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Department of the Treasury
Washington, DC 20224

Person To Contact:
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Refer Reply To:
CC:PSI:B01 – PLR-112434-04
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June 21 2004

Legend:

X =

Trust 1 =

Trust 2 =

D1 =

D2 =

A =

B =

D3 =

D4 =

D =

E =

a =

D5 =

Dear :

This letter responds to the letter dated February 18, 2004, and subsequent correspondence, written on behalf of X, requesting a ruling under § 1362(f) regarding the inadvertent termination of X's election to be an S corporation.

FACTS

The information submitted discloses that, X was incorporated on D1 and elected to be treated as an S corporation effective D2. As of D2, A and B, husband and wife, held the majority of the stock of X. On D3 and D4, A, pursuant to the trust instrument that created Trust 1 and Trust 2, for A and B's children, D and E, respectively, and transferred *a* shares of X stock to each trust.

The provisions of Trust 1 and Trust 2 contained provisions that allowed for the possibility that distributions would be made other than to the beneficiaries.

The beneficiaries of Trust 1 and Trust 2 elected to treat each trust as a qualified subchapter S trust (QSST), effective as of the date each trust became a shareholder of X. At the time of the elections, X and its shareholders were unaware that Trust 1 and Trust 2 did not meet the requirements of § 1361(d)(3)(A)(ii) and, therefore, were ineligible shareholders of X.

Subsequently, upon discovery of the error, X and its shareholders sought to reform the trust instrument on D5 in order to satisfy the requirements of § 1361(d)(3)(A)(ii). As reformed, the trust instrument provides that, if at any time the trust no longer holds any S corporation stock, the trust does not terminate but shall continue to be held, administered, and distributed to the designated beneficiary in accordance with the provisions of the trust instrument.

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.

Section 1361(b)(1) defines "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate, other than a trust described in § 1361(c)(2), and other than an organization described in (c)(6)) who

is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

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 an S corporation shareholder.

Section 1361(d)(1) states that a QSST, with respect to which a 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 § 1361(d)(2) applies.

Section 1361(d)(3)(A) provides that a QSST is a trust, 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. In addition, § 1361(d)(3)(B) requires that the trust distribute all of its income (within the meaning of § 643(b)) currently to one individual who is a citizen or resident of the United States.

Section 1362(f), in relevant part, 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 (B) was terminated under § 1362(d)(2); (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 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 this subsection, 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 the ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

CONCLUSION

Based solely on the information submitted and the representations made, we conclude that, prior to the reformation on D5, Trust 1 and Trust 2 were not valid QSSTs. Therefore, X's S election terminated as of D3, upon the transfer of X's stock to Trust 1, an ineligible shareholder of X. We further conclude that the termination of X's S election constituted an inadvertent termination within the meaning of § 1362(f).

Under the provisions of § 1362(f), Trust1 and Trust 2 will be treated as QSSTs from D3 and D4, and thereafter, respectively. X will be treated as an S corporation from D3, and thereafter, provided that X's S election was otherwise valid and has not otherwise terminated under § 1362(d), and provided that the QSST elections were otherwise valid and have not otherwise terminated.

This ruling is contingent upon X and all its shareholders treating X as having been an S corporation for the period beginning D3, and thereafter, and Trust 1 and Trust 2 as QSSTs as of the date each became a shareholder of X, and thereafter.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code.

This ruling is directed only to the taxpayer requesting 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, copies of this letter are being mailed to your authorized representatives.

Sincerely,

/s/ David R. Haglund

David R. Haglund
Senior Technician Reviewer
Branch 1
Associate Chief Counsel
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Enclosures (2)

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