

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B1 – PLR-118226-03

Date:

Oct 1 2003

Legend

X =

State =

Decedent =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Trust 5 =

Trust 6 =

Trust 7 =

Trust 8 =

D1 =

D2 =

D3 =

Dear :

This responds to your letter dated, March 14, 2003, requesting a ruling that each of Trusts 1 through 8, as reformed, is a qualified subchapter S trust (QSST) under § 1361(d)(3) of the Internal Revenue Code and is exempt for generation skipping tax (GST) purposes.

FACTS

X is a C corporation, formed under the laws of State, having single class of stock. Trusts 1 through 8 are X shareholders. In order for X to elect to be an S corporation, trustees for Trusts 1 through 8 petitioned the Court in State to reform the trusts to comply with § 1361(d)(3). If a favorable private letter ruling is issued in this case, Trusts 1 through 8 will each elect to be QSSTs.

The taxpayer has requested a ruling that Trusts 1 through 8, as reformed, will comply with § 1361(d)(3). The taxpayer has also requested a ruling that the reformation Trusts 1 through 4, as reformed, will not affect the exempt status of those trusts for generation-skipping transfer (GST) tax purposes.

On D1 (prior to September 25, 1985) Decedent bequeathed an equal share of her residuary estate to Trusts 1 and 2. In addition to the residuary bequests, Decedent also exercised a general power of appointment over property in a marital trust, appointing such property to the testamentary trusts in equal shares. Decedent also exercised special powers of appointment over the testamentary trusts created by Decedent's spouse (benefiting each daughter) appointing such property in equal shares to the testamentary trusts.

Under the current terms of Trusts 1 and 2, the trustees are to pay the entire net income to the beneficiary for life. The trustees also have discretion to (1) pay trust corpus to the beneficiary to maintain such beneficiary's standard of living (but limited to health, education, maintenance and support if the beneficiary is a trustee), and (2) pay trust corpus to the beneficiary's issue for support and education. Each daughter has a lifetime special power to appoint any remaining trust corpus to her issue. Trusts 1 and 2 will terminate upon the first to occur of the appointment of all corpus, or death of the beneficiary when the last of the beneficiary's children reach the age of majority. Upon termination, the trusts will distribute the corpus to the beneficiary's issue by right

of representation. The trustees have asked the court to reform Trusts 1 and 2 to permit the trustees' to distribute corpus solely to the beneficiary.

On D2 (prior to September 25, 1985) Trusts 3 through 4 were formed under the laws of State as irrevocable testamentary trusts. Trusts 3 through 4 were formed under the laws of State as irrevocable inter vivos trusts. Under the current terms of Trust 3 and Trust 4, the trustee has discretion to pay all or part of the net income and corpus to the beneficiary and the beneficiary's issue as the trustee determines is necessary for support, education, and maintenance. The beneficiary has a testamentary special power of appointment over the trust. Upon the death of the beneficiary, the remaining trust corpus is to be distributed outright to descendants in equal shares by right of representation. The trustees have asked the court to reform Trust 3 and Trust 4 to require that all trust income is payable annually to the beneficiary and to permit the trustees to distribute corpus solely to the beneficiary for support, education, and maintenance.

On D3 (after September 25, 1985) Trust 5 through 8 were created. The trust instrument provides that during the term of the trust all of the principal of the trust may be distributed solely to the beneficiary of the trust. In certain circumstances the trust instrument also provides for the right to withdraw property from the trust to persons other than the beneficiary. The trustees have asked to court to reform Trusts 5 through 8 to provide only the beneficiary with rights to withdraw property.

As reformed, each trust instrument will provide that in the event that any part of the corpus of a trust consists of Subchapter S stock, the trust instrument is intended to comply with the requirements of the Internal Revenue Code § 1361(d)(3) and that any provision of a trust which is not in compliance with such requirements will be null and void as of the effective date that the trust becomes an S shareholder, with the remaining provisions of the trust to be carried in effect.

It is also represented that no additions, actual or constructive, have been made to the Trusts 1 through 4 after September 25, 1985.

LAW AND ANALYSIS

Section 1361(d)(3) Ruling

Section 1361(a)(1) defines an S corporation as a small business corporation for which an election under § 1362(a) is in effect. Section 1361(b)(1) defines "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate, other than a trust described in § 1361(c)(2), and other than an

organization described in (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(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 a subchapter 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.

Under § 1361(d)(2)(A), the 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 two months before the date of the election.

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.

Based solely on the information submitted and the representations made, we conclude that each of Trusts 1 through 8, as reformed, meet the definition of a QSST under § 1361(d)(3). Therefore, provided that the beneficiaries make the proper elections under § 1361(d)(2) for the trusts, each trust will be treated as a trust described in § 1361(c)(2)(A)(i).

Rev. Rul. 93-79, 1993-2 C.B. 269, provides that a state court order that reforms a trust to meet the requirements of a QSST is recognized prospectively.

Section 2601 Ruling

Section 2601 imposes a tax on every generation-skipping transfer. Under § 1433(a) of the Tax Reform Act of 1986 (Act), the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under

§ 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to any generation-skipping transfer from a trust, if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date. Under § 26.2601-1(b)(1)(ii), any trust in existence on September 25, 1985, will be considered irrevocable unless the settlor had a power that would have caused inclusion of the trust in his or her gross estate under § 2038 or 2042, if the settlor had died on September 25, 1985.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax will not cause the trust to lose its exempt status.

Section 26.2601-1(b)(4)(i)(D) provides that a modification will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. A modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer.

Section 26.2601-1(b)(4)(i)(E), Example 8, considers a situation where a trust is modified to convert the income interest into a unitrust interest. The grantor established an irrevocable trust under the terms of which trust income is payable to A for life and, upon A's death, the remainder is to pass to A's issue, per stirpes. The court approves a modification to the trust that converts A's income interest into the right to receive the greater of the entire income of the trust or a fixed percentage of the trust assets valued annually to be paid each year to A for life. The modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification. In this example, the modification can only operate to increase the amount distributable to A and decrease the amount distributable to A's issue. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the modification will not subject the trust to the provisions of chapter 13.

In the present case, Trusts 1 through 4 were irrevocable on September 25, 1985, and it is represented that no additions, actual or constructive, have been made to the trusts after that date. The proposed reformation will not result in a shift of any beneficial interest to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the proposed reformation. As in Example 8, the

modification can only operate to increase the amount distributable to the respective beneficiary and decrease the amount distributable to any descendant of the beneficiary. In addition, the proposed reformation will not extend the time for vesting of any beneficial interest beyond the period provided for in the trust instruments.

Therefore, based on the facts submitted and the representations made, we conclude that the reformation of the Trusts 1 through 4 will not cause any of the trusts to lose their exempt status for purposes of § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) or cause any of the trusts or any distributions from the trusts to be subject to generation-skipping transfer tax under § 2601. Accordingly, after the proposed reformation, each trust will continue to be exempt from the GST tax imposed under § 2601 provided there are no additions to the Trust after September 25, 1985.

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 is a subchapter S corporation for federal tax purposes.

This ruling is directed only to the taxpayer that 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 the taxpayer.

Sincerely,

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

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