

**Internal Revenue Service**

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Person To Contact:

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Telephone Number:

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Date:

February 17, 2005

Trust 1 =

Trust 2 =

LP =

G =

B =

Co-Trustees =

State 1 =

State 2 =

Country =

D1 =

D2 =

D3 =

D4 =

D5 =

\$x =

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Dear \_\_\_\_\_ :

This responds to a letter dated April 5, 2004, and subsequent correspondence, submitted on behalf of Trust 2, requesting a ruling under § 1361(e) of the Internal Revenue Code.

The information submitted states that Trust 1 was created on D1 by G. G died on D2; upon his death, Trust 1 was divided into three trusts as provided by Article 7 of Trust 1. Paragraph 7.1 of Trust 1 provides that upon the death of G and his spouse the trustee of Trust 1 shall divide Trust 1 as set forth in Article 7 of Trust 1. Trust 2 is one of the trusts created by Article 7. Trust 2 holds investments for the benefit of B, the son of G. Trust 1 and Trust 2 are governed by the law of State 1. B is a nonresident alien and a citizen of Country. Co-Trustees are the co-trustees of Trust 2. Under Paragraph 7.4 of Trust 1, the trustee is required to accumulate the trust's income until D4, after which the trustee is required to distribute income to the beneficiary not less frequently than quarter-annually. Under Paragraph 7.6(a) of Trust 1 the trustee is required to distribute the principal of Trust 2 to B on and not before D5. Under Paragraph 7.5 of Trust 1, the trustee is given limited discretion, subject to the provisions of Paragraph 9.10 of Trust 1, to distribute trust principal for the support, maintenance, health and education of B. Under Paragraph 9.10 of Trust 1 the trustee shall not make any discretionary distributions for the benefit of any beneficiary so long as there are assets reasonably available in Country for similar purposes. On D2, the assets available for distribution to B to pay for B's taxes, education, and living expenses in Country were valued at approximately \$x.

Co-Trustees represent that under Paragraph 9.10 of Trust 1, the trustees of Trust 2 do not have any discretion to make distributions to B until the earlier of D4, or until substantially all the assets in Country available for distribution to B are distributed. No distributions have been made to B from Trust 2 and no distributions are contemplated.

Among the investments held by Trust 2 is a limited partnership interest in LP, a State 2 limited partnership that has made an election to be treated as an association taxable as a corporation for federal tax purposes. LP proposes to elect to be taxed as an S corporation, effective D3. In order to qualify to make the election, Trust 2 will have to qualify as an eligible trust under § 1361(c)(2). In order to be an eligible trust, the trustee proposes to make an election to be an Electing Small Business Trust (ESBT) under § 1361(c)(3).

Co-Trustees request a ruling that the trustees of Trust 2 do not have discretion within the meaning of § 1361(e)(2) to make a distribution of principal or income to B, until D4, or until substantially all the assets in Country available for distribution to B are distributed, and therefore, B is not a potential current beneficiary (PCB) of Trust 2.

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Section 1362(a) provides that, except as provided in section 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

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

Section 1361(b)(1) provides that a "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not (A) have more than 100 shareholders and (B) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual.

Section 1361(c)(2)(A)(v) provides that, for purposes of § 1361(b)(1)(B), an ESBT may be a shareholder of an S corporation. Section 1361(c)(2)(B)(v) provides that in the case of an ESBT, each PCB of such trust shall be treated as a shareholder for purposes of § 1361(b)(1); except that, if for any period there is no PCB of such trust, such trust shall be treated as the shareholder during such period.

Section 1361(e) defines an ESBT. Section 1361(e)(2) provides that, for purposes of § 1361(e), 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 of the trust.

Section 1.1361-1(m)(1)(ii)(D) of the Income Tax Regulations provides that a nonresident alien is an eligible beneficiary of an ESBT. However, if the nonresident alien is a PCB of the ESBT the S corporation will have an ineligible shareholder and its S corporation election will terminate.

Section 1.1361-1(m)(4)(i) provides that for purposes of determining whether a corporation is a small business corporation within the meaning of § 1361(b)(1), each PCB of an ESBT generally is treated as a shareholder of the corporation. Subject to the provisions of § 1.1361-1(m)(4), a PCB generally is, with respect to any period, any person who at any time during such period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust. A person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may, receive a distribution of principal or income of the trust.

Section 1.1361-1(m)(4)(v) provides that a person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event

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(such as the death of the holder of a power of appointment) is not a PCB until such time or the occurrence of such event.

Based solely on the facts and representations submitted, we conclude that B is not a PCB of Trust 2 until D4 or until substantially all the assets in Country available for distribution to B are distributed. B will be a PCB on D4 and, prior to D4, B will be a PCB when substantially all the assets in Country available for distribution to B are distributed.

Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the above-described facts under any other provision of the Code.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to Trust 2 and Trust 2's second authorized representative.

Sincerely,

J. Thomas Hines  
Chief, Branch 2  
Office of Associate Chief Counsel

(Passthroughs & Special Industries)

Enclosures: 2

Copy of this letter

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