

Internal Revenue Service

Department of the Treasury

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LEGEND

Company =

Purchaser =

Trust =

A =

B =

Z =

d1 =

d2 =

d3 =

d4 =

d5 =

d6 =

Dear

This responds to a letter dated October 6, 1998, and subsequent correspondence, submitted by your authorized representative requesting certain rulings under § 1361 of the Internal Revenue Code.

FACTS

Company was incorporated on d1, and elected S corporation treatment on d2, effective for the taxable year beginning d3. Following the death of A on d4, Trust received shares of Company's stock. Subsequently, B, the income beneficiary of Trust, filed an election under § 1361(d)(2) to have Trust treated as a qualified subchapter S trust (QSST). The beneficiary reported all pass-through items of income, deduction, and credit allocable to the shares of Company's stock held by Trust.

On d5, all of the shareholders of Company (including Trust) agreed to sell all of their shares of Company stock to Purchaser, a publicly traded C corporation. The transaction closed d6. As part of the stock purchase agreement, Purchaser and the shareholders of Company made an election under § 338(h)(10). It is represented that the corporate gain from the deemed sale of Company's assets resulting from the § 338(h)(10) transaction is approximately z.

RULING REQUESTED

The taxpayers request a ruling that the corporate and shareholder gain on the deemed sale of assets resulting from a § 338(h)(10) election that is allocable to shares of S corporation stock held by Trust is that of Trust, and not of the income beneficiary of the QSST.

LAW AND ANALYSIS

Section 1361(d)(1)(B) provides that for purposes of § 678(a), the beneficiary of a QSST is treated as owner of that portion of the trust which consists of stock in an S corporation with respect to which the QSST election is made.

Section 1.1361-1(j)(7) of the Income Tax Regulations provides that the income beneficiary who makes the QSST election and is treated (for purposes of § 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder of purposes of §§ 1361(b)(1), 1366, 1367, and 1368.

Section 1.1361-1(j)(8) provides that if a valid QSST election is made, the income beneficiary is treated as owner, for purposes of § 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made. However, solely for purposes of applying the preceding sentence to a QSST, an income beneficiary who is a deemed § 678(a) owner only by reason of § 1361(d)(1) will not be treated as the owner of the S corporation stock in determining and attributing the federal income tax consequences of a disposition of the stock by the QSST. For example, if the disposition is a sale, the QSST election terminates as to the stock sold and any gain or loss recognized on the sale will be that of the trust, not the income beneficiary. Similarly, if a QSST distributes its S corporation stock to the income beneficiary, the QSST election terminates as to the distributed stock and the consequences of the distribution are determined by reference to the status of the trust apart from the income beneficiary's terminating ownership status under §§ 678 and

1361(d)(1). The portions of the trust other than the portion consisting of S corporation stock are subject to subparts A through D of subchapter J of chapter 1, except as otherwise required by subpart E of the Code.

Section 1.338(h)(10)-1(a) provides that if a § 338(h)(10) election is made, the target corporation is generally deemed to sell all of its assets and distribute the proceeds in complete liquidation.

Section 1.338(h)(10)-1(d) provides that a § 338(h)(10) election may be made for a target corporation if a purchasing corporation acquires the target corporation in a qualified stock purchase from S corporation shareholders.

Under § 1.1361-1(j)(8), any gain or loss on the sale of S corporation stock is reported by a QSST rather than the QSST beneficiary. As part of the stock purchase agreement, Purchaser and the shareholders of Company made a § 338(h)(10) election. Consequently, under § 338(h)(10), Company is deemed to sell all of its assets and distribute the proceeds in complete liquidation. A gain or loss resulting from a § 338(h)(10) election is one of the tax consequences of a disposition of stock by the QSST for which the QSST beneficiary is not treated as the owner of stock. Therefore, any gain or loss resulting from an election under § 338(h)(10) is allocated to the QSST as owner of the stock who reports all tax consequences relating to a stock sale under § 1.1361-1(j)(8).

CONCLUSION

After applying the relevant law to the facts submitted and the representations made, we rule that Company's gain from the deemed sale of Company's assets resulting from a § 338(h)(10) election that is allocable to the shares of Company's stock held by Trust is that of Trust and not the beneficiary.

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 or implied concerning whether Company's S corporation election was valid, whether Trust is a QSST under § 1361(d), or on the validity of the § 338(h)(10) election.

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 yours,

Jeff Erickson
Assistant to the Branch Chief,
Branch 3
Office of the Assistant Chief
Counsel
(Passthroughs and Special
Industries)

Enclosures (2)

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