INTERNAL REVENUE SERVICE
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October 23, 1998

Company:

Trust:

State:

M:

N:

P:

Q:

R:

S:

T:

U:

V:

W:

X:

a:

b:

c:

d:

e:

f:

g:

h:

This responds to your letter on Company's behalf dated June 22, 1998, as well as subsequent correspondence, requesting a ruling under § 1362(f) of the Internal Revenue Code that the termination of Company's S corporation election was inadvertent. Company represents the following facts.

Company was incorporated in State on a. It elected under § 1362(a) to be an S corporation, effective b. At the time of the election, Company's shareholders were family members M, N, P, Q, R, S, and T.

On c, d, and e, M and N transferred shares in Company to R as trustee, for the benefit of their minor grandchildren, U, V, W, and X. The attorney retained by M and N to draft the trust agreement was unaware of the effect of holding Company stock in trust would have on Company's S election. He knew nothing about S corporations, including qualified subchapter S trusts (QSSTs). A single trust was created, with a separate share for each grandchild.

R, as trustee, opened a bank account for each grandchild, under which he and they have withdrawal rights. All cash distributions from Company with respect to the stock in trust have been made directly to these accounts. The only withdrawals have been to pay the income taxes due on Company earnings and account interest.

The accountant for the family and for Company was unaware of the existence of the Trust. Viewing the gifts of stock as direct transfers, he prepared gift tax returns claiming the annual exclusion under § 2503. No trust income tax returns were prepared. Company Forms K-1 showed distributions and allocations of corporate tax items directly to the grandchildren. Separate income tax returns were prepared for the grandchildren, reporting the distributions and corporate income allocable to them as shareholders. No QSST elections were filed.

On f, P referred to the Trust in a phone conversation with the accountant. The accountant immediately asked for a copy of the trust agreement and contacted the attorney for N's estate. The current authorized representative was retained on g to assist in resolving the problem. Each grandchild-beneficiary made a QSST election on h.

Section 1361(a)(1) provides that, for purposes of the Code, the term "S corporation" means, with respect to any tax year, a small business corporation for which an election under § 1362(a) is in effect for the year.

Section 1361(b)(1)(B) provides that, for purposes of subchapter S,

the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not, among other things, 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 purposes of § 1361(b)(1)(B), a trust all of which is treated (under §§ 671-679) as owned by an individual who is a citizen or resident of the United States may be a shareholder.

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

Section 1361(d)(3) provides that, for purposes of § 1361(d), 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 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 that 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.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the first tax year for which the corporation is an S corporation) the corporation ceases to be a small business corporation. Section 1362(d)(2)(B) provides that any termination under § 1362(d)(2)(A) shall be effective on and after the date of cessation.

Section 1362(f) provides that if (1)(B) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in termination were inadvertent; (3)(A) no later than a reasonable period of time after discovery of the circumstances resulting in termination, steps were taken so that the corporation is 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 § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as might be required by the Secretary regarding this period, then, notwithstanding the circumstances resulting in termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) of the Income Tax Regulations provides that, for purposes of § 1.1362-4(a), the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The

fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent.

According to the legislative history of § 1362(f)--

> 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. For example, if a corporation, in good faith, determined that it had no earnings and profits, but it is later determined on audit that its election terminated by reason of violating the passive income test for three consecutive years because the corporation in fact did have accumulated earnings, if the shareholders were to agree to treat the earnings as distributed and include the dividends in income, it may be appropriate to waive the terminating events, so that the election is treated as never terminated. 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 (1982); 1982-2 C.B. 718, 723.

Company represents that none of the family member-shareholders understood the significance of the Trust, treating it simply as a technical means of holding title for minor children. Company and all of its shareholders have reported income and paid tax consistent with Company being an S corporation. There was no intent to terminate Company's S corporation election or to take advantage of the income tax laws improperly. As soon as the existence of the Trust was made known to a knowledgeable professional, immediate action was taken to cure the defect, including the amendment of gift and estate tax returns.

After applying the applicable law and regulations to the facts and representations of this ruling request, we conclude that the termination of Company's S corporation election due to an ineligible shareholder was inadvertent within the meaning of § 1362(f).

Consequently, we rule that Company will be treated as continuing to be an S corporation from c to the present, unless Company's S election otherwise is terminated under § 1362(d).

Except for the specific ruling above, no opinion is expressed or implied concerning the federal income, gift, or estate tax consequences of

the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding the validity of Company's election under § 1362(a) to be an S corporation, the qualification of the Trust under § 1361(d)(3) as a QSST, or the availability of the gift tax annual exclusion for the transfers of Company stock in trust to the grandchildren.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

JEFF ERICKSON
Assistant to the Chief,
Branch 3
Office of Assistant
Chief Counsel
(Passthroughs and
Special Industries)

enclosure: copy for § 6110 purposes