

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:  
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Date:  
September 10, 1999

Legend

Grantor =

Trust =

Trust1 =

Trust2 =

X =

D1 =

D2 =

D3 =

D4 =

D5 =

STATE1 =

STATE2 =

This responds to your letter dated March 31, 1999, and subsequent

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correspondence, submitted on behalf of X requesting relief under § 1362(f) of the Internal Revenue Code and requesting the classification of Trust as a qualified subchapter S trust (QSST) under § 1361(d).

### **FACTS**

X incorporated under STATE1 law in D1 and elected subchapter S status as of D2. Grantor is one of three shareholders of X.

Grantor created Trust under STATE2 law on D3. Pursuant to the Trust Agreement, upon formation Trust was divided into two separate trusts, Trust1 and Trust2 (the "Trusts"), with separate beneficiaries. On D4, Grantor funded the Trusts with shares of X. Thus, in order for X to maintain its subchapter S status, the Trusts' beneficiaries were required to file QSST elections by D5. The Trusts' beneficiaries, however, did not file QSST elections in a timely manner thereby terminating X's subchapter S status. The Trusts, however, have operated from their inception as though they were QSSTs.

After learning that Grantor had transferred X shares to the Trusts, X's CEO requested a copy of the Trust Agreement. After reviewing the Trust Agreement, X's counsel were concerned that the Trusts may not meet the definition of qualified subchapter S trusts under § 1361(d)(3).

After learning that X's subchapter S election had terminated and worried that the Trusts may not be QSSTs, X began taking steps to make certain that X qualified as a subchapter S corporation. First, Grantor agreed to modify the Trust Agreement so that the Trusts qualified as QSSTs. Second, X submitted a private letter ruling request seeking relief under § 1362(f).

If a favorable private letter ruling is issued in this case, Grantor will file a petition with a STATE2 Court to reform the Trust Agreement so that the Trusts are administered under the terms and conditions described below.

The following new paragraph G is added at the end of Article 4:

Notwithstanding the preceding provisions of this Article, if any trust administered pursuant to the provisions of this Article holds any S corporation stock, the Trustee shall distribute all of the net income of the trust (as defined in Treas. Reg. § 1.643(b)-1) to the beneficiary of the trust, at least annually.

The following new sentence is added to the end of paragraph C of Article 10:

Notwithstanding the foregoing, no beneficiary of a trust that holds or has previously held any S corporation stock shall be permitted to transfer or assign

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any interest in such trust during his lifetime.

The following new paragraph G is substituted for the current paragraph G of Article 10:

If at any time the market value or asset composition of any trust or the circumstances of the trust or those of its beneficiary or beneficiaries who are then eligible to receive income are such, in the opinion of the Trustee, that it is not economically feasible or is otherwise not in the best interests of that beneficiary or those beneficiaries to continue with the administration of part or all of that trust, the Trustee may in its absolute discretion terminate part or all of that trust provided that the trustee distribute the trust principal attributable to the terminated trust or trust part to (i) that income beneficiary if there is only one such beneficiary, or (ii) to those of such income beneficiaries if there are more than one, and in such proportions, as the Trustee, again in its absolute discretion, determines to be most consistent with the general dispositive plan otherwise expressed for that trust. In all cases of the termination hereunder of any trust which holds S corporation stock, or any separate share of a trust which holds S corporation stock, or any separate share of a trust which holds S corporation stock for a separate income beneficiary thereof, all amounts held by such trust shall be distributed to the income beneficiary of such trust, and all amounts held by such separate share of any such trust shall be distributed to such separate income beneficiary of such separate share. To the extent that interests of any beneficiary, whether vested or contingent, are diminished or defeated by operation of this paragraph, none shall have any standing to complain of loss or damage, except in the event of gross negligence.

The following new paragraph I is added at the end of Article 10:

Notwithstanding any other provision of this instrument, no assets of any trust created hereunder shall be used to discharge any legal obligation of mine to support a beneficiary of such trust.

## LAW AND ANALYSIS

Section 1361(a)(1) provides that an "S corporation" is, with respect to a given year, 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, for purposes of § 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. Under § 1361(d)(1)(A), a qualified subchapter S trust with respect to which a beneficiary makes an election under § 1361(d)(2) will be treated as a trust described in § 1361(c)(2)(A)(i). Section 1361(d)(2) provides for the time and manner in which the beneficiary of a QSST may elect to have the provisions of § 1361(d) apply. A QSST election must be filed within the 2-month-16-day period beginning on the day that the stock is transferred to the trust. Section 1.1361-1(j)(6)(iii) of the Income Tax Regulations.

Section 1361(d)(3) sets for the provisions a trust instrument must contain for the trust to qualify as a QSST. Under § 1361(d)(3)(A), the terms of the trust must require that: (i) during the life of the current income beneficiary, there is only one income beneficiary; (ii) any corpus distributed during the life of the current beneficiary may be distributed only to that beneficiary; (iii) the current income beneficiary's interest terminates on the earlier of the beneficiary's death or the trust's termination; and, (iv) if the trust terminates during the current income beneficiary's life, the trust assets must be distributed to that beneficiary. In addition, § 1361(d)(3)(B) requires that the trust must distribute all of its income (within the meaning of § 643(b)) currently to one individual who is a United States resident or citizen.

Section 1361(d)(3) also provides that a substantially separate and independent share of a trust within the meaning of § 663(c) is treated as a separate trust for purposes of §§ 1361(c) and 1361(d).

Section 1362(f) provides, in part, that, if (1) 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 the termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the 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 such

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adjustments (consistent with the treatment of the corporation as a subchapter S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in the termination, the corporation will be treated as a subchapter 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 § 1362(f) of the Code, states in part:

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 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 upon the information submitted and our examination of the proposed terms that will govern the Trusts if the petition to modify is accepted, we conclude that the Trusts, as modified in accordance with the provisions discussed above, will each meet the definition of a QSST under § 1361(d)(3) as of the effective date of the Court's order approving the petition to modify.

We further conclude that X's subchapter S status was terminated as of D4 and that this termination was inadvertent. Thus, provided that the Trust Agreement is modified in a timely manner in accordance with the provisions discussed above, and the current income beneficiaries of the Trusts elect QSST status effective on the date of modification, X will be treated as a subchapter S corporation for the period from D4 to the modification and continuing, provided that its subchapter S election does not

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otherwise terminate.

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 concerning whether X is a subchapter S corporation for federal tax purposes.

Pursuant to a power of attorney on file with our office, we are sending a copy of this letter to X. This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Signed/Daniel J. Coburn  
Daniel J. Coburn  
Assistant to the Branch Chief, Branch 1  
Office of the Assistant Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter

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