

FACTS

The information submitted states that X was incorporated under the laws of State on Date 1 and wholly owns Y, a State Corporation. X filed Form 2553, Election by a Small Business Corporation, to elect to be an S corporation, effective Date 2, and also filed Form 8869, Qualified Subchapter S Subsidiary Election, to elect to treat Y as a qualified subchapter S subsidiary (QSub), effective Date 2. On Date 2, Trust owned shares of X stock. X represents that Trust satisfied the qualified subchapter S trust (QSST) requirements under § 1361(d)(3). However, the income beneficiary of Trust, A, failed to make an election under § 1361(d)(2) to treat Trust as a QSST effective Date 2. Therefore, Trust was an ineligible S corporation shareholder. Consequently, X's S corporation election and its election to treat Y as a QSub were invalid.

X represents that it and its shareholders have filed tax returns consistent with X being an S corporation and Y being a QSub since Date 2. Moreover, X represents that the failure to file a QSST election for Trust was inadvertent and that A reported Trust's share of X's income (or loss) consistent with the treatment of Trust as a QSST on all affected returns. Finally, X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation and Y as a QSub as may be required by the Secretary.

LAW

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 which is not an ineligible corporation and which 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(b)(3)(A) provides that a QSub shall not be treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation.

Section 1361(b)(3)(B) defines a QSub as a domestic corporation which is not an ineligible corporation, if 100 percent of the stock of the corporation is owned by the S corporation, and the S corporation elects to treat the corporation as a QSub.

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 of

an S corporation.

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) apply.

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 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 of the income (within the meaning of section 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 the trust must make the election under § 1361(d)(2) by signing and filing, with the service center with which the S corporation files its income tax return, the applicable form or a statement including the information listed in § 1.1361-1(j)(6)(ii).

Section 1.1361-1(j)(7)(i) provides that the income beneficiary who makes the QSST election and is treated (for purposes of § 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of §§ 1361(b)(1), 1366, 1367, and 1368.

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 (A) in general, 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, and (B) any termination under § 1362(d)(2) shall be effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under § 1362(a) or § 1361(b)(3)(B)(ii) by any corporation (i) 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) or to obtain shareholder consents, or (ii) was terminated under § 1362(d)(2) or (3) or § 1361(b)(3)(C); (2) the Secretary determines that the

circumstances resulting in such ineffectiveness or termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken so that the corporation for which the election was made or the termination occurred is a small business corporation or a QSub, as the case may be, or to acquire the required shareholder consents; and (4) the corporation for which the election was made or 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 or a QSub, as the case may be) as may be required by the Secretary with respect to this period, then, notwithstanding the circumstances resulting in such ineffectiveness or termination, the corporation shall be treated as an S corporation or a QSub, as the case may be, during the period specified by the Secretary.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election and its QSub election for Y were ineffective on Date 2 because A failed file a QSST election for Trust. We further conclude that the circumstances resulting X's ineffective S corporation election and its ineffective QSub election for Y were inadvertent within the meaning of § 1362(f). Consequently, under § 1362(f), we rule that X will be treated as an S corporation from Date 2 and thereafter, provided that X's S corporation election was otherwise valid and is not otherwise terminated under § 1362(d). Furthermore, under § 1362(f), we rule that Y will be treated as a QSub from Date 2 and thereafter, provided that X's QSub election for Y was otherwise valid and is not otherwise terminated.

These rulings are contingent on the estate of A filing, on behalf of A, a QSST election for Trust, effective Date 2, with the appropriate service center within 120 days from the date of this letter. A copy of this letter should be attached to the QSST election.

Except as specifically ruled above, we express or imply no opinion as to the federal income tax consequences of the facts described above under any other provision of the Code, including X's eligibility to be an S corporation or Y's eligibility to be a QSub. In addition, we express or imply no opinion on whether Trust is a valid QSST.

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.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, we are sending a copy of this letter to X's authorized representatives.

Sincerely,

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

Enclosure:

Copy for § 6110 purposes

cc: