

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:

, ID No.

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Refer Reply To:

CC:PSI:B01

PLR-107557-08

Date:

July 31, 2008

Legend

X =

A =

B =

C =

Trust =

\$x =

Y =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Dear :

This responds to a letter dated February 13, 2008, submitted on behalf of X, requesting certain rulings involving the requirements under § 1361(d) of the Internal Revenue Code.

Facts

The information submitted states that X elected to be an S corporation effective Date 1. The taxpayer represents that, as of Date 2, A owned shares of X as community property and that, as a result, A's wife, B, held a half interest in the shares of X titled in the name of A. On Date 2, A and B created Trust, an irrevocable trust that was intended to be treated (under subpart E of part 1 of subchapter J of chapter 1) as being owned by A and B. Also on Date 2, A and B transferred their interests in the shares of X to Trust.

On Date 2, Trust provided that A and B each had a power to reacquire part of or all the corpus of Trust by substituting other property of an equivalent value, and that this substitution power lapses as to each of the grantors upon their death. Trust further provided that, after paying the trustee's compensation from income, income or principal may be paid, in the trustee's discretion, to either A or B, or both. Trust further provided that the trustee may distribute, in its discretion, the income or principal of Trust to C, the daughter of A and B, and that C has the right to withdraw up to the greater of \$x or y percent of the value of the principal of Trust annually. Trust further provided that, following the death of A and B, the trustee must distribute the income of Trust to C, and may continue to distribute the principal of Trust to C.

On Date 3, B died. Taxpayer represents that B's one-half portion of Trust ceased being a grantor trust on Date 3. On Date 4, A died.

The trustee of Trust petitioned the probate court to modify the terms of Trust to convert Trust into a qualified subchapter S trust (QSST). On Date 5, a judge of the probate court signed an order (the Order) modifying the terms of Trust, as requested, to provide that all income shall be distributed to C in quarterly or more frequent installments, and deleted the provisions of Trust that were not consistent with Trust being a QSST.

On Date 6, C filed a QSST election on behalf of Trust.

The taxpayer requests rulings that (1) Trust, as modified by the Order, qualifies as a QSST within the meaning of § 1361(d)(3), and that (2) Trust has been a permitted S corporation shareholder of X without interruption since immediately prior to Date 3.

Law and Analysis

Section 671 provides that where it is specified in subpart E of part I of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 1.671-4(b)(8) provides that a trust, all of which is treated as owned by a husband and wife who make a single return jointly of income taxes for the taxable year under § 6013, is considered to be owned by one grantor for purposes of § 1.671-4(b).

Section 1.671-4(h)(2) provides that, following the death of the decedent, the trust or portion of a trust that ceases to be treated as owned by the decedent, by reason of the death of the decedent, may no longer report under § 1.671-4. A trust, all of which was treated as owned by the decedent, must obtain a new taxpayer identification number upon the death of the decedent, if the trust will continue after the death of the decedent.

Section 672(a) provides that the term “adverse party” means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. Section 672(b) provides that the term “nonadverse party” means any person who is not an adverse party. Section 672(c) provides that the term “related or subordinate party” means any nonadverse party who is (1) the grantor's spouse if living with the grantor; (2) any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive. For purposes of § 675, among other provisions, a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.

Sections 673 through 677 specify the circumstances under which the grantor is treated as the owner of a portion of a trust.

Section 674(a) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Section 674(b)(5) provides that § 674(a) shall not apply to the following power, regardless of by whom held: (5) A power to distribute corpus either -- (A) to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument; or (B) to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust.

Section 675(2) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which a power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

Section 675(4)(C) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which a power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. The term "power of administration" includes a power to reacquire the trust corpus by substituting other property of an equivalent value.

Section 1.675-1(a) of the Income Tax Regulations provides, in general, that the grantor is treated as the owner of any portion of a trust if under the terms of the trust instrument or circumstances attendant on its operation administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust.

Section 1.675-1(b)(4)(iii) provides that the circumstances which may cause administrative controls to be considered exercisable primarily for the benefit of the grantor include the existence of certain powers of administration exercisable in a nonfiduciary capacity by any nonadverse party without the approval or consent of any person in a fiduciary capacity. The term "powers of administration" includes a power to reacquire the trust corpus by substituting other property of an equivalent value. If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.

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) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for such year.

Section 1361(b)(1)(B) provides that, for purposes of subchapter S, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not 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)(i) provides that, for the purposes of § 1362(b)(1)(B), a trust all of which is treated (under title 26, subtitle A, chapter 1, subchapter J, part I, subpart E of the United States Code) as owned by an individual who is a citizen or resident of the United States may be a shareholder of an S corporation.

Section 1361(c)(2)(A)(ii) and § 1.1361-1(h)(1)(ii) of the Income Tax Regulations provide that, for purposes of § 1361(b)(1)(B), a trust that is described in § 1361(c)(2)(A)(i) immediately before the death of the deemed owner and that continues in existence after such death is a permitted shareholder, but only for the two-year period beginning on the day of the deemed shareholder's death.

Section 1.1361-1(h)(3)(i)(B) provides that, if stock is held by a trust described in § 1.1361-1(h)(1)(ii), the estate of the deemed owner is generally treated as the shareholder as of the day of the deemed owner's death.

Section 1361(d)(1) provides that, in the case of a qualified subchapter S trust with respect to which a beneficiary makes an election under § 1361(c)(2), (A) such trust will be treated as a trust described in § 1361(c)(2)(A)(i), and (B) for purposes of § 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under § 1361(d)(2) is made.

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

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 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 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 (or is required to distribute) all its income (within the meaning of § 643(b)) currently to one individual who is a citizen or resident of the United States. A substantially separate and independent share of a trust within the meaning of § 663(c) shall be treated as a separate trust for purposes of § 1361(c) and (d).

Section 1.1361-1(e)(1) provides that, if stock is held by a trust under title 26, subtitle A, chapter 1, subchapter J, part I, subpart E of the United States Code, the deemed owner is considered to be the shareholder. Section 1.1361-1(e)(2) provides that, for purposes of § 1.1361-1(e)(1), stock owned by a husband and wife (or by either or both of their estates) is treated as if owned by one shareholder, regardless of the form in which they own the stock. For example, if husband and wife are owners of a trust under title 26, subtitle A, chapter 1, subchapter J, part I, subpart E of the United States Code, they will be treated as one individual. Both husband and wife must be U.S. citizens or residents.

Section 1.1361-1(h)(1)(ii) provides that, except as provided in § 1.1361-1(h)(2), a trust, all of which is treated (under title 26, subtitle A, chapter 1, subchapter J, part I, subpart E of the United States Code) as owned by an individual (whether or not the grantor) who is a citizen or resident of the United States (a qualified subpart E trust), is a permitted shareholder.

Section 1.1361-1(h)(3)(i)(B) provides that, if stock is held by a trust defined in § 1.1361-1(h)(1)(ii), the estate of the deemed owner is generally treated as the shareholder as of the day of the deemed owner's death. However, if stock is held by such a trust in a community property state, the decedent's estate is the shareholder only of the portion of the trust included in the decedent's gross estate (and the surviving spouse continues to be the shareholder of the portion of the trust owned by that spouse under the applicable state's community property law). The estate ordinarily will cease to be treated as the shareholder upon the earlier of the transfer of the stock by the trust or the expiration of the 2-year period beginning on the day of the deemed owner's death. If the trust qualifies and becomes an electing QSST, the beneficiary and not the estate is treated as the shareholder as of the effective date of the QSST election, and the rules provided in § 1.1361-1(j)(7) apply.

Section 1.1361-1(j)(6)(iii)(C) provides that, if a trust ceases to be a qualified subpart E trust, satisfies the requirements of a QSST, and intends to become a QSST, the QSST election must be filed within the 16-day-and-2-month period beginning on the date on which the trust ceases to be such a subpart E trust. If the estate of the deemed owner of the trust is treated as the shareholder under § 1.1361-1(h)(3)(i), the QSST election may be filed at any time, but no later than the end of the 16-day-and-2-month

period beginning on the date on which the estate of the deemed owner ceases to be treated as a shareholder.

Section 1.1361-1(j)(7)(i) provides that the income beneficiary who makes the QSST election and is treated (for purposes of § 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of §§ 1361(b)(1), 1366, 1367, and 1368.

Section 1.1361-1(j)(7)(ii) provides that if, upon the death of an income beneficiary, the trust continues in existence, continues to hold S corporation stock but no longer satisfies the QSST requirements, is not a qualified subpart E trust, and does not qualify as an ESBT, then, solely for purposes of § 1361(b)(1), as of the date of the income beneficiary's death, the estate of that income beneficiary is treated as the shareholder of the S corporation with respect to which the income beneficiary made the QSST election. The estate ordinarily will cease to be treated as the shareholder for purposes of § 1361(b)(1) upon the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day of the income beneficiary's death. During the period that the estate is treated as the shareholder for purposes of § 1361(b)(1), the trust is treated as the shareholder for purposes of §§ 1366, 1367, and 1368. If, after the 2-year period, the trust continues to hold S corporation stock and does not otherwise qualify as a permitted shareholder, the corporation's S election terminates. If the termination is inadvertent, the corporation may request relief under § 1362(f).

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 first taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation. The termination is effective on and after the day of the termination.

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.

Conclusion

Based solely on the information submitted and the representations made, we conclude that Trust, as modified by the court, qualifies as a QSST within the meaning of § 1361(d)(3). We further conclude that Trust has been a permitted shareholder of X, subject to the foregoing, provided that X's S corporation election was otherwise valid and has not otherwise terminated under § 1362(d). From Date 2 through Date 3, A and B were treated as the owners of Trust under § 675(4) because A and B retained the powers listed in § 675(4). However, the circumstances surrounding the administration of the Trust determined whether the power of administration was exercisable in a fiduciary or nonfiduciary capacity. This is a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved have been

examined by the Internal Revenue Service office where the returns are filed. Therefore, we cannot determine at this time whether A and B were treated as the owners of Trust under § 675(4)(C). Provided that the circumstances indicate that the power of administration was exercisable in a nonfiduciary capacity, A and B will be treated as the owners of Trust under § 675(4)(C). We further conclude that Trust continued to qualify as a permissible S corporation shareholder under § 1361(c)(2)(A)(ii) for the period beginning on Date 3 and ending on Date 6.

Except as specifically ruled above, we express or imply no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code. Specifically, we express or imply no opinion regarding whether X is otherwise eligible to be an S corporation or whether Trust is otherwise eligible to be a QSST. Further, we express or imply no opinion concerning the tax consequences to Trust or any beneficiary thereof concerning the application of § 1001 with respect to the implementation of (i) the modifications of Trust, or (ii) an order of a court approving any similar modifications.

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

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

Sincerely,

David R. Haglund

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

Enclosures (2)

Copy of this letter

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cc: