

**Internal Revenue Service**

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LEGEND

Company =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

S1 =

S2 =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

a =

b =

c =

This letter responds to a letter dated April 14, 1999, and subsequent correspondence by your authorized representative on behalf of Company, requesting rulings under various sections of subchapter S of the Internal Revenue Code.

### FACTS

According to the information submitted, Company was incorporated on Date 1 under the laws of State, and elected to be treated as an S corporation as defined by § 1361 on Date 2. As of Date 2, Company had two shareholders, S1 and S2.

On Date 3, S1 and S2 each transferred a shares of Company's stock to both Trust 1 and Trust 2, irrevocable trusts established for the benefit of S1's and S2's grandchildren. On Date 4, S1 and S2 transferred b shares of Company's stock to Trust 3, an irrevocable trust set up for another of the shareholders' grandchildren. With the exception of a testamentary power of appointment given to the beneficiary of Trust 3, the substantive sections of the trusts were identical. Although the trust agreements do not provide that any corpus distributed during the life of the current income beneficiary may be distributed only to that beneficiary as required by § 1361(d)(3)(A)(ii), Company represents that under State law and the trusts, the trustees have no power to distribute corpus to anyone but the current income beneficiaries during the lives of the current income beneficiaries. Company represents that all three trusts were intended to be qualified subchapter S trusts (QSSTs) under § 1361(d)(3). However, due to a mistake, the beneficiaries of the trusts failed to timely file QSST elections.

On Date 5, S2 died owning c shares of Company's stock. Company's stock remained in her estate until Date 6, when it was transferred to Trust 4. Trust 4 was intended to be a QSST, but S1, the beneficiary of Trust 4 did not timely file a QSST election.

On Date 7, S1 retained a new attorney for the purposes of estate planning. After reviewing Company's records, this attorney discovered that the Company's S corporation election may have terminated because the trusts did not file QSST elections. On Date 8, the beneficiary of Trust 4, and on Date 9 the beneficiaries of Trust 1, Trust 2, and Trust 3, filed QSST elections with the appropriate service center.

Company maintains that it has consistently filed its returns as an S corporation, and that the failure to file the QSST elections was not 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 the treatment of Company as an S corporation.

### RULINGS REQUESTED

1) Company requests that it be granted relief under § 1362(f) from the termination that resulted from the beneficiaries of Trust 1, Trust 2, Trust 3, and Trust 4 failing to file QSST elections.

2) Company requests a ruling that Trust 1, Trust 2, Trust 3, and Trust 4, are eligible to be QSSTs under § 1361(d).

### 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 1361(d)(3) and § 1.1361-1(j)(1)(i) and (ii) provide that for the purposes of § 1361(d) the term QSST means a trust – (A) the terms of which require that (i) during the life of the current income beneficiary, there shall be only 1 income beneficiary of the trust, (ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary, (iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such 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 such beneficiary; and (B) all of the income (within the meaning of § 643(b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States.

Section 1.1361-1(j)(1)(iii) provides in part, that if the terms of the trust do not preclude the possibility that any of the requirements stated in § 1.1361-1(j)(1)(ii) will not be met, the trust will not qualify as a QSST. For example, if the terms of the trust are silent with respect to corpus distributions, and distributions of corpus to a person other than the current income beneficiary are permitted under local law during the life of the current income beneficiary, then the terms of the trust do not preclude the possibility that corpus may not be distributed to a person other than the current income beneficiary and, therefore, the trust is not a QSST.

Section 1.1361-1(j)(2)(ii)(A) provides that the determination of whether the terms of a trust meet all of the requirements under § 1.1361-1(j)(1)(ii) depends upon the terms of the trust instrument and the applicable local law.

Section 1362(d)(2)(A) provides that 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 presented and representations made, we conclude that the abovementioned trusts are qualified to be QSSTs under § 1361(d), provided that State law provides that during the lives of the current income beneficiaries, any corpus distributed may only be distributed to the respective current income beneficiary of the particular trust in question. Furthermore, we conclude that Company's S election terminated on Date 3 because of the failure of the beneficiaries of the trusts to file QSST elections, and that this termination was inadvertent within the meaning of § 1362(f). Under § 1362(f), Company will be treated as if it were an S

corporation from Date 3 and thereafter, provided Company's S corporation election was valid and was not otherwise terminated under § 1362(d).

Accordingly, all the shareholders of Company, 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. For the purpose of this letter ruling, no adjustments are necessary for the shareholders during closed years. If Company, the trusts, or any of Company's 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.

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