

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
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June 27, 2008

Legend

X =

Trust1 =

Trust2 =

Trust3 =

A =

B =

State1 =

State2 =

Date1 =

Date2 =

Date3 =

Date4 =

Date5 =

a =

b =

Dear _____ :

This responds to a letter dated July 26, 2007, and subsequent correspondence, submitted on behalf of X by X's authorized representative, requesting a ruling under §1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated under the laws of State1 on Date1, and elected to be an S corporation effective Date2. As of Date2, A and B, husband and wife, owned a shares of X as community property under the laws of State2. On or about Date3, A and B established Trust1, with A and B serving as co-trustees. A and B contributed the a shares of X stock to Trust1. On Date4, B died. The trust agreement for Trust1 provided that, upon the death of either A or B, Trust1 would be divided into Trust2 (the survivor's trust) and Trust3 (the decedent's trust), and directed the trustee to transfer the assets of Trust1 to Trust2 and Trust3 in the manner specified in the trust agreement.

Article 2, Section 7, of the trust agreement for Trust1 provides that Trust2 will include (1) the separate property of the surviving settlor, (2) other community property assets of Trust1 selected by the trustee equal in value to the surviving settlor's interest in the community property of the settlors included in or added to Trust1 in any manner, and (3) other assets of Trust1 selected by the trustee to the minimum extent necessary to reduce the dollar value of the estate of the deceased settlor to an amount upon which no federal estate tax would be due.

Article 2, Section 8, of the trust agreement provides, that Trust3 shall consist of the balance of the assets of Trust1 after the assets have been selected for Trust2 plus any amount disclaimed on behalf of the surviving settlor.

Article 2, Section 10, of the trust agreement provides, in part, that it is expressly contemplated that the interest of each settlor in any jointly owned or community property

in Trust1 is an interest in the property as an entity. Accordingly, the trustee is authorized, on any distribution or allocation of the property of Trust1, to partition, allot and distribute the trust estate, pro rata or otherwise, in kind, including undivided interests in such property or any part of it, or partly in cash and partly in kind, or entirely in cash, in the trustee's absolute and sole discretion.

Pursuant to these instructions, the trustee of Trust1 transferred b shares of X to Trust3 on Date5, and the remaining shares of X held by Trust1 were to be transferred to Trust2.

X represents that Trust1 was a trust described in § 1361(c)(2)(A)(i), and therefore was an eligible S corporation shareholder. X represents that Trust2 is a trust described in § 1361(c)(2)(A)(i) and is therefore an eligible S corporation shareholder. X also represents that Trust3 meets the requirements to be treated as a qualified subchapter S trust (QSST) as described in § 1361(d), except that A failed to make the election under § 1361(d)(2). Therefore, Trust3 was not an eligible S corporation shareholder on Date5 and, as a result of the transfer of X stock from Trust1 to Trust3 on Date5, X's S corporation election terminated on Date5.

X represents that X and X's shareholders have filed tax returns consistent with X being an S corporation. X also represents that all of the income with respect to the stock of X held by Trust3 has been consistently reported by A on his individual federal tax returns as if the QSST election for Trust3 had been in effect since Date5. X further represents that the circumstances resulting in the termination of X's S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning. X and each person who was or is a shareholder of X at any time since Date5 agree to make any adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary with respect to such period.

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 a "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not 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 an S corporation shareholder. Section 1361(c)(2)(B)(i) provides that for purposes of § 1361(b)(1), in the case of a trust described in § 1361(c)(2)(A)(i), the deemed owner shall be treated as the shareholder.

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), such trust shall be 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 1362(d)(2)(A) provides that a beneficiary of a QSST (or his legal representative) may elect to have § 1361(d) apply. Section 1361(d)(2)(D) provides that an election under § 1362(d)(2) shall be effective up to 15 days and 2 months before the date of the election.

Section 1.1361-1(j)(6)(ii) of the Income Tax Regulations provides that the current income beneficiary of the trust must make the QSST election under § 1361(d)(2) by signing and filing with the service center with which the corporation files its income tax return the applicable form or statement including the information listed in § 1.1361-1(j)(6)(ii).

Section 1361(d)(3) provides that 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 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 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 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 1362(a)(1) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1362(d)(2) 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 the corporation is an S corporation) such corporation ceases to be a small business corporation. A termination of an S corporation election under § 1362(d)(2) is effective on or 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 such 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 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 under § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary for that 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.

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election terminated on Date5 resulting from the failure of A, as the beneficiary of Trust3, to make the election under § 1361(d)(2).

We further conclude that the termination was inadvertent within the meaning of § 1362(f). In addition, we conclude that, pursuant to the provisions of § 1362(f), X will be treated as an S corporation from Date5 and thereafter, provided that Trust3 qualifies as a QSST and X's election to be an S corporation was otherwise valid and was not terminated under § 1362(d) for other reasons. Accordingly, the shareholders of X must include in income their pro rata share of the separately stated and nonseparately computed items of X as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368. For this purpose, A, as the current income beneficiary of Trust3, shall be treated as the shareholder of X with respect to the stock of X held by Trust3, beginning Date5. If X or its shareholders fail to treat X as described above, this letter ruling shall be null and void.

This ruling is conditioned on A filing a QSST election under § 1361(d)(2) with respect to Trust3, effective Date5, with the appropriate service center within 60 days from the date of this letter. A copy of this letter should be attached to the QSST election.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code, including whether X was or is a small business corporation under § 1361(b), whether Trust1 was a trust described in § 1361(c)(2)(A)(i), whether Trust2 is a trust described in § 1361(c)(2)(A)(i), or whether Trust3 is a QSST within the meaning of § 1361(d)(3). In addition, no opinion is expressed regarding the valuation of the assets includible in B's gross estate, or whether Trust3 was properly funded with b shares of X stock based on the terms of the trust agreement for Trust1.

This ruling is directed only to the taxpayer who requested 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 X's authorized representative.

Sincerely,

J. Thomas Hines
Chief, Branch 2
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

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

cc: