

**Internal Revenue Service**

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

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CC:PSI:B02

PLR-114567-04

Date:

July 14, 2004

X =

A =

B =

Trust 1 =

Trust 2 =

State 1 =

State 2 =

D1 =

D2 =

D3 =

Dear :

This letter responds to a letter dated March 2, 2004, and subsequent correspondence, written on behalf of X by X's authorized representative, requesting a

ruling that the amount treated as a deemed dividend by X and its shareholders is not income to Trust 1 and Trust 2 within the meaning of § 643(b), and that therefore, Trust 1 and Trust 2 will have no obligation to distribute such amount to the income beneficiary to meet the distribution requirements of § 1361(d)(3)(B).

B, X's president, represents that X is a State 1 corporation that was incorporated on D1. Effective D2, X elected to be an S corporation pursuant to § 1362(a). A, Trust 1, and Trust 2 are the shareholders of X. Effective D2, Trust 1 and Trust 2 each elected to be a qualified subchapter S trust (QSST) pursuant to § 1361(d). A is the current income beneficiary of Trust 1 and Trust 2. Trust 1 and Trust 2 are each governed by the laws of State 2.

Prior to D2, X was a subchapter C corporation for federal income tax purposes. B also represents that X expects to have subchapter C earnings and profits within the meaning of § 1.1362-2(c)(3) at the close of the taxable year ending D3. X intends to distribute its subchapter C earnings and profits. However, B represents that X would need to incur additional borrowings to pay a cash dividend sufficient to distribute all or part of its subchapter C earnings and profits. Therefore, X, with the consent of its shareholders, will elect to distribute all or part of its subchapter C earnings and profits through a deemed dividend, as described in § 1.1368-1(f)(3) ("deemed dividend").

The governing instrument for Trust 2 does not state the manner in which dividends should be allocated to income or principal.

Article Fourth (a) of Trust 1 provides that all cash dividends, except such as may be declared out of capital or paid-in surplus, shall be considered as income, and any stock dividends and all distributions other than cash received upon any stock at any time held in trust shall be considered principal (to the extent that it may be lawful so to do).

The law of State 2 provides that income is defined as money or property that a fiduciary receives as a current return from a principal asset. Additionally, the law of State 2 provides that in allocating between principal and income, the fiduciary shall administer a trust in accordance with its terms. Furthermore, the law of State 2 provides that to the extent that the terms of the trust do not provide a rule for allocating between principal and income, the amount shall be added to principal.

Section 643(b) provides that the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

Section 1361(d)(3) provides that the term “qualified subchapter S trust” means a trust (A) 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, (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, and (B) all of the income (within the meaning of § 643(b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States.

Section 1.1368-1(f)(2)(i) provides that an S corporation with accumulated earnings and profits may elect for any taxable year to distribute earnings and profits first as provided in § 1368(e)(3). Except as provided in § 1.1368-1(f)(2)(ii), distributions made by an S corporation making this election are treated as first from earnings and profits under § 1368(c)(2) and second from the AAA under § 1368(c)(1). Any remaining portion of the distribution is treated in the manner provided in § 1368(b). This election is effective for all distributions made during the year for which the election is made.

Section 1.1368-1(f)(3) provides that an S corporation may elect to distribute all or part of its subchapter C earnings and profits through a deemed dividend. If an S corporation makes this election, the S corporation will be considered to have made the election provided in § 1.1368-1(f)(2) (relating to the election to distribute earnings and profits first). The amount of the deemed dividend may not exceed the subchapter C earnings and profits of the corporation on the last day of the taxable year, reduced by any actual distributions of subchapter C earnings and profits made during the taxable year. The amount of the deemed dividend is considered, for all purposes of the Code, as if it were distributed in money to the shareholders in proportion to their stock ownership, received by the shareholders, and immediately contributed by the shareholders to the corporation, all on the last day of the corporation’s taxable year.

Under State 2 law and the applicable governing instruments, the deemed dividend is not income within the meaning of § 643(b). Accordingly, Trust 1 and Trust 2 will have no obligation to make any distribution with respect to the deemed dividend to Trust 1 and Trust 2 under § 1361(d)(3)(B).

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, we express no opinion on whether X is otherwise eligible to be an S corporation, nor on whether any of X’s shareholders are eligible S corporation shareholders under § 1361(d).

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 your authorized representatives.

Sincerely,

J Thomas Hines  
Chief, Branch 2  
(Passthroughs & Special Industries)

Enclosures (2)