

**Internal Revenue Service**

**Department of the Treasury**

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November 5, 1998

Legend

X =

Trust 1 =

Trust 2 =

State =

D1 =

D2 =

D3 =

D4 =

D5 =

This responds to your representative's September 3, 1998 letter, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

## **FACTS**

X was incorporated under State law on D1. On D2, X elected subchapter S status, effective D3. At that time, Trust 1 was the sole shareholder of X. The beneficiary of Trust 1 filed a qualified subchapter S trust (QSST) election under § 1361(d)(2), effective D3. On D4, Trust 2 purchased 50% of the outstanding X stock from Trust 1. Although the Trust 2 beneficiary intended to file a QSST election on behalf of Trust 2, the Trust 2 beneficiary failed to file the election. Trust 1 and Trust 2 (Shareholders) are the shareholders of X.

On or about D5, X's accountant discovered that Trust 2's ownership of stock in X terminated X's S election. Since D4, X and the Shareholders treated X as a valid subchapter S corporation. X and the Shareholders agree to make any adjustments necessary (consistent with the treatment of X as an S corporation) as may be required.

## **LAW AND ANALYSIS**

Section 1361(a)(1) defines an "S corporation", with respect to any taxable year, as a small business corporation for which an S election under § 1362(a) is in effect for that year.

Section 1361(b)(1)(B), for tax years beginning on or before December 31, 1997, provides 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 a trust, all of which is treated as owned by an individual who is a citizen or resident of the United States, is a permitted shareholder of a small business corporation.

Section 1361(d)(1) provides that a QSST whose 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 the portion of the QSST's S corporation stock to which the election under § 1361(d)(2) applies.

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

Section 1362(d)(2) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the taxable year for which the corporation is an S corporation) the corporation ceases to be a small business corporation. The termination is effective on and after the day of the termination.

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 paragraph (2) or (3) of § 1362(d); (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 effectiveness 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 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 or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

The committee reports accompanying the Subchapter S Revision Act of 1982, in discussing § 1362(f) as it relates to inadvertent terminations, state, 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 the taxpayers and the government will work out agreements that protect the revenues without undue hardship to taxpayers . . . . 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.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24.

## CONCLUSIONS

Based solely on the facts submitted and representations made, we conclude that X's subchapter S election terminated on D4 as a result of Trust 2 acquiring X stock. We also conclude that the termination was inadvertent under § 1362(f). Therefore, under the provisions of § 1362(f), X will be treated as an S corporation from D4 and thereafter, and the beneficiary of Trust 2 will be treated as having filed a timely QSST election on behalf of Trust 2 effective D4, and thereafter, provided that the beneficiary of Trust 2 files a QSST election for Trust 2 within 60 days from the date of this letter and X's S corporation election is not otherwise terminated under § 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 S corporation election was a valid election under § 1362 or whether the Shareholders are QSSTs under § 1361(d)(3).

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

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,

signed/Daniel J. Coburn  
Daniel J. Coburn  
Assistant to the Branch Chief, Branch 1  
Office of the Assistant Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter

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