

## Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

October 23, 2001

### Legend

X:

A:

Trust 1:

Trust 2:

Trust 3:

n:

D1:

D2:

D3:

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

This letter responds to your letter dated April 23, 2001, and subsequent correspondence, 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 and elected to be an S corporation effective D1. On D2, A, a shareholder of X, established Trust 1, Trust 2 and Trust 3 (the Trusts) for the benefit of A's minor children and transferred n shares of X's nonvoting common stock to each of the Trusts. On D3, A transferred another n shares of X's nonvoting common stock to each of the Trusts. X represents that Trust 1, Trust 2 and Trust 3 are eligible to be Qualified Subchapter S Trusts (QSSTs). However, due to inadvertence neither A's attorneys or accountants filed an election for Trust 1, Trust 2 or Trust 3 under § 1361(d)(2) to qualify the trusts as QSSTs.

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Since D2, all of the shareholders have reported their shares of X's income as though X were an S corporation. X and its shareholders have agreed to make any adjustments that are deemed necessary to be consistent with the treatment of X as an S corporation since D2. X represents that there was no intent to terminate X's S election, and that the failure to file timely QSST elections was not motivated by tax avoidance or retroactive tax planning. The trustee for Trust 1, Trust 2 and Trust 3 intends to file QSST elections for each of the Trusts to be effective D2, once X receives this letter ruling from the Service. These elections, however, will not be timely filed.

### 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) defines a "small business corporation" as 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 and other than a trust described in § 1361(c)(2)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1361(d)(1) 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) 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 1361(d)(3) defines the term QSST as a trust whose terms require that: (i) during the life of the current income beneficiary, there will be only one income beneficiary of the trust; (ii) any corpus distributed during the life of the current income

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beneficiary may be distributed only to that beneficiary; (iii) the income interest of the current income beneficiary in the trust will 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 will distribute all of its assets to the beneficiary. Section 1361(d)(3)(B) further defines a QSST as a trust all of the income 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) of the Code 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 a corporation is an S corporation) such corporation ceases to be a small business corporation. A termination of an S corporation election under § 1362(d)(2) is effective on and after the date of cessation.

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 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 facts submitted and the representations made, we conclude that X's S corporation election terminated on D2, when A transferred X stock to Trust 1, Trust 2 and Trust 3. We also conclude that the termination was inadvertent within the meaning of section 1362(f).

Pursuant to § 1362(f), X will be treated as continuing to be an S corporation on D2, and thereafter, provided that X's subchapter S election is not otherwise terminated under § 1362(d). This ruling is contingent on X and all of its shareholders treating X as having been an S corporation for the period beginning D2, and thereafter. Accordingly, all of the shareholders in X, in determining their respective income tax liabilities for the period beginning D2, and thereafter, must include their pro rata share of the separately and nonseparately computed items of X as provided in § 1366, make adjustments to stock basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368. This ruling shall be null and void if the requirements of this

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paragraph are not met.

Furthermore, this ruling is contingent on Trust 1, Trust 2 and Trust 3 making QSST elections, effective D2, with the appropriate service center within 60 days of the date of this letter and attaching a copy of this letter to each election.

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the above-described facts under any other provision of the Code. Specifically, no opinion is expressed on whether X is otherwise eligible to be treated as an S corporation or whether Trust 1, Trust 2 and Trust 3 are eligible to be QSSTs.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) 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 forwarded 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