

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Date:

December 05, 2008

Legend

Trust1 =

Trust2 =

Trust3 =

Company =

State =

Date1 =

Date2 =

Will1 =

Will2 =

x =

y =

z =

Dear :

This letter responds to a letter dated August 21, 2008, and subsequent correspondence, submitted on behalf of Trust1, requesting certain rulings under §§ 1361 and 664(d) of the Internal Revenue Code (Code).

Facts

Trust1 was created in State on Date1 as a testamentary trust under Will1. Trust1 is the sole shareholder of Company, a corporation incorporated under State law. Company is currently treated as a C corporation, but Company represents that it will elect to be treated as an S corporation effective Date2.

Currently, there are x individual beneficiaries of Trust1. In addition, there are y remainder beneficiaries of Trust1. The remainder beneficiaries of Trust1 are all individuals except for Trust2 and Trust3. Trust2 and Trust3 were created under Will2. Trust3 is an organization exempt from taxation under § 501(c)(3). Trust2 has z individual beneficiaries. Upon the death of the last of the beneficiaries of Trust2, Trust2 will terminate and the trust estate will be added to Trust3.

Trust1 represents that pursuant to the terms of Will2, Trust2 is not required to pay, not less often than annually, a sum certain (which is not less than 5 percent nor more than 50 percent of the initial net fair market value of all property placed in trust) to one or more persons. In addition, Trust1 represents that pursuant to the terms of Will2, Trust2 is not required to pay not less often than annually, a fixed percentage (which is not less than 5 percent nor more than 50 percent) of the net fair market value of its assets, valued annually, to one or more persons.

Trust1 represents that it has not made an election to be a qualified subchapter S trust. Trust1 further represents that it is not exempt from income tax under subtitle A of the Code. Trust1 also represents that all of the current beneficiaries of Trust1 received their interests in Trust1 by inheritance and not by purchase.

Trust1 requests rulings that:

1. Trust1 is eligible to be an Electing Small Business Trust (ESBT) under § 1361(e), and is thus eligible to be an S corporation shareholder under §§ 1361(b)(1)(B) and 1361(c)(2); and
2. Trust2 is not a charitable remainder trust as defined in § 664(d).

Law and Analysis

Ruling 1

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 a “small business corporation” cannot 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(e)(1)(A) provides that the term “electing small business trust” means any trust if -- (i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in paragraph (2), (3), (4), or (5) of § 170(c), or (IV) an organization described in § 170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary, (ii) no interest in such trust was acquired by purchase, and (iii) an election under § 1361(e) applies to such trust.

Section 1361(e)(1)(B) provides that the term “electing small business trust” shall not include -- (i) any qualified subchapter S trust (as defined in § 1361(d)(3)) if an election under § 1361(d)(2) applies to any corporation the stock of which is held by such trust, (ii) any trust exempt from tax under subtitle A, and (iii) any charitable remainder annuity trust or charitable remainder unitrust (as defined in § 664(d)).

Section 1.1361-1(m)(1)(ii)(A) of the Income Tax Regulations provides that for purposes of § 1.1361-1, a beneficiary includes a person who has a present, remainder, or reversionary interest in the trust.

Section 1.1361-1(m)(1)(ii)(B) provides that a distributee trust is the beneficiary of the ESBT only if the distributee trust is an organization described in § 170(c)(2) or (3).

Section 1.1361-1(m)(1)(ii)(B) further provides that in all other situations, any person who has a beneficial interest in a distributee trust is a beneficiary of the ESBT. In addition, § 1.1361-1(m)(1)(ii)(B) provides that a distributee trust is a trust that receives or may receive a distribution from an ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred.

Section 1361(e)(2) provides that 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 (determined without regard to any power of appointment to the extent such power remains unexercised at the end of such period).

Section 1.1361-1(m)(4)(i) provides that for purposes of determining whether a corporation is a small business corporation within the meaning of § 1361(b)(1), each potential current beneficiary of an ESBT generally is treated as a shareholder of the corporation. Subject to the provisions of § 1.1361-1(m)(4), a potential current beneficiary 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. No person is treated as a potential current beneficiary solely because that person holds any future interest in the trust.

Section 1.1361-1(m)(4)(iv)(A) provides that § 1.1361-1(m)(4)(iv) contains the rules for determining who are the potential current beneficiaries of an ESBT if a distributee trust becomes entitled to, or at the discretion of any person, may receive a distribution from principal or income of an ESBT.

Section 1.1361-1(m)(4)(iv)(B) provides that if the distributee trust is not a trust described in § 1361(c)(2)(A), then the distributee trust is the potential current beneficiary of the ESBT and the corporation's S corporation election terminates.

Section 1.1361-1(m)(4)(iv)(C) provides that if the distributee trust is a trust described in § 1361(c)(2)(A), the persons who would be its potential current beneficiaries (as defined in § 1.1361-1(m)(4)(i) and (ii)) if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT.

Section 1.1361-1(m)(4)(iv)(D) provides that for the purposes of § 1.1361-1(m)(4)(iv)(C), a trust will be deemed to be described in § 1361(c)(2)(A) if such trust would qualify for a QSST election under § 1361(d) or an ESBT election under § 1361(e) if it owned S corporation stock.

Ruling 2

Section 664(d)(1) provides that for purposes of § 664, a charitable remainder annuity trust is a trust -- (A) from which a sum certain (which is not less than 5 percent nor more than 50 percent of the initial net fair market value of all property placed in trust) is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in § 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals, (B) from which no amount other than the payments described in § 664(d)(1)(A) and other than qualified gratuitous transfers described in § 664(d)(1)(C) may be paid to or for the use of any person other than an organization described in § 170(c), (C) following the termination of the payments described in § 664(d)(1)(A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in § 170(c) or is to be retained by the trust for such a use or, to the extent the remainder interest is in qualified employer securities (as defined in § 664(g)(4)), all or part of such securities are to be transferred to an employee stock ownership plan (as defined in § 4975(e)(7)) in a qualified gratuitous transfer (as defined by § 664 (g)), and (D) the value (determined under § 7520) of such remainder interest is at least 10 percent of the initial net fair market value of all property placed in the trust.

Section 664(d)(2) provides that for purposes of § 664 a charitable remainder unitrust is a trust -- (A) from which a fixed percentage (which is not less than 5 percent nor more than 50 percent) of the net fair market value of its assets, valued annually, is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in § 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals, (B) from which no amount other than the payments described in § 664(d)(2)(A) and other than qualified gratuitous transfers described in § 664(d)(2)(C) may be paid to or for the use of any person other than an organization described in § 170(c), (C) following the termination of the payments described in § 664(d)(2)(A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in § 170(c) or is to be retained by the trust for such a use or, to the extent the remainder interest is in qualified employer securities (as defined in § 664(g)(4)), all or part of such securities are to be transferred to an employee stock ownership plan (as defined in § 4975(e)(7)) in a qualified gratuitous transfer (as defined by § 664(g)), and (D) with respect to each contribution of property to the trust, the value (determined under § 7520) of such remainder interest in such property is at least 10 percent of the net fair market value of such property as of the date such property is contributed to the trust.

Section 1.664-1(a)(2) provides that a trust is a charitable remainder trust only if it is either a charitable remainder annuity trust in every respect or a charitable remainder unitrust in every respect.

Conclusions

Ruling 1

Based on the information submitted and representations made, we conclude that Trust2 is a distributee trust within the meaning of § 1.1361-1(m)(1)(ii)(B). Therefore, the beneficiaries of Trust2 will be treated as the beneficiaries of Trust1 for ESBT qualification purposes. Consequently, we conclude that Trust1 is eligible to elect to be treated as an ESBT as defined in § 1361(e) and is thus eligible to be an S corporation shareholder under §§ 1361(b)(1)(B) and 1361(c)(2).

Ruling 2

Based on the information submitted and representations made, we conclude that Trust2 is not a charitable remainder trust as defined in § 664(d). Therefore, we further conclude that Trust2 will not be ineligible under § 1361(e)(1)(B)(iii) to be treated as an ESBT when it becomes a potential current beneficiary of Trust1. Consequently, Trust2 will qualify for deemed § 1361(c)(2)(A) treatment under § 1.1361-1(m)(4)(iv)(D).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed or implied as to whether Company will otherwise qualify as a subchapter S corporation under § 1361.

These rulings are 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.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the ruling request, it is subject to verification on examination.

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

Sincerely,

/s/

Leslie H. Finlow
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)

A copy of this letter
A copy for § 6110 purposes

cc: