

**Internal Revenue Service**

Department of the Treasury

Index Number: 1362.04-00

Washington, DC 20224

Number: **199931020**  
Release Date: 8/6/1999

Person to Contact:

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Refer Reply To:  
PLR-100498-99 CC:DOM:P&SI:3  
Date:  
May 6, 1999

LEGEND

Company =

State =

d1 =

d2 =

d3 =

d4 =

d5 =

Shareholder 1 =

Shareholder 2 =

Trust 1 =

Trust 2 =

Beneficiary 1 =

Beneficiary 2 =

y =

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Z =

Other Shareholders =

Dear

This letter responds to a letter dated December 30, 1998, and subsequent correspondence by your authorized representative on behalf of Company, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, Company was incorporated under the laws of State on d1, and elected to be an S corporation on d2. On d3, Shareholder 1, a shareholder of Company, died. Pursuant to the terms of his grantor trust, upon his

death, y shares of Company stock were transferred to Trust 1 on d4. Company represents that the trust satisfies all of the requirements under § 1361(d)(3) to be a qualified subchapter S trust (QSST). However, because of a mistake by Company's attorneys and accountants, Beneficiary 1, the current income beneficiary of the trust, did not timely file a QSST election as required by § 1361(d)(2). Company and Beneficiary 1 represent that at all times since d4, Beneficiary 1 has treated Trust 1 as if it were a QSST.

On d5, Shareholder 2, another shareholder of Company, transferred z shares of Company stock to Trust 2. Shareholder 2 subsequently transferred additional shares to Trust 2. At the time of the transfers, Shareholder 2 believed that Trust 2 was a grantor trust, and therefore an eligible shareholder of an S corporation. However, Company subsequently discovered that Trust 2 was not a grantor trust, and therefore it was necessary for the beneficiary of Trust 2 to file a QSST election to be an eligible shareholder. Because Company 2 did not discover that a QSST election needed to be filed for Trust 2 until after the filing deadline, the QSST election was not timely filed. Company represents that Trust 2 satisfied all of the requirements under § 1361(d)(3) to be a QSST. Upon discovering that Trust 2 was not a grantor trust, Beneficiary 2 filed amended returns consistent with the treatment of Trust 2 as a QSST.

Company recently discovered that no QSST elections had been filed for Trust 1 and Trust 2, and that its S election had terminated. Within a reasonable time after its discovery, Company has taken steps to correct the aforementioned mistakes. Both Beneficiary 1 and Beneficiary 2, the current income beneficiary of Trust 2 have filed QSST elections. Company represents that all of its shareholders have filed their returns in a manner consistent with Company's treatment as an S corporation, and that the failure to file timely QSST elections was not for a tax avoidance purpose. Company and its shareholders, the Other Shareholders, have agreed to make any adjustments that the Commissioner may require, consistent with the treatment of Company as an S corporation.

## LAW

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable 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 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 for purposes of § 1361(b)(1)(B).

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 the trust is 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 a beneficiary of a QSST (or the beneficiary's legal representative) may elect to have § 1361(d) apply. Section 1361(d)(2)(D) provides that an election under § 1361(d)(2) may be effective up to 15 days and two months before the date of the election.

Section 1362(d)(2)(A) 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 corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(f) provides 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 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.

## CONCLUSIONS

After applying the relevant law to the facts submitted and the representations made, we conclude that Company's S corporation election terminated as a result of the beneficiaries of Trust 1 and Trust 2 failing to timely file QSST elections. We also conclude that the termination was inadvertent under § 1362(f). Therefore under § 1362(f), Company will be treated as an S corporation from d2 and thereafter, provided that the QSST elections filed by the Beneficiaries were validly filed, and that Company's S corporation election is valid and is not otherwise terminated under § 1362(d). Accordingly, all shareholders of Company must include their pro rata share of the separately and nonseparately computed items of Company under § 1366, make any adjustments to stock basis under § 1367, and take into account any distributions made by Company to shareholders under § 1368. During the termination period, Trust 1 and Trust 2 will be treated as if they were QSSTs. If Company, the trusts and their beneficiaries, or any of Company's shareholders fail to treat Company as described above, this ruling will be null and void

Except for the specific ruling above, no opinion is expressed or implied concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding whether

Company is otherwise qualified to be an S corporation, or whether the Trusts are valid QSSTs.

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

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely Yours,

William P. O'Shea  
Chief, Branch 3  
Office of the Assistant Chief  
Counsel  
(Passthroughs and Special  
Industries)

Enclosures (2)

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