Internal Revenue Service

Department of the Treasury

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LEGEND

Company =

Grantor =

d1 =

d2 =

d3 =

d4 =

d5 =

d6 =

x =

y =

the Trusts =

the Shareholders =

This letter responds to a letter dated April 5, 1999, written by your authorized representative 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 on d1, and elected to be treated as an S corporation on d2. On d3, Grantor, a Company shareholder, created x trusts (the Trusts), each for the benefit of one of his grandchildren. Aside from the named trustees and beneficiaries, the terms of the Trusts were identical. Company represents that at the time of their creation, each of the Trusts met the requirements to be Qualified Subchapter S Trusts (QSSTs) as defined by § 1361(d)(3), and therefore were eligible shareholders of an S corporation.

On d3, and on subsequent occasions, Grantor transferred shares of Company's stock to each of the Trusts. Currently, each trust owns y shares. Due to an oversight by Company's tax advisers, the beneficiaries of the Trusts failed to file QSST elections as required by § 1361(d)(3), and therefore were ineligible shareholders of an S corporation. On d4, the Shareholders' tax advisers discovered that the beneficiaries of the Trusts never filed QSST elections, and that Company's S corporation election may have terminated on d3. On d5, the Trusts' beneficiaries filed QSST elections, effective d6, with the appropriate Service Center. Company maintains that the failure to file the elections was neither intentional, nor motivated by tax avoidance or retroactive tax planning. Company and its shareholders agree to make any adjustments that the Commissioner may require consistent with treating Company as an S corporation.

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 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 for purposes of § 1361(b)(1)(B) a trust 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, is an eligible 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 the portion of the trust consisting 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 a beneficiary's legal representative) may elect to have § 1361(d) apply. Section 1361(d)(2)(D) provides that an election under § 1361(d)(2) shall be effective up to 15 days and 2 months before the date of the election.

Section 1362(d)(2)(A) provides than an election to be an S corporation 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 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 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 representations made, we conclude that Company's S corporation election terminated on d3, when Grantor transferred shares of Company to ineligible shareholders. Furthermore, we rule that this termination was inadvertent within the meaning of § 1362(f). Under § 1362(f), Company will be treated as being an S corporation from d3 until d5 and thereafter, provided Company's S corporation election was valid and was not otherwise terminated under § 1362(d). During the termination period, the Trusts will be treated as if the QSST elections were timely made. Accordingly, the Trusts' beneficiaries, and the Shareholders, in determining their respective income tax liabilities during the termination period and thereafter, must include the pro rata share of the separately and nonseparately computed items of Company as provided in § 1367, and take into account any distributions made by Company as provided by § 1368. If Company, the Trusts , or any of the Shareholders fail to treat Company as described above, this ruling shall 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, we express no opinion whether Company is otherwise qualified to be an S corporation, or whether the Trusts are valid QSSTs.

Pursuant to a power of attorney on file with this office, copies of this letter are being sent to your authorized representatives.

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,

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