Internal Revenue Service

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Washington, DC 20224

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Person To Contact:
, ID No.
Telephone Number:

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Date:
March 19, 2007

X =

Shareholders =

Date 1 =

Date 2 =

Date 3 =
Date 4 =

Date 5 =

Date 6 =

Grantor Trust =

Trust =

A =

B =

C =

Y1 =

Dear :

This responds to a letter dated September 7, 2006, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that X made an election to be treated as an S corporation effective Date 1. On Date 2, shares of X were transferred to Grantor Trust. On Date 3, Grantor Trust transferred shares of X to Trust. Trust consists of two equal shares: one share for the benefit of A, a minor, and another share for the benefit of B, also a minor. The Trust instrument provides that each share shall be held, administered and distributed as a separate trust.

On Date 5, C, A and B's parent, filed a late Qualified Subchapter S Trust (QSST) Election under Rev. Proc. 2003-47, 2003-1 C.B. 998, for the respective separate share trusts for A and B, to be effective on Date 3. The IRS accepted the late QSST election by letter dated Date 6.

It was intended that the respective share trusts for A and B under the Trust instrument each qualify as a QSST. However, for taxable year Y1, although the trustees of Trust intended to distribute all of the trust income, they failed to distribute all trust income to A and B as required by § 1361(d)(3)(B). Therefore, X's election terminated on Date 4. Upon discovery of the failure to distribute all trust income, the trustees of Trust distributed the respective shares of trust income for taxable year Y1 to A and B.

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. X and its Shareholders consent to make any adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary.

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) provides that the term "small business corporation" means a domestic corporation that is not an ineligible corporation and does not (A) have more than 100 shareholders, (B) 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, (C) have a nonresident alien as a shareholder, and (D) have more than 1 class of stock.

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 of the Code) (a grantor trust) as owned by an individual who is a citizen or resident of the United States may be a shareholder of an S corporation. 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 QSST with respect to which a beneficiary makes an election under § 1361(d)(2), the trust is treated as a trust described in § 1361(c)(2)(A)(i), and for purposes of § 678(a), the beneficiary of the trust is treated as the owner of that portion of the trust that consists of stock in an S corporation with respect to which the election under § 1361(d)(2) is made. Under § 1361(d)(2)(D), this election will be effective up to 15 days and 2 months before the date of the election.

Section 1362(d)(2) 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 the 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) shall be effective on and after the date of cessation.

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 1361(d)(4)(B) provides that if any QSST ceases to meet any requirement of § 1361(d)(3)(B) but continues to meet the requirements of § 1361(d)(3)(A), the provisions of § 1361(d) shall not apply to such trust as of the first day of the first taxable year beginning after the first taxable year for which it failed to meet the requirements § 1361(d)(3)(B).

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 such 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 pursuant to § 1362(f), agrees to make any 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 termination, the corporation shall be treated as continuing to be an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) provides that the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent.

Section 1.1362-4(d) provides that the Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified by the Commissioner. In the case of a transfer of stock to an ineligible shareholder that causes an inadvertent termination under § 1362(f), the Commissioner may require that ineligible shareholder to be treated as a shareholder of an S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent any loss of revenue due to a transfer of stock to an ineligible shareholder (e.g., a transfer to a nonresident alien).

Based solely on the facts submitted and the representations made, we conclude that X's election to be treated as an S corporation terminated on Date 4. We also conclude that the termination was an inadvertent termination within the meaning of § 1362(f). Accordingly, pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from Date 4, and thereafter, provided X's S corporation election was valid and was not otherwise terminated under § 1362(d). Additionally, from Date 4 and thereafter, the separate share trusts created under the Trust instrument for A and B respectively, will be treated as QSSTs described in § 1361(d)(3) (assuming that they otherwise qualify as QSSTs) and, accordingly, A and B will be treated as shareholders of X. 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 or loss of X, as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368. If X or its shareholders fail to treat themselves as described above, this ruling is null and void.

Except as specifically provided herein, no opinion is expressed or implied as to the federal tax consequences of the facts described above under any other provisions of the Code. In particular, no opinion is expressed as to whether X is otherwise eligible to be an S corporation or whether the separate share trusts for A and B under the Trust instrument are eligible QSSTs under § 1361(d).

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

Pursuant to a power of attorney on file, a copy of this letter is being sent to X's authorized representative.

Sincerely,

James A. Quinn
Senior Technician Reviewer (Acting), Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
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