Internal Revenue Service

Department of the Treasury

Index Number: 1362.04-00

Washington, DC 20224

Number: **200028026**
Release Date: 7/14/2000

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:2 - PLR-119689-99
Date:
April 18, 2000

X =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Trust 5 =

Trust 6 =

Trust 7 =

A =

B =

C =

D =

E =

F =

G =

State =

D1 =

D2 =

D3 =

D4 =

Year 1 =

Year 2 =

Law Firm 1 =

Law Firm 2 =

Accounting Firm =

Dear :

This letter responds to your letter dated November 4, 1999, and subsequent correspondence, submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code.

The information submitted states that X is a corporation incorporated under the laws of State on D1. X elected to be an S corporation effective D1. The current shareholders of X are Trust 1, Trust 2, Trust 3, Trust 4, Trust 5, Trust 6, Trust 7, E, and F. G, as Chief Financial Officer of X, represents that Trust 6 and Trust 7 are grantor trusts pursuant to § 676 and that Trusts 1-5 are qualified subchapter S trusts (QSSTs) within the meaning of § 1361(d)(3). On D2, A and B transferred shares of X to Trust 1, Trust 2, Trust 3, and Trust 6. On D3, C and D transferred shares of X to Trust 4, Trust 5, and Trust 7. Law

Firm 1 drafted the trusts on behalf of A, B, C, and D, with the intent that Trusts 1-5 would each qualify as a QSST. A, B, C, and D used Law Firm 2 to handle the transfer of shares of X to the trusts. Each firm believed that the other firm would be responsible for filing the elections under § 1361(d)(2) (QSST elections) for the QSSTs. Therefore, no QSST elections were filed timely for Trusts 1-5 and X's S corporation election terminated as of D2. E, the Chief Operating Officer of X, represents that the beneficiaries of Trusts 1-5 will file QSST elections.

Accounting Firm, unaware of the stock transfers, prepared X's and the shareholders' tax returns for Year 1 and Year 2 as if the transfer of shares to the trusts had not taken place.

Lacking understanding of the significance of transferring S corporation shares to Trusts 1-5, in Year 2, X made distributions to A, B, C, and D and failed to make distributions to Trusts 1-5. In D4, Accounting Firm learned about the stock transfers. In order to correct the distributions, A and B have made payments to Trust 1, Trust 2, and Trust 3, and C and D have made payments to Trust 4, and Trust 5. These payments are comprised of the amounts that should have been distributed to the trusts and accrued interest.

G represents that X's Articles of Incorporation authorize the issuance of only one class of stock, designated "common shares." G further represents that the laws of State require that all common stockholders receive identical rights with respect to liquidations and distributions.

X and its shareholders have agreed to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary.

G represents that the circumstances resulting in the termination of X's S corporation election were inadvertent. G further represents that X and its shareholders did not use hindsight in requesting relief.

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(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 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 representations made and the information submitted, we conclude that X's S corporation election terminated on D2, under § 1362(d)(2) of the Code, because the respective beneficiary of Trusts 1, 2, and 3 failed to file an election under § 1361(d)(2). Furthermore, X's S corporation election would have terminated on D3 because the respective beneficiary of Trusts 4 and 5 failed to file an election under § 1361(d)(2).

We conclude that the termination of X's S corporation election was an inadvertent termination within the meaning of § 1362(f) of the Code. We also conclude that the potential termination of X's S corporation election on D3 would have been inadvertent within the meaning of § 1362(f). Accordingly, pursuant to the provisions of § 1362(f), X will be treated as an S corporation effective D2 and thereafter, provided X's election to be an S corporation was valid and was not otherwise terminated under § 1362(d). From D2 and D3, respectively, Trusts 1-3 and Trusts 4-5 will be treated as trusts described in § 1361(c)(2)(A)(i) and the respective beneficiary will be treated, for purposes of § 678, as the owner of that portion of the respective trust that consists of X stock. 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. This ruling is conditioned on the filing, within 60 days from the date of this letter, of (1) any amended returns consistent with X being an S corporation and (2) an election under § 1361(d)(2) for each of Trusts 1-5. If X or its shareholders fail to treat X as described above, this ruling shall be null and void.

Section 1361(b)(1)(D) provides that a small business corporation cannot have more than one class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that a corporation generally is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

Section 1.1361-1(l)(2)(i) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable

state law, and binding agreements relating to distribution and liquidation proceeds. Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Based solely on the representations made and the information submitted, we conclude that the distributions made in Year 2 to A, B, C, and D that should have been made to one or more of Trust 1, 2, 3, 4, or 5 did not create a second class of stock.

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 each of the Trusts is a QSST under § 1361(d)(3). 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.

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

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes