

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:

Telephone Number:

Refer Reply To:

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Date:

April 26, 2006

Legend:

X =

A =

B =

C =

State =

Trust =

d1 =

d2 =

d3 =

d4 =

d5 =

d6 =
Dear

This letter responds to a letter dated November 22, 2005, and subsequent correspondence submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated under the laws of State on d1 and elected to be an S corporation effective d1. On d2, A, the sole shareholder of X formed Trust, a grantor trust, and contributed all of the X stock to it. Trust was a permissible S corporation shareholder under § 1361(c)(2)(A)(i). On d3, A died. Upon A's death, Trust ceased to qualify as a grantor trust. Trust remained a permissible S corporation shareholder under § 1361(c)(2)(A)(ii) for the 2-year period beginning on the day of the A's death and ending on d4. Trust's trust agreement provided that upon A's death, Trust's assets shall be divided into separate shares for the benefit of A's children. However, Trust did not distribute the shares of X stock on or before d4. Accordingly, Trust ceased to qualify as an eligible shareholder on d5. On d6, the Trust transferred the X stock to two subtrusts, each a separate share of Trust, for the benefit of A's children, B and C. The trust agreement provides that each separate share must qualify as a qualified subchapter S trust (QSST) under § 1361(d). However, the income beneficiaries of each subtrust, B and C, failed to file QSST elections.

X represents that all of its shareholders have filed their returns in a manner consistent with X's treatment as an S corporation. X also represents that the terminating event, Trust ceasing to be an eligible shareholder, was not motivated by tax avoidance or retroactive tax planning. From d5 to d6, Trust was treated as the owner of the X stock and filed its returns accordingly. Since d6, B and C have been treated as the owner of the X stock, consistent with the subtrusts being QSSTs, and X, B and C filed their returns accordingly. X and its shareholders have agreed to make any adjustments that the Commissioner may require, consistent with the treatment of X as an S corporation.

Section 1361(a)(1) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for such 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 may be a shareholder if all of it 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.

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.

Section 1361(c)(2)(A)(ii) and § 1.1361-1(h)(1)(ii) of the Income Tax regulations provide that for purposes of § 1361(b)(1)(B), 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, is a permitted shareholder, but only for the 2-year period beginning on the day of the deemed owner's death. Section 1.1361-1(h)(3)(i)(B) provides that if stock is held by a trust described in § 1.1361-1(h)(1)(ii), the estate of the deemed owner is generally treated as the shareholder as of the day of the deemed owner's death.

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), 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) 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 § 1362(d)(2) shall be effective up to 15 days and 2 months before the date of the election.

Section 1361(d)(3) provides that the term "qualified subchapter S trust" means a trust -- (A) the terms of which require that -- (i) during the life of the current income beneficiary, there shall be only one 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 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)(3) provides that for purposes of § 1361(c) and § 1361(d), a substantially separate and independent share of a trust, within the meaning of § 663(c) and the regulations thereunder, is treated as a separate trust. For a separate share which holds S corporation stock to qualify as a QSST, the terms of the trust applicable to that separate share must meet the QSST requirements stated in § 1.1361-1(j)(1)(i) and (ii).

Section 1.1361-1(j)(6)(ii) 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(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. A termination of an S corporation election under § 1362(d)(2) is effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (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 under § 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.

Based solely on the facts submitted and the representations made, we conclude that X's S election was terminated on d5, the day after the two year period that began on d3, because Trust was no longer an eligible shareholder of X. We conclude that this termination was inadvertent within the meaning of § 1362(f). Furthermore, if the S corporation election had not been otherwise terminated on d5, X's S election would have terminated on d6 when the subtrusts, which are ineligible shareholders, first acquired X stock. This potential termination would have also been an inadvertent termination under § 1362(f). Accordingly, under the provisions of § 1362(f), X will be treated as continuing to be an S corporation from d5, and thereafter, provided that X's S election was valid and was not otherwise terminated under § 1362(d).

This ruling is contingent on X and all of its shareholders treating X as having been an S corporation for the period beginning d5 and thereafter. Accordingly, all of the shareholders in X, in determining their respective income tax liabilities for the period beginning d5 and thereafter 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.

Furthermore, this ruling is contingent on each subtrust making a QSST election, effective d6, with the appropriate service center within 60 days of the date of this letter. A copy of this letter should be attached to the QSST elections. If X or its shareholders fail to treat themselves as described above, this ruling shall be null and void.

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, including whether X was or is a small business corporation under § 1361(b), or whether each of the subtrusts are QSSTs within the meaning of § 1361(d)(3).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Internal Revenue Code 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 sent to X's authorized representatives.

Sincerely,

Beverly Katz
Senior Technician Reviewer, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2):

Copy of this letter

Copy for section 6110 purposes