

INTERNAL REVENUE SERVICE
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November 25, 1998

Re:

Legend:

X:

Trust 1:

EIN:

Trust 2:

EIN:

Trust 3:

EIN:

Trust 4:

Trust 5:

Trust 6:

Trust 7:

QSST 1:

TIN:

QSST 2:

TIN:

QSST 3:

TIN:

QSST 4:

TIN:

QSST 5:

TIN:

QSST 6:

TIN:

QSST 7:

TIN:

QSST 8:

TIN:

QSST 9:

TIN:

TIN:

QSST 11:

TIN:

QSST 12:

TIN:

QSST 13:

TIN:

QSST 14:

TIN:

QSST 15:

TIN:

QSST 16 :

TIN:

QSST 17 :

TIN:

QSST 18 :

TIN:

QSST 19 :

TIN:

QSST 20 :

TIN:

QSST 21 :

TIN:

A:

SSN:

B:

SSN:

C:

SSN:

D:

SSN:

E:

SSN:

a: 3

date 1:

date 2:

date 3:

date 4:

Dear _____ :

We received your representative's letter, dated _____, submitted on X's behalf, requesting a ruling under § 1362(f) of the Internal Revenue Code. This letter responds to that request.

The represented facts are as follows: X is a corporation that elected to be treated as an S corporation under § 1362 effective for its taxable year beginning date 1. One of X's shareholders was Trust 1. X's law firm erroneously concluded that Trust 1 could be treated as a separate qualified subchapter S trusts (QSST). On date 3, X's law firm discovered this error while reviewing the electing small business trusts' (ESBT) elections made by some of X's trust shareholders to determine if those shareholders that had elected to be ESBTs could qualify as QSSTs.

X's law firm determined that the a separate shares of Trust 1 could not qualify as separate QSSTs because the will that created Trust 1 provided that the trustees may pay unto or expend for the benefit of a single beneficiary, such part of the principal of his and/or their respective share or shares as the trustees may deem necessary notwithstanding the right of any other beneficiary. This provision fails the QSST requirement in § 1361(d)(3)(A)(ii) that any corpus distributed during the life of the current income beneficiary may be distributed only to the beneficiary. X now requests an extension of time for Trust 1 to make an ESBT election under § 1361(e) and Notice 97-12, 1997-3 I.R.B. 11, and an extension of time to file Trust 1's shareholder consent to X's S corporation election to be effective date 1.

Trust 2 and Trust 3 received shares of X on date 2 and filed ESBT elections the next day. The elections were each defective because the elections failed to list all current potential income beneficiaries. X has filed this request to ask for permission for Trust 2 and Trust 3 to file corrected ESBT elections and shareholder consents to X's S corporation election to be effective date 1.

Additionally, X's law firm erroneously concluded that four trust shareholders, Trust 4, Trust 5, Trust 6 and Trust 7, could not qualify as QSSTs and therefore had to be ESBTs in order to be qualified S corporation shareholders. X's law firm determined during the review of corporate shareholders on date 3 that the four trusts could qualify as 21 QSSTs. The beneficiaries of the

21 QSSTs, QSST 1, QSST 2, QSST 3, QSST 4, QSST 5, QSST 6, QSST 7, QSST 8, QSST 9, QSST 10, QSST 11, QSST 12, QSST 13, QSST 14, QSST 15, QSST 16, QSST 17, QSST 18, QSST 19, QSST 20 and QSST 21, and the trustees of the four trust shareholders filed statements on date 4 to convert from ESBTs to QSSTs pursuant to Rev. Proc. 98-23, 1998-10 I.R.B. 30. X then filed this request to obtain an extension of time to file the QSSTs' shareholder consents to X's S corporation election beginning date 1.

After X's election on date 1 to become an S corporation, X added 5 new shareholders. These shareholders, A, B, C, D and E, have also filed consents to X's S corporation election.

It has been represented that the terminating events were inadvertent and that the termination was not the result of retroactive tax planning or motivated by tax avoidance. X's management is not knowledgeable in technical tax matters and relied solely on the law firm with regard to all tax issues, including the preparation of X's tax returns. X and its trust shareholders took steps to seek relief immediately after their discovery of the termination of the S corporation status.

Section 1361(a)(1) provides that, for purposes of the Code, 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 the year.

For taxable years beginning after December 31, 1996, § 1361(b)(1) defines a "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not (A) have more than a certain number of shareholders, (B) have as a shareholder a person (other than an estate and other than a trust described in § 1361(c)(2)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1361(c)(2)(A)(i) provides that, for purposes of § 1361(b)(1)(B), a trust all of which is treated (under §§ 671-679 as owned by an individual who is a citizen or resident of the United States may be a shareholder. Section 1361(c)(2)(A)(v) provides that, for purposes of § 1361(b)(1)(B), an ESBT 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), (A) the trust shall be treated as a trust described in § 1361(c)(2)(A)(i), and (B) for purposes of § 678(a), the beneficiary of the trust shall be treated as the owner of that portion of the trust that 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 the beneficiary of a QSST (or his legal representative) may elect to have § 1361(d) apply. Section 1361(d)(2)(D) provides that this election will be effective up to 15 days and 2 months before the date of the election.

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 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 that beneficiary, (iii) the income interest of the current income 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 (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. A substantially separate and independent share of a trust within the meaning of 663(c) shall be treated as a separate trust for purposes of § 1361(c) and (d).

Section 1361(e)(1)(A) provides that the term "electing small business trust" means a trust that (i) does not have as a beneficiary any person other than an individual, an estate, or an organization described in § 170(c)(2) through (5), (ii) has no beneficiary that acquired the trust interest by purchase, and (iii) elects to be an electing small business trust.

Section 1361(e)(1)(B) provides that the term "electing small business trust" shall not include (i) any QSST (as defined in § 1361(d)(3)) if an election under § 1361(d)(2) applies to any corporation the stock of which is held by such trust; (ii) any trust exempt from tax under Subtitle A; and (iii) any charitable remainder annuity trust or charitable remainder unitrust (as defined in § 664(d)).

Notice 97-12, 1997-3 I.R.B. 11, provides that the trustee of an ESBT must make the election by signing and filing with the service center with which the corporation files its income tax return, a statement that (1) contains the names, addresses, and taxpayer identification numbers of all potential current beneficiaries, the trust, and the corporation; (2) identifies the election as an election made under § 1361(e)(3); (3) specifies the date on which the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed); (4) specifies the date on which the stock of the corporation was transferred to the trust; and (5) provides all information and representations necessary to show (A) that

all potential current beneficiaries meet the shareholder requirements of § 1361(b)(1), and (B) that the trust meets the definitional requirements of an ESBT under section 1361(e).

Section 1362(d)(2)(A) provides that an election under § 1362(a) will be terminated whenever (at any time on or after the first day of the first tax year for which the corporation is an S corporation) the corporation ceases to be a small business corporation. Section 1362(d)(2)(B) provides that any termination under § 1362(d)(2)(A) will be effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was not effective for the taxable year for which made by reason of a failure to meet the requirements of § 1361(b) or to obtain the shareholder consents, (2) the Secretary determines that the circumstances resulting in the ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were taken so that the corporation is a small business corporation or to acquire the required shareholder consents, and (4) the corporation and each person who was a shareholder in the corporation at any time during the period specified pursuant to § 1362(f) agrees to make any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to the period, then, notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation is treated as an S corporation during the period specified by the Secretary.

With respect to § 1362(f), the committee reports accompanying the Subchapter S Revision Act of 1982 state the following:

If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.

The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped that taxpayers and the government will work out agreements that protect the revenue without undue hardship to taxpayers. . . . It is expected that the waiver may be made retroactive for all years, or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24; H.R. Rep. No. 826, 97th Cong., 2d Sess. 12 (1982), 1982-2 C.B. 730, 735.

X represents that all of its shareholders from date 1 to the present intended that X be an S corporation from date 1 and thereafter and have filed consents to X's S corporation election. X also represents that the status of the shareholders is correct and the status of the shareholders who are trusts has been correctly elected. X further represents that the corporation and its shareholders filed tax returns and reported to shareholders in a manner consistent with treatment of X as an S corporation.

Based solely on the facts submitted and the representations made, we conclude that the termination of X's subchapter S corporation election, which resulted from the transfers described above, was an "inadvertent termination" within the meaning of § 1362(f). X will be treated as an S corporation from date 1 and thereafter provided within 60 days from the date of this letter: Trust 1, Trust 2 and Trust 3 file correct ESBT elections with the appropriate service center pursuant to § 1361(e) and Notice 97-12 with an effective date of date 1; and all of the shareholders of X must have filed shareholder consents to X's S corporation election with the service center within 60 days of the date of this letter. A copy of this letter should be attached to the ESBT elections and shareholder consents filed with the service center. This ruling shall be null and void if the requirements of this paragraph are not met.

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the above-described facts under any other provision of the Code. Specifically, no opinion is expressed on whether the election made by X to be treated as an S corporation was a valid election under § 1362, whether Trust 1, Trust 2, or Trust 3 are ESBTs, or whether Trust 4, Trust 5, Trust 6, and Trust 7 qualify as 21

QSSTs withing the meaning of § 1361(d)(3). or whether X's current shareholders are valid S corporation shareholders.

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.

Sincerely yours,

Joseph H. Makurath
Senior Technician Reviewer,
Branch 7
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)