

**Internal Revenue Service**

Department of the Treasury  
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Person To Contact:

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Date:

January 11, 2005

X =

A =

B =

Date 1 =

Date 2 =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Trust 5 =

Dear \_\_\_\_\_ :

This responds to a letter dated December 18, 2003, and additional correspondence, submitted on behalf of X, requesting a ruling under section 1362(f) of the Internal Revenue Code.

Facts

X elected to be taxed as an S corporation effective Date 1. At the time of the election, X erroneously believed that Trust 2 and Trust 4 were shareholders of X. However, after the death of B on Date 2, X discovered that in fact, Trust 3 and Trust 5, held shares in X. After the death of B, the shares of X held by Trust 5 were transferred to Trust 3.

The income beneficiaries intended to file elections for the trusts that held X stock, Trust 3 and Trust 5, to be treated as a "qualified subchapter S trusts" (QSSTs) under section 1361(d). However, the income beneficiaries did not timely file the appropriate elections under 1362(d)(2). In addition, after A transferred shares to Trust 1, the trustees of Trust 1 failed to make an election to treat Trust 1 as an "electing small business trust" (ESBT). As a result of the failure to file these elections, X's S corporation election was invalid.

X represents that there was no intent to terminate X's S corporation election and that the failure to file timely the QSST elections for Trust 3 and Trust 5 as well as the ESBT election for Trust 1 was not motivated by tax avoidance or retroactive tax planning. X also represents that since Date 1 and thereafter, Trust 3 and Trust 5 have complied with the requirements under section 1361(d), which defines a QSST. Similarly, X represents that since Date 1 and thereafter, Trust 1 has complied with the requirements under section 1361(e), which defines an ESBT.

X and its shareholders agree to make any adjustments required by the Secretary 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 section 1362(a) is in effect for such year.

Section 1361(b)(1) defines a "small business corporation" as a domestic corporation which is not an ineligible corporation and which does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in section 1361(c)(2), or an organization described in section 1361(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(d)(1) provides that a QSST whose beneficiary makes an election under section 1362(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), a 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.

Section 1361(d)(3) defines a QSST as a trust (A) the terms of which require that (i) during the life of the current income beneficiary, there shall be only one 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 beneficiary in the trust shall terminate on the earlier of the 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 that beneficiary; and (B) all of the income (within the meaning of section 643(b) of which is distributed (or required to be distributed) currently to one individual who is a citizen or resident of the United States.

Section 1361(c)(2)(A)(v) provides that an ESBT (as defined in section 1361(e)) is a permitted S corporation shareholder. Section 1361(e)(1)(A) provides that, for purposes of section 1361, and except as provided in section 1361(e)(1)(B), the term ESBT means any trust if (i) the trust does not have as a beneficiary any person other than an individual, an estate, or an organization described in section 170(c)(2), (3), (4), or (5); (ii) no interest in the trust was acquired by purchase; and (iii) an election under section 1361(e) applies to the trust.

Section 1361(e)(3) provides that such an election is to be made by the trustee and is to apply to the tax year of the trust for which made and all subsequent tax years unless revoked with the consent of the Service.

Section 1.1361-1(m)(2)(i) of the Income Tax Regulations provides that the trustee of the trust must make the ESBT election by signing and filing, with the service center where the S corporation files its income tax return, a statement that meets the requirements of section 1.1361-1(m)(2)(6). Section 1.1361-1(m)(2)(iii) provides that the trustee must file the ESBT election within the period of time prescribed by section 1.1361-1(j)(6)(iii) for filing qualified subchapter S trust (QSST) elections (generally within the 16-day-and-2-month period beginning on the day the stock is transferred to the trust).

Section 1362(f) provides, in relevant part, that if (1) an election under section 1362(a) by any corporation was not effective for the taxable year for which made (determined without regard to section 1362(b)(2)) 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 such termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in ineffectiveness, steps were taken so that the corporation is once more 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 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, the corporation shall be treated as continuing to be an S corporation during the period specified by the Secretary.

### Conclusion

Based solely on the information submitted and the representations made, we conclude that X's subchapter S election was invalid because appropriate elections were not filed for Trust 3, Trust 5 and Trust 1. In addition, we conclude that the election was inadvertently invalid within the meaning of section 1362(f). Therefore, X will be treated as continuing to be an S corporation from Date 1, and thereafter, provided that the beneficiaries for Trust 3 and Trust 5 file QSST elections, and the trustee of Trust 1 files an ESBT election with the appropriate service center within 60 days of the date of this letter. A copy of this letter should be attached to the QSST and ESBT elections.

Except as specifically set forth above, we express no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X is otherwise eligible to be treated as an S corporation, whether Trust 3 and Trust 5 are eligible to be treated as QSSTs, or whether Trust 1 is eligible to be an ESBT.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your taxpayer.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

David R. Haglund  
Senior Technician Reviewer, Branch 1  
Office of Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

Copy for § 6110 purposes