

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:2 - PLR-110007-03
Date:
September 22, 2003

X =

D1 =

D2 =

D3 =

Year 1 =

Year 2 =

Year 3 =

Trust 1 =

Trust 2 =

Dear :

This responds to a letter dated February 11, 2003, and subsequent correspondence, submitted on behalf of X by X's authorized representative, requesting a ruling under § 1361(e) of the Internal Revenue Code.

The information submitted states that X elected to be an S corporation for its taxable year beginning D1 of Year 1. X's shareholders at the time of its S corporation election included Trust 1 and Trust 2, both of which made timely elections to be treated as electing small business trusts (ESBTs).

Both Trust 1 and Trust 2 include provisions allowing the trustees to distribute, at any time and from time to time, in the trustees' sole discretion, to any one or more of the "potential Charitable Beneficiaries" such sums of net income (but not principal) from the trust as such trustees deem advisable. The potential charitable beneficiaries shall

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be such one or more organizations as may be selected by the trustees, in their sole discretion, from time to time, consisting only of corporations, associations, and institutions which are organized and operated exclusively for religious, charitable, literary and educational purposes and projects and which are described in §§ 170(c) and 501(c)(3).

Prior to D1 of Year 1, the trustees of Trust 1 permanently disclaimed the power to make discretionary distributions to any charitable beneficiary before D2 of Year 2 and permanently disclaimed the power to make discretionary distributions to any charitable beneficiary other than two named foundations after D1 of Year 2.

On D3 of Year 3 (subsequent to D1 of Year 1 and May 14, 2002, but prior to December 31, 2002), the trustees of Trust 2 permanently and immediately disclaimed the power to make discretionary distributions to any charitable beneficiary other than one named foundation. X represents that the disclaimers by the trustees of Trust 1 and Trust 2 are valid under the trust instruments and applicable local law.

Section 1362(a) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1361(a)(1) 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) provides that a "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not (A) have more than 75 shareholders and (B) 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)(v) provides that, for purposes of § 1361(b)(1)(B), an ESBT may be a shareholder of an S corporation. Section 1361(c)(2)(B)(v) provides that in the case of an ESBT, each potential current beneficiary (PCB) of such trust shall be treated as a shareholder for purposes of § 1361(b)(1); except that, if for any period there is no PCB of such trust, such trust shall be treated as the shareholder during such period.

Section 1361(e) defines an ESBT. Section 1361(e)(2) provides that, for purposes of § 1361(e), the term "potential current beneficiary" means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust.

Section 1.1361-1(m)(4)(i) of the Income Tax Regulations provides that, in general, for purposes of determining whether a corporation is a small business corporation within the meaning of § 1361(b)(1), each PCB of an ESBT generally is treated as a shareholder of the corporation. Subject to the provisions of § 1.1361-

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1(m)(4), a PCB generally is, with respect to any period, any person who at any time during such period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust. A person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may receive a distribution of principal or income of the trust.

Section 1.1361-1(m)(4)(vi)(A) provides that, in general, a person to whom a distribution is or may be made during a period pursuant to a power of appointment is a PCB. Thus, if any person has a lifetime power of appointment that would permit distributions from the trust to be made to more than 75 persons, the corporation's S corporation election will terminate because the number of PCBs will exceed the 75-shareholder limit of § 1361(b)(1)(A).

Section 1.1361-1(m)(4)(vi)(B) provides that if the holder of a power of appointment permanently releases the power in a manner that is valid under the applicable local law, the persons that would be PCBs solely because of the power will not be PCBs after the effective date of the release.

Section 1.1361-1(m)(9) provides that § 1.1361-1(m) is applicable for taxable years of ESBTs beginning on and after May 14, 2002.

Based solely on the facts and representations submitted, we conclude that X's S corporation election was not ineffective because of the power of the trustees of Trust 1 to make distributions of trust income to an unlimited number of charitable beneficiaries, because that power was disclaimed prior to the effective date of X's S corporation election. We further conclude that X's S corporation election was not ineffective as a result of the power of the trustees of Trust 2 to make distributions of trust income to an unlimited number of charitable beneficiaries prior to their disclaimer on D3 of Year 3 because that power was permanently released by a disclaimer that was valid under applicable local law pursuant to § 1.1361-1(m)(4)(vi)(B), and was made prior to the date of applicability of § 1.1361-1(m).

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, including whether X was or is a small business corporation under § 1361(b).

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This ruling is directed only to the taxpayer 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 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