

# Internal Revenue Service

Department of the Treasury

Number: **200305021**  
Release Date: 01/31/2003  
Index Number: 1362.04-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:  
CC:PSI:2-PLR-162876-01  
Date:  
October 25, 2002

## Legend

X =

A =

B =

C =

D =

Trust =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

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

This is in reply to a letter dated October 24, 2001, submitted on behalf of X by X's authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that X incorporated on Date 1. The shareholders of X were A, B, C, and D. X elected to be treated as an S corporation effective Date 2. On Date 3, A died. Pursuant to the terms of A's will, Trust was created with B as the current income beneficiary. On Date 4, within two years of A's death, A's shares of X were transferred to Trust. The terms of the will that create Trust meet the "qualified subchapter S trust" ("QSST") requirements. The Trustee was provided with discretion as to distribution of Trust income and principal. However, B was not aware of the need to make the QSST election, and B was not so advised by the accountants and attorneys. As a result, B failed to file the election required under § 1361(d)(2).

B is the president of X. B represents that, due to an oversight, Trust failed to currently distribute all trust income to B.

Additionally, X, in Years 1, 2, 3, and 4, made a number of distributions (the "Distributions") to X's shareholders. The Distributions were not pro rata in accordance with the shareholders' ownership of X stock. X is not authorized by its Articles of Incorporation to issue more than one class of stock. Additionally, the bylaws of X provide that shares of common stock have identical distribution and liquidation rights. X plans to make certain remedial distributions to equalize the cumulative amount of per share distributions, including interest, to correct the disproportionate distributions.

Since Date 2, X has continued to operate and file its state and federal income tax returns as an S corporation. However, the former accountants of X did not report X's income as passing through to B; rather, the former accountants caused the Trust itself to report its share of the income of X in taxable Year 1, Year 2, and Year 3. In taxable Year 4, B properly reported her share income of X. B represents that the failure to file the QSST election, Trust's failure to currently distribute income, and the non-pro rata Distributions were not motivated by tax avoidance or retroactive tax planning. X and X's shareholders agree to make any adjustments (consistent with the treatment of X as an S corporation) that the Secretary may require.

Section 1361(a)(1) of the Internal Revenue Code defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1361(b)(1)(B) provides that the term “small business corporation” is a domestic corporation which is not an ineligible corporation, which does not have as a shareholder a person (other than an estate and other than a trust described in § 1361(c)(2) or an organization described in § 1361(c)(6)) who is not an individual.

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

Section 1361(c)(2)(A)(iii) provides that a trust with respect to S corporation stock transferred to it pursuant to the terms of a will is a permitted S corporation shareholder, but it is only a permitted shareholder for the two year period beginning on the day on which such stock is transferred to it.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that, except as provided in § 1.1361-1(l)(4) (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation 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 based on the governing provisions of a corporation. Such provisions include binding agreements relating to distribution and liquidation proceeds.

Section 1.1361-1(l)(2)(v), in Example 2, illustrates a determination of whether, if distributions differ in timing, the difference in timing causes the corporation to be treated as having more than one class of stock. In the example, S, a corporation, has two shareholders. Under the corporation’s bylaws, the shareholders are entitled to equal distributions. S distributes \$50,000 to one shareholder in the current year, but does not distribute \$50,000 to the other shareholder until one year later. In the example, the difference in timing was not due to a binding agreement relating to distributions, and the difference in timing did not cause S to be treated as having more than one class of stock.

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 beneficiary of such trust shall be treated as the owner (for purposes of § 678(a)) of that portion of the QSST which consists of S corporation stock to which an election under § 1361(d)(2) applies. Section 1361(d)(2) provides that a beneficiary of a QSST may elect to have § 1361(d) apply. Under § 1361(d)(2)(D), this election will be effective up to 15 days and 2 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 § 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 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 a corporation is an S corporation) such corporation ceases to be a small business corporation. A termination of an S corporation election under § 1362(d)(2) is 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 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 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 of 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, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts submitted and the representations made, we conclude that X's S election was terminated on Date 5, the day after the two year period that began on the day that X stock was transferred to the Trust because Trust was no longer an eligible shareholder of X beginning on Date 5. In addition, we conclude that this termination was inadvertent within the meaning of § 1362(f). Furthermore, X's S election would have terminated as a result of Trust's failure to distribute income as required by a QSST, if the S corporation election had not been otherwise terminated by the failure to file the QSST election. This potential termination would have been inadvertent within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from Date 5, and thereafter, provided that X's S election was valid and was not otherwise terminated. However, this ruling is contingent on the beneficiary of Trust filing a QSST election, with an effective date of Date 6, with the appropriate service center within 60 days of this ruling. A copy of this letter must be attached to the QSST election.

If Trust files a valid QSST election effective Date 6, Trust will be treated as a trust described in § 1361(c)(2)(A)(i) and B will be treated under § 678 as the owner of the portion of Trust consisting of X stock. Accordingly, the shareholders of X, in determining their respective income tax liabilities beginning Date 6, and thereafter, must include their pro rata share of the separately stated and non-separately computed items of X as provided in § 1366, make any adjustments to basis provided in § 1367, and take into account any distributions made by X as provided in § 1368. If X or its shareholders fail to treat themselves as described above, this ruling shall be null and void. Furthermore, this ruling is contingent on Trust distributing all income accumulated on Date 6, or thereafter, to B within 60 days of the date of this letter.

In addition, based on the information submitted and the representations made, we conclude that because X's stock has identical distribution rights under its governing provisions, the difference in timing between X's non-pro rata distributions and the remedial distributions does not cause X to have more than one class of stock for purposes of § 1361(b)(1)(D). However, such disproportionate and remedial distributions must be given appropriate tax effect. Under these circumstances, we conclude that X's S election did not terminate because of the disproportionate distributions.

Except as specifically ruled upon above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provisions of the Code. Specifically, no opinion is expressed on whether X is otherwise eligible to be treated as an S corporation or whether Trust is eligible to be a QSST.

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

Sincerely,

J. Thomas Hines  
Chief, Branch 2  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

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