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May 4, 1999

Trust =

A =

B =

Date 1 =

X =

State =

Dear :

This responds to your letter dated August 6, 1998, submitted on behalf of Trust, requesting a ruling under § 1361(e) of the Internal Revenue Code.

The information submitted states that Trust was established on Date 1, by A and B ("Grantors") for the benefit of the children of their marriage and the issue of such children.

Trust currently holds stock in X, a State Limited Liability Company. The Trust trustees propose to contribute Trust's interest in X to a newly formed corporation that will elect S corporation status in exchange for the stock of the newly formed corporation.

Trust represents that: (1) Trust has not made an election to be a qualified subchapter S trust, (2) Trust is not exempt from tax under subtitle A of the Code and (3) each Trust beneficiary is an individual.

Article Second of Trust provides that the trustees shall

hold, manage, invest, and reinvest the trust estate and shall collect and receive the interest, income, and profits therefrom for the benefit of the children born of Grantors' marriage and issue of such children, including issue born after the date of Trust.

Article Second A.1. of Trust provides that during the term of Trust, the trustee may pay, from time to time, the net income of Trust in such proportions and amounts as he, in his sole discretion, shall determine to or for the benefit of any of Grantors' children and issue of Grantors' children who shall be living from time to time.

Article Second A.2. of Trust provides that the trustee may pay to or for the benefit of any of Grantors' children and/or their issue who shall be living from time to time, or to one or more trusts for the benefit of any of Grantors' children and/or their issue, such sums from the principal of the trust as the trustee shall deem necessary or desirable for such beneficiary's health, support, education and maintenance.

Article Second B.1. of Trust provides that the trustee, in his discretion and at any time, may divide Trust into separate equal shares so as to have one share for each child of Grantors who is then living and one share to be further divided on a per stirpes basis for the then living issue of each deceased child of Grantors. Each such share shall thereafter be administered as a sub-trust for the primary benefit of the descendant for whom it was established.

Article Second B.2. of Trust provides that upon the death of a primary beneficiary of a sub-trust, such sub-trust shall be further divided into separate shares for such primary beneficiary's issue who shall survive him or her, per stirpes. In default of such issue, such primary beneficiary's sub-trust shall be divided into separate shares for the issue, per stirpes, of such primary beneficiary's ancestor who (a) is in the generation closest to such primary beneficiary's generation, (b) is a descendant of Grantors and (c) has issue who survive such primary beneficiary, or failing such issue, into separate shares for the issue, per stirpes, of Grantors, who shall survive such primary beneficiary.

Article Second C. of Trust provides that during any period prior to the termination date of Trust in which there shall be no children or issue of children of Grantors then living, Trust (or sub-trusts) shall be administered for the benefit of the then living grandchildren of B's parents and their issue.

Article Second D.1. of Trust provides that Trust and any

sub-trusts shall terminate twenty-one years after the death of the last to survive of the group consisting of B's parents and all of their issue living at the date of signing of the trust agreement; or, if earlier, upon such date as shall be required in order to avoid a violation of the applicable rule against perpetuities.

Article Second D.2. of Trust provides that upon the termination of Trust (or sub-trusts), if there are issue of the Grantors then living, the then remaining principal and any accrued or undistributed income of the trust (or sub-trust) shall be distributed to the Grantors' issue who shall be living at the date of termination, per stirpes; or if Trust has been partitioned into separate sub-trusts, each sub-trust shall be distributed to the primary beneficiary for whom the sub-trust was created.

Article Second D.3. of Trust provides that upon termination of Trust (or sub-trusts), if there are no issue of the Grantors then living, the trustees of Trust (or sub-trusts) shall divide the then remaining principal and any accrued or undistributed income of Trust so as to provide one share for each then living grandchild of the parents of B, and one share for each deceased grandchild of theirs who shall have then living issue.

Section 1361(a) of the Code 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.

Section 1362(b)(1) of the Code 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 75 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), (C) have a nonresident alien as a shareholder, and (D) more than one class of stock.

Under § 1361(c)(2)(A)(v) of the Code an electing small business trust is an eligible shareholder of an S corporation. Section 1361(e) defines electing small business trust.

Section 1361(e)(1)(A) of the Code provides that, except as provided in § 1361(e)(1)(B), 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) of the Code 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 of chapter 1, and (iii) any charitable remainder annuity trust or charitable remainder unitrust (as defined in § 664(d)).

Section 1361(e)(2) of the Code provides that for purposes of § 1361, 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.

Notice 97-49, 1997-2 C.B. 304, provides that for purposes of § 1361(e)(1)(A)(i), the term beneficiary does not include a distributee trust, but does include those persons who have a beneficial interest in the property held by the distributee trust. Furthermore, the Notice provides that for purposes of § 1361(e)(2) if a distributee trust becomes entitled to, or at the discretion of any person may receive, a distribution from principal or income of the electing small business trust ("ESBT"), then the trust will become a potential current beneficiary and the S corporation election will terminate unless the distributee trust is a trust described in § 1361(c)(2)(A).

Accordingly, based on the representations made and the information provided, we conclude that for purposes of § 1361(e)(1)(A)(i) the beneficiaries of Trust are individuals and are qualified beneficiaries.

Furthermore, we conclude that the power given to the trustee under Article Second B.1. to subdivide the trust into sub-trusts does not affect Trust's qualification as an ESBT. This conclusion is based on the assumption that the division of Trust is not considered a sale of exchange under § 1001. Furthermore, if the trustee subdivides Trust, any sub-trust created must qualify as a trust described under § 1361(c)(2)(A) and the beneficiary of the resulting trust must satisfy the shareholder restrictions of § 1361(b)(1).

With respect to the power given to the trustee under Article Second A.2. to make certain distributions either directly to or in trust for the benefit of any of Grantors' children and/or their issue, this is a power to make a distribution for purposes of § 1361(e)(2). However, since there are currently no distributee trusts identified or currently in existence, the

power to distribute to these trusts will be disregarded for purposes of § 1361(e)(2). Thus, there is no distributee trust that is a potential current beneficiary. If a distributee trust is identified or otherwise comes into existence in any period, then the distributee trust will become a potential current beneficiary and the S corporation election will terminate unless the distributee trust is a trust described in § 1361(c)(2)(A). Furthermore, the beneficiary of any new trust must satisfy the shareholder restrictions of § 1361(b)(1).

Accordingly, upon Trust making a valid and timely election under § 1361(e)(3), Trust will satisfy the requirements of § 1361(e)(1).

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.

In accordance with the power of attorney of file with this office, we are forwarding a copy of this letter to Trust.

Sincerely yours,

J. THOMAS HINES
Senior Technician Reviewer
Branch 2
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
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