Internal Revenue Service

Department of the Treasury

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LEGEND

X =

A =

B =

C =

d1 =

d2 =

d3 =

d4 =

d5 =

T1 =

T2 =

This letter responds to a letter dated February 28, 2001, and subsequent correspondence submitted by your authorized representative on behalf of X, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, X was incorporated on d1 and elected to be treated as an S corporation effective d2. On d3, C transferred X stock to T1 and T2, irrevocable trusts established for the benefit of A and B. X represents that T1 and T2 were intended to be qualified subchapter S trusts (QSSTs) under § 1361(d)(3).

In d4, however, X discovered that A and B failed to timely file QSST elections for

T1 and T2, respectively, and that X's S corporation election may have terminated on d3. Subsequently, A and B filed QSST elections for T1 and T2 on d5.

X requests a ruling that its termination was inadvertent under § 1362(f). X represents that the failure to make QSST elections for T1 and T2 was inadvertent and not motivated by tax avoidance or retroactive tax planning. Since d3, X treated T1 and T2 as S corporation shareholders and T1 and T2 were treated as QSSTs. X and its shareholders have agreed to make any adjustments necessary consistent with the treatment of X as an S corporation.

LAW AND ANALYSIS

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, in part, that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which 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 the 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 of the United States may be a shareholder of an S corporation.

Section 1361(d)(1) provides that in the case of a QSST with respect to which a beneficiary makes an election under § 1361(d)(2), (A) such trust will be treated as a trust described in § 1361(c)(2)(A)(i), and (B) for the purposes of § 678(a), the beneficiary of such trust will be treated as the owner of that portion of the trust which consists of stock in an S corporation.

Section 1361(d)(2)(A) provides that a beneficiary of a QSST (or his legal representative) may elect to have § 1361(d)(2) apply.

Section 1361(d)(2)(D) provides that a QSST election shall be effective up to 15 days and two months before the date of the election.

Section 1362(d)(2)(A) 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 the corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2); (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.

CONCLUSIONS

After applying the relevant law to the facts submitted and the representations made, we conclude that X's S corporation election terminated on d3 under § 1362(d)(2) when A and B failed to make timely QSST elections for T1 and T2, respectively, under § 1361(d)(2). We also conclude that the termination of X's S corporation election was inadvertent within the meaning of § 1362(f). Therefore under § 1362(f), X will be treated as an S corporation from d3 and thereafter, provided that X's S corporation election is valid and is not otherwise terminated under § 1362(d).

During the period of termination, T1 and T2 will be treated as if they were QSSTs. Accordingly, the shareholders of X 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, T1, T2, or the shareholders fail to treat X as described above, this ruling will be null and void.

Except for the specific ruling above, we express no opinion concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, we express no opinion on whether X is otherwise qualified to be an S corporation, or whether T1 and T2 are valid QSSTs.

This ruling is directed only to the taxpayer requesting it. Under § 6110(k)(3), it may not be used or cited as precedent.

Under a power of attorney on file in this office, we are sending a copy of this letter to your authorized representatives.

Sincerely yours,
Mary Beth Collins
Assistant to the Branch Chief, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

cc: