regulations provide that, for purposes of § 1361(b)(1)(B), a trust with respect to stock transferred to it pursuant to the terms of a will may be a shareholder, but only for the two-year period beginning on the day on which such stock is transferred to it.

Section 1.1361-1(h)(3)(i)(B) of the Income Tax Regulations provides that, if stock is held by a trust described in § 1.1361-1(h)(1)(ii), the estate of the deemed owner is generally treated as the shareholder as of the day of the deemed owner’s death.

Section 1.1361-1(h)(3)(i)(D) of the Income Tax Regulations provides that, if stock is transferred to a testamentary trust described in § 1.1361-1(h)(1)(iv), the estate of the testator is treated as the shareholder until the earlier of the transfer of that stock by the trust or the expiration of the two-year period beginning on the day that the stock is transferred to the trust.

Section 1361(d)(1) provides that, in the case of a qualified subchapter S trust with respect to which a beneficiary makes an election under § 1361(c)(2), (A) such trust will be treated as a trust described in § 1361(c)(2)(A)(i), and (B) for purposes of § 678(a) the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under § 1361(d)(2) is made.

Section 1361(d)(2)(A) provides that a beneficiary of a QSST (or his legal representative) may elect to have § 1361(d) apply. Section 1361(d)(2)(D) provides that an election under § 1362(d)(2) shall be effective up to 15 days and 2 months before the date of the election.

Section 1361(d)(3) provides that the term “qualified subchapter S trust” means 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 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)(3) provides that for purposes of § 1361(c) and § 1361(d), a substantially separate and independent share of a trust, within the meaning of § 663(c) and the regulations thereunder is treated as a separate trust. For a separate share which holds S corporation stock to qualify as a QSST, the terms of the trust applicable to that separate share must meet the QSST requirements stated in § 1.1361-1(j)(1)(i) and (ii).

Section 1.1361-1(j)(6)(iii) provides that if S corporation stock is transferred to a trust, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust.

Section 1.1361-1(j)(6)(iii)(C) provides that if a trust ceases to be a qualified subpart E trust, satisfies the requirements of a QSST, and intends to become a QSST, the QSST election must be filed within the 16-day-and-2-month period beginning on the date on which the trust ceases to be a qualified subpart E trust. If the estate of the deemed owner of the trust is treated as the shareholder under § 1.1361-1(h)(3)(i), the QSST election may be filed at any time, but no later than the end of the 16-day-and-2-month period beginning on the date on which the estate of the deemed owner ceases to be treated as a shareholder.

Section 1.1361-1(j)(7)(i) provides that the income beneficiary who makes the QSST election and is treated (for purposes of § 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of §§ 1361(b)(1), 1366, 1367, and 1368.

Section 1362(d)(2) provides that an election under § 1362(a) shall 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) such corporation ceases to be a small business corporation. The termination is effective on and after the day of the termination.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation 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; (2) the Secretary determines that the circumstances resulting in such ineffectiveness were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness, steps were taken so that the corporation for which the election was made is a small business corporation, or to acquire the required shareholder consents; and (4) the corporation for which the election was made, and each person who was a shareholder in such corporation at any time during the period specified pursuant to § 1362(f), agrees to make such adjustments (consistent with the treatment of such 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, such corporation shall be treated as an S corporation during the period specified by the Secretary.

Rev. Rul. 93-79, 1993-2 C.B. 269, provides that a reformation of a trust to meet the requirements of a QSST is recognized prospectively.

### Conclusion

Based solely on the information submitted and the representations made, we conclude that X's S corporation election was terminated on Date 4, when the Trust 1 shares became ineligible shareholders. We conclude that the termination of X's S corporation election was an inadvertent termination within the meaning of § 1362(f). Moreover, had X's S corporation election not already terminated on Date 4, it would have terminated on Date 7, when the Trust 2 shares became ineligible shareholders. Similarly, this termination would have also been inadvertent. Accordingly, pursuant to the provisions of § 1362(f), X will be treated as an S corporation from Date 4 and thereafter, provided that X's S corporation election was otherwise valid and not otherwise terminated under § 1362(d).

This ruling is contingent on QSST elections being made for the Trust 1 shares effective Date 4 and elections being made for the Trust 2 shares effective Date 8 within

120 days of the date of this letter. A copy of this letter should be attached to the QSST elections.

The shareholders of X must include their pro-rata share of the separately stated and non-separately computed items of X as provided in § 1366, make adjustments to basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368. If X or its shareholders fail to treat themselves as described above, this ruling is null and void.

Except as specifically ruled above, we express or imply no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code. Specifically, we express or imply no opinion regarding whether X is otherwise eligible to be an S corporation.

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

In accordance with a power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,

Faith P. Colson

Faith P. Colson  
Senior Counsel, Branch 1  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter

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