

**Internal Revenue Service**

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:  
CC:PSI:2-PLR-112595-01  
Date:  
August 21, 2001

Legend

X:

Trust:

A:

B:

Court:

c:

D1:

D2:

D3:

D4:

D5:

Dear \_\_\_\_\_ :

This letter responds to your letter dated \_\_\_\_\_, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

Facts

The represented facts are as follows: X was incorporated on D1, and filed an S election on D2 effective D1. On D3, A, a shareholder of X, transferred c shares of X stock to Trust. Trust was established as an inter vivos Qualified Terminable Interest Property (QTIP) trust under § 2523(f). A believed that Trust was an eligible S corporation shareholder and a qualifying subchapter S trust (QSST) as provided under § 1361. Trust mandated the distribution of the net income each year to B, A's spouse,

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during her lifetime. Principal distributions could only be made to B, and Trust did not provide for distributions to any other party during B's lifetime. B attempted to file a QSST election with the Service after the stock was transferred to the Trust.

On D4, the attorney who drafted Trust discovered that B, the income beneficiary of the Trust, was not eligible to make a QSST election under § 1.1361-1(j)(4) of the Income Tax Regulations because A, the grantor of Trust, should have been treated as the owner of the income portion of the trust under § 677. However, A would not have been treated as the owner of the entire trust under §§ 671 to 677. Accordingly, Trust was not a grantor trust eligible to hold S corporation stock under § 1361(c)(2)(A)(i).

A took immediate steps to make Trust an eligible S corporation shareholder by petitioning Court to reform Trust to provide A, the grantor, with the power to substitute assets of equivalent value as provided under § 675(4)(C) in order to make Trust a grantor trust eligible to hold S corporation stock under § 1361(c)(2)(A)(i). On D5, Court granted the petition to modify Trust retroactively to D3.

X then filed this ruling request asking both that Trust be treated as an eligible S corporation shareholder under § 1361(c)(2)(A)(i) from D3 through D5, and that X be treated as continuing to be an S corporation during that same time period under § 1362(f).

X represents that A, as an officer and shareholder of X, relied on outside counsel to ensure that X's S corporation election did not terminate. X also represents that tax avoidance was not a motive for any of these actions. X and its shareholders 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 for the taxable year.

Section 1361(b)(1) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not--(A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate, trust described in § 1361(c)(2), or an organization described in § 1361(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 may be a shareholder if all of it is treated (under subpart E of part I of subchapter J of chapter 1 of title 26) as owned by an individual who is a citizen or resident of the United States.

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Section 675(4) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which a power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. Section 675(4)(C) provides that “power of administration” means, among other things, a power to reacquire the trust corpus by substituting other property of an equivalent value.

Section 1361(d)(1) provides that in the case of a QSST with respect to which a beneficiary makes an election under § 1361(d)(2)--(A) such trust shall be treated as a trust described in § 1362(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)(3) provides that a QSST 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 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 the 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 one individual who is a citizen or resident of the United States.

Section 1.1361-1(j)(4) of the Income Tax Regulations provides, in part, that if property is transferred to a QTIP trust under § 2523(f), the income beneficiary may not make a QSST election even if the trust meets the requirements set forth in § 1.1361-1(j)(1)(ii) because the grantor would be treated as the owner of the income portion of the trust under § 677. In addition, if property is transferred to a QTIP trust under § 2523(f), the trust does not qualify as a permitted shareholder under § 1361(c)(2)(A)(i) and § 1.1361-1(h)(1)(i) (a qualified subpart E trust), unless under the terms of the QTIP trust, the grantor is treated as the owner of the entire trust under §§ 671 to 677.

Section 1362(f) 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

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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, such corporation shall be treated as an S corporation during the period specified by the Secretary.

#### Conclusion

Based solely on the information submitted, and the representations made, we conclude that the termination of X's subchapter S election, as described above, was inadvertent within the meaning of § 1362(f). Therefore, X will be treated as continuing to be an S corporation from D3 through D5, and thereafter, unless X's subchapter S election is otherwise terminated under § 1362(d). In addition, Trust will be treated as an eligible S corporation shareholder under § 1361(c)(2)(A)(i) and A will be treated as the owner of the entire Trust, from D3 through D5, and thereafter, until the earlier of the termination of Trust or the death of A. Accordingly, A must include the Trust's pro rata share of the separately and nonseparately computed items of X under §1366, make any adjustments to stock basis under § 1367, and take into account any distributions made by X to Trust under § 1368. If X or X's shareholders fail to comply with the requirements of this paragraph, this ruling shall be null and void.

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. In particular, no opinion is expressed or implied concerning whether X is an S corporation.

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 with this office, a copy of this letter is being sent to X.

Sincerely yours,  
Matthew Lay  
Senior Technician Reviewer, Branch 2  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures: 2

Copy of this letter  
Copy for § 6110 purposes