Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC: PSI: B01 – PLR-117085-03
Date:
Nov 5 2003

In Re:

X =

Trust 1 =

Trust 2 =

Corporation 1 =

Corporation 2=

Corporation 3=

State =

D1 =

D2 =

D3 =

D4 =

Dear :

This letter responds to a letter dated February 12, 2003, and subsequent correspondence, written on behalf of X, Trust 1, Trust 2, Corporation 1, Corporation 2 and Corporation 3 ("Taxpayers") requesting relief under section 1362(f).

FACTS

According to the information submitted, X, a domestic entity, was incorporated under the laws of State on D1. As of D2, X's shareholders included two irrevocable trusts, Trust 1 and Trust 2 ("Trusts"). Pursuant to a plan of reorganization, as of D2, X owned 100 percent of the outstanding stock of Corporation 1, Corporation 2 and Corporation 3 (Subsidiaries). As of D2, X intended to be treated as an S corporation and for Subsidiaries to be treated as Qualified Subchapter S Subsidiaries (QSubs) under section 1361(b)(3). To this end, X timely elected subchapter S status, effective D2, by filing Form 2553 with the Service on D3. On D3, X also timely filed a Form 8869 with respect to Subsidiaries to be treated as QSubs. During the period at issue, Taxpayers relied on the advice of their accountants with respect to their taxation and the effectiveness of the S election and QSub elections.

The agreements creating the Trusts provide that (1) during the life of the current income beneficiary, there shall be only 1 income beneficiary of the trust, (2) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary, (3) 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 (4) all income must be distributed to the income beneficiary. State law provides that 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.

Taxpayers intended the Trusts to be treated as Qualified Subchapter S Trusts (QSSTs) with respect to the stock of X; however, they did not realize that the beneficiaries of Trusts were required to make separate elections in order for the Trusts to be treated as QSSTs with respect to the stock of X. Accordingly, the beneficiaries did not make the necessary elections under section 1361(d)(2) for the Trusts to be as valid shareholders. In addition, Taxpayers were not aware of the requirement that the beneficiaries of the Trusts, not the trustees, sign the Form 2553.

Taxpayers represents that as soon as the invalid elections were brought to their attention they took steps to obtain relief. Taxpayers also represents that there was no intent to knowingly make an invalid S election or QSub elections. Moreover, Taxpayers represent that there was no tax avoidance motive, nor was there any intent to engage in any retroactive tax planning.

X timely filed a Form 1120S for the taxable year D4. Because Taxpayers and their advisors believed that the Subsidiaries were QSubs, no separate returns were filed with respect to Subsidiaries. X's shareholders reported on their individual income tax returns for D4, their pro rata share of the income and deductions of X and Subsidiaries. The beneficiaries of the Trusts each reported, on their individual income tax returns for D4, their respective Trust's share of the income and deductions of X and (Subsidiaries). Taxpayers consent and agree to make such adjustments as the Service may require with respect to all periods since D2.

LAW AND ANALYSIS

Section 1361(a)(1) of the Code provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.

Section 1361(b)(1)(B) provides that for purposes of subchapter S, a "small business corporation" cannot 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 a trust, all of which is treated as owned by an individual who is a citizen or resident of the United States, is a permitted shareholder of a small business corporation.

Section 1361(d)(1) provides that in the case of a QSST with respect to which a beneficiary makes an election under section 1361(d)(2), such trust shall be treated as a trust described in section 1361(c)(2)(A)(i), and for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust consisting of stock in an S corporation with respect to which the election under section 1361(d)(2) is made.

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 1 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 section 643(b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States.

Section 1.1361-1(j)(6)(ii) 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 section 1.1361-1(j)(6)(ii).

Section 1362(a)(2) provides that an election to be an S corporation will only be valid if all persons who are shareholders on the day on which such election is made consent to such election.

Section 1.1362-6(b)(1) of the regulations provides that except as provided in section 1.1362-6(b)(3)(iii), the election of the corporation is not valid if any required consent is not filed in accordance with the rules contained in section 1.1362-6(b).

Section 1.1362-6(b)(3)(i) provides that the necessary consent may be made on Form 2553 or on a separate statement in the manner described in section 1.1362-6(b)(1).

Section 1.1362-6(b)(2)(iv) provides that in the case of a QSST, the person treated as the shareholder for purposes of section 1361(b)(1) must consent to the election.

Section 1362(f) of the Code provides that if (1) an election under section 1362(a) by any corporation was not effective for the taxable year for which it was made (determined without regard to section 1362(b)(2)) by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents, (2) the Secretary determines that the circumstances resulting in such ineffectiveness was inadvertent, (3) no later than a reasonable period of time after discovery of the event resulting in the ineffectiveness, 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 this subsection, 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, the corporation shall be treated as an S corporation during the period specified by the Secretary.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24, in discussing section 1362(f) of the Code, states in part:

> If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the

> event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.
>
> The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped that taxpayers and the government will work out agreements that protect the revenues without undue hardship to taxpayers. . . . It is expected that the waiver may be made retroactive for all years or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.

CONCLUSION

Based on the information submitted and the representations made, we conclude that X's S corporation election was invalid on D2, because the beneficiaries of the Trusts did not make the required elections under section 1361(d)(2) and because the trustees of the Trusts, not the beneficiaries, signed the Form 2553. Because X's subchapter S election was invalid on D2, none of its Subsidiaries met the definition of a QSub as of D2 and, thus, their QSub elections were also invalid. We conclude, however, that the facts causing such ineffectiveness were inadvertent within the meaning of section 1362(f) of the Code.

Consequently, X shall be treated as an S corporation for the taxable year beginning D2, provided that X files a new Form 2553 and the Trusts file QSST elections meeting the requirements of section 1.1361-1(j)(6)(ii), effective D2, with the appropriate service center within 60 days of this letter. A copy of this letter should be attached to the Form 2553 and to each QSST election. Provided these requirements are met, the Subsidiaries will be treated as QSubs, effective D2.

Except as specifically ruled upon above, no opinion is expressed as to the federal income tax consequences of the facts described above under any other provision of the Code. In particular, no opinion is expressed or implied as to whether X otherwise qualifies as a Subchapter S Corporation under section 1361.

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.

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

Sincerely,

/s/ Dan Carmody

Dan Carmody
Special Counsel, Branch 1
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for Section 6110 purposes