

**Internal Revenue Service**

**Department of the Treasury**

Number: **200245020**  
Release Date: 11/8/2002  
Index Number: 1362.04-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:3 PLR-120208-02

Date:

August 1, 2002

Company =

State =

A =

B =

C =

D =

Trust 1 =

Trust 2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Dear :

This letter responds to your letter dated April 3, 2002, and subsequent correspondence submitted on behalf of Company, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

## **FACTS**

Company incorporated in State on Date 1, and elected to be an S corporation effective Date 2. On Date 2, Company had two shareholders, A and B.

On Date 3, Company transferred its stock to Trust 1 and Trust 2. C is the income beneficiary of Trust 1. D is the income beneficiary of Trust 2.

Company retained new accountants to prepare its federal income tax returns on or about Date 4. On or about Date 4, it was discovered that Qualified Subchapter S Trust (QSST) elections under § 1361(d)(2) were not filed for Trust 1 and Trust 2. Thus, Company's S election had terminated on Date 3.

Company represents that since Date 3 it has filed returns as an S Corporation and has treated Trust 1 and Trust 2 as QSSTs. C and D have reported Trust 1 and Trust 2's share of Company's income and other items on their individual tax returns respectively. Company and its shareholders agree to make any adjustments consistent with the treatment of Company as an S corporation as may be required by the Commissioner.

## **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 for the taxable year.

Section 1361(b)(1) defines the term "small business corporation" as a domestic corporation that is not an ineligible corporation and that 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 § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

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 for purposes of § 1361(b)(1)(B).

Section 1361(d)(1) states that a QSST whose beneficiary makes an election under § 1361(d)(2) will be treated as a trust described in § 1361(c)(2)(A)(i), and the QSST's beneficiary will be treated as the owner (for purposes of § 678(a)) of that portion of the trust that consists of S corporation stock with respect to which the election under § 1362(d)(2) is made.

Under 1361(d)(2)(A), the beneficiary of a QSST may elect to have § 1361(d) apply. Under 1361(d)(2)(D), this election will be effective up to 15 days and two months

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before the date of the election.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the first taxable year for which the corporation is an S corporation) such 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), (2) the Secretary determines that the circumstances resulting in such termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such 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 agrees to make adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to the termination 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.

Section 1.1362-4(b) of the Income Tax Regulations provides that, for purposes of § 1.1362-4(a), 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.

### **CONCLUSIONS**

Based on the facts submitted and representations made, we conclude that Company's S corporation election terminated on Date 3 when C and D failed to make timely QSST elections for Trust 1 and Trust 2, respectively, under § 1361(d)(2). We further conclude that the termination of Company's S corporation election was inadvertent within the meaning of § 1362(f).

Under § 1362(f), Company will be treated as if it were an S corporation from Date 3 and thereafter, provided Company's S corporation election is valid and is not otherwise terminated under § 1362(d). However, this ruling is contingent on C and D filing QSST elections for Trust 1 and Trust 2, respectively, with an effective date of Date 3, with the appropriate service center within 60 days from the date of this ruling. A copy of this letter must be attached to the QSST elections.

During the period of termination, Trust 1 and Trust 2 will be treated as if they

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were QSSTs. Accordingly, the shareholders of Company, in determining their respective income tax liabilities, must include their pro rata share of the separately and nonseparately computed items of Company under § 1366, make any adjustments to stock basis under § 1367, and take into account any distributions made by Company under § 1368. If Company or any of the shareholders fail to treat Company as described above, this ruling shall be null and void.

Except as expressly provided herein, we express or imply no opinion concerning the federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion concerning whether Company is otherwise qualified to be an S corporation, or whether Trust 1 and Trust 2 are valid QSSTs.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code 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 your authorized representatives.

Sincerely,  
Mary Beth Collins  
Senior Technician Review, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

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