

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:  
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Date:  
October 8, 2002

Legend

X =

A =

B =

Trust =

D1 =

State =

Dear :

This letter responds to a letter dated June 13, 2002, and subsequent correspondence, submitted on behalf of X, requesting rulings under § 1362 of the Internal Revenue Code.

A, the president of X, represents that X filed an election to be treated as an S corporation effective D1 and that X received notification from the Service that its S corporation election had been accepted. A further represents that Trust, a shareholder of X, filed an election to be treated as an electing small business trust (ESBT) effective D1. Trust proposes to contribute all of its X stock to a newly-formed State limited liability company (LLC) in return for a 100% membership interest in the LLC. The LLC will not elect to be treated as an association taxable as a corporation under § 301.7701-3(c) of the Procedure and Administration Regulations.

Article V, Section 2, Paragraph (c) of the instrument establishing the Trust provides that B, the primary beneficiary of the Trust, may currently appoint amounts of the Trust corpus to members of a class of B's descendants as defined in the Trust.

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Section 1361(a)(1) provides that, in general, for purposes of Title 26, the term “S corporation” means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for such year.

Section 1361(b)(1)(B) provides that, for purposes of subchapter S, 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, 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 electing small business trust (ESBT) may be an S corporation shareholder.

Section 1361(e)(2) provides that, for purposes of § 1361, 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)(4)(vi)(A) of the Income Tax Regulations provides, in general, that a person to whom a distribution is or may be made during a period pursuant to a power of appointment is a potential current beneficiary. Thus, if any person has a lifetime power of appointment that would permit distributions from the trust to be made to more than 75 persons, the corporation’s S corporation election will terminate because the number of potential current beneficiaries will exceed the 75-shareholder limit of § 1361(b)(1)(A). Also, the S corporation election will terminate if the currently exercisable power of appointment allows distributions to be made to an ineligible shareholder as defined in § 1361(b)(1)(B) and (C).

Section 301.7701-2(a) provides, in part, that a business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

Section 301.7701-3(a) provides, in part, that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal income tax purposes as provided in § 301.7701-3. An eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Section 301.7701-3(b)(1)(ii) provides that, except as provided in § 301.7701-3(b)(3), unless the entity elects otherwise, a domestic eligible entity is disregarded as an entity separate from its owner if it has a single owner.

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Based solely on the facts and representations submitted, we conclude that Trust's contribution of its X stock to the LLC in exchange for a 100% membership interest in the LLC will not terminate the S corporation election of X or the ESBT election of Trust. We further conclude that the holding of X stock by the LLC will not affect X's S corporation election.

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. We express no opinion concerning whether X is an S corporation for federal tax purposes or whether Trust is currently a qualified ESBT. In particular, we express no opinion as to the effect of the power of appointment in Article V, Section 2, Paragraph (c) of the instrument establishing the Trust on the qualification of X or the Trust.

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

Pursuant to a power of attorney on file with this office, a copy of this letter is being forwarded to X's authorized representative.

Sincerely yours,

J. THOMAS HINES  
Chief, Branch 2  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures: 2

Copy of this letter

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