Internal Revenue Service

Department of the Treasury

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November 15, 1999

X =

A =

B =

C =

D =

D1 =

D2 =

D3 =

D4 =

Trust =

Country =

Year 1 =

Year 2 =

Dear :

This letter responds to a letter dated April 5, 1999, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that X's election to be an S corporation was accepted effective D1. At that time, X believed that it had made a valid S corporation election.

When X filed its Form 2553, Election by a Small Business Corporation, Trust held shares in X. D, as X's president, represents that Trust met the definition of a qualified subchapter S trust (QSST) under § 1361(d)(3) of the Code. However, no election under § 1361(d)(2) (QSST election) was filed as to Trust. Additionally, on X's Form 2553, with respect to Trust, A, Trust's beneficiary's legal representative, as well as trustee of Trust, signed as trustee. A should have signed the Form 2553 on behalf of the beneficiary of Trust in A's capacity as legal representative rather than as trustee. Upon the death of the beneficiary in Year 1, Trust was terminated and X's stock was distributed outright to seven individuals.

Additionally, on D2, B, a shareholder of X, renounced B's United States citizenship and became a citizen of Country. In Year 2, B read an Internal Revenue Service publication and discovered that B's renunciation violated the requirements for an S corporation. B did not understand that the renunciation would disqualify X from S corporation status. In D3, B's lawyer explained the implications of B's renunciation. B then immediately informed X's other shareholders and on D4 transferred B's shares to B's spouse, C, who is a United States citizen. C represents that C is not holding X stock as a nominee for B.

D represents that the circumstances resulting in the invalidity of X's election to be an S corporation and in the potential termination on D2 of the S corporation election were inadvertent. X represents also that X and its shareholders did not intend to engage in tax avoidance or retroactive tax planning. X and each person who was or is a shareholder of X agree to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary with respect to such period.

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 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), as in effect for taxable years

beginning on or before December 31, 1997, provided that a "small business corporation" cannot have as a shareholder a person

(other than an estate, and other than a trust described in § 1361(c)(2)) who is not an individual.

Section 1361(c)(2)(A)(i) provides that for purposes of § 1361(b)(1)(B), a trust all of which is treated (under subpart E of part I of subchapter J of Chapter 1) as owned by an individual who is a citizen or resident of the United States may be a shareholder.

Section 1361(c)(2)(B)(i) provides that for purposes of § 1361(b)(1), in the case of a trust described in § 1361(c)(2)(A)(i), the deemed owner shall be treated as the 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 § 1361(d)(2), such trust shall be treated as a trust described in § 1361(c)(2)(A)(i) and, for purposes of § 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 § 1361(d)(2) is made.

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

Section 1362(a)(2) provides that an election under § 1362(a) shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.

Section 1.1362-6(b)(1) of the Income Tax Regulations provides that except as provided in § 1.1362-6(b)(3)(iii), the election of the corporation is not valid if any required consent is not filed in accordance with the rules contained in § 1.1362-6(b).

Section 1.1362-6(b)(2)(iv) of the regulations provides that in the case of a trust described in § 1361(c)(2)(A) (including a trust treated under § 1361(d)(1)(A) as a trust described in

§ 1361(c)(2)(A)(i)), only the person treated as the shareholder for purposes of § 1361(b)(1) must consent to the election.

Section 1361(b)(1)(C) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not have a nonresident alien as a shareholder.

Section 1362(d)(2)(A) provides that an election under § 1362(a) will be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation. Section 1362(d)(2)(B) provides that the termination shall be effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation (A) was not effective for the taxable year for which made (determined without regard to § 1362(b)(2)) by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consents, or (B) was terminated under § 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken (A) so that the corporation is a small business corporation, or (B) to acquire the required shareholder consents, and (4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to § 1362(f), 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 such ineffectiveness or termination, such 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 effective D1 was ineffective because no QSST election was filed as to Trust and because the shareholder consent for Trust provided on X's Form 2553 was improper. We hold also that the ineffectiveness of X's S corporation election was inadvertent within the meaning of § 1362(f). In addition, B's becoming a nonresident alien shareholder of X would have resulted in the termination of X's S corporation election had the S corporation election been effective when made and this potential termination would have

been inadvertent within the meaning of § 1362(f).

We further hold that under the provisions of § 1362(f), X will be treated as an S corporation effective D1 to D4 and thereafter, provided X's election to be an S corporation was not otherwise invalid and provided that the election was not otherwise terminated under § 1362(d). Accordingly, X's shareholders, in determining their federal tax liability, must include their pro rata share of the separately and nonseparately computed items of X under § 1366, make any adjustments to stock basis under § 1367, and take into account any distributions made by X to shareholders under § 1368. If X or its shareholders fail to treat X as described above, this ruling shall be null and void.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code, including whether Trust was a QSST under § 1361(d)(3). In particular, we express no opinion on the characterization of the transfer of B's shares to C on D4.

This ruling letter 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,

H. GRACE KIM
Assistant to the Chief
Branch 2
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
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