

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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Legend

X =

State =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

Trust =

Trustee =

A =

B =

Dear

This letter responds to a letter, dated November 27, 2001, and subsequent correspondence, submitted by you on behalf of X as its authorized representative, requesting inadvertent termination relief under section 1362(f) of the Internal Revenue

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Code.

X was incorporated on D1 under the laws of State. X elected to be an S corporation, effective D2.

A, the sole shareholder of X, died on D3 and all shares of X stock were transferred to his estate. On D4, A's estate distributed all of the X stock to Trust. B, the beneficiary of Trust, represents that Trust met all of the requirements to elect to be treated as a qualified subchapter S trust (QSST) under section 1361(d)(3). However, Trustee of Trust and B, were not aware that a QSST election needed to be made, nor were they advised to make this election by counsel handling the administration of A's estate. Therefore, B did not make a timely QSST election under section 1361(d)(2), which resulted in termination of X's S corporation election on D4.

As a result of other tax issues unrelated to the QSST issue, Trust was terminated on D5, and all of the shares of X were distributed to B, making B the sole shareholder of X. After termination of Trust, B retained counsel to resolve the other tax related issues. In D6, B's counsel discovered that B had not made a QSST election for Trust. Subsequently, X submitted this ruling request for inadvertent termination relief under section 1362(f).

B represents that the transfer of X stock to Trust and the subsequent failure to file the QSST election were not motivated by tax avoidance or retroactive tax planning and that for all taxable years from D4 to D5, B reported her share of X income, deductions and credits as if she owned the X stock directly.

X, B, and Trust have agreed to make any adjustments that the Commissioner may require consistent with the treatment of X as an S corporation.

Section 1361(a)(1) defines an "S" corporation as 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 a "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not have as a shareholder a person (other than an estate, a trust described in section 1361(c)(2), or an organization described in section 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 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 which consists of stock in an S corporation with respect to which the election under section 1361(d)(2) is made.

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Section 1361(d)(2)(A) provides that a beneficiary of a QSST (or his legal representative) may elect to have section 1361(d) apply. Section 1361(d)(2)(D) provides that an election under section 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 section 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 section 1.1361-1(j)(6)(ii).

Section 1362(d)(2) provides that an election under section 1362(a) shall be terminated whenever (at any time on or after the first day of the first 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 section 1362(d)(2) is effective on and after the date of cessation.

Section 1362(f), in relevant part, provides that, if: (1) an election under section 1362(a) by any corporation was terminated under section 1362(d)(2) or (3); (2) the Secretary determines that the termination was inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the termination, steps were taken so that the corporation is a small business corporation; and (4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to section 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 such period, then, notwithstanding the circumstances resulting in the termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts and representations submitted, we conclude that X's S corporation election terminated on D4 when Trust, an ineligible S corporation shareholder, acquired X stock. We also conclude that the termination was inadvertent within the meaning of section 1362(f).

We further conclude that under the provisions of section 1362(f), X will be treated as continuing to be an S corporation from D4 to D5, and afterwards, provided (1) X's S election was valid and was not otherwise terminated, and (2) during the period from D4 to D5, B reported her share of X income, deductions and credits as if she owned the X stock directly.

Accordingly, the shareholders of X must include their pro rata share of the separately and nonseparately computed items of X under section 1366, make any adjustments to stock basis under section 1367, and take into account any distributions made by X to shareholders under section 1368. If X, Trust, or any of X's shareholders

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fail to treat X as described above, during the period from D4 to D5, this ruling will be null and void.

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 on whether X's original election to be an S corporation was a valid election under section 1362 or whether Trust is a QSST within the meaning of section 1361(d)(3).

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

Under a power of attorney on file with this office, we are sending a copy of this letter to X.

Sincerely yours,
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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