Subpart D.—Miscellaneous Provisions

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1993. See Rev. Rul. 93–42, page 260.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1993. See Rev. Rul. 93–51, page 262.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1993. See Rev. Rul. 93–55, page 263.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1993. See Rev. Rul. 93–64, page 264.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1993. See Rev. Rul. 93–71, page 266.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1993. See Rev. Rul. 93–82, page 267.

Subchapter S.—Tax Treatment of S Corporations and Their Shareholders

Part I.—In General

Section 1362.—Election; Revocation; Termination

State court order retroactive effect. Purported retroactive effect of a state court order reforming a trust to be a "qualified subchapter S trust" will not be recognized for federal tax purposes when the trust is a shareholder in a corporation that has filed an S election. The Service will not follow *Flitcroft v. Commissioner,* 328 F.2d 449 (9th Cir. 1964).

Rev. Rul. 93–79

ISSUE

If a state court order retroactively reforms a trust to meet the requirements of section 1361(d)(3) of the Internal Revenue Code for a "qualified subchapter S trust" (QSST), does the order have retroactive effect for purposes of determining the trust's eligibility to be a shareholder of an S corporation?

FACTS

X, a corporation, filed an election on March 15, 1992, to be an S corporation for its taxable year beginning January 1, 1992. A trust (the Trust) was one of the shareholders participating in the S corporation election.

The terms of the Trust satisfy the requirements for QSSTs set forth in section 1361(d)(3)(A)(i), (iii), and (iv), as well as section 1361(d)(3)(B) of the Code. However, the terms of the Trust also provide that, under certain circumstances, a portion of the Trust's corpus may be distributed to a person other than the current income beneficiary. The terms of the Trust, therefore, do not satisfy the corpus distribution requirement of section 1361(d)(3)(A)(ii).

On January 31, 1993, the beneficiaries of the Trust executed an agreement reforming the trust instrument's terms to provide that during the life of the current income beneficiary no trust beneficiary other than the current income beneficiary would be entitled to receive distributions of trust corpus. On February 15, 1993, the appropriate state court issued an order ruling that the Trust was reformed retroactive to December 31, 1991.

LAW AND ANALYSIS

Section 1361(a)(1) of the Code defines the term "S corporation" as a small business corporation for which an election under section 1362(a) is in effect for the taxable year.

Section 1361(b)(1) of the Code, which defines the term "small business corporation," permits only individuals, estates, and certain trusts (described in section 1361(c)(2)) to be shareholders of a small business corporation. Section 1361(b)(1)(B).

Section 1361(c)(2)(A) of the Code provides that, for purposes of section 1361(b)(1)(B), certain trusts may be shareholders of a small business corporation. Under section 1361(d)(1), a QSST is treated as a trust described in section 1361(c)(2)(A)(i).

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

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

Section 1362(b)(1) of the Code requires that the electing corporation must satisfy the S corporation eligibility requirements when the election is filed.

Section 1362(b)(2) of the Code provides, in part, that if an election is made on or before the 15th day of the third month of the taxable year, but on one or more days during that year, and before the election was made, the corporation did not meet the requirements of section 1361(b), then the election will be treated as made for the following taxable year.

Section 1362(g) of the Code provides that, if a small business corporation has made an election under section 1362(a) and if the election has been terminated under section 1362(d), the corporation (and any successor corporation) is not eligible to make an election under section 1362(a) for any taxable year before its fifth tax year that begins after the first taxable year for which the termination is effective, unless the Secretary consents to the election.

In the present situation, the original terms of the Trust did not satisfy the requirements of section 1361(d)(3)(A)(ii) of the Code regarding distributions of corpus. Consequently, the Trust was not a QSST and was ineligible to be an

S corporation shareholder. Thus, the S corporation election filed by *X* on March 15, 1992, was ineffective because the Trust held shares of *X* at the time the election was filed. In an effort to cure the ineffective election, the Trust's beneficiaries obtained a court-approved retroactive reformation of the governing trust instrument.

Retroactive changes of the legal effects of a transaction through judicial nullification of a transfer or judicial reformation of a document do not have retroactive effect for federal tax purposes. *American Nurseryman Publishing Company v. Commissioner*, 75 T.C. 271, 276–277 (1980), *aff'd without published opinion*, 673 F.2d 1333 (7th Cir. 1982); *Estate of Hill v. Commissioner*, 64 T.C. 867 (1975), *aff'd without published opinion*, 568 F.2d 1365 (5th Cir. 1978); *Emerson Institute v. United States*, 356 F.2d 824 (D.C. Cir. 1966), *cert. denied*, 385 U.S. 822 (1966); *Piel v. Commissioner*, 340 F.2d 887 (2d Cir. 1965); *M.T. Straight Trust v. Commissioner*, 245 F.2d 327 (8th Cir. 1957); *Eisenberg v. Commissioner*, 161 F.2d 506 (3d Cir. 1947), *cert. denied*, 332 U.S. 767 (1947); *Sinopoulo v. Jones*, 154 F.2d 648 (10th Cir. 1946).

American Nurseryman considered whether an S corporation election was terminated when stock in the corporation was transferred to a trust. A state court found that the stock transfer was a mistake and held it to be void. The Tax Court disregarded the effect of the state court action for purposes of determining the federal tax status of the corporation and found that the S election was terminated. The court followed the consistently expressed judicial opinion that judicial reformation cannot operate to change the federal tax consequences of a completed transaction.

Quoting its opinion in *M.T. Straight Trust v. Commissioner*, 24 T.C. 69 (1955), *aff'd*. 245 F.2d 327 (8th Cir. 1957), the court in *American Nurseryman* said that it recognized that "[t]here are numerous cases in which the construction or interpretation of an instrument by a decision of a State court involving the taxpayer and rendered subsequent to the taxable period involved has been relied upon to determine the tax consequences of the document," but the court stated that "In the instant case, however, the reformation decree is not a determination of the legal effect of the original trust instrument under local law, nor does it purport to be such a determination. On the contrary, it alters and modifies the instrument." 75 T.C. 275. The court went on to observe that "as a general rule a reformation of an instrument has retroactive effect as between the parties to the instrument, but not as to third parties who previously acquired rights under the instrument." 75 T.C. 276.

In *Flitcroft v. Commissioner*, 328 F.2d 449 (9th Cir. 1964), *rev'g*. 39 T.C. 52 (1962), the taxpayers established trusts that were not by their terms irrevocable. State law mandated that a trust was not irrevocable unless expressly stated in the trust instrument. A state court reformed the trusts, based on the asserted original intent of the grantors, and decreed that the trusts were irrevocable from their execution. The Ninth Circuit held that the trusts were irrevocable for federal tax purposes. The Service does not follow the Ninth Circuit's decision in *Flitcroft* to the extent it requires the Service to give effect to a retroactive reformation.

Accordingly, the reformation of the Trust will not be recognized retroactively to cure the defective S corporation election filed by *X*. Because an ineligible trust held shares of *X* stock at the time *X*'s S corporation election was filed, *X* was not a small business corporation on that date (as required by section 1362(a) of the Code) and on each day of 1992 before that date (as required by section 1362(b)(2)(B)(i)). Therefore, *X* never became an S corporation because the S corporation election filed by *X* on March 15, 1992, was ineffective. Furthermore, the provision of section 1362(b)(2) permitting certain otherwise ineffective elections to be effective for the following taxable year does not permit the election filed by *X* to be valid for the following taxable year, 1993, because *X* was not a small business corporation when the election was filed.

The trust reformation, however, will be recognized prospectively. Therefore, because *X* has never been an S corporation, it may file a new S corporation election for a subsequent taxable year without waiting the 5-year period specified in section 1362(g) of the Code for new S corporation elections by corporations whose previous elections have terminated.

HOLDING

A state court order, which retroactively reforms a trust to meet the requirements of a qualified subchapter S trust, does not have retroactive effect for purposes of determining the trust's eligibility to be a shareholder of an S corporation.

Chapter 3.—Withholding of Tax on Nonresident Aliens and Foreign Corporations

Subchapter A.—Nonresident Aliens and Foreign Corporations

Section 1441.—Withholding of Tax on Nonresident Aliens

Rules by which withholding under section 1441 is not required if an alien student, teacher, or researcher who has income exempt under treaty submits Form 8233 along with certain representations to the withholding agent. See Rev. Proc. 93–22A, page 343.

Subtitle B.—Estate and Gift Taxes

Chapter 11.—Estate Tax

Subchapter A.—Estates of Citizens or Residents

Part II.—Credits Against Tax

Section 2013.—Credit for Tax on Prior Transfers

26 CFR 20.2013–4: Valuation of property transferred.

For purposes of the credit for tax on prior transfers, the value of the transferred property is not reduced by post-death interest accruing on deferred federal estate taxes payable from the transferred property. See Rev. Rul. 93–48, below.

Part IV.—Taxable Estate

Section 2055.—Transfers for Public, Charitable, and Religious Uses

26 CFR 20.2055–1: Deduction for transfers for public, charitable and religious uses; in general.
(Also Sections 2013, 2056; 20.2013–4, 20.2056(b)–4.)

Value of transfers. The Service has adopted the result of recent court decisions, which hold that post-death interest accruing on deferred federal estate tax payable from a testamentary transfer does not ordinarily reduce the