



D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

Year 1 =

m =

n =

o =

Dear :

This letter responds to your letter dated January 27, 2006, and subsequent correspondence, submitted on behalf of X, requesting a ruling under §1362(f) of the Internal Revenue Code.

#### Facts

X was incorporated under the laws of State on D1. X elected to be an S corporation effective D2. On D3, A transferred m shares of X stock to Trust, a grantor trust that was treated (under subpart E of part I of subchapter J of chapter 1) as entirely owned by A. Trust was an eligible shareholder under §1361(c)(2)(A)(i). On D4, A died, causing Trust to cease being a grantor trust. Under §1361(c)(2)(A)(ii), Trust remained an eligible shareholder until D5, two years after A's death. Trust did not distribute the shares of X stock on or before D5. Accordingly, Trust ceased to be an eligible shareholder on D6.

The terms of the Trust agreement provide that upon the death of A, the assets of Trust were to be held in Trust1 and Trust2. It was intended that Trust1 and Trust2 qualify as qualified subchapter S trusts (QSSTs) under §1361(d)(3). Due to an oversight, shares of X stock were not transferred to Trust1 and Trust2 until D7. On D7, Trust transferred n shares of X stock to Trust1 and o shares of X stock to Trust2.

Additionally, B, the beneficiary of Trust1 and Trust2, failed to file QSST elections for Trust1 and Trust2.

X represents that there was no tax avoidance or retroactive tax planning involved in the failure of Trust to distribute the m shares of X stock to an eligible shareholder on or before D5 and in the failure of Trust1 and Trust2 to file QSST elections. It is represented that X and its Shareholders have treated X as an S corporation since D2. In addition, X and the Shareholders agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary.

### Law and Analysis

Section 1361(a)(1) provides that the term “S corporation” means, with respect to any taxable year, a small business corporation for which an election under §1362(a) is in effect for such year.

Section 1361(b)(1)(B) provides that the term “small business corporation” means a domestic corporation that is not an ineligible corporation and that does not, among other requirements, 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, for purposes of §1361(b)(1)(B), 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.

Section 1361(c)(2)(A)(ii) provides that for purposes of §1361(b)(1)(B), a trust which was described in §1361(c)(2)(A)(i) immediately before the death of the deemed owner and which continues in existence after such death, is a permitted shareholder, but only for the 2-year period beginning on the day of the deemed owner’s death.

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), the trust is 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 may elect to have §1361(d)(1) apply.

Section 1361(d)(3) provides that for purposes of §1361(d), the term “qualified subchapter S trust” means a trust (A) the terms of which require that (i) during the life of the current income beneficiary, there shall only be 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 income beneficiary, the trust shall distribute all of its assets to such beneficiary, and (B) all 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 1.1361-1(j)(6)(ii) of the Income Tax Regulations provides that the current income beneficiary of a QSST must make the election under §1361(d)(2) by signing and filing with the service center with which the corporation files its income tax returns the applicable form or a statement including the information listed in §1.1361-1(j)(6)(ii).

Section 1362(d)(2)(A) provides that an election under §1362(a) is terminated whenever (at any time on or after the 1<sup>st</sup> day of the 1<sup>st</sup> taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation. Section 1362(d)(2)(B) provides that any termination under §1362(d)(2)(A) 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 §1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in termination, steps were taken so that the corporation for which the termination occurred is a small business corporation; and (4) the corporation for which the termination occurred, and each person who was a shareholder of the corporation at any time during the period specified pursuant to §1362(f), agree to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to this period, then, notwithstanding the circumstances resulting in termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) provides that for purposes of §1.1362-4(a), the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent.

#### Conclusion

Based solely on the facts submitted and representations made, we conclude that X's S corporation election was terminated on D6 when Trust became an ineligible shareholder. We also conclude that the termination was inadvertent within the meaning of §1362(f). Consequently, we conclude that X will continue to be treated as an S corporation from D6 and thereafter, provided that X's S corporation election was valid and was not otherwise terminated under §1362(d).

This ruling is contingent on Trust1 and Trust2 making QSST elections, with an effective date of D7, with the appropriate service center within 60 days from the date of this letter and attaching a copy of this letter to the elections. In addition, from Year 1, and thereafter, Trust1 and Trust2 will be treated as QSSTs holding n shares of X stock and o shares of X stock, respectively, and B will be treated as the owner of the X stock deemed held by Trust1 and Trust2. Accordingly, X's shareholders, in determining their respective income tax liabilities, must include their pro rata share of the separately stated and non-separately computed items of X under §1366, make any adjustments to stock basis under §1367, and take into account any distributions made by X under §1368.

Except for the specific ruling above, no opinion is expressed or implied concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed or implied on whether X is otherwise eligible to be an S corporation, or on whether Trust1 and Trust2 qualify as QSSTs.

Under a power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

This ruling is directed only to the taxpayer who requested it. According to §6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

/s/

Mary Beth Collins  
Senior Technician Reviewer, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures (2):

Copy of this letter

Copy for §6110 purposes

cc: