

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:  
CC:DOM:P&SI:3 PLR-117320-99  
Date:  
February 17, 2000

Company:

State:

Shareholders:

Trust:

M:

N:

a:

b:

c:

d:

e:

f:

g:

This letter responds to letters from your authorized representative dated September 17 and November 10, 1999, submitted on behalf of Company, requesting a ruling under § 1362(f) of the Internal Revenue Code that the termination of Company's

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S corporation election was inadvertent. Company represents the following facts.

Company was incorporated under the laws of State on a and elected under § 1362(a) to be an S corporation effective the same date. Company's current shareholders are listed in the legend of this letter. Company's S election terminated on b when N failed to timely elect under § 1361(d)(2) to treat Trust as a qualified subchapter S trust (QSST).

M created Trust on c for M's benefit, transferring to the trust d shares of Company stock.

M died on e. In accordance with Trust's governing instrument, Trust continued for the benefit of N, with f shares of Company stock as its only assets.

Except as provided in § 1362(g), § 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1361(b)(1)(B) provides that, for purposes of subchapter S, the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not, among other things, 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 this chapter) as owned by an individual who is a citizen or resident of the United States may be a shareholder of an S corporation for purposes of § 1361(b)(1)(B). Former § 1361(c)(2)(A)(ii) provided that a trust meeting the description of § 1361(c)(2)(A)(i) immediately before the death of the deemed owner and which continues in existence after her death may be a shareholder of an S corporation, but only for the 60-day period beginning on the day of the deemed owner's death. If the entire corpus of a trust described in the preceding sentence is includible in the gross estate of the deemed owner, the preceding sentence shall apply, but for a 2-year period rather than 60 days. Section 1361(c)(2)(B)(ii) provides that, in the case of a trust described in § 1361(c)(2)(A)(ii), the estate of the deemed owner shall be treated as the 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)–

- (A) the trust shall be treated as a trust described in § 1361(c)(2)(A)(i), and
- (B) for purposes of § 678(a), the beneficiary of the trust shall be treated as the owner of that portion of the trust which consists of stock in an S

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corporation with respect to which the election under § 1361(d)(2) is made.

For purposes of § 1361(d), 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 the 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 that beneficiary, and
- (B) all of the income (within the meaning of § 643(b)) of which is distributed (or required to be distributed) currently to one individual who is a citizen or resident of the United States.

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)(iii)(C) of the Income Tax Regulations provides that, if a trust ceases to be a qualified subpart E trust but also satisfies the requirements of a QSST, the QSST election must be filed within the 16-day-and-2-month period beginning on the date on which the trust ceases to be a qualified subpart E trust. If the estate of the deemed owner of the trust is treated as the shareholder, the QSST election may be filed at any time but no later than the end of the 16-day-and-2-month period beginning on the date on which the estate of the deemed owner ceases to be treated as a shareholder.

Section 1362(d)(2)(A) provides that an election under § 1362(a) terminates whenever the corporation ceases to be a small business corporation.

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 termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in termination, steps were taken so that the corporation is a small business corporation, and (4) the

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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 the adjustments (consistent with the treatment of the corporation as an S corporation) as might be required by the Secretary regarding this period, then, notwithstanding the circumstances resulting in termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) provides that the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent.

According to the legislative history of § 1362(f)--

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. For example, if a corporation, in good faith, determined that it had no earnings and profits, but it is later determined on audit that its election terminated by reason of violating the passive income test for three consecutive years because the corporation in fact did have accumulated earnings, if the shareholders were to agree to treat the earnings as distributed and include the dividends in income, it may be appropriate to waive the terminating events, so that the election is treated as never terminated. 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 (1982); 1982-2 C.B. 718, 723.

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Company represents that the failure of N to timely file a QSST election was an oversight by N and N's tax advisors that was discovered only recently when documents were requested for estate planning purposes.

Company represents that for the period g, Trust paid out its income to N as required by the trust agreement. The trustee for Trust represents that Trust satisfies the QSST requirements of § 1361(d)(3) and that the income distribution requirement has been and will continue to be met.

After applying the applicable law and regulations to the facts and representations of this ruling request, we conclude that the termination of Company's S corporation election due to N's failure to timely elect to have the QSST rules of § 1361(d) apply to Trust was inadvertent within the meaning of § 1362(f).

Consequently, we rule that Company will be treated as continuing to be an S corporation from b to the present, unless Company's S election otherwise is terminated under § 1362(d). As a condition for this ruling, for income tax reporting purposes, N is to be treated as the owner of the shares in question for the period from b to the present.

Except for the specific ruling above, no opinion is expressed or implied concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding Company's eligibility to be an S corporation.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,  
WILLIAM P. O'SHEA, Chief, Branch 3  
Office of Assistant Chief Counsel  
(Passthroughs and Special Industries)

enclosure: copy for § 6110 purposes