

**INTERNAL REVENUE SERVICE**

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September 25, 2000

X =

A =

B =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Trust 5 =

Trust 6 =

Trust 7 =

Trust 8 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Dear

This is in reply to your letter dated February 9, 2000, and subsequent correspondence, submitted on behalf of X requesting a

ruling under § 1362(f) of the Internal Revenue Code.

X was incorporated on Date 1. X elected to be an S corporation effective Date 1. The current shareholders of X are B, Trust 2, Trust 3, Trust 4, Trust 5, Trust 6, and Trust 7. On Date 2, A, a grantor of Trust 1 and Trust 8 died. Trust 1 and Trust 8 each held stock in X at the time of A's death. B, X's president, represents that at the time of A's death Trust 1, a revocable trust, was a qualified shareholder under § 1361(c)(2)(A)(i). B further represents that at the time of A's death Trust 8 was also a qualified shareholder under § 1361(c)(2)(A)(i).

Upon the death of A, Trust 8 was divided into three subtrusts; Trust 5, Trust 6, and Trust 7. B represents that Trusts 5, 6, and 7 were each qualified subchapter S trusts (QSSTs) under § 1361(d)(3). However, the income beneficiaries of Trusts 5, 6, and 7 failed to timely file an election under § 1361(d)(2)(A) (QSST election). Accordingly, the subchapter S election of X was terminated on Date 5.

B, represents that the QSST elections for Trusts 5, 6, and 7 were not timely filed because the beneficiaries of the trusts were unaware of the need to make the election.

Upon the death of A, Trust 1 ceased to qualify as a grantor trust. Trust 1 continued to qualify as a subchapter S trust under § 1361(c)(2)(A)(ii) for the 2-year period beginning on the day of the deemed owner's death and ending on Date 4. Trust 1 did not distribute the shares of stock it held in X on or before Date 4. Accordingly, Trust 1 ceased to qualify as an eligible shareholder on Date 5.

In Date 3, the attorney for X discovered that Trust 1 had not distributed the interests it held in X on or before Date 4, and that Trust 1 was no longer a qualified shareholder. Following the discovery of Trust 1's failure to qualify as an eligible S corporation shareholder, the assets of Trust 1 were transferred to Trusts 2, 3, and 4. B represented that Trusts 2, 3, and 4 are each a qualified S corporation shareholder.

B represents that the terminating events, the failure of Trust 1 to timely distribute out the interests it held in X and the failure of the beneficiaries of Trusts 5, 6, and 7 to make the QSST elections, were not part of a plan to terminate X's S election or for tax avoidance purposes. 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.

Section 1361(a)(1) of the Code 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.

For taxable years beginning on or before December 31, 1997, § 1361(b)(1)(B) of the Code provides, in part, that 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 and other than a trust described in § 1361(c)(2)) who is not an individual.

Section 1361(c)(2)(A)(i) of the Code 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. Section 1361(c)(2)(B)(i) provides that for purposes of § 1361(b)(1), in the case of a trust described in § 1361(c)(2)(A)(i), the deemed owner shall be treated as the shareholder.

Section 1361(d)(1) of the Code provides that in the case of a qualified subchapter S trust (QSST) with respect to which a beneficiary makes an election under § 1361(d)(2), such trust shall be treated as a trust described in § 1361(c)(2)(A)(i) and, 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) of the Code 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 § 1361(d)(2) shall be effective up to 15 days and 2 months before the date of the election.

Section 1.1361-1(j)(6)(ii) of the Income Tax Regulations provides that the current income beneficiary of the trust must make the election under § 1361(d)(2) by signing and filing with the service center with which the corporation files its income tax return the applicable form or a statement including the information listed in § 1.1361-1(j)(6)(ii).

Section 1362(d)(2)(A) of the Code provides that an election under § 1361(a) shall be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(f) of the Code provides that if (1) an election under § 1362(a) by any corporation (A) 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, or (B) was terminated under paragraph (2) or (3) of § 1362(d), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken (A) so that the corporation is a small business corporation, or (B) to acquire the required shareholder consents, and (4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to § 1362(f), 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 circumstances resulting in such ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts submitted and the representations made, we hold that X's election to be an S corporation terminated on Date 5, as a result of the failure of Trust 1 to timely distribute the interests it held X to qualified beneficiaries and the failure of the beneficiaries of Trusts 5, 6, and 7 to make the election required under § 1361(d)(2)(A). We also hold that the termination was inadvertent within the meaning of § 1362(f) of the Code.

We further hold that, pursuant to the provisions of § 1362(f) of the Code, X will be treated as an S corporation from Date 5, provided that X's election to be an S corporation was otherwise valid and was not terminated under § 1362(d). From Date 5, Trusts 2, 3, 4, 5, 6, and 7 will be treated as trusts described under § 1361(c)(2)(A)(i), and the respective beneficiary of each trust will be treated for purposes of § 678 as the respective owner of the portion of the trust which consists of X stock. Therefore, the shareholders of X, must include their pro rata share of the separately stated and nonseparately computed items of X as provided in § 1366, make any 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 X as described above, this letter ruling will be null and void.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provisions of the Code.

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 the power of attorney on file with this office, a copy of this letter is being sent to X.

Sincerely yours,  
J. THOMAS HINES  
Acting Branch Chief, Branch 2  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures: 2  
Copy of this letter  
Copy for § 6110 purposes