

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
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LEGEND

X =

State =

d1 =

d2 =

d3 =

d4 =

d5 =

d6 =

d7 =

A =

B =

C =

D =

E =

F =

Dear _____ :

This letter responds to a letter, dated October 30, 2001, by your authorized representative on behalf of X, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

FACTS

X was incorporated on d1 under the laws of State, and elected to be treated as an S corporation effective d2. At the time of its S corporation election, X had two shareholders: A, an individual, and the estate of B, A's deceased spouse. On d3, pursuant to the terms of B's will, the estate of B transferred the shares of X held by the estate to C, a marital trust for the benefit of A.

X represents that B intended C to be a Qualified Terminable Interest Property (QTIP) trust for estate tax purposes and a Qualified Subchapter S Trust (QSST) under § 1361(d)(3) for income tax purposes. The terms of C provide that: (i) during A's life, A shall be the only income beneficiary of the trust, (ii) any corpus distributed during A's life may be distributed only to A, (iii) the income interest of the trust shall terminate upon A's death, and (iv) all the income of the trust be distributed currently to A.

Under § 1361(c)(2)(iii), C was an eligible S corporation shareholder for two years after B's estate transferred the stock to C. At the expiration of the two year period, A was required to file a QSST election under § 1361(d)(2) for C to continue to be an eligible S corporation shareholder. A did not file the election. As a result of A's failure to file the QSST election, X's S corporation election terminated on d4.

A died on d5, and pursuant to the terms of C, the shares of X were transferred to successor trusts D and E. At the time of the transfer, D and E were ineligible to be shareholders of an S corporation. If X's S corporation election had not terminated on d4, the election would have terminated on transfer of X's shares to D and E.

The shareholders of X decided to sell or distribute all of X's assets and liquidate the corporation, effective d6. In the course of examining X's books and records, the attorneys for X determined that D and E were ineligible S corporation shareholders. In d6, D and E transferred all of the shares of X to F, an individual.

X represents that it did not intend to terminate its S corporation election. X further represents that during the time that D and E held the shares, D and E reported their allocable S corporation income on Form 1041, U.S. Income Tax Return for Estates and Trusts as separately taxable non-grantor type trusts. X represents that this resulted in no tax avoidance by the X or any of its shareholders. X requests a ruling that the termination of its S corporation election was inadvertent within the meaning of § 1362(f).

LAW AND ANALYSIS

Section 1361(a) 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.

Section 1361(b)(1)(B) provides 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, a trust described in § 1361(c)(2) or an organization described in § 1361(c)(6)) who is not an individual.

Section 1361(c)(2)(A) provides, in part, that for the purposes of § 1362(b)(1)(B) the following trusts may be shareholders of an S corporation: (i) a trust all of which is treated (under subpart I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States and (iii) a trust with respect to stock transferred to it pursuant to the terms of a will, but only for the two year period beginning on the day on which such stock is transferred to it.

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

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 was 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 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 the period, then, notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation shall be treated as continuing to be an S corporation during the period specified by the Secretary.

Section 1.1362-4(d) of the Income Tax Regulations provides, in part, that in the case of a transfer of stock to an ineligible shareholder that causes an inadvertent termination under § 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of an S corporation during the period the ineligible shareholder actually held stock in the corporation.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that X's election to be treated as an S corporation was terminated on d4, when the two year period in which C was an eligible shareholder expired . Furthermore, the election would have been terminated on d5, when the shares were transferred to D and E, also ineligible shareholders of an S corporation. We also conclude that the termination was inadvertent within the meaning of § 1362(f). Pursuant to § 1362(f), X will be treated as continuing to be an S corporation from d4, and thereafter, provided that X's S corporation election was otherwise valid and 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 d3 and thereafter. Furthermore, it is based upon X's representation that trusts reported their allocable S corporation income on Form 1041, U.S. Income Tax Return for Estates and Trusts as separately taxable non-grantor type trusts, and that there was no tax avoidance by X or any of its shareholders. Accordingly, all of the shareholders in X, and those deemed shareholders of X, in determining their respective income tax liabilities for the period beginning d4, 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.

Except as provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion about whether X is otherwise eligible to be an S corporation.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

/s/

Christine Ellison
Chief, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)