

## Internal Revenue Service

Department of the Treasury

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Person to Contact:

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April 6, 1999

### Legend:

Company =

Year =

Date 1 =

Date 2 =

State =

Trust 1 =

Trust 2 =

Trust 3 =

Shareholders =

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Dear

This responds to a letter dated July 9, 1998, and subsequent correspondence, written on behalf of Company, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

#### **FACTS**

According to the information submitted, Company was incorporated in Year, and elected on Date 1 to be an S corporation as defined by § 1361(a)(1). On Date 2, Trust 1, Trust 2 and Trust 3 (the Trusts) were formed. The agreement for each Trust (referred to collectively as the "Trust Agreements") created separate shares within the meaning of § 663(c) for the respective beneficiaries (Separate Share Trusts). Each Separate Share Trust was funded with shares of Company's stock. Each Separate Share Trust was intended to satisfy the requirements of a qualified subchapter S Trust (QSST) as described in § 1361(d)(3). To accomplish this, the Trust Agreements each contained terms in apparent satisfaction of the requirements of § 1362(d)(3)(A)(i)

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through (iv). The beneficiary of each Separate Share Trust also filed the election required by § 1361(d)(2) effective for Date 2. However, another provision of each Trust Agreement allowed for the possibility of the distribution of both trust income and corpus to beneficiaries other than the current income beneficiary of each Separate Share Trust. This possibility prevented the Separate Share Trusts from satisfying the requirements of § 1361(d)(3)(A)(i) and (ii).

Nonetheless, each Separate Share Trust has been administered at all times in a manner consistent with the requirements of a QSST under § 1361(d)(3). Each Separate Share Trust has had only one current income beneficiary. Furthermore, counsel for the Company has prepared, and the interested parties have consented to file, petitions seeking reformation of the Trust Agreements with the appropriate State court. As reformed, the Trust Agreements will not permit the respective trustees to make distributions of income or principal to any person other than the current income beneficiary of each Separate Share Trust consistent with the requirements of § 1361(d)(3)(A)(i) and (ii). Additionally, while all income has been distributed currently to the appropriate beneficiaries, the Trust Agreements as reformed will explicitly require the current distribution of all income.

Company did not know that the transfers to the Trusts terminated its S corporation status and the termination was not motivated by tax avoidance or retroactive tax planning. The shareholders of Company during the termination period and Company agree to make any adjustments required by the Secretary consistent with the treatment of Company as an S corporation.

### **LAW AND ANALYSIS**

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

As of Date 2, § 1361(b) defined the term "small business corporation" to mean a domestic corporation that is not an ineligible corporation and that does not (A) have more than 35 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. Under § 1361(d), a QSST (defined in § 1361(d)(3)) may be treated as an eligible shareholder described in § 1361(c)(2)(A)(i).

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 the beneficiary; (iii) the income interest of the current income beneficiary in the trust

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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 the 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. In this case, the conflicting provisions of the Trusts allowed for the remote possibility of income and corpus distribution to a beneficiary other than the current income beneficiary. Thus, the Trust Agreements did not satisfy the requirements of § 1361(d)(3). See Rev. Rul. 93-31, 1993-1 C.B. 186, and Rev. Rul. 89-45, 1989-1 C.B. 267.

Under § 663(c) and § 1.663(c)-1(a) of the Income Tax Regulations, if a single trust has more than one beneficiary, and if different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts for certain purposes. Section 1.663(c)-3 provides that the applicability of the separate share rule provided by § 663 will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate shares had been created. Under § 1361(d)(3), 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 1362(d)(2)(A) provides that an election under § 1362(a) terminates 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. The Trusts were not trusts described in § 1361(c)(2) when Company's stock was transferred to the Trusts on Date 2. Therefore, Company's status as an S corporation terminated on Date 2.

Section 1362(f) provides, in part, that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2); (2) the Secretary determines that the circumstances resulting in the 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 pursuant to § 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 the termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

## **CONCLUSION**

After applying the relevant law to the facts submitted and the representations made, we rule that the termination of Company's subchapter S corporation election, as

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described above, was an inadvertent termination within the meaning of § 1362(f). Under the provisions of § 1362(f), Company will be treated as continuing to be an S corporation from Date 2 and thereafter, assuming Company's S corporation election was valid and was not otherwise terminated under § 1362(d). This ruling is contingent upon the successful reformation of the Trust Agreements in accordance with the representations made.

We further rule that in any year in which the beneficiary of a Separate Share Trust, as reformed, elects to have the trustee retain all or any portion of the income (within the meaning of § 643(b)) of such Separate Share Trust, the election by the beneficiary will not change the status of the Separate Share Trust as a QSST.

Except as specifically set forth above, we express no opinion concerning the federal tax consequences of the foregoing facts. Specifically, we express no opinion on whether (1) Company otherwise qualifies as an S corporation or (2) the election to treat Company as an S corporation was effective.

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

Sincerely yours,

Jeff Erickson  
Assistant to the Branch Chief,  
Branch 3  
Office of the Assistant Chief  
Counsel  
(Passthroughs and Special  
Industries)

Enclosures (2):

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