

Internal Revenue Service

Department of the Treasury

Number: 200201027
Release Date: 1/4/2002
Index Number: 1362.04-00

Washington, DC 20224

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Refer Reply To:

CC:PSI:2 - PLR-130954-01

Date:

October 5, 2001

X =

A =

B =

C =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

D8 =

D9 =

Year 1 =

Trust 1 =

Trust 2 =

Dear :

This letter responds to a letter, dated May 24, 2001, and

subsequent correspondence, submitted by you on behalf of X as its authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated in Year 1. X elected to be an S corporation beginning on D1. As of D1, all of the shares of X were owned by individual shareholders A and B.

On D2, A and B established Trust 1 for the benefit of their child C. A, the president of X, represents that Trust 1 met all of the requirements to elect to be treated as a qualified subchapter S trust (QSST) under § 1361(d)(3). However, C failed to file a timely election for Trust 1 to be treated as a QSST. On D3, A and B transferred shares of X stock to Trust 1. A and B transferred additional shares of X stock to Trust 1 on D4, D5, D6, D7, and D8.

On D9, Trust 1 was merged with Trust 2, which is represented as being a QSST for the benefit of C, for which a timely election was made. All of the shares of X stock owned by Trust 1 are now owned by Trust 2.

A represents that the transfers of X stock to Trust 1 and the subsequent failure to file the QSST election were not motivated by tax avoidance or retroactive tax planning. For all taxable years from D3 to D9, Trust 1's income was reported consistent with Trust 1 being treated as a QSST with C as its beneficiary.

X, and X's shareholders agree to make any adjustments (consistent with the treatment of X as an S corporation) that the Secretary may require.

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 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 § 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), 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) 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 section 1362(d)(2) or (3); (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 conclude that X's S corporation election terminated on D3 when Trust 1, an ineligible S corporation shareholder, acquired X stock. We also conclude that the termination was inadvertent within the meaning of § 1362(f). We further conclude that X's S corporation election would have terminated upon the further transfers of X stock to Trust 1 on D4, D5, D6, D7, and D8.

We further conclude that under the provisions of § 1362(f), X will be treated as continuing to be an S corporation from D3 to D9, and afterwards, provided (1) X's S election was valid and was

not otherwise terminated, (2) Trust 1 satisfied the requirements to be a QSST and C was treated under § 678 as the owner of the portion of Trust 1 consisting of X stock during the period from D3 to D9, and (3) Trust 2 satisfies the requirements to be a QSST.

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, during the period from D3 to D9, 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 and X's other authorized representative.

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

Enclosures: 2
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