Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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Date:
March 14, 2003

X =

Trust 1 =

Trust 2 =

A =

B =

D1 =

D2 =

D3 =

D4 =

D5 =

State =

Accounting Firm =

Dear :

This letter responds to a letter from X's authorized representative, dated November 14, 2002, and subsequent correspondence, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated under the laws of State on D1. X elected to be an S corporation effective D2. On D2, A and B were the shareholders of X. On D3, A and B transferred shares of X to Trust 1 and Trust 2. A, X's president, represents that Trust 1 and Trust 2 were intended to be qualified subchapter S trusts ("QSSTs"). However, no QSST election was timely filed on behalf of Trust 1 and Trust 2. Therefore, X's S election terminated on D3. Additionally, Trust 1 and Trust 2 failed to distribute all of the trusts' income as required by § 1361(d)(3)(B). The respective beneficiaries of Trust 1 and Trust 2 reported their allocable share of X's income consistent with the treatment of Trust 1 and Trust 2 as QSSTs.

On D4, Accounting Firm began reviewing the returns of X and the returns of the beneficiaries of Trust 1 and Trust 2. In the course of this review, Accounting Firm discovered that no QSST election was timely filed on behalf of Trust 1 and Trust 2. Additionally, Accounting Firm discovered that Trust 1 and Trust 2 failed to distribute all the trusts' income as required by § 1361(d)(3)(B). On D5, the trustees of Trust 1 and Trust 2 distributed all the trusts' income as required by § 1361(d)(3)(B) to each respective Trust beneficiary.

A represents that the circumstances resulting in the termination of X's S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning. X and its shareholders have agreed to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary.

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 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 the term "small business corporation" is a domestic corporation which is not an ineligible shareholder and which 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 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(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 § 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(d)(2)(A) provides that an election under § 1362(a) will be terminated whenever (at any time on or after the 1st day of the 1st 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 the termination shall be effective on and after the date of cessation.

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 § 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 § 1362(d)(2) or (3), (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 in 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, such corporation shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the representations made and the information submitted, we conclude that X's S corporation election terminated on D3, under § 1362(d)(2) of the Code, because the respective beneficiaries of Trust 1 and Trust 2 failed to timely file an election under § 1361(d)(2). We further conclude that the termination of X's S election was an inadvertent termination within the meaning of § 1362(f). Accordingly, pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from D3 and thereafter, provided X's election to be an S corporation was not invalid and provided that the election was not otherwise terminated under § 1362(d). All of X's

shareholders in determining their respective income tax liabilities for the period beginning D3 and thereafter, must include their pro rata share of the separately stated and non-separately stated 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. Additionally, from D3 and thereafter, Trust 1, and Trust 2 will be treated as QSSTs described in § 1361(d)(3), and the respective beneficiaries of Trust 1 and Trust 2 will be treated, as the respective owners of the X stock held by Trust 1 and Trust 2 provided that the respective beneficiaries of Trust 1 and Trust 2 file a QSST election effective D3 for each Trust with the appropriate service center within 60 days following the date of this letter. If Trust 1, Trust 2, X, or X's shareholders fail to treat X as described above, this ruling shall be null and void. A copy of this letter should be attached to the QSST elections.

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. Specifically, no opinion is expressed on whether X is otherwise eligible to be treated as an S corporation or whether Trust 1 and Trust 2 are eligible QSSTs under § 1361(d)(3).

This ruling letter 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.

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to X.

Sincerely yours,

J. THOMAS HINES
Chief, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

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