

Internal Revenue Service

Department of the Treasury
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Person To Contact:

Telephone Number:

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Date:

October 17, 2005

Legend

X =

A =

B =

Trust 1 =

Trust 2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Dear

This letter responds to a letter dated May 25, 2005, submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated on Date 1 and elected to be an S corporation effective Date 2. In Date 3, the shareholders of X consisted of individuals and Trust 1, a voting trust with two individual beneficiaries, A and B. Trust 1 is a permissible S corporation shareholder under § 1361(c)(2)(A)(iv). However, under § 1361(c)(2)(B)(iv), the beneficiaries of Trust 1, A and B, are treated as the shareholders of the S corporation. On Date 4, B contributed his beneficial interest in Trust 1 to Trust 2, a grantor trust that was treated (under subpart E of part 1 of subchapter J of chapter 1) as entirely owned by B. Trust 2 was eligible to be an S corporation shareholder under § 1361(c)(2)(A)(i). However, under § 1361(c)(2)(B)(i), the deemed owner of Trust 2, B, is treated as the shareholder of the S corporation.

The trust agreement for Trust 2 provides that upon B's death, the beneficial interests in Trust 1 are to be allocated by the trustee to eleven subtrusts, each a separate and independent share of Trust 2. These eleven subtrusts are to be established for the benefit of eleven separate individuals. The trust agreement for Trust 2 also provides that each subtrust must satisfy all of the requirements of a qualified subchapter S trust set forth in § 1361(d) and that the consent of the beneficiary of each subtrust to the continuation of X's S election is a condition precedent to the formation and funding of each subtrust.

When B died on Date 5, Trust 2 ceased to be a grantor trust. Under § 1361(c)(2)(A)(ii), Trust 2 remained a permissible S corporation shareholder until Date 6, two years after B's death. However, under § 1.1361-1(h)(3)(1)(B), the estate of B was treated as the shareholder of the S corporation from Date 5 to Date 6. On Date 6, each subtrust, by the terms set forth in the trust agreement for Trust 2, satisfied all of the requirements of a qualified subchapter S trust ("QSST") within the meaning of § 1361(d)(3). However, the income beneficiaries of the subtrusts failed to timely file an election under § 1361(d)(2)(A). Accordingly, the S election of X terminated on Date 6. In Date 7, the tax return preparers of Trust 2 discovered the beneficiaries' failure to file the QSST elections and notified X of these omissions.

X represents that the trustee of Trust 2 inadvertently failed to require that the QSST elections be filed as a condition to the funding of the subtrusts. X also represents that X was unaware of the beneficiaries' failure to file the QSST elections and that these omissions took place outside the knowledge and reasonable control of X and were not a part of any plan or intention of X to terminate its S election. X represents that for all taxable years during the termination period, X and X's shareholders have filed tax returns consistent with X being an S corporation.

Section 1361(a)(1) provides that the term “S corporation” means, with respect to any taxable year, a small business corporation for which an election under § 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 § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual.

Section 1361(c)(2)(A)(i) provides that for purposes of section 1361(b)(1)(B), a trust may be a shareholder if all of it is treated (under subpart E of part I of subchapter J of chapter 1 of title 26) as owned by an individual who is a citizen or resident of the United States. Section 1361(c)(2)(B)(i) provides that for purposes of section 1361(b)(1), in the case of a trust described in section 1361(c)(2)(A)(i), the deemed owner shall be treated as the shareholder.

Section 1361(c)(2)(A)(ii) and section 1.1361-1(h)(1)(ii) provide that for purposes of section 1361(b)(1)(B), a trust which was described in section 1361(c)(2)(A)(i) immediately before the death of the deemed owner and which continues in existence after such death, is a permitted shareholder, but only for the 2-year period beginning on the day of the deemed owner’s death. Section 1.1361-1(h)(3)(i)(B) provides that if stock is held by a trust described in section 1.1361-1(h)(1)(ii), the estate of the deemed owner is generally treated as the shareholder as of the day of the deemed owner’s death.

Section 1361(c)(2)(A)(iv) provides that a trust created primarily to exercise the voting power of stock transferred to it may be a shareholder. Section 1361(c)(2)(B)(iv) provides that in the case of a trust described in § 1361(c)(2)(A)(iv), each beneficiary of the trust shall be treated as a shareholder.

Section 1361(d)(1) provides that in the case of a qualified subchapter S trust (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.

Section 1362(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 1362(d)(2) shall be effective up to 15 days and 2 months before the date of the election.

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 the 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 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 section 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 1.1361-1(j)(3) provides that for purposes of section 1361(c) and section 1361(d), a substantially separate and independent share of a trust, within the meaning of section 663(c) and the regulations thereunder is treated as a separate trust. For a separate share which holds S corporation stock to qualify as a QSST, the terms of the trust applicable to that separate share must meet the QSST requirements stated in section 1.1361-1(j)(1)(i) and (ii).

Section 1.1361-1(j)(6)(iii)(C) provides that if a trust ceases to be a qualified subpart E trust, satisfies the requirements of a QSST, and intends to become a QSST, the QSST election must be filed within the 16-day-and-2-month period beginning on the date on which the trust ceases to be a qualified subpart E trust. If the estate of the deemed owner of the trust is treated as the shareholder under section 1.1361-1(h)(3)(i), the QSST election may be filed at any time, but no later than the end of the 16-day-and-2-month period beginning on the date on which the estate of the deemed owner ceases to be treated as a shareholder.

Section 1362(a) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

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 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 § 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 was terminated under § 1362(d)(2) or (3); (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 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 specified under § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary for that period, then, notwithstanding the circumstances

resulting in such 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 hold that X's election to be an S corporation terminated on Date 6, as a result of the failure of the beneficiaries of the eleven subtrusts to make the election required under § 1361(d)(2)(A). We also hold that the termination was inadvertent within the meaning of § 1362(f).

We further hold that, pursuant to the provisions of § 1362(f), X will be treated as an S corporation from Date 6, and thereafter, provided that the required QSST elections with an effective date of Date 6 are filed with the appropriate service center within 60 days from the date of this letter, the eleven subtrusts otherwise qualify as QSSTs, and X's election to be an S corporation was otherwise valid and was not terminated under § 1362(d). Accordingly, the shareholders of X must include their pro rata share of the separately stated and nonseparately computed items of X as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368. If X or its shareholders fail to treat X as described above, this letter 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, including whether X was or is a small business corporation under § 1361(b) or whether each of the eleven subtrusts are QSSTs within the meaning of § 1361(d)(3).

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 a power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely yours,

Beverly Katz
Senior Technician Reviewer, Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter
Copy for § 6110 purposes