Internal Revenue Service

Department of the Treasury

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CC:PSI:B1-PLR-120625-02
Date:
June 13 2002

Legend:

X =

State =

D1 =

T1 =

T2 =

D2 =

D3 =

Dear :

This responds to a letter dated April 3, 2002, together with related documents, submitted on behalf of X, requesting a ruling under §1362(f) of the Internal Revenue Code.

FACTS

X is a corporation of the State, which elected to be treated as a Subchapter S corporation effective D1. T1 and T2, shareholders of X, elected to be treated as Qualified Subchapter S Trusts ("QSSTs") effective D1. However, the trustees of T1 and T2 failed to make all of the required trust income distributions for the second and third taxable years since the QSST elections became effective. As a result, X's S election was terminated as

of D2. The trustees of T1 and T2 distributed the undistributed trust income at issue on D3.

X represents that the failure of timely making all of the required trust income distributions was not motivated by tax avoidance or retroactive tax planning. Further, X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary with respect to the period specified by §1362(f) of the Code.

LAW AND ANALYSIS

Section 1361(a)(1) defines an "S corporation", with respect to any taxable year, as a small business corporation for which an S election under §1362(a) is in effect for such year.

Section 1361(b)(1)(B) provides that a small business corporation cannot 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 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 Subchapter S corporation shareholder.

Section 1361(d)(3) defines the term "qualified Subchapter S trust" as 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 beneficiary, the trust shall distribute all 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 1361(d)(1) states that a QSST whose beneficiary makes an election under §1361(d)(2) will be treated as a trust described in §1361(c)(2)(A)(i), and the QSST's beneficiary will be treated as the owner (for purposes of §678(a)) of that portion of the

QSST's S corporation stock to which the election under §1362(d)(2) applies.

Under §1361(d)(2)(A), the beneficiary of a QSST may elect to have §1361(d) apply. Under §1361(d)(2)(D), this election will be effective up to 15 days and two months before the date of the election.

Section 1.1361-1(j)(5) of the Income Tax Regulations provides that if a QSST ceases to meet the income distribution requirement specified in §1.1361-1(j)(1)(i), but continues to meet all of the requirements in §1.1361-1(j)(1)(ii), the provisions of §1.1361-1(j) will cease to apply as of the first day of the first taxable year beginning after the first taxable year in which the trust ceased to meet the income distribution requirement. If a corporation's S election is inadvertently terminated as a result of a trust ceasing to meet the QSST requirements, the corporation may request relief under §1362(f).

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 taxable year for which the corporation is an S corporation) the corporation ceases to be a small business corporation. The termination is effective on and after the day of the cessation. §1362(d)(2)(B).

Section 1362(f), in relevant part, provides that, if: (1) an election under §1362(a) by any corporation was terminated under §1362(d); (2) the Secretary determines that the termination was inadvertent; (3) no later than a reasonable period of time after discovery of the event resulting in the termination, steps were taken so that the corporation is once more a small business corporation; and (4) the corporation, and each person who was a shareholder in 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 such period, then, notwithstanding the terminating event, the corporation shall be treated as continuing to be 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 consequence of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is

> hoped that the 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

Based solely on the facts submitted and the representations made, we conclude that X's Subchapter S election terminated on D2 when T1 and T2 failed to make all of the required trust income distributions. We also conclude that the termination constituted an "inadvertent termination" within the meaning of §1362(f).

Further, we conclude that, pursuant to §1362(f), X will be treated as continuing to be an S corporation from D2, assuming X's S corporation election is valid and not otherwise terminated under §1362(d).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X is a valid S corporation or whether T1 and T2 are valid QSSTs.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being mailed to your authorized representatives.

Sincerely,
Dianna K. Miosi
Chief, Branch 1
Associate Chief Counsel
(Passthroughs and Special Industries)

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