

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

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Date:  
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LEGEND:

X =

A =

B =

C =

D =

Living Trust =

Family Trust =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

m =

Dear

This letter responds to your letter dated, November 10, 1998, written on behalf of X requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

### **FACTS**

X was incorporated on Date 1, and elected to be an S corporation effective Date 1. A, B, and Living Trust each owned m shares of X on Date 1. C had previously established Living Trust on Date 2 for estate planning purposes. It is represented that Living Trust was a grantor trust under subpart E, part 1, subchapter J, and a permissible S corporation shareholder under § 1361(c)(2)(A)(i).

C died on Date 3 and the entire corpus of Living Trust was included in the gross estate of C. Living Trust continued to own X's stock on Date 4, the day after the expiration of the two-year period described in § 1361(c)(2)(A)(ii). In late Date 5, it was discovered that X's S corporation election may have terminated on Date 4 because the Living Trust was an ineligible shareholder. Subsequently, on Date 6, the m shares of X's stock owned by Living Trust were transferred to the Family Trust. It is represented that the Family Trust is a permitted shareholder under § 1361(d). D, the current income beneficiary of the Family Trust, filed a "qualified subchapter S trust" election for the Family Trust on Date 7.

X represents that the termination was inadvertent and that X and its shareholders were unaware that the Living Trust was an ineligible shareholder beginning Date 4. X represents that it did not intend to terminate its S corporation election. X and its shareholders agree to make any adjustments (consistent with the treatment of X as an S corporation) that may be required.

### **LAW AND ANALYSIS**

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

Section 1361(b)(1)(B) provides that one of the requirements for a domestic corporation to be a small business corporation is that the corporation does not have as

a shareholder a person (other than an estate or a trust described in § 1361(c)(2)) 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 under § 1361(b)(1)(B).

Section 1361(c)(2)(A)(ii), as in effect on Date 3, provides that a trust described in § 1361(c)(2)(A)(i) immediately before the death of the deemed owner and which continues in existence after the deemed owner's death may be a shareholder under § 1361(b)(1)(B), but only for the 60-day period beginning on the day of the deemed owner's death. If a trust is described in the preceding sentence and if the entire corpus of the trust is includible in the gross estate of the deemed owner, the preceding sentence shall be applied by substituting "two-year period" for "60-day period".

Section 1362(d)(2) provides that an election to be an S corporation will be terminated whenever the corporation ceases to be a small business corporation.

Section 1362(f) provides that, (A) if an election under § 1362(a) by any corporation was terminated under § 1362(d)(2), (B) the Secretary determines that the termination was inadvertent, (C) no later than a reasonable period of time after discovery of the circumstances resulting in such termination, steps were taken so that the corporation is a small business corporation, and (D) 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 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 terminating event, the corporation shall be treated as an S corporation during the period specified by the Secretary.

The committee reports accompanying the Subchapter S Revision Act of 1982 explain § 1362(f) as follows:

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 revenues 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.

### **CONCLUSIONS**

X's S corporation election terminated on Date 4 when Living Trust continued to own X's stock. Based solely on the facts submitted and representations made, we conclude that the termination of X's subchapter S election on Date 4, was inadvertent within the meaning of § 1362(f).

Under § 1362(f), X will be treated as continuing to be an S corporation during the period from Date 4, to Date 6, and thereafter, provided that X's S corporation election is valid and is not otherwise terminated under § 1362(d). During the period from Date 4, to Date 6, Living Trust will be treated as a shareholder of X. Therefore, Living Trust, in determining its federal income tax liability for that period, must include its pro rata share of the separately and nonseparately computed items of X under § 1366, make any adjustments to stock basis under § 1367, and take into account any distributions made by X to shareholders under § 1368. If X or any of its shareholders fail to comply with the requirements described above, this ruling will be null and void.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X is an S corporation for federal tax purposes, or whether the Family Trust is a qualified subchapter S trust under § 1361(d).

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

Pursuant to a power of attorney on file in this office, we are sending a copy of this letter to X.

Sincerely yours,

Donna M. Young  
Senior Technician Reviewer,  
Branch 3  
Office of the Assistant Chief  
Counsel  
(Passthroughs and Special  
Industries)

Enclosures (2)  
Copy of this letter  
Copy for § 6110 purposes