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Person To Contact:
, ID No.
Telephone Number:

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Legend:

X =

T =

A =
B =

State =
D1 =
D2 =
D3 =
D4 =
D5 =

Dear :

This letter responds to the letter dated October 28, 2004, submitted on behalf of X, requesting rulings under §§ 1362(b)(5) and 1362(f) of the Internal Revenue Code, § 26.2601-(b)(1) and (4) of the Generation-Skipping Transfer Tax Regulations, and § 301.9100-3 of the Procedure and Administration Regulations.

Facts

X was incorporated on D1 under the laws of State. The shareholders of X intended X to be treated as an S corporation effective D2, but X inadvertently failed to timely file an S corporation election. X also intended to file elections to treat its

subsidiaries as Qualified Subchapter S Subsidiaries (QSubs) effective D2, but X failed to timely file the QSub elections.

On D3, A created an irrevocable trust, T, for the purpose of benefiting B and members of B's family. On D2, the intended effective date of the S election and the QSub elections, T was a shareholder of X. The trustees of T intended to make an Electing Small Business Trust (ESBT) election effective D2, but they failed to timely file the ESBT election.

Pursuant to Rev. Proc. 98-55, relief for late S corporation election and automatic relief for late ESBT and QSub elections were requested on D4. However, the elections were invalid because T did not satisfy the definitional requirements of an ESBT under § 1361(e)(1)(A). Under the limited power of appointment contained in the terms of T, T had potential beneficiaries that were persons other than individuals, estates, or organizations described in § 170(c)(2) through (5). Furthermore, the limited power of appointment caused X to have more than 75 shareholders, making X disqualified to be a small business corporation under § 1361(b)(1).

Paragraph A-I-1 of T provides that during B's lifetime, the trustees, in their discretion, are to pay so much or all of the net income and principal of T for the benefit of B.

Paragraph A-I-2 provides that B shall have the power to direct the disposition, in whole or in part and from time to time, of the principal and undistributed net income of T to or in trust for the benefit of such person or persons (other than A or A's wife), trust or trusts, corporation or corporations, charitable foundation or charitable foundations, as B, in B's sole discretion, may select, except that this power shall not be exercisable, directly or indirectly, in favor of or for the benefit of B, B's estate, B's creditors, or the creditors of B's estate. B's power is exercisable during B's lifetime at any time following the death of A, or by the terms of B's will. B's power of appointment is releasable, from time to time, in whole or in part. If B exercises or releases his power during his lifetime, the exercise or release shall be by instrument in writing delivered to the trustees and shall become effective upon such delivery.

Paragraph A-I-3 provides that to the extent B has not exercised his power under the terms of paragraph A-I-2, upon B's death, if his spouse survives him, all assets of T are to be retained in trust and the trustees shall from time to time pay so much or all of the net income and principal to or for the benefit of B's surviving spouse or to or for the benefit of B's living issue as the trustees, in their sole discretion, deem necessary for the health, support, maintenance and education of such persons, including reasonable luxuries.

Paragraphs A-II-1,A-II-1-a, and A-II-1-b, provide that to the extent B has not exercised his power under paragraph A-I-2, upon B's death, if he is not survived by his

spouse, T assets shall be allocated in equal shares, one each for the living children of B and a share for the children of any deceased child of B. The trustees are to pay so much or all of the net income and principal of each share to or for the benefit of the child for whom the share was allocated as the trustees shall from time to time, in their discretion, deem necessary for the health, support, maintenance and education of such child, including reasonable luxuries.

Paragraph A-II-1-f provides that upon the expiration of twenty-one (21) years following the death of the survivor of B, any surviving spouse of B living on the date of the creation of T, A, A's spouse, A's brother, A's brother's spouse, and the issue of A's brother and spouse living at the date of the creation of T, each share of T, principal and undistributed net income, is to be distributed to the child of B for whom the share was allocated or, in the case of a share held for the benefit of the issue of a deceased child of B, the share is to be distributed to the then living issue of the deceased child, per stirpes.

On D5, B executed a partial release of his limited power of appointment, contingent upon receipt of a favorable private letter ruling from the Internal Revenue Service. B released the right to exercise the limited power of appointment (i) to a non-permitted S corporation shareholder, (ii) to more than 75 persons or entities (taking into consideration any existing shareholders), and (iii) in any manner that postpones or suspends the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of T, extending beyond the lives in being as enumerated in T, plus a period of 21 years.

Rulings Requested

1. B's partial release of the limited power of appointment is not treated as a constructive addition to T for generation-skipping transfer tax purposes.

2. B's partial release of the limited power of appointment is not treated as a modification to T and T remains as an exempt trust for generation-skipping transfer tax purposes.

3. The consent by the trustee of T to X's election to be treated as an S corporation and the consent by the trustee of T to the ESBT election is not a modification to T and T remains an exempt trust for generation-skipping transfer tax purposes.

4. Under § 1362(b)(5), X is treated as an S corporation effective D2.

5. The limited power of appointment contained in the terms of T caused X's election to be treated as an S corporation to be invalid. However, the

ineffectiveness of the S corporation election was inadvertent under the meaning of § 1362(f).

6. An extension of time to make QSub elections effective D2 for the subsidiaries of X is granted under § 301.9100-3.

Law

Section 2601 imposes a tax on every generation-skipping transfer (GST) made after October 26, 1986.

Under § 1433(a) of the Tax Reform Act of 1986 and § 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) and § 26.2601-1(b)(1)(i), the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(1)(v)(A) provides that, except as provided under § 26.2601-1(b)(1)(v)(B), where any portion of a trust remains in the trust after the post-September 25, 1985, release**,** exercise, or lapse of a power of appointment over that portion of the trust, and the release**,** exercise, or lapse is treated to any extent as a taxable transfer under chapter 11 or chapter 12, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed is treated as if that portion had been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse. The creator of the power will be considered the transferor of the addition except to the extent that the release, exercise, or lapse of the power is treated as a taxable transfer under chapter 11 or chapter 12.

Section 26.2601-1(b)(1)(v)(B) provides a special rule for certain powers of appointment. Under this section, the release, exercise, or lapse of a power of appointment (other than a general power of appointment as defined in § 2041(b)) will not be treated as an addition to a trust if (1) such power of appointment was created in an irrevocable trust that was not subject to chapter 13 under § 26.2601-1(b)(1); and (2) in the case of an exercise, the power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust, plus a period of 21 years plus, if necessary, a reasonable period of gestation (the perpetuities period).

Section 26.2601-1(b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax under § 26.2601-1(b)(1), (2), or (3) (hereinafter referred to

as an exempt trust) will not cause the trust to lose its exempt status. In general, unless specifically provided otherwise, the rules contained in § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. Unless specifically noted, the rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(D)(1) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy § 26.2601-1(b)(4)(i)(A), (B), or (C)) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided in the original trust. Furthermore, a modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered a shift in a beneficial interest in a trust.

Section 2041(a)(2) provides that the value of the gross estate shall include the value of all property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under §§ 2035 to 2038, inclusive. Section 2041(b)(1) defines the term "general power of appointment" as a power that is exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or the creditors of the decedent's estate. Section 2514 provides for a similar definition of a general power of appointment for gift tax purposes. Section 2514(b) provides that the exercise or release of a general power of appointment created after October 21, 1942, shall be deemed a transfer of property by the individual possessing such power.

Section 1361(a)(1) defines an “S corporation” as a small business corporation for which an election under § 1362(a) is in effect.

Section 1361(b)(1) defines a “small business corporation” as a domestic corporation which is not an ineligible corporation which does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate and other than a trust described in subsection (c)(2)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than 1 class of stock.

Section 1361(b)(3)(A) provides that a QSub shall not be treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation.

Section 1361(b)(3)(B) defines a QSub as a domestic corporation that is not an ineligible corporation, if 100 percent of the stock of the corporation is owned by an S corporation, and the S corporation elects to treat the corporation as a QSub.

A taxpayer makes a QSub election with respect to a subsidiary by filing a Form 8869, Qualified Subchapter S Subsidiary Election, with the appropriate service center.

Section 1.1361-3(a)(4) of the Income Tax Regulations provides that a QSub election will be effective on the date specified on the election form or on the date the election is filed if no date is specified. The effective date specified on the election form cannot be more than two months and 15 days prior to the date of filing and cannot be more than 12 months after the date of filing.

Section 1361(e)(1)(A) provides that 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, (III) an organization described in paragraph (2), (3), (4), or (5) of § 170(c), or (IV) an organization described in § 170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary, (ii) no interest in such trust was acquired by purchase, and (iii) an election under this subsection applies to such trust.

Section 1362(a) provides that a small business corporation may elect to be an S corporation.

Section 1362(b)(2) provides in relevant part that if an S election is made within the first two and one-half months of a corporation's taxable year, then the corporation will be treated as an S corporation for the year in which the election is made. Under § 1362(b)(3), however, if an S election is made after the first two and one-half months of a corporation's taxable year, then that corporation will not be treated as an S corporation until the taxable year after the year in which the S election is filed.

Section 1362(b)(5) provides that if (1) no § 1362(a) election is made for any taxable year and (2) the Secretary determines that there was reasonable cause for the failure to timely make such election, then the Secretary may treat such an election as timely made for such taxable year and § 1362(b)(3) shall not apply.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was not effective for the taxable year for which made (determined without

regard to subsection (b)(2)) by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consents, (2) the Secretary determines that the circumstances resulting in such ineffectiveness were inadvertent, (3) no later than a reasonable period of time after the discovery of the circumstances resulting in such ineffectiveness, steps were taken so that the corporation is a small business corporation, and (4) the corporation, and each person who was a shareholder of the corporation at any time during the period of inadvertent ineffectiveness of the S election, agrees to makes such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such ineffectiveness, the corporation is treated as an S corporation during the period specified by the Secretary.

Section 301.9100-1(c) provides that the Commissioner has discretion to grant a reasonable extension of time under the rules set forth in § 301.9100-3 to make a regulatory election. Section 301.9100-1(b) defines a regulatory election as an election with a due date prescribed by a regulation published in the Federal Register, or a revenue ruling, revenue procedure, notice, or announcement published in the Internal Revenue Bulletin.

Requests for relief under §301.9100-3 will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the Government. Section 301.9100-3(a).

Analysis and Conclusion

(1) Rulings 1 and 2

In the present case, it has been represented that T was irrevocable on September 25, 1985, and that there have been no additions, constructive or otherwise, to T after that date. Consequently, T is currently exempt from the GST tax. Based on the representations made and the facts submitted, B's power of appointment is not exercisable in favor of B, B's estate, B's creditors, or the creditors of B's estate and is not a general power of appointment. Therefore, B's partial release of the power of appointment would not result in any shift of a beneficial interest in T to a person or persons who occupy a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the release and will not extend the time for vesting of any beneficial interest in T beyond the period provided for prior to the release. Accordingly, the proposed release of B's limited power of appointment will not constitute a constructive addition to T. For these same reasons, the proposed release will not be a modification to T under § 26.2601-1(b)(4).

(2) Ruling 3

The consent by the trustee of T to X's election to be treated as an S corporation and the consent by the trustee of T to the ESBT election does not have any effect on the dispositive provisions of T. Therefore, the consent does not result in any shift of a beneficial interest in T to a person or persons who occupy a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the consent and will not extend the time for vesting of any beneficial interest in T beyond the period provided for prior to the consent and will not be a modification to T. Accordingly, T will remain an exempt trust for GST tax purposes, following the partial release by B of his power of appointment.

(3) Ruling 4

X did not timely file an election to be treated as an S corporation under § 1362(a). X has, however, established reasonable cause for not making a timely S election and is entitled to relief under § 1362(b)(5). Therefore, based solely on the facts submitted and the representations made, and provided that X otherwise qualifies as an S corporation, we conclude that X will be treated as an S corporation effective D2. This ruling is conditioned on X, within 60 days of the date of this letter, filing a new Form 2553, Election by a Small Business Corporation, with the appropriate service center with an effective date of D2. A copy of this letter should be attached to the election.

(4) Ruling 5

X represents that its invalid S corporation election was inadvertent, unintended, and not the result of tax avoidance or retroactive tax planning. X further represents that at all relevant times, X and its shareholders treated X as an S corporation. X and its shareholders agree to make any adjustments required by the Secretary consistent with the treatment of X as an S corporation with respect to the period specified by § 1362(f).

Based solely on the facts submitted and the representations made, we conclude that X's election to be treated as an S corporation as of D2 was invalid and also conclude that the invalid election constitutes an inadvertent invalid election within the meaning of § 1362(f). Under the provisions of § 1362(f), X will be treated as an S corporation as of D2 and thereafter, provided that X's S corporation election is not otherwise terminated under § 1362(d). Furthermore, the trustee of T will be treated as having filed timely an ESTB election on behalf of T effective D2, provided that X's S corporation election is not otherwise terminated under § 1362(d) and provided further that the trustee of T file an ESTB election for T with the appropriate service center, effective D2, within 60 days of the date of this letter. A copy of this letter should be attached to the election.

(5) Ruling 6

Based solely on the facts submitted and the representations made, we conclude that X has satisfied the requirements of §§ 301.9100-1 and 301.9100-3 with regard to the request for an extension of time to make Qsub elections for its subsidiaries. As a result, X is granted an extension of time of 60 days from the date of this letter to file a Form 8869 to elect to treat its subsidiaries as QSubs effective D2. A copy of this letter should be attached to the election and is included for that purpose.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed concerning whether X is a valid S corporation, whether T is a valid ESBT, or whether X's subsidiaries are valid QSubs.

This letter 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.

Under a power of attorney on file in this office, a copy of this letter will be sent to your authorized representatives.

Sincerely,

/s/ Heather C. Maloy

Heather C. Maloy
Associate Chief Counsel
(Passthroughs and Special Industries)

CC: