Internal Revenue Service

Department of the Treasury

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Legend

X =

Date 1 =

Trust 1 =

Trust 2 =

Trust 3 =

This responds to your letter dated October 1, 1999, and subsequent correspondence, written on behalf of X, requesting a ruling that X's election to be treated as an S corporation was an inadvertent invalid election under section 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, X was incorporated on Date 1. Subsequent to incorporation X made an S corporation election, effective Date 1, that was accepted by the applicable Service Center. At the time that X filed the election to be taxed as an S corporation X's shareholders included Trust 1, Trust 2 and Trust 3 (the Trusts). It is represented that the Trusts possessed the elements of a qualified subchapter S trust (" QSST") described in section 1361(d)(3)(A). Due to an oversight,

none of the Trusts' beneficiaries made a timely QSST election under section 1361(d)(2). Because the Trusts did not timely file the QSST elections, X's election to be treated as an S corporation was ineffective. When X's accountant discovered the oversight, X submitted this private letter ruling request.

X represents that at all relevant times, X and its shareholders treated X as an S corporation. X and its shareholders agree to make any adjustments necessary (consistent with the treatment of X as an S corporation) as may be required. Further, X represents that the failure to file timely QSST elections was not motivated by tax avoidance.

LAW AND ANALYSIS

Section 1361(a)(1) defines an S corporation as a small business corporation for which an election under section 1362(a) is in effect. Section 1361(b)(1) defines "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, other than a trust described in section 1361(c)(2), and other than an organization described in (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 chapter 1) as owned by an individual who is a citizen or resident of the United States, may be a subchapter S corporation shareholder.

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

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

Under section 1362(d)(2), an election to be an S corporation will be terminated whenever the corporation ceases to be a small business corporation.

Section 1305 of the Small Business Job Protection Act ("Act"), Pub. L. No. 104-188, 110 Stat. 1755, enacted August 20, 1996, amends section 1362(f), effective for taxable years beginning after December 31, 1982. Section 1362(f) provides that if (1) an election under section 1362(a) by any corporation was not effective for the taxable year for which made by reason of a failure to meet the requirements of section

1361(b) or to obtain shareholder consents, (2) the Secretary determines that the circumstances resulting in the ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were taken so that the corporation is a small business corporation or 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 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 circumstances resulting in the ineffectiveness or termination, the corporation is treated as continuing to be an S corporation during the period specified by the Secretary.

The legislative history for the Act indicates that Congress intends that the Internal Revenue Service be reasonable in exercising its authority and apply standards that are similar to those applied under present law to inadvertent terminations and other late or invalid elections. H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 226 (1996).

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24, in discussing section 1362(f) of the Code, provides, in part, 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 . . . . [I]t may be appropriate to waive the terminating event when the one class of stock requirement was inadvertently breached, but no tax avoidance had resulted. 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.

CONCLUSIONS

Based solely on the facts submitted and the representations made, we conclude: (1) X's election to be treated as a subchapter S corporation was

ineffective because the elections under section 1361(d)(2) were not filed; (2) the ineffectiveness of the election was inadvertent within the meaning of section 1362(f); (3) no later than a reasonable period of time after discovery of the terminating event, steps were taken to acquire the required shareholder consents; and (4) no tax avoidance was intended nor will result from the continued treatment of X as a subchapter S corporation. Therefore, pursuant to section 1362(f), X will be treated as a subchapter S corporation beginning on Date 1, and thereafter, provided that X's subchapter S election is not otherwise terminated under section 1362(d).

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. Specifically, no opinion is expressed on whether X's original election to be an S corporation was a valid election under section 1362 or whether the Trusts are QSSTs within the meaning of section 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 in this office, a copy of this letter will be sent to the taxpayer.

Sincerely,

Signed/David R. Haglund

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

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