

Internal Revenue Service

Department of the Treasury

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November 15, 1999

Re: EIN-

Legend:

- Grandparent =
- Trust 1 =
- Trust A =
- Beneficiary =
- Trustee =
- Date 1 =
- x =
- Corporation =
- Charity =

This is in response to your letter dated February 26, 1999, in which you requested a ruling regarding the application of the generation-skipping transfer (GST) tax provisions of Chapter 13 of the Internal Revenue Code. Specifically, you requested a ruling that the exempt status of Trust A for GST tax purposes would not be affected by the following: (i) the Trustee's consent to Corporation's S election on behalf of Trust A; (ii) the Trustee's execution of an "electing small business trust" election on behalf of Trust A; and (iii) the Trustee's execution of the shareholder agreement on behalf of Trust A.

According to your submission, on Date 1, Grandparent transferred x shares of Corporation common stock to Trust 1, an irrevocable trust. Pursuant to the terms of trust instrument, Trust 1 was divided into four separate trusts of equal value for the benefit of Grandparent's four children, including Trust A for the benefit of Beneficiary and her descendants.

Article 2(e) of Trust 1 provides that during the lifetime of each child, the Trustee shall pay to or expend for the benefit of such child so much or all of the net income of the trust estate of such child as the Trustee in its absolute discretion deems best. Subject to the above provision in favor of each child, so much or all of the net income of the trust estate shall be paid to, or expended or applied for the benefit of, the descendants of each child as shall be living from time to time, at such times and in such equal or unequal proportions among them and in such

manner as the Trustee in its absolute discretion deems best. Any net income not so distributed by the Trustee during any calendar year shall be accumulated and added to the principal of the respective trust estate.

Article 2(f) of Trust 1 provides that the Trustee is fully authorized to pay to each child such sums from the principal of the trust estate of such child as the Trustee deems necessary or advisable from time to time for the best interests of the child and his or her descendants, in that order and as a group, taking into consideration all other income available to such child for such purposes from all sources known to the Trustee.

Article 2(g) provides that each child has the right at any time and from time to time during his or her lifetime by instrument in writing delivered to the Trustee to direct that any part or all of the trust estate of such child as then constituted shall be held in trust for the benefit of, or distributed to or in trust for the benefit of, any one or more of such child's descendants in such amount and in such manner and upon such terms and conditions as may be specified in such instrument in writing.

Article 2(h) of Trust 1 states that upon the death of a child, the trust estate of such child as then constituted shall be held in trust for the benefit of, or distributed to or in trust for the benefit of, any one or more of such child's descendants, in such amount and in such manner and upon such terms and conditions as such child shall appoint by his or her last will, specifically referring to the power of appointment conferred upon him or her.

Pursuant to Article 2(i), in default of the exercise of the power of appointment by a child, upon the death of such child, the trust estate of the child, or the part not effectively appointed, shall be distributed per stirpes to the child's then living descendants, if any. If there are no such descendants, the trust estate, or the part not effectively appointed, shall be distributed per stirpes to Grandparent's then living descendants, subject to certain withholding provisions. Each portion otherwise distributable to a descendant of Grandparent for whom a trust estate or share of a trust estate is then being held is to be added to such trust estate or share.

Under Article 2(k), if at any time prior to the complete vesting or distribution of the trust, no child of Grandparent nor any other descendant of the Grandparent shall be living, the entire remaining trust estate then in the hands of the Trustee shall be paid, transferred, and delivered to Charity.

Article 2(m) of Trust 1 provides that notwithstanding any other provision, the trusts created pursuant to the terms of

Trust 1 will terminate not later than twenty-one years after the death of the last survivor of Grandparent's descendants living on Date 1. If the trusts created pursuant to the terms of Trust 1 have not sooner terminated, the Trustee is directed to distribute any property then held in a trust to the beneficiary for whom the trust is named.

The primary asset of Trust A is stock in Corporation, a C corporation. The Corporation's Board of Directors proposes to elect to treat Corporation as a small business corporation (an "S corporation"). Trustee proposes to consent to the S election. In order to convert Corporation to an S corporation, each of its shareholders must be eligible to hold S corporation stock as of the first day of the year for which the election is to take effect. Trustee proposes to make an election under § 1361(e)(3) to treat Trust A as an electing small business trust so that it will qualify as an eligible S corporation shareholder.

In an effort to ensure the continuing qualification of Corporation as an S corporation, Trustee intends to enter into a shareholder agreement with Corporation and Corporation's other shareholders to protect the S election.

Under the Section 3(a) of the proposed shareholder agreement, no shareholder may transfer, and no person may acquire, the legal or beneficial ownership of any share if such transfer or acquisition would cause the S status of the Corporation to terminate. Specifically, no transfer may be made to any person that is not eligible to be a shareholder of an S corporation under the applicable provisions of the Code as in effect at the time of the purported transfer. In addition, no shareholder may affirmatively transfer shares to a person if the transfer would cause the Corporation to exceed the maximum number of persons who are allowable S corporation shareholders.

Section 3(b) of the proposed shareholder agreement provides that no shareholder shall make any transfer of shares to any trust having multiple beneficiaries or amend any trust that owns shares to increase the number of beneficiaries unless all such beneficiaries are persons eligible to be transferees pursuant to Section 3(a) and immediately after such transfer or amendment, the number of shareholders the Corporation is deemed to have for purposes of § 1361 would not exceed the maximum number of persons who are allowable S corporation shareholders pursuant to that section.

Notwithstanding any other provision of the shareholder agreement, the shareholders and the Corporation acknowledge and agree in Section 3(c) that none of the following shall be prohibited by the terms of the shareholder agreement: (i) the addition of a trust beneficiary due to the birth of an additional

descendant of Grandparent; (ii) the exercise of a power of appointment granted to a beneficiary pursuant to the terms of any irrevocable trust that is in existence on the date of the agreement and that owns shares; (iii) the transfer of shares to any person in whose favor a power of appointment described in (ii) above is exercised; or (iv) the distribution of shares to (A) a beneficiary of any irrevocable trust that is in existence on the date of the agreement and that owns shares, pursuant to the terms thereof or (B) to the beneficiary of any trust created pursuant to the exercise of a power of appointment described in (ii) above, even if such addition, exercise, or distribution shall cause the termination of the Corporation's S election.

Section 3(d) provides that prior to any transfer or other disposition of shares, if the Corporation in its discretion so requires, an opinion of counsel to the Corporation must first be received by the Corporation (the cost of which shall be borne by the shareholder whose shares are to be transferred or disposed of) that the transferee is (i) eligible to be a shareholder of an S corporation in accordance with the applicable requirements of the Code or (ii) that the transfer otherwise is allowable pursuant to the provisions of the shareholder agreement.

In addition to the other requirements of Section 3 of the shareholder agreement, Section 3(g) provides that no transfer of shares (including, without limitation, transfers pursuant to Section 3(c)) shall be permitted, and no purported transfer shall be effective, until a permitted transferee has executed a Supplemental Signature Page to the shareholder agreement. All parties agree that upon execution and acceptance of a Supplemental Signature Page, the shareholder agreement shall be amended and the transferee shall have the rights and obligations of a shareholder under the agreement.

Section 3(h) of the shareholder agreement provides that shareholders possessing 66 2/3% of the total voting power of all outstanding shares may at any time and from time to time agree in writing to authorize or ratify any transfer of shares which would otherwise not be permitted by the shareholder agreement, in which event the transfer shall be deemed for all purposes to comply with the shareholder agreement notwithstanding any other provision of the agreement.

Under Section 3(i), if a transfer of shares is required to be made pursuant to Section 3(c)(ii), (iii), or (iv) to a transferee who is not already a shareholder and who has not previously executed, or currently refuses to execute, a Supplemental Signature Page to the shareholder agreement (a non-consenting transferee), certain procedures will apply. The shareholders may allow the transfer of shares to the non-consenting transferee pursuant to the procedure set forth in

Section 3(h). Otherwise, the shares that otherwise would be transferred to the non-consenting transferee shall instead be redeemed by the Corporation for a price equal to the fair market value of the shares as of the valuation date.

Pursuant to Section 5 of the proposed shareholder agreement, any purported transfer in violation of the shareholder agreement shall not affect the beneficial or legal ownership of shares.

Section 6 of the agreement states that subject to any limitations on dividends or other distributions imposed by statute, the Corporation shall make pro rata dividend distributions of money, based on ownership of shares, to pay the Federal, state, and local income tax on the income and gain of the Corporation (net of any tax benefits produced for the shareholders by the Corporation's losses, deductions, and credits for the current year and for each prior year during which the Corporation's S election was in effect) that passes through to the shareholders under the applicable provisions of the Code in respect of each taxable year (or portion thereof) of the Corporation for which its S election is in effect.

Section 7 of the proposed shareholder agreement provides that the Corporation shall (a) not issue more than one class of shares, (b) use its best efforts to avoid a termination of its S election, and (c) in the event of a termination of the S election, use its best efforts to distribute to each shareholder such shareholder's net share of the Corporation's undistributed taxable income for all taxable years for which the S election was in effect, to the extent permitted by law and consistent with the obligations of the Corporation to creditors, agreements to which the Corporation is a party, and other business considerations, within the period when such a distribution will be considered a non-dividend distribution under § 1371(e)(1).

Section 9 of the proposed shareholder agreement states that if the Corporation's status as an S corporation is terminated inadvertently and the Corporation wishes to obtain a ruling under § 1362(f), each shareholder agrees to make any adjustments required pursuant to § 1362(f)(4) and approved by the Corporation's Board of Directors. A shareholder's obligation to make such adjustments shall continue after the shareholder has ceased to own shares in the Corporation and after the shareholder agreement has terminated.

Except as directed by the shareholder agreement, the existing Trustee will continue to serve in the same manner as it previously served. In addition, Trust A will continue to be administered in accordance with the terms and conditions set forth in Trust 1.

Section 2601 imposes a tax on every generation-skipping transfer. Section 26.2601-1(a)(1) of the Generation-Skipping Transfer Tax Regulations provides that the GST tax applies to any generation-skipping transfer made after October 22, 1986. Section 26.2601-1(b)(1) provides an exception to this rule for any distributions from a trust that was irrevocable on September 25, 1985. However, this exception does not apply to a pro rata portion of any generation-skipping transfer under an irrevocable trust where additions were made to the trust after September 25, 1985.

In addition, a modification to a trust that results in a change in the quality, value, or timing of any beneficial interest provided for under the trust instrument will cause the trust to lose its exempt status.

In the present case, it has been represented that Trust A was irrevocable on September 25, 1985, and that there have been no additions, constructive or otherwise, to Trust A after that date. Based on the representations made and the facts submitted, we conclude that there is no change in the quality, value, or timing of any beneficial interest in Trust A resulting from the following: (i) the Trustee's consent to Corporation's proposed S election; (ii) the Trustee's election to treat Trust A as an electing small business trust; and (iii) the Trustee's execution of the proposed shareholder agreement. Therefore, items (i) - (iii) above will not cause Trust A to lose its exempt status with respect to the GST tax. Provided that there are no additions, constructive or otherwise, to Trust A after September 25, 1985, distributions from Trust A to skip persons will not be subject to the GST tax.

Except as specifically ruled herein, we express no opinion as to the consequences of this transaction under the cited provisions of the Code or under any other provisions of the Code. Specifically, we express no opinion on whether Trust A will qualify as an electing small business trust within the meaning of § 1361(e).

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

Sincerely,
Assistant Chief Counsel
(Passthroughs and Special Industries)
By George Masnik
Chief, Branch 4

Enclosure

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