Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

199901017

Contact Person:

Telephone Number:

In Reference to:
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Date: OCT 5 1998

LEGEND:

X =

Trust 1 =

Trust 2 =

Trust 3 =

A =

B =

C =

D =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

m =

This responds to a letter dated June 8, 1998, and subsequent correspondence, written on X's behalf, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, X was formed under a plan of merger effective on D1 and elected to be treated as an S corporation effective for its taxable year beginning D2. On D3, A established Trust 1, Trust 2, and Trust 3 (collectively, the Trusts) for the benefit of B, C, and D, respectively. On D4, A, the sole shareholder of X, transferred m shares of X's stock to each of the Trusts.

It is represented that Trust 1, Trust 2, and Trust 3 each possess the elements of a qualified subchapter S trust (a QSST) under § 1361(d)(3). B, the beneficiary of Trust 1, C, the beneficiary of Trust 2, and D, the beneficiary of Trust 3, however, each failed to timely file QSST elections required by § 1361(d)(2). B, C, and D were unaware that QSST elections were needed to make Trust 1, Trust 2, and Trust 3 eligible shareholders of X.

In D5, X's accountant learned QSST elections had not been filed for the Trusts. Subsequently, on D6, QSST elections for Trust 1, Trust 2, and Trust 3 were filed with the appropriate service center.

X represents that throughout the period from D4 to present, Trust 1, Trust 2, and Trust 3 have filed tax returns as if valid QSST elections had been in effect. X and its shareholders agree to make any adjustments (consistent with the treatment of X as an S corporation) that may be required. X represents that failing to file the QSST elections was not part of a plan to terminate X's S corporation election or motivated by tax avoidance. It was merely inadvertent.

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)(B) provides that one of the requirements for a taxpayer to be a small business corporation is that the taxpayer cannot have as a shareholder a person (other than an estate and other than a trust described in § 1361(c)(2)) who is not an individual.

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)--(A) such trust shall be treated as a trust described in § 1361(c)(2)(A)(i), and (B) 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 the beneficiary of a QSST may elect to have § 1361(d) apply. Under the temporary regulations in effect at the time the election should have been filed, a QSST election had to be filed within the 61-day period beginning on the date the stock of a corporation was transferred to a trust. Section 18.1361-1(a) of the Temporary Income Tax Regulations.

Section 1362(d)(2) provides that an election to be an S corporation will be terminated whenever the corporation ceases to be a small business corporation.

Section 1362(f) provides in relevant part that, (A) if an election under § 1362(a) by any corporation was terminated under § 1362(d)(2), (B) the Secretary determines that the termination was inadvertent, (C) no later that a reasonable period of time after discovery of the circumstances resulting in such termination, steps were taken so that the corporation is a small business corporation, and (D) the corporation and each person who was a shareholder of 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 the period, then, notwithstanding the terminating event, the corporation shall be treated as an S corporation during the period specified by the Secretary.

The committee reports accompanying the Subchapter S Revision Act of 1982 Act 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 consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped that 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

After applying the relevant law to the facts submitted and representations made, we conclude that the termination of X's subchapter S election on D4 was inadvertent within the meaning of § 1362(f).

Under § 1362(f), X will be treated as continuing to be an S corporation during the period from D4 to D6, and thereafter, assuming X's S corporation election was valid and not otherwise terminated under § 1362(d). During the period from D4 to D6, and thereafter, the Trusts will be treated as trusts described in § 1361(d), and B, C, and D will each be treated for purposes of § 678 as the owners of that portion of their respective trust that consists of X stock.

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. Specifically, no opinion is expressed concerning whether X is an S corporation or whether the Trusts are QSSTs under § 1361(d)(3).

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

Under the power of attorneys on file in this office, a copy of this letter will be sent to X, A, B, C, and D.

Sincerely yours,

Jeff Erickson

Jeff Erickson
Assistant to the Branch Chief,
Branch 3
Office of the Assistant Chief
Counsel
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Industries)

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