Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:
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X =

H =

W =

A =

B =

C =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Dear :

This letter responds to a letter, dated December 23, 1999, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

X elected to be a subchapter S corporation beginning D1 with H and W as the sole shareholders. On D2, H and W (husband and wife) transferred all their stock in X to Trust 1. Trust 1 was a revocable living trust, which qualified as a grantor trust under subpart E of part I of subchapter J of chapter 1. As such, H and W were treated as the owners of the Trust 1 assets.

On D3, H died. On D4, pursuant to provisions of Trust 1, the stock of X was transferred to Trust 2, Trust 3, and Trust 4. These transfers were done in consultation with and based on the advice of an attorney who was not aware that X was an S corporation.

Trust 2 qualified as a grantor trust, but Trust 3 and Trust 4 did not qualify as grantor trusts. A represents that Trust 3 and Trust 4 were qualified under § 1361(d) to be Qualified Subchapter S Trusts (QSST). However, no elections under § 1361(d)(2) (QSST election) was filed as to Trust 3 and Trust 4.

On D5, W died. Provisions of Trust 1 provided that all the shares of X stock held by Trust 2, Trust 3, and Trust 4 should be distributed to B at the death of W. A, as successor trustee and executor of W's estate, hired a certified public accounting firm to help with any estate and income tax filings as a result of W's death. On D6 the accounting firm advised A that Trust 3 and Trust 4 were ineligible shareholders of X and X's S election had terminated on D4. On D7, A transferred all the shares of X owned by Trust 2, Trust 3 and Trust 4 to B and C. B and C are married individuals.

A represents that the terminating event was 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 defines an "S corporation" as a small business corporation for which an election under section 1362(a) is in effect for the taxable year.

Section 1361(b)(1)(B) provides that a "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not have as a shareholder a person (other than an estate, a trust described in section 1361(c)(2), or an organization described in section 1361(c)(6)) who is not an individual.

Section 1361(c)(2)(A)(i) 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) 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 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 was terminated under § 1362(d)(2); (2) the Secretary determines that the circumstances resulting in such termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the termination, steps were taken so that the corporation is a small business corporation; and (4) the corporation, and each person who was a shareholder of the corporation at any time during the period specified under § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary for that period, then, notwithstanding the circumstances resulting in such termination, the corporation

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

Based solely on the facts and representations submitted, we hold that X's S corporation election terminated on D4 when Trust 3 and Trust 4, ineligible S corporation shareholders, acquired X stock. We also conclude that the termination was inadvertent within the meaning of § 1362(f).

We further hold that under the provisions of § 1362(f), X will be treated as continuing to be an S corporation during the period from D4 to D7, and thereafter, provided that the election was not otherwise terminated under section 1362(d). From D4 to D5, Trust 3 and Trust 4 will be treated as trusts described in § 1361(c)(2)(A)(i) and W will be treated, for purposes of section 678, as the owner of that portion of the trusts consisting of X stock. After D5 B will be treated as the owner of the X stock and, on D7 and thereafter, B and C will be treated as the owners of the X stock. Accordingly, 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 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 ruling will 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, including whether X was or is a small business corporation under § 1361(b) of the Code.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code 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 X's authorized representative.

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

Enclosures: 2
Copy of this letter
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