

**Internal Revenue Service**

Department of the Treasury

Index Number: 1361.03-02  
Number: **199922052**  
Release Date: 6/4/1999

Washington, DC 20224

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Refer Reply To:

CC:DOM:P&SI:Br.1-PLR-115223-98

Date:

April 15, 1999

Legend

Estate =

A =

B =

C =

X =

Date1 =

Will =

Court =

x =

This responds to your letter submitted on behalf of Estate requesting a ruling regarding the classification of Trust A and Trust B, created under Will, as qualified subchapter S trusts under § 1361(d) of the Internal Revenue Code.

**FACTS**

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A died on Date1, leaving Will to control the distribution of his property. Paragraph SIXTH of Will provides for the creation of Trust A and Trust B (hereinafter "Trusts") to be administered under Paragraph EIGHTH. Under Will, Trusts were funded with x shares of X, a subchapter S corporation. Under the current version of Paragraph EIGHTH, Trusts do not meet the definition of qualified subchapter S trusts under § 1361(d)(3).

If a favorable private letter ruling is issued in this case, the taxpayer will file a petition with Court to reform Trusts in accordance with the terms contained in taxpayer's ruling request. Paragraph EIGHTH will be reformed so that Trusts are administered under the terms and conditions described below.

1. All of the income of Trusts will be paid to or for the benefit of B in quarterly or other convenient installments.
2. If the income of Trusts is insufficient to provide adequately for B's health and support, the Trustee may pay or apply for those purposes first from the principal of Trust B and then from the principal of Trust A (provided that none of the principal of Trust A is distributed so long as readily marketable assets remain in Trust B) such sum or sums as the trustee determines.
3. Neither Trust A nor Trust B will terminate during B's life.
4. Upon B's death, the trustee shall divide the remaining principal of Trust A and Trust B, if any, into as many shares as there are children of A then living and previously deceased children of A leaving issue. The share set apart for the issue of a previously deceased child will be distributed to the issue. Each share set apart for a living child will be held as a separate trust for each child. The income and principal of each share shall be distributed as follows:
  - A. All of the net income will be payable to or for the benefit of the child in quarterly or other convenient installments. When the child (with the exception of C, whose share shall continue in trust) reaches the age of 25 years, the trustee will distribute to the child one-third of the trust principal at its then value;
  - B. The trustee will continue to hold and administer the remainder of each trust share and will distribute all of the net income therefrom to each child quarterly or in other convenient installments. When the child (with the exception of C) reaches the age of 30 years, the trustee will distribute

to the child one-half of the trust principal at its then value;

- C. The trustee will continue to hold and administer the remainder of each trust share and will distribute all of the net income therefrom to each child quarterly or in other convenient installments. When the child (with the exception of C) reaches the age of 35 years, the trust will terminate and the entire remaining principal will be distributed to each child.
- D. The trustee will continue to hold and administer the balance of the principal of C's trust share and will pay all of the income therefrom to or for C's benefit (in quarterly or other convenient installments) until C's death. Furthermore, the trustee may pay or apply, out of the principal of the trust if necessary, outpatient and hospital expenses related to C's treatment for a medical problem diagnosed at the date of execution of the Will. The trust share set aside for C will not terminate during C's life.
- E. If any child dies after the separate trust share has been set aside but before the entire trust principal is distributed to the child, the trustee will distribute the trust share to or for the benefit of the issue of the predeceased child or to A's then living issue if the predeceased child leaves no issue. If A's then living issue is still an income beneficiary of any trust share established above, the amount to be distributed to the living issue will be added to the principal of the issue's existing trust share.
- F. If at the time of A's death or at the termination of any trust created by Will, all or a portion of trust principal vests in absolute ownership in a beneficiary who is under 21 years old, the trustee may distribute the trust fund's assets either outright to the beneficiary or to a custodian under the New York Uniform Transfers to Minors Act. If the assets are transferred to a custodian under the New York Uniform Transfers to Minors Act, the custodian will pay, distribute, or apply the entire net income of the principal held for the minor beneficiary for the beneficiary's health, support, maintenance or education.

#### **LAW AND ANALYSIS**

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Section 1361(a)(1) provides that an "S corporation" is, with respect to a given year, a small business corporation for which an election under § 1362(a) is in effect. 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, other than a trust described in § 1361(c)(2), and other than an organization described in (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. Under § 1361(d)(1)(A), a qualified subchapter S trust with respect to which a beneficiary makes an election under § 1361(d)(2) will be treated as a trust described in § 1361(c)(2)(A)(i). Section 1361(d)(2) provides for the time and manner in which the beneficiary of a QSST may elect to have the provisions of § 1361(d) apply. Included is the requirement that the QSST election must be filed within the 2 month 16 day period beginning on the day that the stock is transferred to the trust.

Section 1361(d)(3) sets for the provisions a trust instrument must contain for the trust to qualify as a QSST. Under § 1361(d)(3)(A), the terms of the trust must require that: (i) during the life of the current income beneficiary, there is only one income beneficiary; (ii) any corpus distributed during the life of the current beneficiary may be distributed only to that beneficiary; (iii) the current income beneficiary's interest terminates on the earlier of the beneficiary's death or the trust's termination; and, (iv) if the trust terminates during the current income beneficiary's life, the trust assets must be distributed to that beneficiary. In addition, § 1361(d)(3)(B) requires that the trust must distribute all of its income (within the meaning of § 643(b)) currently to one individual who is a United States resident or citizen.

Section 1361(d)(3) also provides that a substantially separate and independent share of a trust within the meaning of § 663(c) is treated as a separate trust for purposes of §§ 1361(c) and 1361(d).

## **CONCLUSION**

Based upon the information submitted and our examination of the proposed terms that will govern Trusts if the petition to modify is accepted and provided that all of the income (within the meaning of § 643(b)) is distributed currently to the appropriate income beneficiary, we conclude that Trusts, as modified in accordance with the provisions discussed above, will meet the definition of a QSST under § 1361(d)(3) as of the effective date of the Court's order approving the petition to modify.

Except as specifically set forth above, no opinion is expressed concerning the

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federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X is, in fact, a subchapter S corporation for federal tax purposes.

Pursuant to a power of attorney on file with our office, we are sending a copy of this letter to your authorized representative. This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Signed/Dianna K. Miosi  
Dianna K. Miosi  
Chief, Branch 1  
Office of the Assistant Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)  
Copy of this letter  
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