

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

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CC:PSI:3-PLR-123986-02  
Date:  
September 4, 2002

**LEGEND**

Company =

Trust A =

Trust B =

A =

B =

C =

Date 1 =

Date 2 =

Year 1 =

Year 2 =

Year 3 =

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Dear \_\_\_\_\_ :

This letter responds to a letter dated April 19, 2002, submitted on behalf of Company, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

### **FACTS**

Company elected to be an S corporation effective Date 1, Year 1. On Date 1, Year 1, Trust A and Trust B became shareholders of Company. It is represented that both Trust A and Trust B satisfy the requirements of a Qualified Subchapter S Trust (QSST) under § 1361(d)(2) and that they timely filed QSST elections. A is the income beneficiary of Trust A, and B is the income beneficiary of Trust B. Under each trust's governing instrument, the trustees are not required to distribute annually all of the trust's income (within the meaning of § 643(b)) to each trust's current income beneficiary.

When preparing Company's Year 3 tax returns, Company's new accountants discovered that the trustees had not distributed Trust A's or Trust B's income to A and B, respectively, for the taxable years ending Year 1, Year 2, and Year 3. The trustees were unaware that the failure to distribute all the income of a QSST would result in a termination of Company's S election. Upon discovery of the requirement, the trustees immediately took corrective action by making the required distributions for Year 3 and reporting the distributions on the relevant parties' Year 3 tax returns.

Company and its shareholders, Trust A, Trust B, and C, represent that they have filed their returns for Years 1 through 3 consistent with the treatment of Company as an S corporation. It is further represented that A and B's individual income tax returns for Years 1 through 3 properly included all of their share of the S corporation income that they should have received from Trust A and Trust B, respectively. Because the trusts did not distribute their income in Years 1 and 2, some of the other income of the trusts was not reported by the income beneficiaries in those years. However, it is represented that this income was taxed at the higher trust rate for those tax years. Company and its shareholders agree to make any adjustments consistent with the treatment of Company as an S corporation as may be required by the Secretary.

Company requests that inadvertent termination relief be granted under § 1362(f).

### **LAW AND ANALYSIS**

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 an S corporation cannot 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.

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Section 1361(c)(2)(A)(i) provides that a trust all of which is treated (under subpart E of part I of subchapter J of chapter 1) as owned by an individual who is a citizen or resident of the United States may be a shareholder for purposes of § 1361(b)(1)(B).

Section 1361(d)(1) provides that a QSST whose beneficiary makes an election under § 1361(d)(2) will be treated as a trust described in § 1361(c)(2)(A)(i).

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 the trust as of the first day of the first taxable year beginning after the first taxable year for which the trust failed to meet the requirements of § 1361(d)(3)(B).

Section 1362(a) provides that except as provided in § 1362(g), a small business corporation may elect to be an S corporation.

Section 1362(d)(2)(A) 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.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was terminated under paragraph (2) or (3) of § 1362(d), (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 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 termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

**CONCLUSION**

Based on the facts submitted and the representations made, we conclude that Company's S corporation election terminated on Date 2, Year 2, because the trustees of Trust A and Trust B failed to distribute all of the trusts' income for the taxable year ending Year 1. We also conclude that the termination was inadvertent under § 1362(f). Therefore, under § 1362(f), Company will be treated as continuing to be an S corporation from Date 2, Year 2, and thereafter, provided that Company's S corporation election is valid and is not otherwise terminated under § 1362(d). If Company, Trust A, Trust B, or C fail to treat Company as described above, this ruling will be null and void. Moreover, this ruling is contingent on Company and all of its shareholders treating Company as having been an S corporation for the period Date 2, Year 2, and thereafter, and on Company and its shareholders making any adjustments necessary for the consistent treatment of Company as an S corporation.

Except for the specific ruling above, we express or imply no opinion concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion regarding whether Company is otherwise qualified to be an S corporation, or whether Trust A or Trust B is a valid QSST.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to Company's authorized representative.

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

Sincerely,

/s/

Christine Ellison  
Chief, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

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