

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B02 – PLR-133925-03

Date:

May 07, 2004

X =

A =

Partnership =

LLC =

Trust 1 =

Trust 2 =

Trust 3 =

Dear :

This letter responds to your letter dated May 27, 2003, and subsequent correspondence submitted by you as X's authorized representative on behalf of X, requesting a ruling under § 1361 of the Internal Revenue Code.

The information submitted states that X is an S corporation, currently owned by individuals including A. X is in the business of selling insurance services, but is represented as not being an insurance company subject to tax under subchapter L. Pursuant to a series of proposed transactions, stock of X will be transferred to Partnership and Trust 1. Partnership is owned by A, Trust 2, and LLC. LLC is owned by A and Trust 3. A will be the grantor of Trusts 1, 2, and 3. Neither Partnership nor LLC will elect to be treated as an association taxable as a corporation for federal income tax purposes.

Trust 1 and Trust 3 (the Irrevocable Trusts) have substantially identical terms. A is the initial trustee of the Irrevocable Trusts. The Irrevocable Trusts provide that during

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A's life the trustee shall pay or apply such sums from income and principal as, in the trustee's discretion, are necessary or advisable for the health, education, support, and maintenance of A's spouse and descendants. Upon A's death, the remaining trust assets are to be distributed or held in trust for the benefit of A's spouse and descendants in the manner described in the trust instrument.

Trust 2 provides that from the date Trust 2 is funded until the twentieth anniversary of such date, the trustee shall pay A or A's estate an annual annuity amount equal to 7.23% of the initial fair market value of the assets of Trust 2. The annuity amount is to be paid from income, accumulated income, and principal in that order. Any excess income is to be added to principal. At the end of the annuity period, the remaining trust assets are to be distributed or held in trust for the benefit of A's spouse and descendants in the manner described in the trust instrument. The trustee has the power to add the spouse of any current beneficiary under any trust created under the terms of the Trust 2 as an additional beneficiary of that trust.

Section 671 provides that where it is specified in subpart E of Part I of subchapter J 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(b)(5) provides that § 674(a) does not apply to a power to distribute corpus either (A) to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument; or (B) to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust. A power does not fall within the powers described in § 674(b)(5) 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.

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Section 677(a)(1) provides that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under § 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse.

Section 1361(a)(1) provides that for purposes of title 26, 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 for such year.

Section 1361(b)(1)(B) provides that, for purposes of subchapter S, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not 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)), who is not an individual.

Section 1361(b)(2)(B) defines the term "ineligible corporation," for purposes of § 1361(b)(1) to include an insurance company subject to tax under subchapter L.

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 of an S corporation.

Section 1361(c)(2)(B)(i) provides that in the case of a trust described in § 1361(c)(2)(A)(i), the deemed owner shall be treated as the shareholder.

Section 301.7701-3(a) of the Procedure and Administration Regulations provides, in part, that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in § 301.7701-3. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Section 301.7701-3(b)(1) provides that, except as provided in § 301.7701-3(b)(2), a domestic eligible entity is (i) a partnership if it has two or more members; or (ii) disregarded as an entity separate from its owner if it has a single owner.

Based solely on the facts and representations submitted, we conclude that Trust 1, Trust 2, and Trust 3 will be grantor trusts each of which will be treated as owned by A

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and that Partnership and LLC will be treated as owned by A and will be disregarded as entities separate from A. Therefore, A will continue to be treated as the owner of the X stock and the transactions described above will not cause the S corporation election of X to terminate because of an ineligible shareholder under § 1361(b)(1)(B).

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. Specifically, we express no opinion as to the consequences of the proposed transactions under the estate and gift tax provisions of chapters 11 and 12 of subtitle B, including the proper valuation of any property or interest in property for federal estate and gift tax purposes.

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.

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

Sincerely,

J. THOMAS HINES
Chief, Branch 2
Office of Associate Chief Counsel

(Passthroughs and Special Industries)

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