

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Legend

X =

A =

B =

C =

STATE =

D1 =

D2=

D3 =

TRUST1 =

TRUST2 =

This responds to your representative's letter dated February 24, 1999, and subsequent correspondence, written on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code.

FACTS

X incorporated under the laws of STATE and elected subchapter S corporation status effective for its tax year beginning on D1. A was X's sole shareholder until D2. On D2, TRUST1 and TRUST2 (hereinafter "the Trusts") acquired newly issued shares of X.

The Trusts each timely elected to be treated as a small business electing trust (ESBT) under § 1361(e)(3) as of D2.

Pursuant to the Trusts' trust agreement ("Agreement"), B is the primary beneficiary of TRUST1 and C is the primary beneficiary of TRUST2. The Agreement provides the primary beneficiary of each Trust with the following limited power of appointment:

Subject to Subparagraph 2 below¹, the primary beneficiary shall have the right and power, at any time and from time to time, to appoint any portion or all of the then remaining principal of the trust to and among any person or persons (excluding himself or herself, his or her estate, his or her creditors and the creditors of his or her estate) in such amounts or proportions and upon such estates (whether in trust or otherwise) as he or she shall designate by instrument in writing duly signed and acknowledged by him or her and delivered to the Independent Trustees during his or her lifetime, or in his or her Last Will and Testament, in either case by specific reference to this Indenture of Trust. Any appointment made by the primary beneficiary pursuant to the provisions hereof shall take effect during his or her lifetime or thereafter, as he or she shall specify.

Agreement, First Section, paragraph C.1.

A tax specialist, upon reviewing the Agreement, determined that this provision could cause X to lose its S corporation status, either because the Trusts may have a potential current beneficiary that does not qualify as an eligible subchapter S corporation shareholder or because X could be treated as having more than 75

¹Subparagraph 2 states that the Independent Trustee must approve any exercise of the power of appointment by the primary beneficiary if, at the time the exercise is to take effect, more than 1/3 of the value of Trust's assets comprise equity interests in one or more partnerships, limited liability companies, corporations, or other organizations that are not publicly traded.

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shareholders.

After learning that X may have terminated its subchapter S election, X's representatives began taking steps to make certain that X qualified as a subchapter S corporation. X represents that by D3, each primary beneficiary executed a partial release of his or her respective limited power of appointment (the "Release") and delivered the Release to an Independent Trustee. Each Release was intended to be effective as of D2.

During the time that the Trusts own shares in any subchapter S corporation, each Release limits the primary beneficiary's ability to appoint Trust principal to individuals who are eligible shareholders of a subchapter S corporation and who, in general, are related to the primary beneficiary by blood or marriage (the "Permitted Appointees"). The Permitted Appointees are listed in eight separate classes, with each class representing a different relationship to the primary beneficiary. However, the Release will eliminate one or more of these classes from the definition of Permitted Appointees to prevent the total number of Permitted Appointees from equaling or exceeding the maximum number of persons who may be shareholders of a small business corporation under § 1361(b).

X represents that from D3 to the present, the number of Permitted Appointees in all eight classes totaled eleven persons. X also represents that at the time the Trusts acquired the X shares, A and X believed that the Trusts' ownership of the shares would not affect X's subchapter S election. In addition, X and its shareholders executed a consent to make any adjustments that may be required by the Secretary in order to obtain a waiver of the effect of the possible inadvertent termination of X's subchapter S election. X further represents that no tax avoidance would result from granting X a waiver of the effect of an inadvertent termination.

LAW AND ANALYSIS

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) defines a "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 and other than a trust described in § 1361(c)(2)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1361(e)(1)(A) provides that, except as provided in § 1361(e)(1)(B), 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, or (III) an organization described in paragraph (2), (3), (4), or (5) of § 170(c), (ii) no interest in such trust was

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acquired by purchase, and (iii) an election under this subtitle applies to such trust.

Section 1361(c)(2)(B)(v) provides that each potential current beneficiary of an ESBT shall be treated as a shareholder for purposes of determining whether a corporation qualifies as a small business corporation, except that the trust is treated as the shareholder for any period in which there is no potential current beneficiary.

Section 1361(e)(2) provides that, for the purposes of § 1361, the term "potential current beneficiary" means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income from the trust.

In Notice 97-49, 1997-36 I.R.B. 8, the Service stated that the issue of whether the term "potential current beneficiary" includes a person to whom a distribution is or may be made during a period pursuant to a power of appointment was reserved and is currently under study.

Section 1362(f) provides, in part, that, if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in the termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the termination, 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 specified pursuant to § 1362(f), agrees to make such adjustments (consistent with the treatment of the corporation as a subchapter S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in the termination, the corporation will be treated as a subchapter S corporation during the period specified by the Secretary.

S.Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982) 1982-2 C.B. 718, 723-24, in discussing § 1362(f) of the Code, states in part:

If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.

The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been

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inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped that taxpayers and the Government will work out agreements that protect the revenues without undue hardship to taxpayers ... [I]t is expected that the waiver may be made retroactive for all years, or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.

Based solely on the facts submitted and the representations made, we conclude that X's subchapter S corporation election is valid because either the power of appointment did not cause X to cease to be a small business corporation, or, although the power of appointment caused X to cease to be a small business corporation, the resulting termination of the election was inadvertent under § 1362(f). Therefore, X will be treated as continuing to be a subchapter S corporation during the period from D2 to D3, and thereafter, provided that X's subchapter S corporation election was valid and was not otherwise terminated under § 1362(d). X, A, and the Trusts must treat X as having been a subchapter S corporation for the period beginning D2, and thereafter. Accordingly, A, and the Trusts must, in determining their respective income tax liabilities for the period beginning D2, and thereafter, include the pro-rata share of the separately and nonseparately computed items of X as provided in § 1366, make adjustments to stock basis as provided by § 1367, and take into account any distributions made by X as provided by § 1368. If X, A, and the Trusts fail to treat X as having been a subchapter S corporation for the period as described above, this ruling shall be void.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

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.

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.

Sincerely,

Signed/Daniel J.Coburn

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Enclosures (2)
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