

**Internal Revenue Service**

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:  
CC:PSI:B1-PLR-159543-01  
Date:  
April 25 2002

Legend:

X =  
Trust A =  
Trust B =  
Date 1 =  
Year 1 =  
  
:

This responds to the letter dated October 25, 2001, together with subsequent correspondence, submitted on behalf of X requesting relief under section 1362(f) of the Internal Revenue Code.

Facts

You have represented that the facts are as follows: X is a corporation which made an S corporation election effective Date 1. As of Date 1, X had ineligible shareholders, including Trust A and Trust B. The trustee of Trust A had failed to make an ESBT election, effective Date 1, and the beneficiary for Trust B failed to make an election to be treated as a QSST, effective Date 1. Subsequently, X submitted this ruling request for inadvertent invalid election relief under 1362(f).

Since Date 1, all of the shareholders have reported their shares of X's income as though X were an S corporation. X and its shareholders have agreed to make any adjustments that are deemed necessary to be consistent with the treatment of X as an S corporation since Date 1. X represents that there was no intent to knowingly make an invalid S election, and that the failure to file timely ESBT and QSST elections was not motivated by tax avoidance or retroactive tax planning.

X also represents that Trust A complies with the requirements under section

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1361(e), which defines an ESBT. Similarly, X represents that Trust B complies with the requirements under section 1361(d), which defines a QSST.

## LAW AND ANALYSIS

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under section 1362 is in effect.

Section 1361(b)(1)(B) provides that, in order to be a small business corporation, a taxpayer 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)(v) provides that an ESBT (as defined in section 1361(e)) is a permitted S corporation shareholder. Generally, an ESBT is any trust if: (1) the trust does not have as a beneficiary any person other than an individual, an estate, or an organization described in section 170(c)(2), (3), (4), or (5); (2) no interest in the trust was acquired by purchase; and (3) an election to be an ESBT has been filed with respect to the trust.

In Notice 97-12, the Service provided guidance regarding ESBT elections. In particular, the trustee of an ESBT must file the ESBT election within the time requirements prescribed in regulation section 1.1361-1(j)(6)(iii) for filing QSST elections (generally within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust).

Section 1361(d)(1) states that a QSST whose beneficiary makes an election under section 1361(d)(2) will be treated as a trust described in section 1361(c)(2)(A)(i), and the QSST's beneficiary will be treated as the owner (for purposes of section 678(a)) of that portion of the QSST's S corporation stock to which the election under section 1361(d)(2) applies. Under section 1361(d)(2)(A), the beneficiary of a QSST may elect to have section 1361(d) apply. Under section 1361(d)(2)(D), this election will be effective up to 15 days and two months before the date of the election. Section 1361(d)(3) defines a QSST as a trust the terms of which provide: (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) 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; (4) 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 (5) 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.

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Section 1362(f), in relevant part, provides that, if (1) an election under section 1362(a) by any corporation (A) was not effective for the taxable year for which 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, or (B) was terminated under paragraph (2) or (3) of section 1362(d); (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination was inadvertent, (3) no later than a reasonable period of time after discovery of the event 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 of the corporation at any time during the period specified pursuant to section 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 ineffectiveness or termination, the corporation shall be treated as continuing to be an S corporation during the period specified by the Secretary.

The committee reports accompanying the Subchapter S Revision Act of 1982 explain 1362(f) as follows:

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.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24; H.R. Rep. No. 826, 97th Cong., 2d Sess. 12 (1982), 1982-2 C.B. 730, 735.

## CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that X's election to be treated as an S corporation was not valid because not all of the

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shareholders were eligible shareholders. We also conclude that the invalid election constituted an "inadvertent invalid election" within the meaning of section 1362(f). Pursuant to section 1362(f), X will be treated as continuing to be an S corporation from Date 1, and thereafter, provided that the trustee for Trust A files an ESBT election, effective Date 1, and the beneficiary of Trust B files a QSST election, effective Date 1, with the appropriate service center within 60 days of the date of this letter. A copy of this letter should be attached to each election.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed on whether X is otherwise eligible to be an S corporation, whether Trust A is eligible to be ESBT or whether Trust B is eligible to be a QSST.

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 your authorized representative.

Sincerely,

**/s/ David R. Haglund**

David R. Haglund  
Senior Technician Reviewer, Branch 1  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter

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