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**Department of the Treasury****P.O. Box 7604****Ben Franklin Station****Washington, DC 20044****Person to Contact:****Telephone Number:****Refer Reply To:**

CC:DOM:P&amp;SI:4/PLR-105105-99

November 15, 1999

Re:

Legend:

Trust 1	=
Grandparent 1	=
Grandparent 2	=
Daughter	=
Trust A	=
Beneficiary	=
Trustee	=
Date 1	=
Date 2	=
Date 3	=
<u>x</u>	=
Corporation	=
Charity A	=

Dear :

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 1 transferred x to Trust 1, an irrevocable trust. Pursuant to Article 2 of Trust 1, Trust 1 was immediately divided into four separate trusts of equal value for the benefit of Grandparent 1's four children, including Daughter.

Article 2(a) of the trust agreement provides that the trustee shall pay to each beneficiary for whom a trust is named, and his or her descendants, or any one or more of them, such part or all of the income and principal of the trust (even though

exhausting the trust) at such time or times and in such equal or unequal proportions among them as the trustee shall decide, considering the needs, best interests, and welfare of such beneficiary and his or her descendants, in that order and as a group. Any undistributed income of a trust shall be accumulated and from time to time added to principal.

Article 2(c) provides that if a beneficiary for whom a trust is named dies before the complete distribution of that trust, then on the death of such beneficiary, the principal of that trust shall be distributed to or for the benefit of such of the beneficiary's descendants then living or thereafter born in such proportions and subject to such trusts, powers, and conditions as such beneficiary may provide and appoint by will specifically referring to this power to appoint.

Pursuant to Article 2(d), any part of a trust not effectively disposed of by any other provisions shall be divided and allocated on the death of the beneficiary for whom such trust is named per stirpes among the then living descendants of such beneficiary, if any. If there are no living descendants of the beneficiary, the portion of the trust not effectively disposed of will be divided and allocated per stirpes among the then living descendants of the nearest lineal ancestor of the beneficiary who also is a descendant of Grandparent 1 and of whom one or more descendants then are living, or if none, per stirpes among the then living descendants of Grandparent 2. Each share allocated to a beneficiary for whom a trust is named shall be added to that trust, and each share allocated to any other beneficiary shall be retained in trust as a separate trust named for him or her and disposed of as provided in Article 2 of Trust 1.

Article 2(e) of the trust agreement states that notwithstanding any other provisions in the trust agreement, no property shall be retained in a trust created under Trust 1 or pursuant to the exercise of any power of appointment under Trust 1 for more than twenty-one years after the death of the last to die of the descendants of Grandparent 2 who were living on Date 2. Each trust, if any, still retained in trust at the end of that period shall be distributed immediately to the beneficiary for whom the trust is named.

Article 3 provides that any part of the trust property or any separate trust not effectively disposed of by Article 2 shall be distributed to Charity A.

Daughter died on Date 3, without having exercised her limited testamentary power of appointment over the property held in trust for her benefit. Accordingly, the corpus of Daughter's trust was distributed equally to three trusts established for the

benefit of Daughter's descendants, including Trust A for the benefit of Beneficiary and her descendants.

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 2; (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.

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.

Section 26.2601-1(b)(1)(v)(B) provides a special rule for certain powers of appointment. This section provides that 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 is not subject to Chapter 13 under § 26.2601-1(b)(1); and (2) in the case of an exercise, such 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.

Section 2041(b) provides that the term "general power of appointment" means a power that is exercisable in favor of the individual possessing the power, his estate, his creditors, or the creditors of his estate.

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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