

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

Number: **200505002**

Release Date: 2/4/05

Index Number: 1362.04-00, 1361.03-02,  
1361.03-00

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Refer Reply To:  
CC:PSI:B01 – PLR-117906-04

Date:  
Oct 28 2004

**Legend:**

X =

State =

D1 =

D2 =

A =

D3 =

Family Trust =

D4 =

Dear :

This responds to the letter dated March 25, 2004, and related correspondence, submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code ("Code") for an 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, one of the original shareholders of X, A, died. On D3, A's estate transferred a portion of A's stock in X to Family Trust, pursuant to the terms of A's will. Under § 1361(c)(2)(A)(iii), Family Trust had been an eligible S corporation shareholder for two years after A's estate transferred the stock to it. At the expiration of the two-year period, on D4, the beneficiary of Family Trust was required to make an election under § 1361(d)(2) to treat Family Trust as a qualified subchapter S trust (QSST). The election was not filed.

### **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 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)(iii) provides, that for purposes of § 1361(b)(1)(B), a trust with respect to stock transferred to it pursuant to the terms of a will may be a shareholder of an S corporation, but only for the two year period beginning on the day on which such stock is transferred to it.

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), thereby, an eligible shareholder of an S corporation, and the QSST's 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 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 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 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); (2) the Secretary determines that the circumstances resulting in the 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 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 this subsection, 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 the termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(d) of the Income Tax Regulations provides, in part, that in the case of a transfer of stock to an ineligible shareholder that causes an inadvertent termination under § 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of an S corporation during the period the ineligible shareholder actually held stock in the corporation.

## **CONCLUSIONS**

Based solely on the facts submitted and the representations made, we conclude that X's S election terminated on D4, upon the expiration of the two-year period following the transfer of stock to Family Trust on D3. We also conclude that the termination constituted an "inadvertent termination" 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 D4 and thereafter, assuming X's S corporation election is valid and not otherwise terminated under § 1362(d).

In addition, we conclude that the beneficiary of Family Trust has until sixty (60) days from the date of this letter to elect to treat Family Trust as a QSST, effective D4. The election should be made with the appropriate service center. Copies of this letter should be attached to the election.

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 Family Trust is a valid QSST.

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 your authorized representative.

Sincerely,

/s/ Dan Carmody

Dan Carmody  
Senior Counsel  
Branch 1  
Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter  
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cc: