

Internal Revenue Service

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Person To Contact:

Telephone Number:

Refer Reply To:

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PLR-147732-06

Date:

March 23, 2007

Legend:

X =

Trust 1 =

Trust 2 =

Date 1 =

Date 2 =

Date 4 =

State 1 =

State 2 =

Dear _____ :

This responds to a letter dated September 29, 2006 and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting relief pursuant to § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated under the laws of State on Date 1 and elected to be treated as an S corporation, effective Date 1. On Date 2, shares of X were transferred to Trust 1, an ineligible S corporation shareholder.

On Date 3, shares of X were transferred to Trust 2, an ineligible S corporation shareholder. Trust 1 and Trust 2 were each intended to be a qualified subchapter S trust (QSST). However, none of the income beneficiaries filed a timely QSST election. Furthermore, Trust 2 was not a valid QSST because it provided a possibility for a distribution of corpus to someone other than the income beneficiary. Trust 2's Article 4, § 3(c) provided as follows:

If at any time while my wife is the income beneficiary of the Trust Estate, any of my descendants should for any reason be in need of funds for his or her proper care, maintenance, support or education, the Trustees may in their absolute discretion pay to or apply for the benefit of any of my descendants such amounts from the principal of the Trust Estate, up to the whole thereof, as the Trustees may from time to time deem reasonably necessary or advisable for such purposes.

Therefore, X's S election terminated on Date 2 and would have terminated on Date 3 if the election had not terminated on Date 2. Each income beneficiary reported their allocable share of X's income consistent with the treatment of each Trust as a QSST.

X represents that the circumstances resulting in the termination of X's S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning. Furthermore, X and its shareholders were unaware that Trust 2 did not meet the requirements of a QSST under § 1361(d)(3)(A)(ii) and no distributions were made to anyone other than the income beneficiary. X and its shareholders have agreed to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary. The Trust 2 trustee represents that a petition will be filed with the State 2 Court to modify Trust 2 to substitute Article 4, § 3(c) with, "Any corpus distributed during the life of the current income beneficiary may only be distributed to such beneficiary."

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)(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(d)(1) provides that in the case of a QSST with respect to which a beneficiary makes an election under § 1361(d)(2) -- (A) such trust shall 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 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)(A) provides that an election under § 1362(a) will be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation. Section 1362(d)(2)(B) provides that the termination shall be effective on and after the date of cessation.

Section 1361(d)(3)(A) provides that a QSST is a trust, 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. In addition, § 1361(d)(3)(B) requires that the trust distribute all of its income (within the meaning of § 643(b)) currently to one individual who is a citizen or resident of the United States.

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 § 1362(d)(2) or (3), (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.

Based solely on the representations made and the information submitted, we conclude that X's S corporation election terminated on Date 2, under § 1362(d)(2), because shares of X were transferred to an ineligible shareholder, and that this termination of X's S election was inadvertent within the meaning of § 1362(f).

We conclude that X's S election would have terminated on Date 3, under § 1362(d)(2), because shares of X were transferred to an ineligible shareholder, and that this termination would have been inadvertent within the meaning of § 1362(f). We further conclude that the proposed terms that will govern Trust 2, if the petition to modify is accepted, will meet the definition of a QSST under § 1361(d)(3) as of the effective date of the Court's order approving the petition to modify.

Provided that Trust 2 is modified in a timely manner in accordance with the provisions discussed above, the current income beneficiary of Trust 2 elects QSST status for Trust 2 effective on the date of modification, and current income beneficiary of Trust 1 elects QSST for Trust 1 effective Date 2, then X will be treated as continuing to be an S corporation from Date 2 and thereafter, provided X's S corporation election was valid and was not otherwise terminated under § 1362(d). All of X's shareholders in determining their respective income tax liabilities during the termination period and thereafter, must include their pro rata share of the separately stated items of income (including tax-exempt income), loss, deduction, or credit and non-separately stated computed items of income or loss 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.

Additionally, during the termination period and thereafter, Trust 1 will be treated as a QSST described in § 1361(d)(3) (assuming it otherwise qualifies as a QSST) provided that the income beneficiary files a QSST election effective Date 2 with the appropriate service center within 60 days following the date of this letter. Trust 2 will be treated as a QSST described in § 1361(d)(3) (assuming it otherwise qualifies as a QSST) provided that the income beneficiary files a QSST election effective on the date the petition to modify the trust is approved by the court.

PLR-147732-06

If Trust 1, Trust 2, X, or X's shareholders fail to treat X as described above, this ruling shall be null and void. A copy of this letter should be attached to the QSST elections.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above 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.

This ruling letter 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 the power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,

Bradford R. Poston
Senior Counsel, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

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