

Internal Revenue Service

Department of the Treasury

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X =

A =

B =

C =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Year 1 =

Year 3 =

Dear _____ :

This is in reply to a letter, dated August 14, 2001, submitted on behalf of X by X's authorized representative, requesting a ruling under §1362(f) of the Internal Revenue Code.

The information submitted states that X incorporated in Year 1 and filed a timely S election, effective Date 1. At the time of the S election, 51% of X's stock was owned by A and B as community property and the remaining 49% of X stock was held by C. On Date 2, A and B formed Trust 1 into which they transferred their 51% shares of X.

On Date 3, A died. Pursuant to the terms of his will and the terms of Trust 1, the 51% of X stock owned as community property by A and B was transferred to Trust 2, with B as the beneficiary. Trust 2 filed the appropriate QSST election on or about Date 4. Subsequently, Trust 2 was split into two separate trusts each with B as the beneficiary: Trust 3 and Trust 4. Each new trust received 25.5% of X's shares, respectively, on or about Date 5.

The accounting firm representing Trust 3 and Trust 4 prepared the QSST elections for Trust 3 and Trust 4 and forwarded the election to B's accountant, but B's accountant mistakenly failed to mail the election and then inadvertently placed the documents in the client's file. In Year 3, the error was discovered and soon thereafter action was commenced to correct the error.

C, the president of X, represents that the transfer of X stock to Trust 3 and Trust 4 and the subsequent failure to file the QSST elections was not motivated by tax avoidance or retroactive tax planning. For all taxable years, Trust 3 and Trust 4's income has been reported consistent with Trust 3 and Trust 4 being treated as a QSSTs with B as their beneficiary.

X and X's shareholders agree to make any adjustments (consistent with the treatment of X as an S corporation) that the Secretary may require.

Section 1361(a)(1) of the Internal Revenue Code defines an "S corporation" means, as a small business corporation for which an election under §1362(a) is in effect for the taxable year .

Section 1361(b)(1)(B) provides that the term "small business corporation" is 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 §1361(c)(2) or an organization described in §1361(c)(6)) 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), 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) provides that a beneficiary of a QSST (or his legal representative) may elect to have §1361(d) apply. Section 1362(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) provides that an election under §1362(a) shall be terminated whenever (at any time on or after the first day of the taxable year for which a 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 (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 paragraph (2) or (3) of §1362(d), (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 was a shareholder of 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, 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 or about Date 5 when Trust 3 and Trust 4, ineligible shareholders, acquired X stock. We also conclude that this termination was inadvertent within the meaning of §1362(f).

We further conclude that under the provisions of §1362(f), X will be treated as continuing to be an S corporation from Date 5, and thereafter, provided (1) X's S

election was valid and was not otherwise terminated, (2) Trust 3 and Trust 4 satisfied the requirements to be QSSTs and B was treated under §678 as the owner of the portion of Trust 3 and Trust 4 consisting of X stock from Date 5 onward.

Accordingly, all of the shareholders in X, in determining their respective income tax liabilities for the period beginning Date 5 and thereafter must include their pro rata share of the separately stated and non-separately 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. If X or its shareholders fail to treat themselves as described above, this ruling shall be null and void.

Furthermore, this ruling is contingent on Trust 3 and Trust 4 making QSST elections, effective Date 5, with the appropriate service center within 60 days of the date of this letter and attaching a copy of this letter to each election.

Except as specifically ruled upon above, we express no opinion concerning the Federal tax consequences of the transactions described above under any other provisions of the Code. Specifically, no opinion is expressed on whether X is otherwise eligible to be treated as an S corporation or whether Trust 3 and Trust 4 are eligible to be QSSTs.

This ruling 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's authorized representative.

Sincerely,
J. Thomas Hines
Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: (2)
Copy of this letter
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