

## 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-152312-02**

Date:

**Dec 9 2002**

### Legend:

X =

State =

D1 =

D2 =

T1 =

T2 =

D3 =

Dear :

This responds to the letter dated September 19, 2002 and related correspondence, submitted on behalf of X, requesting relief under §1362(f) of the Internal Revenue Code ("Code") for inadvertent termination of S election.

### **FACTS**

The information submitted discloses that X is a corporation organized under the laws of the State, which elected to be treated as a Subchapter S corporation effective D1. On D2, a portion of X's stock were transferred to T1 and T2. X represents that, as of D2, T1 was not a permitted shareholder of X under §1361(c)(2)(A) of the Code. The income

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beneficiary of T1 did not make a Qualified Subchapter S Trust ("QSST") election for T1 effective D2. Therefore, X's S election terminated as of D2.

X also represents that, as of D2, T2 was a permitted shareholder under §1361(c)(2)(A). However, on D3, T2 became an impermissible shareholder of X upon the resignation of its trustee. The income beneficiary of T2 did not make a QSST election for T2 effective D3. Therefore, X's S election would have terminated again as of D3.

### **LAW AND ANALYSIS**

Section 1361(a)(1) defines an "S corporation", with respect to any taxable year, as a small business corporation for which an S election under §1362(a) is in effect for such year.

Section 1361(b)(1)(B) provides that a small business 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.

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 Subchapter S corporation shareholder.

Section 1361(d)(3) defines the term "qualified Subchapter S trust" as a trust -

(A) 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 beneficiary, the trust shall distribute all its assets to such beneficiary, and

(B) all of the income (within the meaning of §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.

Section 1361(d)(1) states 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), and the QSST's

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beneficiary will be treated as the owner (for purposes of §678(a)) of that portion of the QSST's S corporation stock to which the election under §1362(d)(2) applies.

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 taxable year for which the corporation is an S corporation) the corporation ceases to be a small business corporation. The termination is effective on and after the day of the cessation. §1362(d)(2)(B).

Section 1362(f), in relevant part, provides that, if: (1) an election under §1362(a) by any corporation was terminated under §1362(d); (2) the Secretary determines that the termination was inadvertent; (3) no later than a reasonable period of time after discovery of the event resulting in the termination, steps were taken so that the corporation is once more a small business corporation; 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 any 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 terminating event, 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 consequence of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped that the 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, 97<sup>th</sup> Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24; H.R. Rep. No. 826, 97<sup>th</sup> Cong., 2d Sess. 12 (1982), 1982-2 C.B. 730, 735.

## CONCLUSIONS

Based solely on the facts submitted and the representations made, we conclude that X's Subchapter S election terminated upon the transfer of a portion of its stock to T1 on D2 and would also have terminated upon the resignation of T2's trustee on D3. We also conclude that the terminations constituted "inadvertent terminations" within the meaning of §1362(f).

Further, we conclude that, pursuant to §1362(f), X will be treated as continuing to be an S corporation from D2 and thereafter, assuming X's S corporation election is valid and not otherwise terminated under §1362(d).

In addition, we conclude that the income beneficiary of T1 has until sixty (60) days from the date of this letter to elect to treat T1 a QSST, effective D2, and that the income beneficiary of T2 has until sixty (60) days from the date of this letter to elect to treat T2 a QSST, effective D3. The elections should be made with the appropriate service center. Copies of this letter should be attached to the elections.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X is a valid S corporation or whether T1 and T2 are valid QSSTs.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) 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.

Sincerely,

**/s/ David R. Haglund**

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

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