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Department of the Treasury

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Date:
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Legend

X =

A =

B =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Date 1 =

Date 2 =

Date 3 =

Dear

This is in reply to a letter dated May 25, 2001, together with subsequent correspondence, submitted on behalf of X, requesting rulings under §§1361(d)(3) and 1362(f) of the Internal Revenue Code.

Facts

The information submitted states that, on Date 1, A created Trust 1, Trust 2, Trust 3, and Trust 4 (“the Trusts”) for the benefit of each of A’s children. X is a corporation that elected to be treated as an S corporation effective Date 2. Each of the Trusts first acquired shares of X stock on Date 2. A intended for each Trust to qualify as a “qualified subchapter S trust” (“QSST”) under §1361(d). However, the beneficiaries of the Trusts failed to file the required elections under §1361(d)(2).

Under the terms of the agreement creating the Trusts, each Trust originally had only one income beneficiary during the life of that beneficiary. The annual net income of each Trust is required to be distributed to that Trust's beneficiary if the Trust holds stock in an S corporation. Any corpus distributed during the life of the income beneficiary may be distributed only to that beneficiary. The income interest of the beneficiary of each Trust does not terminate until the earlier of the Beneficiary's death or the termination of the Trust. Upon termination of any Trust during the life of the beneficiary, the remaining assets of the Trust are required to be distributed to the beneficiary.

The beneficiary of Trust 2, B, died on Date 3. X represents that the trustee of Trust 2 intends to distribute the X stock held by Trust 2 prior to the end of the 2-year period beginning on Date 3.

X represents that at all relevant times, X and its shareholders treated X as an S corporation. X and its shareholders agree to make any adjustments required by the Secretary consistent with the treatment of X as an S corporation.

Law and Analysis

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.

As of Date 2, §1361(b) defined the term "small business corporation" to mean a domestic corporation that is not an ineligible corporation and that does not (A) have more than 35 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. Under §1361(d), a QSST (defined in §1361(d)(3)) may be treated as an eligible shareholder described in §1361(c)(2)(A)(i).

Section 1361(d)(1) provides that a QSST whose beneficiary makes an election under section §1362(d)(2) will be treated as a trust described in §1361(c)(2)(A)(i), and the QSST's beneficiary will be treated as the owner (for purposes of §678(a)) of that portion of the QSST's S Corporation stock to which the election under §1361(d)(2) applies. Under §1361(d)(2)(A) of the Code, a beneficiary of a QSST (or legal representative) may elect to have §1361(d) apply. Under §1361(d)(2)(D), this election will be effective up to 15 days and two months before the date of the election.

Section 1361(d)(3) defines a QSST as 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 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 1.1361-1(j)(7)(ii) of the Income Tax Regulations provides, in part, that if, upon the death of the income beneficiary, the trust continues in existence, continues to hold S corporation stock but no longer satisfies the QSST requirements, and is not a qualified subpart E trust, then, solely for purposes of §1361(b)(1), the estate of that income beneficiary is treated as the shareholder of the S corporation with respect to which the income beneficiary made the QSST election. The estate ordinarily will cease to be treated as the shareholder for purposes of §1361(b)(1) upon the earlier of the transfer of stock by the trust or the expiration of the 2-year period beginning on the day of the income beneficiary's death. Section 1.1361-1(j)(7)(ii) also provides that during the period that the estate is treated as the shareholder for purposes of §1361(b)(1), the trust is treated as the shareholder for purposes of sections 1366, 1367, and 1368.

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 was a shareholder of 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.

Conclusion

Based solely on the facts provided, we conclude that X's S corporation election was invalid because the Trusts were ineligible S corporation shareholders. In addition, we conclude that this election was inadvertently invalid within the meaning of §1362(f). Pursuant to §1362(f), X will continue to be treated as an S Corporation on Date 2 and thereafter, provided that X's S corporation election was otherwise valid and was not terminated under §1362(d).

We also conclude that (i) Trust 1, Trust 3, and Trust 4 satisfy the requirements to qualify as QSSTs under §1361(d)(3) and were permitted S corporation shareholders from and after Date 2, and (ii) Trust 2 satisfied the requirements to qualify as a QSST under §1361(d)(3) and was a permitted S corporation shareholder from Date 2 through

Date 3. During these periods, Trust 1, 2, 3, and 4, will be treated as trusts described in §1361(c)(2)(A)(i), and the respective beneficiary of each Trust will be treated for purposes of section 678 as the owner of the portion of the Trust which consists of X stock. From and after Date 2, the shareholders of X must include their pro rata share of the separately stated and non-separately computed items of X as provided in §1366, make any adjustments to basis provided in §1367, and take into account any distributions made by X as provided in §1368. For purpose of the preceding sentence, Trust 2 will be treated as the shareholder of any X stock held by Trust 2 after Date 3. If X or its shareholders fail to treat themselves as described above, this ruling shall be null and void. Moreover, X's S election will terminate if Trust 2 continues to hold X stock after the expiration of the 2-year period beginning on Date 3.

This ruling is conditioned upon the beneficiaries of Trusts, 1, 3, and 4 filing QSST elections effective Date 2 with the appropriate service center within 60 days following the date of this letter. A copy of this letter should accompany the QSST elections.

Except as specifically ruled upon above, we express no opinion concerning the Federal tax consequences of the transactions described above under any other provisions of the Code. Specifically, no opinion is expressed regarding whether X is otherwise eligible to be 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 the power of attorney on file with this office, copies of this letter are being sent to X's authorized representatives.

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