

[Code Sec: 1361]

1990, unless X's election is otherwise terminated under the provisions of section 1362(d) and provided that X meets the following conditions. As an adjustment under section 1362(f)(4), X must send a payment of \$Y attached to a copy of this letter to the following address: Internal Revenue Service, 310 Lowell Street, Andover, MA 05501. A copy of this letter is enclosed for this purpose. X must send this payment no later than 30 days from the date of this letter. Also X shall report the distribution of all its C corporation earnings and profits on its 1991 return, and the shareholders of X shall report the income they receive from the distribution on their 1991 returns. This ruling shall be null and void should X or any of its shareholders fail to meet any of these conditions. Furthermore, if these conditions are not met, X must notify the Service Center where X's S election was filed that the election has terminated.

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, no opinion is expressed on whether the original election made by X to be an S corporation was a valid election under section 1362(a) of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. (Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked by the adoption of temporary or final regulations to the extent such regulations are inconsistent with any conclusion in this ruling. See section 11.04 of Rev. Proc. 92-1, 1991-1 I.R.B. 9, 30. However, when the criteria in section 11.05 of Rev. Proc. 92-1 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to the authorized representatives of X.

Sincerely yours, DIANNA K. MIOSI,
Assistant to the Chief, Branch 1, Office of the
Assistant Chief Counsel, (Passthroughs and Special Industries)

LTR 9227013, March 30, 1992

Symbol: CC:P&SI:3-TR-31-1900-91

Uniform Issue List No.: 1361.00-00

IRS Letter Rulings Reports

Interest on certain governmental obligations; State and municipal; Organizations to which part applies; S corporation defined.

This responds to your letter dated September 30, 1991, in which you requested rulings on behalf of the above referenced taxpayer and its shareholders under subchapter S of the Internal Revenue Code.

Information submitted discloses that X, a small business corporation, filed an election for S corporation status to be effective beginning October 1, 1987, pursuant to section 1362(a) of the Code. On August 23, 1991, the grantors, A and B, established two irrevocable trusts, T1 and T2 (collectively known as "Trusts"). The trustees of T1 are C and D and the sole beneficiary is E. The trustees of T2 are E and D and the sole beneficiary is C.

It is represented that the Trusts will not hold insurance policies on the life of A or B. Trusts' assets will not be used to contribute, invest in, or acquire insurance policies on the life of A or B nor will Trusts' income or principal be utilized to pay premiums on insurance policies on the life of A or B.

The Trusts provide that each grantor reserves unto himself or herself during his or her lifetime, the power without the approval or consent of any other person, including the trustees or either of them, to reacquire all or any part of the Trust corpus by substituting other property of equivalent value therefor. This power of substitution is not assignable and may be exercised only by one or both of the grantors and shall lapse as to each grantor upon that grantor's death or written waiver of the power, delivered to the trustees, provided that this power shall lapse at anytime after September 30, 1992 when the Trust shall not have as part of their corpus any stock of a closely held corporation in which the grantors together own more than twenty percent of the stock, thereof.

The grantors have waived all rights which they may have, if any, to a distribution of proceeds from the Trust, including any rights to seek reimbursement for any taxes paid, by them as grantor on account of income of the Trust, for the benefit of the Trust and/or its beneficiaries.

The trustees have the power to have the Trusts taxed as qualified subchapter S trusts, if the beneficiaries in each case so elect. The Trusts provide that the net income from the Trust shall be paid entirely to C and E, respectively, as the sole income beneficiary of each Trust. The Trusts

provide that the income interest of the sole beneficiary shall terminate on the beneficiary's death. The Trusts also provide that any principal or corpus distributed during the life of the income beneficiary shall be distributed only to the income beneficiary, and in the event the Trust terminates during the lifetime of the income beneficiary, the remaining trust property shall be distributed to the income beneficiary, fully discharged of any obligations in trust.

Section 671 of the Internal Revenue Code provides the general rule that where the grantor is treated as the owner of any portion of a trust, there shall be included in computing this taxable income and credits those items of income, deductions and credits against tax of the trust, attributable to that portion of the trust to the extent that such items would be taken into account in computing the taxable income or credits against the tax of the individual.

Section 675(4) of the Code provides that the grantor of a trust shall be treated as the owner of any portion of a trust in respect of which a power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, subsection (C) of section 675(4) provides that the term "power of administration" includes a power to reacquire the trust corpus by substituting other property of an equivalent value.

Section 1361(a)(1) of the Code provides that for purposes of this title, the term "S corporation" means, for any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.

Section 1361(b)(1)(B) of the Code provides that for purposes of this subchapter, 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 and other than a trust described in section 1361(c)(2)) who is not an individual.

Section 1361(c)(2)(A)(i) of the Code provides that for purposes of section 1361(b)(1)(B), a trust all of which is treated (under subpart E of part B of subchapter J of chapter 1—sections 671 through 679) as owned by an individual who is a citizen or resident of the United States may be a shareholder in a small business corporation.

Section 1361(c)(2)(B)(i) of the Code provides that for purposes of subsection 1361(b)(1), in the case of a trust described in section 1361(c)(2)(A)(i), the deemed owner shall be treated as the shareholder.

Section 1361(d)(1) of the Code provides, in general, that in the case of a qualified subchapter S trust, for which a beneficiary makes an election under section 1361(d)(2), such trust shall be treated as a trust described in section 1361(c)(2)(A)(i), and for purposes of section 678(a) the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation for which the election under section 1361(d)(2) is made.

Section 1361(d)(2) of the Code provides, in general, for the time and manner in which a beneficiary of a qualified subchapter S trust may elect to have the provisions of section 1361(d) apply.

Section 1361(d)(3) of the Code defines the term "qualified subchapter S trust" as a trust the terms of which require that during the life of the current income beneficiary there shall be only one income beneficiary of the trust; any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary; the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust; and upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary. In addition, such trust must distribute (or be required to distribute) currently all of its income (within the meaning of section 643(b) of the Code) to one individual who is a citizen of the United States.

Section 1366(a)(1) of the Code includes as an item of income, a shareholder's pro rata share of the S corporation's income. Section 1367(a)(1) provides that the basis of each shareholder's stock in an S corporation shall be increased by any items of income described in section 1366(a)(1).

The power to substitute corpus of equivalent value meets the definition of section 675(4)(C) of the Code as a general power of administration. Accordingly, the grantors will be treated as the owners of the Trusts under section 675, and they will be taxed under section 671 on the income of X allocated to the Trusts. Under section 671, the grantors must include in computing their taxable income, deductions and credits, all items of income, deductions and credits against tax of the Trusts.

The grantors will be the deemed shareholders of the stock of X as provided in section 1361(c)(2)(B)(i) of the Code. Accordingly, Trusts meet the definition of permitted S corporation shareholders under section 1361(c)(2)(A)(i), and

satisfy the shareholder eligibility requirement of section 1361(b)(1)(B). The holding of the X stock by the Trusts will not terminate X's election. The basis of the stock held by the Trusts is increased or decreased by the share of income or loss from X, as described in section 1366(a).

Upon the waiver or lapse of the power to substitute corpus of equivalent value, the Trusts will be "qualified subchapter S trusts" within the meaning of 1361(d)(3) of the Code provided that C and E, the current income beneficiaries of the respective Trusts, are citizens of the United States and make proper elections under section 1361(d)(2) and provided that all of the Trusts' income (within the meaning of section 643(b)) is distributed at least annually to C and E, respectively. Therefore, the Trusts will be treated as trusts described in section 1361(c)(2)(A)(i) and satisfy the shareholder eligibility requirements of section 1361(1)(B). The holding of the X stock by the Trusts will not terminate X's election.

Section 2001 of the Code imposes a tax on the estate of every decedent who is a citizen or resident of the United States. Section 2033 provides for the inclusion in the gross estate of any property in which the decedent had an interest at the time of his death. Section 2038 provides that the gross estate shall include the value of all property of which the decedent has made a transfer, except where there has been a bona fide sale for adequate and full consideration in money or money's worth, by trust or otherwise where the enjoyment of that property was subject at the date of his death to any change through the exercise of a power by the decedent, alone or in conjunction with another person, to alter, amend, revoke, or terminate the interest in the property or where the decedent relinquished this power within the three year period ending on the date of the decedent's death.

The Tax Court in *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975) [CCH Dec. 33,642], acq., 1977-1 C.B. 1, held that the power to substitute corpus of equal value does not constitute a power to alter, amend, or revoke a trust within the meaning of section 2038(a)(2) of the Code. At the time the Trusts were created, the Grantors made irrevocable transfers to the Trusts and retained no interests in or powers over the Trusts that would cause the Trust property to be included in the gross estate of either grantor at death. Therefore, the grantors' power to substitute the existing corpus in the Trusts with property of equal value does not require that the Trust property be included in the gross estates of either grantors under section 2038(a) of the Code.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the above-described facts under any other provision of the Code. Specifically, no opinion is expressed or implied concerning the validity of X's election under section 1362.

This Ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that the Ruling may not be used or cited as precedent. Temporary or final regulations, pertaining to one or more of the issues addressed in this Ruling have not yet been adopted. Therefore, this Ruling may be modified or revoked by adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusion in the Ruling. See section 11.04 of Rev. Proc. 92-1, 1992-1 I.R.B. 9. However, when the criteria in section 11.05 of Rev. Proc. 92-1 are satisfied, a Ruling is not revoked or modified retroactively, except in rare or unusual circumstances.

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

Sincerely yours, William P. O'Shea Chief,
Branch 3, Office of the Assistant Chief Counsel,
(Pass-throughs and Special Industries)

LTR 9227014, March 30, 1992

Symbol: CC:IF&A:10-TR-31-0061-92

Uniform Issue List No.: Q174.05-01

[Code Section 174]
Research and experimental expenditures;
Change in election; From current deduction to
amortization.

This is in reference to a request filed on behalf of X (the taxpayer) for permission to change to the deferred expense method of deducting the research and experimental expenditures relating to the specifically-named Projects, pursuant to the provisions of section 174(a)(3) of the Internal Revenue Code, beginning with the 52-53 week tax year ending December 27, 1991 (year of change).

It is represented that the taxpayer is currently expensing research and experimental expenditures incurred in the specifically named Projects. The change in accounting method will apply only to the research and experimental expenditures paid or incurred by the taxpayer on or after the first day of the year of change, in accordance with section 1.471-3(a) of the Income