

**Internal Revenue Service**

**Department of the Treasury**

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Person to Contact:

Telephone Number:

Refer Reply To:  
CC:PSI:1-PLR-128527-02  
Date:  
June 28 2002

Legend:

- X =
- A =
- B =
- Trust 1 =
- Trust 2 =
- Trust 3 =
- Trust 4 =
- State =
- a =
- b =
- c =
- D1 =
- D2 =
- D3 =
- D4 =
- D5 =
- Year 1 =

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Dear

This responds to your letter dated May 14, 2002, submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code.

### Facts

According to the information submitted and representations therein, X was incorporated under the law of State on D1. An election to treat X as a subchapter S corporation effective D2 was filed on D3. A and B, who were husband and wife, owned a% of the outstanding shares of X as community property. The remaining b% of the outstanding shares of X were owned among the children of A and B. A and B transferred their share of X to Trust 1 on or shortly after D4. A died on D5. Upon A's death, Trust 1 was divided into Trust 2, Trust 3, and Trust 4, under the terms of Trust 1. After the division, Trust 2 and Trust 3 held b% and c% of the outstanding shares of X, respectively. Trust 4 held no outstanding shares of X. Soon after the division, Trust 2 was terminated and the shares of X held by Trust 2 were transferred to B.

In Year 1, the trustee of Trust 3 and B realized that an election to qualify Trust 3 as a Qualified Subchapter S Trust (QSST) had not been made, causing the termination of X's S election on D5.

X represents that at all relevant times, X and its shareholders treated X as an S corporation and filed their tax returns accordingly. X and its shareholders agree to make any adjustments required by the Secretary consistent with the treatment of X as an S corporation.

### 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) defines a "small business corporation" as a domestic corporation which is not an ineligible corporation which does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate and other than a trust described in subsection (c)(2)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than 1 class of stock.

Section 1361(c)(2)(A)(i) provides that, for purposes of § 1361(b)(1)(B), trusts that may be shareholders include a trust all of which is treated as owned by an individual who is a citizen or resident of the United States.

Section 1361(d)(1) provides in part that in the case of a qualified subchapter S trust with respect to which a beneficiary makes an election under § 1361(d)(2) – such

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trust shall be treated as a trust described in § 1361(c)(2)(A)(i).

Section 1361(d)(3) provides that the term “qualified subchapter S trust” means a trust – (A) the terms of which require that – (i) during the life of current income beneficiary, there shall be only 1 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 such 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 such beneficiary, and (B) all of the income (within the meaning of § 643(b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated 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) the Secretary determines that the circumstances resulting in the termination were inadvertent, (3) no later than a reasonable period of time after the 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 of the corporation at any time during the period of inadvertent termination of the S election, 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 the termination, the corporation is treated as an S corporation during the period specified by the Secretary.

The committee reports accompanying the Subchapter S Revision Act of 1982 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.

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S. Rep. No. 640, 97<sup>th</sup> Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24; H.R. Rep. No. 826, 97<sup>th</sup> Cong., 2d Sess. 12 (1982), 1982-2 C.B. 730, 735.

### Conclusion

Based solely on the facts submitted and the representations made, we conclude that X's election to be treated as an S corporation terminated on D5. We also conclude that the termination constituted an "inadvertent termination" within the meaning of § 1362(f). Under the provisions of § 1362(f), X will be treated as continuing to be an S corporation from D5, and thereafter, and the beneficiary of Trust 3 will be treated as having filed timely a QSST election on behalf of Trust 3, effective D5, provided that X's S corporation election is not otherwise terminated under § 1362(d) and provided further that the beneficiary of Trust 3 file a QSST election for Trust 3 with the appropriate service center, effective D5, within 60 days of the date of this letter. A copy of this letter should be attached to the election.

Except as specifically provide herein, no opinion is expressed or implied as to the federal tax consequences of the facts described above under any other provision of the Code. In particular, no opinion is expressed as to whether X is an S corporation for federal tax purposes; whether Trust 1 and Trust 2 were trusts permitted as shareholders of an S Corporation under § 1361(c)(2); or whether Trust 3 is a QSST under § 1361(d).

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

Under a power of attorney on file in this office, a copy of this letter will be sent to your authorized representative.

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