

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:
 , ID No.

Telephone Number:

Refer Reply To:
CC:PSI:01
PLR-115103-16
Date:
November 04, 2016

Legend

- Company =

- State =
- Date 1 =
- Date 2 =
- Date 3 =
- Date 4 =
- Date 5 =
- Date 6 =
- A =
- B =

- Trust 1 =
- Trust 2 =

- Trust 3 =

- Period =

Dear :

This letter responds to a letter received by our office, dated May 6, 2016, submitted on behalf of Company by its authorized representatives, requesting rulings related to its S elections under § 1362(f) of the Internal Revenue Code.

FACTS

Company represents that it was incorporated on Date 1 under the laws of State and elected to be treated as an S corporation effective Date 2. On Date 2, A and B owned all of the outstanding shares of Company. On Date 3, A and B transferred shares of Company stock to Trust 1; a revocable trust treated as a wholly-owned grantor trust under §§ 671 and 676.

On Date 4, A died and Trust 1 ceased to be a grantor trust with respect to A's interests, but continued to qualify as an eligible S corporation shareholder under § 1361(c)(2)(A)(ii) for the two year period beginning on the date of A's death. Following A's death, Trust 1 continued to be a grantor trust with respect to B's interest

Effective Date 5, A's shares of Company stock were transferred to Trust 2 and Trust 3. Company represents that Trust 2 and Trust 3 intended to be qualified subchapter S trusts (QSSTs) described in § 1361(d)(3)(A) as of Date 5 and thereafter. However, B, the income beneficiary, failed to make QSST elections within the meaning of § 1361(d)(2), thereby causing Company's S corporation election to terminate on Date 5.

Company represents that the trustee of Trust 2 and Trust 3 failed to distribute currently all of its income to B. On Date 6, Trust 3 distributed all of its undistributed income to B. Company represents the trustee of Trust 2 plans to take remedial steps to distribute all undistributed income to B. Had Company's S corporation election not terminated on Date 5, the failure of the trust to distribute all of its income currently to the income beneficiaries would have terminated Company's S corporation election

Further, Company learned that the distributions it made for Period were not consistent with its governing instruments and could be construed as creating a second class of stock, and thus, could potentially have terminated its S corporation election effective beginning Period.

Company represents that each share of Company stock has identical rights to liquidation proceeds and distributions under its governing documents and no provisions exist in its articles of incorporation, by-laws, or other agreement that varies these rights. Neither Company nor its shareholders knew that disproportionate distributions could potentially terminate Company's S corporation election.

Company represents that it has taken remedial steps to make corrective distributions to its shareholders to eliminate the cumulative amount of the disproportionate distributions made from Company to its shareholders. Company further represents that the disproportionate distributions were inadvertent and Company always intended to be an S corporation.

Company and its shareholders represent that at all times they intended Company be an S corporation. Company represents that Company and its shareholders have

filed their federal income tax returns consistent with having a valid S corporation election in effect for Company. Company and its shareholders have agreed to make such adjustments (consistent with the treatment of Company as an S corporation) as may be required by the Secretary.

LAW

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

Section 1361(b)(1) provides that the term “small business corporation” means a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (B) have as a shareholder a person other than an estate, a trust described in § 1361(c)(3), or an organization described in § 1361(c)(6) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1362(b)(5) provides that if (A) an election under § 1362(a) is made for any taxable year (determined without regard to § 1362(b)(3)), after the date prescribed by § 1362(b) for making such election for such taxable year or no such election is made for any taxable year, and (B) the Secretary determines that there was reasonable cause for the failure to timely make the election, the Secretary may treat such an election as timely made for the taxable year (and § 1362(b)(3) shall not apply).

Section 1361(d)(1) provides that a QSST whose beneficiary makes an election under § 1362(d)(2) will be treated as a trust described in § 1361(c)(2)(A)(i), 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. Under § 1361(d)(2)(A), a beneficiary of a QSST may elect to have § 1361(d) apply. Under § 1361(d)(2)(D), this election will be effective up to 15 days and two months before the date of the election.

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 (with 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)(3) provides that for purposes of § 1361(c) and § 1361(d), a substantially separate and independent share of a trust, within the meaning of § 663(c) and the regulations thereunder is treated as a separate trust. For a separate share which holds S corporation stock to qualify as a QSST, the terms of the trust applicable to that separate share must meet the QSST requirements stated in § 1.1361-1(j)(1)(i) and (ii).

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

Section 1362(a) provides, in part, that 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 1st day of the 1st taxable year for which the corporation is an S corporation such corporation ceases to be a small business corporation.

Section 1362(f) provides, in part, that if (1) an election under § 1362(a) by any corporation was not effective for the taxable year for which made (determined without regard to § 1362(b)(2)) by reason of a failure to meet the requirements of § 1361(b), (2) the Secretary determines that the circumstances resulting in such ineffectiveness were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness, steps were taken so that the corporation for which the election was made is a small business corporation, and (4) the corporation for which the election was made, and each person who was a shareholder in the corporation at any time during the period specified pursuant to § 1362(f), agrees to make 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 ineffectiveness, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that a corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in § 1.1361-1(l)(4)(relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

Section 1.1361-1(l)(2)(i) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds. Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Section 1.1361-1(l)(3) provides that, except as provided in §§ 1.1361(b)(3), (4), and (5) (relating to restricted stock, deferred compensation plans, and straight debt), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account.

CONCLUSION

Based solely on the facts submitted and representations made, we conclude that Company's S corporation election terminated beginning on Date 5, when the stock in Company was transferred to Trust 2 and Trust 3 because B failed to timely file the required QSST elections under § 1361(d)(2). Had Company's S corporation election not already terminated, we conclude that the failure of Trust 2 and Trust 3 to distribute all of its income as required by § 1361(d)(3) would have caused Company's S corporation election to terminate. We further conclude that these terminating events were inadvertent within the meaning of § 1362(f).

This relief is contingent upon the income beneficiaries of Trust 2 and Trust 3 filing a QSST election for Trust 2 and Trust 3 effective Date 5 within 120 days from the date of this letter. A copy of this letter should be attached to the election. In addition, Trust 2 must, within 120 days of the date of this letter, distribute to B all income required to be distributed under § 1361(d)(3) not previously distributed.

Had Company's S corporation election not already terminated, we further conclude that, if distributions made by Company to its shareholders that failed to comply with its operating documents caused Company's S corporation election to terminate, the termination was inadvertent within the meaning of § 1362(f). Therefore, Company will be treated as an S corporation effective the beginning of Period and thereafter, provided Company's S corporation election is not otherwise terminated under § 1362(d). The shareholders of Company must include their pro rata shares of the separately stated and nonseparately computed items of income or loss of Company as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account

any distributions made by Company as provided in § 1368. The failure to take the action described above shall cause this ruling to be null and void.

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion regarding whether Company is otherwise eligible to be an S corporation or whether Trust 2 or Trust 3 meet the requirements of a QSST.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the ruling request, it is subject to verification on examination.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to Company's authorized representatives.

Sincerely,

Faith P. Colson

Faith P. Colson
Senior Counsel, Branch 1
(Passthroughs & Special Industries)

Enclosures (2)
Copy of Letter
Copy for § 6110 purposes