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Department of the Treasury  
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Date:  
May 18, 2018

LEGEND:

A =

B =

X =

Trust =

State =

Date 1 =

Date 2 =

Date 3 =

Dear

This responds to a letter dated October 24, 2017, and subsequent information, submitted on behalf of A, B, and X, requesting rulings under §§ 1361(b)(1)(D) and 1361(e) of the Internal Revenue Code (the Code).

## Facts

The information submitted states that A and B were married on Date 1, and are in the process of finalizing the division of assets as a result of their divorce. One such marital asset of A and B are shares of stock in X, an S corporation. The shares of X stock are currently held by a revocable trust of which A is the grantor (A's grantor trust).

The State court presiding of the divorce of A and B issued a divorce decree on Date 2, as modified by an order dated Date 3 (together, the "Decree"). A key part of the Decree is a requirement that A cause A's grantor trust to transfer all of the shares of X stock it holds to Trust, the beneficiaries of which are A and B with certain agreed-upon provisions. A and B negotiated the terms of the Trust and both signed the agreement setting forth the Trust's terms. The Decree orders that the transfer of the shares of X stock to the Trust is subject to the prior approval of the tax issues by the IRS.

Other than a nominal amount of cash, the Trust will be funded only with the shares of X stock currently held by A's grantor trust. The Trust agreement provides that the principal purpose of the Trust is to set forth and govern all incidents of ownership and control of the X stock owned by the Trust. The Trust is a single trust. However, for administrative purposes only, the property held in Trust will be accounted for internally in two separate shares (each a "Share" and together the "Shares"), one for A, and one for B. Each Share holds 50% of the X stock held in Trust. . In connection with the divorce, B provided consideration for B's lifetime distribution rights under the Trust, but provided no consideration for any remainder interest in the Trust.

The X stock is subject to certain liabilities and the Trust may assume certain liabilities. A, B, and X represent that the sum of the amount of liabilities to be assumed by the Trust, plus the amount of the liabilities to which the property to be transferred to the Trust is subject, will not exceed the total of the adjusted basis of the property transferred.

Some or all distributions received by the Trust from X will be used by the trustee of Trust to make required payments on the liabilities against which the X stock is pledged, and those payments will be made equally from A's share and B's share. In exchange for B agreeing to have the liabilities be paid from B's Share, A's Share will issue to B's Share a promissory note for amounts paid out of B's share with respect to the liabilities. Additionally, although distributions from X to Trust will be applied equally to each share, A will have a right to certain distributions from Trust that will not be shared by B.

The trustee of the Trust intends to elect to treat the Trust as an electing small business trust (ESBT) under § 1361(e).

Taxpayer requests that we rule as follows:

(1) X will not be considered to have a second class of stock in violation of § 1361(b)(1)(D) solely as a result of the provisions in the Trust agreement.

(2) The consideration provided by B for B's lifetime distribution rights in connection with the divorce does not prevent the Trust from qualifying as an ESBT under § 1361(e)(1)(C).

Ruling 1:

Section 1361(b)(1) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (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, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1.1361-1(l)(1) provides, in part, that a corporation is generally treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

Section 1.1361-1(l)(2)(i) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state laws, and binding agreements relating to distribution and liquidation proceeds (collectively, governing provisions). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement of § 1361(b)(1)(D) and § 1.1361-1(l). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Trust Agreement is not a governing provision that is required to be taken into account under § 1.1361-1(l)(2)(i). Accordingly, the Trust Agreement is disregarded in determining whether the outstanding shares of X stock confer identical rights to distributions and liquidation proceeds. Therefore, X will not be considered as having more than one class of stock under § 1361(b)(1)(D), as a result of the Trust Agreement.

Ruling 2:

Section 1361(c)(2)(A)(v) provides that for purposes of § 1361(b)(1)(B), an electing small business trust (“ESBT”) may be an S corporation shareholder.

Section 1361(e) provides that an ESBT 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 § 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)(C) provides that for purposes of § 1361(e)(1)(C) provides that for purposes of §1361(e)(1)(A) the term “purchase” means any acquisition if the basis of the property acquired is determined under § 1012.

Section 1012(a) provides that the basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (related to corporate distributions and adjustments), K (related to partners and partnerships, and P (related to capital gains and losses).

Section 1041(a) provides that no gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) (1) a spouse, or (2) a former spouse, but only if the transfer is incident to the divorce.

Section 1041(b) provides that, in the case of any transfer of property described in § 1041(a), the property shall be treated as acquired by the transferee by gift, and the basis of the transferee in the property shall be the adjusted basis of the transferor.

Section 1041(c) provides that for purposes of § 1041(a)(2), a transfer of property is incident to the divorce if the transfer occurs (1) within one year after the date on which the marriage ceases, or (2) is related to the cessation of the marriage.

Section 1041(e) provides that § 1041(a) shall not apply to the transfer of property in trust to the extent that (1) the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds (2) the total of the adjusted basis of the property transferred. Proper adjustment shall be made under § 1041(b) in the basis of the transferee in such property to take into account gain recognized.

Section 1.1041-1T(b), Q&A-7, of the Temporary Income Tax Regulations provides that a transfer of property is related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument, as defined in § 71(b)(2), and the transfer occurs not more than six years after the date on which the marriage ceases. A divorce

or separation instrument includes a modification or amendment to such decree or instrument.

A is causing A's grantor trust to transfer the shares of X stock to the Trust pursuant to the divorce Decree, and the amount of the liabilities assumed plus the liabilities that the property transferred is subject to does not exceed the adjusted basis of the property transferred.

Accordingly, based on the facts submitted and representations made, provided that the transfer of the shares of X stock to the Trust occurs within six years of the entry of final judgment and the terms of the Trust as executed by A and B remain materially identical to those submitted, we conclude that § 1041(a) applies and A and B will not recognize any gain or loss on the transfer of the shares of X stock from A's grantor trust to the Trust.

Further, § 1041(b) applies such that the transfer is treated as a gift under § 1041(b). As such, B's acquisition of B's lifetime distribution rights in the Trust for consideration is not a purchase within § 1361(e) because the sale is not governed by § 1012(a). Accordingly, B's acquisition of B's distribution rights will not disqualify Trust from being an ESBT.

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, we neither express nor imply any opinion concerning the application of § 682 to the Trust and whether the Trust is a grantor trust under § 671.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Pursuant to the power of attorney on file with this office, we are sending a copy of this letter to X's authorized representatives.

Sincerely,

*Faith P. Colson*

Faith P. Colson  
Senior Counsel, Branch 1  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

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