

Internal Revenue Service

Department of the Treasury

Index Number: 1362.04-00
Number: **199909010**
Release Date: 3/5/1999

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:DOM:P&SI:03-PLR-109980-98

Date:

November 23, 1998

Legend

Company =

Predecessor =

B =

C =

D =

E =

F =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

CC:DOM:P&SI:03-PLR-109980-98

Date 6 =

Date 7 =

Date 8 =

Trust 1 =

Beneficiary 1 =

Trust 2 =

Beneficiary 2 =

Subsequent Shareholders =

Dear

This letter is in response to your letter dated April 17, 1998, and subsequent correspondences, submitted on behalf of Company, requesting rulings under §§ 1362(f) and 1361(d) of the Internal Revenue Code.

FACTS

Company represents the following facts. Company (d.b.a. Predecessor) was incorporated on Date 1. Company elected to be taxed as an S corporation under

CC:DOM:P&SI:03-PLR-109980-98

§ 1362(a), effective Date 2. The election on Form 2553 was filed on or about Date 3 and indicated the consent of B and C (the only shareholders on Date 2). However, the Form 2553 did not indicate the consent of D, E, and F, who had acquired stock in the corporation during the brief period of time between Date 2 and Date 3. D, E, and F approved the shareholder resolution to seek S corporation status, and they, along with B and C, have at all times treated the corporation as if a valid S election was in effect. It was the belief of all parties involved that only the shareholders as of the effective date of the S election needed to consent to the election.

In addition, on Dates 4 and 5, F contributed stock to Trust 1 and Trust 2. The terms of each trust required that: 1) during the life of the current income beneficiary, there can be only one income beneficiary of the trust; 2) any corpus distributed during the life of the current income beneficiary may only be distributed to that beneficiary; 3) the current income beneficiary's income interest in the trust will terminate on the earlier of the beneficiary's death or the termination of the trust; and 4) upon the termination of the trust during the life of the current income beneficiary, the trust must distribute all of its assets to the beneficiary. Furthermore, all of the income of each trust (within the meaning of § 643(b)) was distributed currently to the respective beneficiaries, all citizens or residents of the United States. Qualified subchapter S trust (QSST) elections necessary to make these trusts eligible shareholders were not timely filed by the beneficiaries. Neither Company, F, or the beneficiaries of Trust 1 and Trust 2 were aware that QSST elections had to be filed. After this omission was discovered, QSST elections with an effective date of Date 6 for both trusts were filed with the appropriate service center on Date 7. On Date 8, a new Form 2553, with an effective date of Date 6, was submitted to the appropriate service center which contained the consents of B, C, D, E, and F, as well as all Subsequent Shareholders.

DISCUSSION

Under § 1361(a)(1), an S corporation is a small business corporation for which an election under § 1362(a) is in effect. Section 1362(a)(2) specifies that the election will only be effective if all persons who are shareholders on the day the election is made consent to the election. In addition, Section 1361(b) defines a small business corporation, in part, as a corporation that has as shareholders only individuals, estates, certain exempt organizations, or trusts described in § 1361(c)(2). Under § 1361(d), a QSST (defined in § 1361(d)(3)) may be treated as an eligible trust described in § 1361(c)(2)(A)(i). Section 1361(d)(3) provides that a QSST is a trust (A) the terms of which require that during the life of the current income beneficiary, there shall be only one income beneficiary of the trust; any corpus distributed during the life of the current income beneficiary may be distributed only to the beneficiary; the income interest of the current income beneficiary in the trust shall terminate on the earlier of the beneficiary's death or the termination of the trust; and upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to the beneficiary; and (B) of which all of the income (within the meaning of § 643(b)) is

CC:DOM:P&SI:03-PLR-109980-98

distributed (or required to be distributed) currently to one individual who is a citizen or resident of the United States. In order for a QSST to be treated as an eligible shareholder, the beneficiary of a QSST must make an election in accordance with § 1361(d)(2) in the manner and form and at the time specified by the Secretary.

In the present situation, the original election under § 1362(a) was ineffective for failure to obtain the necessary consents. Furthermore, even if the election had been effective, the S corporation status would have terminated upon the transfer of stock to Trusts 1 and 2 as timely QSST elections were not made. Section 1362(f) provides relief for both ineffective elections and inadvertent terminations under appropriate circumstances.

Section 1362(f) 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 subsection (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 the ineffectiveness or termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the 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 this subsection, 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 the ineffectiveness or the termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

In the present situation, Company has demonstrated that it has met the requirements for relief under § 1362(f) for the ineffective election. Company has demonstrated that the shareholders who did not supply consents approved the election and intended it to be effective. In addition, within a reasonable time after discovering that the original election had been ineffective, Company filed a new election with all necessary consents with the appropriate service center. Finally, Company and all of the shareholders have agreed to make any adjustments that might be required by the

Secretary. Therefore, Company will be treated as if its election to be treated as an S corporation was effective as of Date 2.

Also, although Trusts 1 and 2 both met the QSST requirements as specified in § 1361(d)(3), the trust beneficiaries failed to file timely QSST elections as required by § 1361(d)(2) and § 1.1361-1(j)(6) (as then in effect). Absent such elections, Trusts 1 and 2 could not be considered eligible shareholders under § 1361(c)(2). Therefore, Company did not qualify as a small business corporation under § 1361(b) and

CC:DOM:P&SI:03-PLR-109980-98

§ 1362(d)(2) on Date 4, the date the trusts first acquired the stock.

In this case, the requirements for relief under § 1362(f) for inadvertent termination have been satisfied. The corporation did not know that the transfer terminated its S corporation status, and the transfer was not part of a plan to terminate the status. Company continued to file its corporate return, and all parties calculated their tax liabilities, as if Company were an S corporation. In addition, within a short period of becoming aware of the failure to file the QSST elections, proper elections were filed for both trusts with the appropriate service center. Furthermore, all parties have agreed to make any adjustments that might be required. Therefore, Company will be treated as if its S corporation status had not terminated due to the transfer of stock to Trust 1 and Trust 2.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude as follows:

1. Company's election to be taxed as an S corporation effective Date 2 was inadvertently invalid due to a failure to obtain all necessary shareholder consents. However, pursuant to § 1362(f), Company's S election will be treated as effective Date 2, unless Company otherwise fails to qualify as a valid S corporation.

2. Company's status as an S corporation terminated inadvertently with the stock transfer to Trust 1 and Trust 2 on Date 4. Although both trusts satisfy the requirements for QSSTs under § 1361(d)(3), timely elections under § 1361(d)(2) were not filed. Pursuant to § 1362(f), Trust 1 and Trust 2 will be treated as trusts described in § 1361(c)(2)(A)(i) beginning Date 4, and thereafter during the life of Beneficiary 1 and Beneficiary 2, respectively, as long as Trust 1 and Trust 2 continue to meet the requirements of § 1361(d)(3). Company will continue to be treated as an S corporation from Date 4 unless Company's S election otherwise terminates under § 1362(d).

This ruling is contingent on Company and all of its current and former shareholders treating Company as having been an S corporation for the period beginning Date 2, and thereafter. Accordingly, all current and former shareholders, in determining their respective income tax liabilities for the period beginning Date 2, and thereafter, must include the pro rata share of the separately and nonseparately computed items of Company as provided in § 1366, make adjustments to stock basis as provided in § 1367, and take into account any distributions made by Company as provided by § 1368.

Except as specifically set forth above, we express no opinion concerning the federal tax consequences of the foregoing facts. Specifically, we express no opinion on Company's qualification otherwise as a valid S corporation or on the Subsequent

CC:DOM:P&SI:03-PLR-109980-98

Shareholders' qualification as eligible shareholders.

This letter is issued only to the taxpayer who requested it. Under § 6110(k)(3), it may not be used or cited as precedent.

A copy of this letter should be attached to Company's next federal income tax return. A copy is enclosed for that purpose.

Pursuant to a power of attorney on file with this office, this letter is being sent to you and a copy is being sent to Company.

Sincerely yours,

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

Enclosures:
Copy of this letter
Copy for § 6110 purposes