

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:1-PLR-118104-00
Date:
November 17, 2000

Legend:

X =

A =

B =

C =

D =

E =

F =

G =

H =

I =

a =

b =

c =

d =

e =

State =

D1 =

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D2 =

D3 =

D4 =

D5 =

This responds to your representative's letter dated September 19, 2000, submitted on behalf of X requesting relief under section 1362(f) of the Internal Revenue Code.

FACTS

X incorporated under the laws of State on D1 and elected to be treated as a subchapter S corporation effective D2. On D3, shareholders of X transferred stock to trusts A, B, C, D, E, F, G, and H. After this transfer, trust A owned a a% interest in X, each of trusts B through F owned a b% interest in X, trust G owned a c% interest in X, and trust H owned a d% interest in X. On D4, shareholders of X transferred a e% interest in X to trust I. None of trusts A through I were permissible holders of S corporation stock, causing a termination of X's S election on D3. When they discovered this termination, X and its shareholders requested relief under section 1362(f) of the Code.

X represents that at all relevant times, X and its shareholders treated X as an S corporation. X represents that each of trusts A through I is eligible to be treated as a qualified subchapter S trust. 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 section 1362 is in effect."

Section 1361(b)(1)(B) provides that, in order to be a small business corporation, a taxpayer cannot have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual.

Section 1361(c)(2)(A) of the Code provides that five types of domestic trusts may be shareholders of an S corporation: (i) a trust all of which is treated (under subpart E of part I of subchapter J) as owned by an individual who is a citizen or resident of the United States; (ii) a trust which was described in clause (i) immediately before the death

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of the deemed owner and which continues in existence after such death, but only for the 2-year period beginning on the day of the deemed owner's death; (iii) a trust with respect to stock transferred to it pursuant to the terms of a will, but only for the 2-year period beginning on the day on which such stock is transferred to it; (iv) a trust created primarily to exercise the voting power of stock transferred to it; and (v) an electing small business trust.

Section 1361(d) of the Code provides that a qualified subchapter S trust can be treated as a trust described in section 1361(c)(2)(A)(i) if a beneficiary of the trust makes an election for such treatment. A qualified subchapter S trust is a trust the terms of which require that (i) during the life of the current income beneficiary, there shall be only one 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. In addition, all of the income of the trust must be distributed (or required to be distributed) currently to one individual who is a senior resident of the United States.

Section 1362(d)(2)(A) provides that an election to be treated as a subchapter S corporation terminates 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. Under section 1362(d)(2)(B), the termination is effective on and after the date the S corporation ceases to meet the requirements of a small business corporation.

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) 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 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 the 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.

The committee reports accompanying the Subchapter S Revision Act of 1982 explain section 1362(f) as follows:

If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service

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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.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24;
H.R. Rep. No. 826, 97th 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 D3 when X's stock was issued to trusts A through I. We also conclude that the termination constituted an "inadvertent termination" within the meaning of section 1362(f). Under the provisions of section 1362(f), X will be treated as continuing to be an S corporation from D3, and thereafter, provided that X's S corporation election was valid and was not otherwise terminated under section 1362(d), and that each of trusts A through I files a timely QSST election, effective D5, with the appropriate Service Center.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed concerning whether the original election made by X to be treated as an S corporation was a valid election under section 1362 or whether any of trusts A through I qualifies as a qualified subchapter S trust.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

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

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

cc: