

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:

April 28, 2000

X =

A =

B =

C =

D =

Trust =

Foundation =

State =

D1 =

D2 =

Dear :

This letter responds to a letter dated September 30, 1999, and subsequent correspondence, submitted by you on behalf of X, A, and Trust, requesting certain rulings concerning the federal income and estate tax consequences of the creation of Trust.

The information submitted states that X is a corporation which has elected to be treated as a subchapter S corporation effective for its taxable year beginning D1. X has two classes of stock outstanding, Class A nonvoting stock and common voting stock. These two classes of stock are identical in all respects, except voting rights.

Trust is a trust established by A under the laws of State on D2. The current trustees of Trust are C and D.

Article 2, paragraph (a), of Trust provides that, during the life of B, the trustees may pay at any time and from time to time such parts or all of the net income and principal to and among B and B's issue of all generations living from time to time, equally or unequally and to the exclusion of any one or more of them, as the trustees determine taking into consideration the management role, if any, of any such person in X, or any successor or related entity. Any net income not so paid shall be accumulated and added to principal.

Article 2, paragraph (b), of Trust provides that, upon the death of B, the trustees shall administer or distribute the trust property remaining after providing for compliance with Article 2, paragraph (a), to or for such persons, other than B, B's estate, B's creditors or the creditors of B's estate, in such manner, interests and proportions, either in fee or upon any new trusts, conditions, or limitations, as B may appoint by B's last will making specific reference to this special power of appointment. The trustees shall divide any trust property as to which such power of appointment is not effectively exercised into shares for the then living issue of B, per stirpes, or if there is no such issue, into shares for A's then living issue, per stirpes, and shall administer each share so set apart according to Article 2, paragraph (c). If no issue of A survives B, upon B's death the trustees shall administer the trust property according to Article 2, paragraph (i).

Article 2, paragraph (i), of Trust provides that whenever the trustees are directed to administer trust property according to Article 2, paragraph (i), they shall distribute such property to Foundation, or if it is not then in existence, to such one or more charitable or educational organizations then described in § 170(c), and in such proportions if more than one, as the trustees determine.

Article 3, paragraph (a), of Trust provides that the trustees may at any time add any one or more organizations described in §§ 501(c)(3) and 170(c)(2), not to exceed a total of ten, to the class of beneficiaries eligible to receive distributions under Article 2. Any such addition of beneficiaries shall be by a written instrument signed by the trustees and filed with the original trust instrument. The trustees may irrevocably release this power at any time by written instrument signed by them and filed with the original trust instrument. The determination by the trustees to exercise or release the power to designate additional beneficiaries of Trust under Article 2 shall be final and binding on all persons.

Article 3, paragraph (b), of Trust provides that, notwithstanding the provisions of Article 2, if A is treated as

the owner of any portion of Trust under Article 2 pursuant to Subchapter J, Subpart E, of the Code or similar provisions of any state law, the trustees shall pay directly to the Internal Revenue Service or any similar state agency the amount or amounts necessary to satisfy A's personal income tax liability attributable to the trust or assets of the trust, calculated as provided in the following sentence. The amount or amounts so paid to any such agency during any year shall equal the amount by which A's personal income tax liability payable to such agency exceeds A's personal income tax liability computed as though A were not treated as the owner of the Trust. Payments under Article 3, paragraph (b) shall be paid from income and, to the extent income is insufficient, from principal.

Article 5, paragraph (c), of Trust provides, in part, that A, during A's life and competency, and thereafter a majority of the legally competent members of the oldest generation of A's issue of which there are legally competent members, shall have the power to remove any trustee and appoint a successor; provided, however, that A's issue shall not have the power to remove an original trustee, and further provided that the successor trustee shall not be a person who is related or subordinate to A or to any person having the power to remove within the meaning of § 672(c).

Article 13 of Trust provides that the trustees may amend Trust at any time to cause any trust created under Trust to qualify as a permissible shareholder in an S corporation under the Internal Revenue Code of 1986 or any subsequent federal tax laws. Otherwise Trust is irrevocable and cannot be amended.

A represents that as soon as reasonably practicable after receipt of the rulings requested, A will contribute either a portion of A's nonvoting stock in X or cash to Trust. If A transfers cash to Trust, the trustees will then use the cash to purchase outstanding shares of X's nonvoting stock at a price determined by an independent appraisal.

RULING REQUESTS 1 AND 2

X, A, and Trust request rulings that A will be treated as the owner of Trust under § 674(a) and that Trust is a trust described in § 1361(c)(2)(A)(i) and therefore is an eligible shareholder in X, an S corporation.

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, a trust described in subsection (c)(2), or an organization described in subsection

(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, for purposes of § 1361(b)(1)(B), 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 shareholder.

Section 671 provides that where it is specified in subpart E 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 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(c) provides that § 674(a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor -- (1) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or (2) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries). A power does not fall within the powers described in § 674(c) if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

We conclude that A will be treated as the owner of Trust under § 674(a). Accordingly, during A's life, Trust will be a permitted shareholder of an S corporation under § 1361(c)(2)(A)(i).

RULING REQUEST 3

X, A, and Trust request a ruling that the value of the property in Trust will not be includable in A's gross estate for federal estate tax purposes.

Section 2033 provides for the inclusion in the gross estate of any property in which the decedent had an interest at the time of his death.

Section 2035(a) provides that if a decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the three-year period ending on the date of the decedent's death, and the value of such property (or interest therein) would have been included in the decedent's gross estate under §§ 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death, the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

Sections 2036, 2037, and 2038 provide that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, under which the decedent retained an interest in or a power over the transferred property.

In the present case, A has not retained any interest or reversion in Trust nor does A have the power to alter, amend, or revoke Trust. Neither A nor A's spouse may serve as trustee of Trust. A has retained the right to remove and replace the trustees. However, any successor trustee selected by A cannot be related or subordinate to A within the meaning of § 672(c). Accordingly, A will not be treated as retaining the discretionary powers of the trustee solely as a result of the retained power to remove the trustee of Trust and appoint a successor trustee. See Rev. Rul. 95-58, 1995-2 C.B. 191. In addition, A will not hold a general power of appointment over the property in Trust.

Accordingly, we conclude that, based on the facts presented, under the terms of Trust, A has not retained any power or interest that would cause Trust to be includable in A's gross estate under §§ 2036, 2037, 2038, or 2041.

RULING REQUEST 4

X, A, and Trust request a ruling that, if B survives A, upon A's death, Trust will qualify during the life of B as an electing small business trust within the meaning of § 1361(e) if the trustees make the required election described therein.

Section 1361(c)(2)(A)(v) provides that an "electing small business trust" may be a shareholder in 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, or (III) an organization described in paragraph (2), (3), (4), or (5) of § 170(c), (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 1361(e)(3) provides that an election under § 1361(e) shall be made by the trustee. Any such election shall apply to the taxable year of the trust for which made and all subsequent taxable years of such trust unless revoked with the consent of the Secretary.

We conclude that, if B survives A, upon A's death, Trust will qualify during the life of B as an electing small business trust within the meaning of § 1361(e) if the trustees make the required election described therein.

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.

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

Pursuant to a power of attorney on file with this office, a copy of this letter is being forwarded to X.

Sincerely yours,
H. GRACE KIM
Assistant to the Chief Branch 2
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes