Internal Revenue Service

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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B01
PLR-117543-06
Date: September 6, 2006

Legend:

X =

State =

D1 =

Trust =

D2 =

Dear :

This responds to the letter dated March 10, 2006, and related correspondence, submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code (Code).

FACTS

According to the information submitted, X was incorporated pursuant to the laws of State. X elected to be treated as an S corporation for federal tax purposes, effective D1. At the time of the election, X believed that all of its shareholders were eligible shareholders of an S corporation.

The trust agreement of Trust, one of X's shareholders, however, contained provisions that allowed for the possibility that distributions would be made other than to the beneficiary of Trust. The beneficiary of Trust elected to treat Trust as a qualified subchapter S trust (QSST), effective D1. At the time of the election, X and its shareholders were unaware that Trust did not meet the requirements of § 1361(d)(3)(A)(ii) and, therefore, was an ineligible shareholder of an S corporation.

Subsequently, upon discovery of the error, X and its shareholders sought to reform the trust agreement of Trust through state court action in order for Trust to qualify as a QSST. On D2, the trust agreement was reformed and no distributions would be made other than to the beneficiary of Trust during the lifetime of the beneficiary.

X and its shareholders have agreed to make any adjustments that the Commissioner may require consistent with the treatment of X as an S corporation, effective D1.

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 that an S corporation cannot 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 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 an S corporation shareholder.

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

Section 1361(d)(3)(A) provides that a QSST is a trust, 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 the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary. In addition, § 1361(d)(3)(B) requires that the trust distribute all of its income (within the meaning of § 643(b)) currently to one individual who is a citizen or resident of the United States.

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 in relevant part that if (1) an election under § 1362(a) by any corporation 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, (2) the Secretary determines that the circumstances resulting in such ineffectiveness were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness, 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 this subsection, 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, such corporation shall be treated as an S corporation during the period specified by the Secretary.

CONCLUSION

Based solely upon the facts submitted and the representations made, we conclude that, prior to the reformation, Trust did not satisfy the QSST requirements of § 1361(d)(3). Therefore, X's S election was ineffective for the taxable year beginning D1. We further conclude that the ineffectiveness of X's S election constituted an inadvertent invalid S election within the meaning of § 1362(f).

Under § 1362(f), Trust will be treated as a QSST from D1, and thereafter. X will be treated as an S corporation from D1, and thereafter, provided that X's S election was otherwise valid and has not otherwise terminated under § 1362(d), and provided that the Trust's QSST election was otherwise valid and has not otherwise terminated.

This ruling is contingent upon X and all its shareholders treating X as having been an S corporation and Trust as a QSST for the period beginning D1, and thereafter.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the above-described facts under any other provision of the Code, including whether X was otherwise eligible to be an S corporation, or whether Trust was otherwise eligible to be a QSST.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) 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,

David R. Haglund
Senior Technician Reviewer
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter
Copy for § 6110 purposes