

Internal Revenue Service

Department of the Treasury

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Date:

July 5, 2001

Legend:

A =

B =

C =

X =

Y =

Trust =

a =

b =

c =

\$d =

e =

f =

State1 =

Year1 =

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D1 =D2 =D3 =D4 =

This letter responds to your January 16, 2001 request for a private letter ruling, submitted on behalf of Trust, requesting rulings on the transactions described below.

FACTS

According to the information submitted, X is a State1 corporation, incorporated in Year1. X elected subchapter S status for Federal tax purpose, effective D1.

On D2, A created five irrevocable trusts, including Trust. Trust was created for the benefit of B. A then transferred to Trust a shares of stock in Y, a corporation for which an S election was in effect. Trust elected to be treated as a qualified subchapter S trust (QSST) effective D2. On D3, Y merged into X, and Trust received b shares of X stock in exchange for its stock in Y.

Under the terms of its trust agreement, if Trust holds or receives stock in an S corporation, the trustee is required to hold such stock in a separate S Corporation Trust for the benefit of Trust's beneficiary B. All of the net income of the S Corporation Trust is required to be distributed to that beneficiary at least annually so long as the S Corporation Trust holds S corporation stock. Upon termination of the S Corporation Trust, the remaining principal and accumulated income of the trust estate is required to be distributed to Trust's beneficiary, B.

Effective D4, Trust purchased c additional shares of X from C pursuant to the Stock Purchase Agreement. The Stock Purchase Agreement required Trust to execute a promissory note. The terms of the promissory note required payment of \$d payable in e monthly installments. The promissory note is secured by the stock of X (the "Stock Pledge Agreement"). If any of the X stock purchased from C is sold by Trust during the period of f years following the date of purchase, Trust must pay C an additional amount equal to a defined percentage of the amount in excess of the purchase price. In conjunction with the Stock Purchase Agreement, Trust executed a separate agreement (the "Dividend Agreement") which provided that monthly payments under the promissory note would be made from cash distributions received from X by Trust.

LAW AND ANALYSIS

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Section 1.1361-1(j)(3) provides that for purposes of section 1361(c) and (d), a substantially separate and independent share of a trust, within the meaning of section 663(c) and the regulations thereunder, is treated as a separate trust. For a separate share which holds S corporation stock to qualify as a QSST, the terms of the trust applicable to that separate share must meet the QSST requirements stated in sections 1.1361-1(j)(1)(i) and (ii).

Under section 1361(d)(1), if the beneficiary of a QSST makes an election under section 1362(d)(2), the QSST is treated as a trust described in section 1361(c)(2)(A)(i) and the beneficiary of such trust is treated as the owner of the portion of the trust which consists of stock in an S corporation under section 678(a).

Section 1361(d)(3) provides that a QSST is a trust, the terms of which require that:

(1) During the life of the current income beneficiary, there shall be only one income beneficiary of the trust;

(2) Any corpus distributed during the life of the current income beneficiary may be distributed only to the beneficiary;

(3) The income interest of the current income beneficiary in the trust shall terminate on the earlier of the beneficiary's death or the termination of the trust; and

(4) Upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to the beneficiary.

In addition, section 1361(d)(3)(B) provides that the QSST must distribute (or be required to distribute) all of its income (within the meaning of section 643(b)) currently to one individual who is a citizen or resident of the United States.

Section 1.1361-1(j)(2)(iv) of the Income Tax Regulations provides, in part, that if the income beneficiary transfers or assigns the income interest or a portion of the income interest to another, the trust may no longer qualify as a QSST, depending on the facts and circumstances, because the transferee of the current income beneficiary's income interest and any person treated as a beneficiary under section 1.643(c)-1 will be treated as a current income beneficiary.

Section 1.1361-1(j)(7) provides, in part, that the income beneficiary who makes the QSST election and is treated (for purposes of section 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of section 1361(b)(1), 1366, 1367, and 1368.

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Based on the information submitted and representations made, we conclude that the execution of the Stock Purchase Agreement, the Stock Pledge Agreement, and the Dividend Agreement will not cause Trust to fail to qualify as a QSST and will not terminate the election by X to be treated as an S corporation. Moreover, the transfer of X stock to Trust and the performance of the trustee's obligations to Trust will not terminate the election by X to be treated as an S corporation.

Except as specifically ruled on above, we express no opinion about the Federal tax consequences of any aspect of the above described transaction. Specifically, no opinion is expressed as to whether X met or continues to meet the requirements of section 1361(b) of the Code, or whether X's S election terminated under section 1362(d) as a result of events not specifically addressed and ruled on by this letter ruling. Furthermore, no opinion is expressed as to whether Trust met or continues to meet the requirements of section 1361(d).

This ruling is directed only to the taxpayer requesting 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 on file with this office, a copy of this letter is being sent to the taxpayer and to the taxpayer's second authorized representative.

Sincerely,
David R. Haglund
Senior Technical Reviewer
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

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