

Internal Revenue Service

Department of the Treasury

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Date:

September 30, 1999

X =

A =

B =

C =

Trust =

Fund A-1 =

Fund A-2 =

Dear :

This is in reply to a letter dated May 21, 1999, and subsequent correspondence, submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code.

The information submitted states that X incorporated on April 1, 1966 and elected to be an S corporation on December 29, 1986. On September 26, 1994, B, a grantor of Trust, which held

stock in X, died. A, B's spouse, was the other grantor of Trust. Trust consisted, in part, of the community property of A and B. The X stock held by Trust was A's and B's community property. As a revocable trust and therefore under subpart E of part I of subchapter J, Trust was a permitted shareholder of an S corporation pursuant to § 1361(c)(2)(A)(i). Upon B's death, the portion of Trust of which A was the grantor/owner continued to be owned by A and was a permitted shareholder under § 1361(c)(2)(A)(i). C, X's president, represents that B's portion of Trust was a permitted shareholder for the 2-year period as specified in § 1361(c)(2)(A)(ii).

Trust's agreement (Agreement) provided that upon the death of either A or B, the trust estate was to be divided into two separate funds, Fund A and Fund B. Fund A was to be funded with the survivor's one-half interest in the community property, all of the separate property and quasi-community property of the survivor, and the death proceeds of all life insurance policies on the decedent's life owned by the survivor. Additionally, Fund A was to be allocated a fractional share of the decedent's trust estate, up to the whole thereof, equal to the smallest marital deduction under § 2056(a) necessary to eliminate any federal estate tax in the decedent's estate. Fund B was to be allocated the balance of the trust estate.

Fund A was to be further divided into Fund A-1 and Fund A-2. Fund A-1 is revocable by A and thus qualifies as a permitted shareholder of an S corporation. A is the beneficiary of Fund A-2. C represents that Fund A-2 meets the requirements of a qualified subchapter S trust (QSST) under § 1361(d)(3).

On July 18, 1997, stock certificates in X (with respect to X stock then held by Trust) were issued to Fund A-1 and to Fund A-2. This issuance occurred after the 2-year period specified in § 1361(c)(2)(A)(ii) with respect to B's portion of Trust. Thus, X's S corporation election terminated on September 27, 1996 due to B's portion of Trust ceasing to be a permitted S corporation shareholder. In addition, A failed to file an election under § 1361(d)(2) with respect to Fund A-2.

Following the death of B, A relied on A's accountant to handle all tax matters, including all necessary elections relating to the administration of the various trusts. In March 1999, A's new accountant, while reviewing the file, discovered that the necessary steps to preserve X's S corporation election had not been taken. On May 21, 1999, A filed an election under § 1361(d)(2) with respect to Fund A-2.

C represents that the circumstances resulting in the termination of X's election to be an S corporation were

inadvertent. Additionally, X and each shareholder of X agree to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary with respect to such period.

Section 1362(a) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

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 the corporation is an S corporation) such corporation ceases to be a small business corporation. Section 1362(d)(2)(B) provides that any termination under § 1362(d)(2)(A) shall be effective on and after the date of cessation.

For taxable years beginning on or before December 31, 1997, § 1361(b)(1)(B) provided that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not 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.

Section 1361(c)(2)(A)(i) of the Code provides that for purposes of § 1361(b)(1)(B), 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. Section 1361(c)(2)(B)(i) provides that for purposes of § 1361(b)(1), in the case of a trust described in § 1361(c)(2)(A)(i), the deemed owner shall be treated as the shareholder.

For taxable years beginning on or before December 31, 1997, § 1361(c)(2)(A)(ii) provided that a trust which was described in § 1361(c)(2)(A)(i) immediately before the death of the deemed owner and which continues in existence after such death may be a shareholder for purposes of § 1361(b)(1)(B) for the 2-year period beginning on the day of the deemed owner's death if the entire corpus of the trust is includible in the gross estate of the deemed owner.

Section 1361(d)(1) of the Code provides that in the case of a qualified subchapter S trust (QSST) with respect to which a beneficiary makes an election under § 1361(d)(2), such trust shall be treated as a trust described in § 1361(c)(2)(A)(i) and, for purposes of § 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under § 1361(d)(2) is made.

Section 1361(d)(2)(A) of the Code provides that a beneficiary of a QSST (or his 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 1.1361-1(j)(6)(ii) of the Income Tax Regulations provides that the current income beneficiary of the trust must make the election under § 1361(d)(2) by signing and filing with the service center with which the corporation files its income tax return the applicable form or a statement including the information listed in § 1.1361-1(j)(6)(ii).

Section 1362(f) of the Code provides that if (1) an election under § 1362(a) by any corporation (A) was not effective for the taxable year for which made (determined without regard to § 1362(b)(2)) by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consents, or (B) was terminated under paragraph (2) or (3) of § 1362(d), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken (A) so that the corporation is a small business corporation, or (B) to acquire the required shareholder consents, 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 such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then notwithstanding the circumstances resulting in such ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts submitted, and the representations made, we conclude that the termination of X's S Corporation election occurred on September 27, 1996, upon the expiration of the two-year period specified in § 1361(c)(2)(A)(ii) and that the termination of X's S corporation election constituted an "inadvertent termination" within the meaning of § 1362(f).

In addition, A's failure to timely file an election under § 1361(d)(2) with respect to Fund A-2 would have resulted in the termination of X's S corporation election on July 18, 1997 had the S corporation election been in effect at that time. This potential termination would have been inadvertent within the meaning of § 1362(f).

Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from September 27, 1996,

provided that X's S corporation election was valid and is not otherwise terminated under § 1362(d). During the period from September 27, 1996 to July 18, 1997 the portion of Trust of which B was the grantor/owner is treated as a shareholder of X. Also during that period the portion of Trust of which A was the grantor/owner is treated as a trust described in §1361(c)(2)(A)(i), with A being treated as wholly owning that portion. From July 19, 1997 until May 21, 1999, Fund A-2 will be treated as a trust described in § 1361(c)(2)(A)(i) and A will be treated, for purposes of § 678, as the owner of that portion of the trust consisting of X stock. Also during that period, Fund A-1 will be treated as a trust described in § 1361(c)(2)(A)(i). Therefore, the shareholders of X must include their pro rata share of the separately stated and nonseparately computed items of X as provided in § 1366, make any adjustments to basis provided in § 1367, and take into account any distributions made by X as provided in § 1368. If X or its shareholders fail to treat themselves as described above, this ruling shall be null and void.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code. In particular, no opinion is expressed or implied as to whether Fund A-2 is a QSST within the meaning of § 1361(d)(3).

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.

In accordance with the power of attorney on file with this office, we are forwarding a copy of this letter to X.

Sincerely yours,

H. GRACE KIM
Assistant to the Chief
Branch 2
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes