

Internal Revenue Service

Department of the Treasury

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X =

Trust 1=

Trust 2=

State =

Firm =

A =

B =

a =

b =

c =

z =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

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Dear

This letter responds to a letter dated January 12, 2001, and subsequent correspondence, written on behalf of X, requesting inadvertent termination relief under section 1362(f).

FACTS

According to the information submitted, X, a domestic entity, was incorporated under the laws of State on D1. X elected subchapter S status, effective D2. A, its sole shareholder, consented to the election. In D3, A and his spouse, B, sought legal advice from advisor. Advisor recommended that they create certain trusts to hold their assets. Advisor referred A and B to an attorney to assist them with the establishment of the trusts. Advisor, A and B all believed that the attorney was a competent professional. Pursuant to attorney's advice Trust 1 and Trust 2 (the "Trusts"), were formed in D3, naming A and B's children, a, b, and c as one-third beneficiaries ("beneficiaries") as to each.

On D4, A transferred to Trust 1 z% of the total stock in X and also transferred another z% of the total stock in X to B, who in turn immediately transferred the X stock to Trust 2. Attorney, A and B all believed the Trust 1 and Trust 2 were eligible S corporation shareholders. As such, X continued filing income tax returns as an S corporation from D5 through D7. Attorney never informed A, B or the beneficiaries that Qualified Subchapter S Trusts (QSST) elections needed to be filed when the X stock was transferred to the Trusts. Thus, no QSST election was filed.

A and B were never advised that the QSSTs had to maintain separate equal shares for each beneficiary or that the QSSTs were required to distribute current trust accounting income proportionately to the beneficiaries. As a result, during the years D5 through D6, some of the trust accounting income was retained and taxed at the trust level. In addition, the taxable income of the Trusts that was distributed to the income beneficiaries was not done so on a proportionate basis.

In late D7, A and B learned that the improper treatment of the Trusts for the years D5 through D6 may have terminated X's S corporation status. Upon learning of its possible termination, A and B immediately sought to correct this problem by filing the instant private letter ruling request.

X, A, B, and the beneficiaries represent that at no time did they desire to terminate X's S corporation status. Rather, X, A, B and the beneficiaries relied on the sophistication and tax expertise of attorney to advise them of all requirements necessary to qualify and maintain the Trusts status as a "qualified subchapter S trusts." X, A, B and the beneficiaries have agreed to make any adjustments that the Commissioner of the Internal Revenue Service may require. To this end, the beneficiaries have corrected the misallocation of the trust accounting income for the years D5 through D6 by making payments (including interest) in D7 to the beneficiaries

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who received less in distributions than their prorata share and by making corresponding adjustments to each of the beneficiaries' D7 federal individual income tax returns. The adjustments ensure that each income beneficiary reported an identical aggregate amount of taxable income from X on his or her tax return for the years at issue.

In addition, A and B obtained court approval to reform the Trusts, and to divide each of the two trusts into three equal separate trusts (for a total of six trusts) ("Separate Trusts") for the benefit of each of the three beneficiaries, a, b and c. Each of the Separate Trusts provides the following: (1) that during the life of the current income beneficiary, there shall be only one income beneficiary of the trust, (2) that any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary, (3) that 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 (4) that 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.

LAW AND ANALYSIS

Section 1361(a)(1) of the Code provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.

Section 1361(b)(1)(B) provides that for purposes of subchapter S, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not have as a shareholder a person (other than an estate and other than a trust described in subsection 1361(c)(2)) who is not an individual.

Section 1361(b)(1)(D) provides that for purposes of subchapter S, a small business corporation is only permitted to have one class of stock. A corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Section 1.1361-1(l)(1).

Section 1361(c)(2)(A)(i) provides that a trust, all of which is treated as owned by an individual who is a citizen or resident of the United States, is a permitted shareholder of a small business corporation.

Section 1361(d)(1) provides that in the case of a qualified subchapter S trust (QSST) with respect to which a beneficiary makes an election under section 1361(d)(2), such trust shall be treated as a trust described in section 1361(c)(2)(A)(i), and for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust consisting of stock in an S corporation with respect to which the election under section 1361(d)(2) is made.

In order to qualify as a QSST, section 1361(d)(3)(A) requires that (1) during the life of the current income beneficiary, there shall be only 1 income beneficiary of the

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trust, (2) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary, (3) 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 (4) 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.

Section 1362(d)(2)(A) provides that an election under section 1362(a) shall 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 any termination under section 1362(d)(2)(A) shall be effective on and after the date of cessation.

Section 1362(f) of the Code provides that if (1) an election under section 1362(a) by any corporation was terminated under paragraph (2) or (3) of section 1362(d), (2) the Secretary determines that the termination was inadvertent, (3) no later than a reasonable period of time after discovery of the event resulting in the 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 of 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 terminating event, the corporation shall be treated as continuing to be an S corporation during the period specified by the Secretary.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24, in discussing section 1362(f) of the Code, states in part:

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.

CONCLUSION

Based on the information submitted and the representations made, we conclude

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that X's S corporation election terminated on D4, as a result of the transfer of X stock to ineligible shareholders, the Trusts. However, we conclude that the facts causing such ineligibility were inadvertent and that the termination of X's S corporation election as a result of the QSST deficiencies was an "inadvertent termination" within the meaning of section 1362(f) of the Code.

Consequently we rule that X will be treated as continuing to be an S corporation from D4 and thereafter, provided that the respective beneficiaries of the Separate Trusts file QSST elections within 60 days of the date of this letter, and that X's S election otherwise is not terminated under section 1362(d).

Except as specifically ruled upon above, no opinion is expressed as to the federal income tax consequences of the facts described above under any other provision of the Code. In particular, no opinion is expressed or implied as to whether X otherwise qualifies as an Subchapter S Corporation under section 1361.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer and the second authorized representative indicated on the taxpayer's Power of Attorney.

Sincerely,
David R. Haglund
Senior Technician Reviewer,
Branch 1
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

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