§1118 ESTATE ADMINISTRATION CONSIDERATIONS

The following considerations arise with respect to an estate whose decedent was an S corporation shareholder.

§1118.1 Estate as a Shareholder

An estate is permitted to be a shareholder of an S corporation. (See §105.2.) However, if the administration of the estate is unduly prolonged,
IRS may take the position that the estate has been closed for tax purposes even though it is still open for state law purposes. (Reg. § 1.641(b)-3(a)) This could result in the termination of an S corporation election if the beneficiary of the S corporation stock under the decedent’s will was a trust that did not qualify as an S corporation shareholder. See the discussion of unexpected trusts at ¶105.5.

¶1118.2 Beneficiary—A Disqualified Shareholder

If the beneficiary of an estate is a disqualified shareholder, the surviving shareholders must take steps if they wish to prevent the loss of the Subchapter S election.

If the beneficiary is a nonresident alien or disqualified shareholder other than a trust, the transfer of shares to that beneficiary must be avoided. The estate could sell the shares to someone who is a qualified shareholder (e.g., one of the other shareholders) or it could sell the shares back to the corporation in a stock redemption. The proceeds from the sale or redemption could be distributed to the disqualified beneficiary instead of distributing the stock. If the beneficiary is a trust, other options may be possible before it becomes necessary to sell the stock or transfer it to someone else.

If S corporation stock is transferred to a disqualified trust under the terms of a will, the trust may continue to hold the stock as an S corporation for two years from the day the stock is transferred to it. (See Section 1361(c)(2)(B)(iii) and the discussion at ¶105.3.) During that two-year period, the estate of the testator under whose will the stock was transferred to the trust will be treated as the shareholder.

Within that two-year period, consideration should be given to methods of avoiding termination of the S corporation status. The stock could be sold to a qualified shareholder or redeemed by the corporation, or it could be distributed to the trust’s beneficiaries. It might even be possible to alter the provisions of the disqualified trust so that it would qualify as an S corporation shareholder. Several techniques are available for converting the trust to a qualified shareholder:

1. Beneficiary’s disclaimer of a provision in the trust;
2. Trust amendment if permitted; or
3. A court ordered reformation of the trust.

Example: A testamentary trust under the will of Jay Williams provides that all of the income should be distributed to Samuel Benjamin for life but gives the trustees authority to distribute principal to Samuel Benjamin and/or Edith Benjamin. Because of Edith’s interest in the trust, this would not be a qualified Subchapter S trust. If Edith filed a qualified disclaimer relinquishing all her rights in the trust, the trust could be a
qualified Subchapter S trust. Alternatively, the trustee could file an ESBT election.

(For a discussion of which types of trusts may own S corporation stock without destroying the election, see ¶105.3 and 105.4.)

¶1118.3 Year of Death

When a shareholder dies prior to the end of the corporation's taxable year, there is an exception to the general rules concerning pass-through of income, losses, deductions, and so on. The deceased shareholder's shares of all S corporation items are included in the final Form 1040 pursuant to Section 1366(a)(I). The special rule for the method of calculating how much income is allocated to the final Form 1040 is discussed at ¶701.2A.

After the death of a shareholder, ownership of his or her stock passes to his or her estate. The estate does not need to file any consent to the election, nor does it have the power to revoke the election, unless it owns more than 50 percent of the outstanding shares. The estate could cause a termination of the election by transferring shares to a disqualified shareholder.

If the estate transfers S corporation stock to a trust, then the trust has a two year grace period when it will qualify as an S corporation shareholder. If the trust would meet the requirements of a qualified subchapter S trust (discussed at ¶105.3), then the beneficiary would need to make the special election described at ¶105.3B in order for the trust to qualify as an S corporation shareholder. If the trust does not meet the requirements of a qualified subchapter S trust, or if the shareholder refuses to file the special consent, then the trustee may be able to make an ESBT election (discussed at ¶105.3E). If neither of these steps is taken or if the trust does not qualify as S corporation shareholder for other reasons, then the Subchapter S election will be terminated at the end of the two year grace period.

The S corporation stock will receive a new tax basis pursuant to Section 1014 upon the death of a shareholder (see ¶705). The new tax basis of the stock will generally be the same as the value used for federal estate tax purposes on the Federal Estate Tax Return, Form 706. This would be the value of the stock on the date of death or the alternate valuation date, if selected on the Form 706. If no Form 706 is required to be filed, the fair market value of the stock at the date of the decedent's death will be the new tax basis for the S corporation stock inherited by the estate or other beneficiary. Even though a Form 706 was filed, Technical Advice Memorandum 199933001 permitted a beneficiary to use a different valuation for the basis of stock in a closely held corporation inherited from a decedent. The beneficiary was not estopped from claiming a different value because he was not in privity with the executor of the estate and he had no involvement in preparing the estate tax return or in resolving the subsequent audit.
of the estate tax return. In such cases, if there is sufficient evidence to establish a different fair market value for the purposes of basis, then a taxpayer can rebut by clear and convincing evidence the presumptive value of the stock as reflected on the estate tax return.

The step up in basis discussed earlier relates only to the basis of the S corporation stock. There is no similar adjustment for the basis of the assets held by the S corporation itself. If there is a potential Section 1374 built-in gains tax problem, the death of a shareholder will not affect this potential liability. (See ¶602.4 for a discussion of built-in gains tax.)

**Valuation of S Corporation Stock:** Valuation of the S corporation stock on the Form 706 generally would be done in the same manner as for any other corporation. However, since an S corporation is usually not liable for corporate income tax, no deduction in the value of the stock will be made for federal income tax liabilities on the corporation’s net income. In this respect, the S corporation is valued in a manner similar to a partnership for which no reduction in value is taken for income tax on the entity’s income. (For principles of valuing closely held businesses generally, see Reg. ¶20.2031-2(f)(2) and Rev. Rul. 59-60, 1959-1 CB 237.)

In *Walter L. Gross Jr.,* TC Memo 1999-254, aff’d 272 F.3d 333 (6 Cir. 11/19/2001), cert. denied, 537 US 827, 10/7/02 the issue involved was the valuation of an S corporation for gift tax purposes. The IRS expert determined that a zero percent corporate tax rate was an appropriate assumption to make in determining the earnings of the S corporations available for distribution. Moreover, he also ignored shareholder level taxes in arriving at his discount rate. Nevertheless, the Tax Court found that the IRS expert was more persuasive in his valuation testimony than was the taxpayer’s expert. The Sixth Circuit affirmed the Tax Court and found that the Tax Court’s conclusions in determining that tax affecting was not appropriate in this case were not clearly erroneous.

In *Estate of Richie C. Heck, deceased v. Commissioner,* TC Memo 2002-34 (February 5, 2002), valuing S corporation stock, the parties agreed that the only tax applicable to the income of the S corporation was California’s 1.5% income tax on S corporations. No amount was taken into account for federal income tax. Furthermore, the Government’s expert applied a 10% discount for “additional risks associated with S corporations” including the potential loss of S corporation status and the shareholder liability for income taxes on the corporation’s income. The taxpayer’s expert took into account similar factors to those of the Government’s expert in addressing problems associated with S corporation status, to the extent that the discount relates to the same lack of control problem. The court viewed these two experts in agreement regarding the need for a discount for lack of control which the court viewed as a minority status discount.
Dallas v. Commissioner, TC Memo 2006-212 (September 28, 2006), was another case involving valuation of the stock of an S corporation. In valuing the corporation using a capitalization of income approach, the issue was whether to decrease the assumed income stream of the corporation because of tax burdens imposed on the corporation or its shareholders after the hypothetical sale to a mythical purchaser. The Tax Court opinion pointed out that there is no evidence in the record that the corporation expects to cease to qualify as an S corporation. Neither was the Tax Court convinced that a hypothetical willing buyer would tax-affect earnings in valuing the S corporation stock. Thus, the Tax Court concluded that there was insufficient evidence to establish that a hypothetical buyer and seller would tax-affect the S corporation's earnings and therefore that tax affecting is not appropriate.

¶ 1118.4 Liquidation of an S Corporation After a Shareholder's Death

The tax effect of liquidating an S corporation after the death of a shareholder is generally similar to the tax effect of any corporate liquidation. The major difference is that the shares of the decedent have a new tax basis after death.

Upon the liquidation of a corporation, the corporation recognizes gain or loss in an amount equal to the difference between the fair market value of its assets and the basis of its assets. If the Section 1374 built-in gains tax (discussed at ¶ 602.4) does not apply, liquidation of an S corporation generally produces no tax to the corporation. Upon liquidation, the gain or loss recognized by the corporation is passed through to the S corporation shareholders, increasing or decreasing their tax basis for the stock. Basis adjustments are discussed at ¶ 705.1.

In addition, each shareholder of a liquidated corporation is treated as having sold his or her shares for the fair market value of the net proceeds received from the liquidation (assets minus liabilities). Gain or loss is computed by comparing the net fair market value of the net liquidation proceeds received with the tax basis of the stock (see ¶ 705), adjusted for any gain or loss that passed through to the shareholder from the corporation in connection with the liquidation.

Example: Robert Corporation is solely owned by Mr. Morris. It has always been an S corporation, so the Section 1374 built-in gains tax does

(Text continues on page 11:31.)
not apply. The corporation’s assets have a fair market value of $400,000, and the corporation’s basis for these assets is $100,000. The corporation has no liabilities. Mr. Morris’s basis for his stock of Robert Corporation is $20,000. Mr. Morris died and his personal representatives caused the corporation to be liquidated. Upon the death of Mr. Morris, his estate got a new tax basis of $400,000 for the stock. Upon the liquidation, Robert Corporation is treated as having realized a gain of $300,000 ($400,000 net fair market value of assets minus $100,000 basis). This $300,000 corporation gain passes through to Mr. Morris’s estate as the shareholder increasing its basis for the stock from $400,000 to $700,000. Upon the liquidation of the corporation, the estate receives $400,000 worth of assets. Since the estate now has a basis of $700,000 for the stock, it will have a capital loss of $300,000. The $300,000 gain passing through from the S corporation will be offset by the $300,000 loss recognized by the estate on the liquidation if they are the same type of gain. If some of the gain is ordinary and some of the loss is capital, then there might not be a complete offset.

The result of the step-up in basis of the corporation stock is that upon liquidation, there exists the possibility of a complete offset, so that no gain or loss will be recognized and no tax liability will be incurred. Of course, if the Section 1374 built-in gains tax applies, there will be additional corporate tax caused by the liquidation and thus the liquidation may not be entirely free of tax.

(For an illustration involving similar numbers, but without a step-up in basis, see the example at ¶1126.2.)
105.2 Estates

Before the Subchapter S Revision Act of 1982, the term “estate” for Subchapter S purposes was limited to the estate of a decedent. (Rev. Rul. 66-266, 1966-2 CB 356)

Section 1361(c)(3), added by the Subchapter S Revision Act of 1982, specifically states that the term “estate” includes not only the estate of a decedent but also includes the estate of an individual in a bankruptcy case.

For the discussion of a situation when a decedent’s estate was transmuted into a testamentary trust by prolonging the period of estate administration beyond a reasonable length of time, see ¶105.5.

105.3 Eligible Trusts (Other Than Voting Trusts and Charitable Trusts)

Only domestic trusts designated in Section 1361(c)(2) may be S corporation shareholders. (Section 1361(b)(1)(B))

Domestic Trusts: The tests for whether a trust is domestic or foreign are set forth in IRC § 7701(a)(30) and § 7701(a)(31) and also in Regulations § 301.7701-7. As indicated previously, only certain domestic trusts may be shareholders of S corporations. A trust is considered to be a domestic trust if it meets a two part test:

1. A court within the United States must be able to exercise primary supervision over the administration of the trust (court test); and
2. One or more United States persons must have the authority to control all substantial decisions of the trust (control test).

The terms of the trust instrument and applicable law must be applied to determine whether the court test and the control test are met. The regulations provide a safe harbor for the court test. Under this safe harbor, a trust satisfies the court test if: (a) the trust instrument does not direct that the trust be administered outside of the United States; (b) the trust is in fact administered exclusively in the United States; and (c) the trust is not subject to an automatic migration provision. A prohibited migration
provision is one that provides that a United States court's attempt to assert jurisdiction or otherwise supervise the administration of the trust directly or indirectly would cause the trust to migrate from the United States to a foreign jurisdiction (except in the case of foreign invasion of the United States or widespread confiscation or nationalization of property in the United States).

In applying the court test certain definitions apply. The term "court" includes any federal, state, or local court. The term "the United States" is used in a geographical sense to include only the states and the District of Columbia. Accordingly, a court within a territory or possession of the United States or within a foreign country is not a court within the United States.

The term "is able to exercise" means that a court has or would have the authority under applicable law to render orders or judgments resolving issues concerning administration of the trust. The term "primary supervision" means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust. A court may have primary supervision under this definition notwithstanding the fact that another court has jurisdiction over a trustee, a beneficiary, or trust property.

The term "administration of the trust" means the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions.

Definitions are also provided with respect to the control test. The term "United States person" means a US person within the meaning of IRC § 7701(a)(30). This includes a domestic corporation regardless of whether its shareholders are US persons.

The term "substantial decisions" means those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law that are not ministerial. Ministerial decisions include those regarding details such as the bookkeeping, the collection of rents, and the execution of investment decisions. Substantial decisions include, but are not limited to:

- Decisions concerning amounts and timing of distributions;
- Selection of beneficiaries;
- Allocating receipts to income or principal;
- Whether to terminate the trust;
- Whether to compromise, arbitrate or abandon claims of the trust;
- Whether to sue on behalf of the trust or defend suits against the trust;
105.3 QUALIFYING AN S CORPORATION

- Whether to remove, add, or replace a trustee;
- Whether to appoint a successor trustee, even if the power to appoint a successor trustee is not accompanied by a power to remove a trustee; and
- The power to make investment decisions even if the US person hires an investment advisor for the trust so long as the US person can terminate the investment advisor's power to make investment decisions at any time.

The term "control" means having the power to make all of the substantial decisions of the trust with no other person having the power to veto any of those decisions. The determination of whether US persons have control is made considering all persons who have authority to make substantial decisions of the trust, and is not restricted to trust fiduciaries.

In the event of an inadvertent change in any person that has the power to make a substantial decision of the trust that would cause the residency of the trust to change from domestic to foreign, or visa versa, the trust is allowed 12 months from the date of the change to make necessary changes. These changes may be either with respect to the persons who control the substantial decisions or with respect to the residence of such persons in order to avoid a change in the residency of the trust. Inadvertent change means the death, incapacity, resignation, change in residency or other change with respect to a person who has a power to make a substantial decision of the trust that would cause an unintended change to the residency of the trust. If the corrective change is made within 12 months, the trust is treated as retaining its pre-change residency during the 12-month period. If the corrective change is not made within 12 months, the trust's residency changes as of the date of the inadvertent change. Extensions of time may be granted by application to the Internal Revenue Service.

The foregoing is a summary of the provisions regarding the determination of whether the trust is domestic or foreign. A more detailed discussion is beyond the scope of this volume.

Qualified Subpart E Trust: Reg. §1.1361-1(b)(1)(i) provides that a trust, all of which is treated (under Subpart E, Part I, Subchapter J, Chapter I of the Code) as owned by an individual who is a citizen or resident of the United States, will be a permitted shareholder whether or not the individual is the grantor of the trust. (This applies only during the period of time that the trust holds S corporation stock.)

After the death of the deemed owner, a trust that was a qualified Subpart E trust and that continues in existence may continue to be an S corporation shareholder for a limited period of time. For tax years beginning after December 31, 1996, there is a grace period of two years.
For years before that, the grace period was only 60 days unless the entire corpus of the trust was included in the deemed owner’s estate, in which case the grace period was also two years after the death of the deemed owner. Prior to its amendment in 2003, Reg. § 1.1361–1(h)(1)(i)(ii) provided that, if the trust consisted of community property, and the decedent’s community property interest in the trust was includible in the decedent’s gross estate for federal estate tax purposes, the entire corpus of the trust was deemed includible in the decedent’s gross estate. In addition, in determining whether the entire corpus of the trust was includible in the deemed owner’s gross estate, if the decedent’s spouse was treated as the owner of a portion of the trust under Subpart E immediately before the decedent’s death, the surviving spouse’s portion was disregarded.

After the death of the deemed owner, and during the applicable grace period, Reg. § 1.1361–1(h)(3)(i)(B) provides the identity of the shareholder for purposes of Sections 1366 (relating to the pass-through of items of income, loss, deduction, or credit), 1367 (relating to adjustments to basis of shareholder’s stock), and 1368 (relating to distributions). These regulations treat the estate of the deemed owner as the shareholder as of the day of the deemed owner’s death. However, if stock is held by such a trust in a community property state, the decedent’s estate is the shareholder only of the portion of the trust included in the decedent’s gross estate, and the surviving spouse continues to be the shareholder of the portion of the trust owned by that spouse under the applicable state’s community property law. The estate will ordinarily cease to be treated as a shareholder upon the earlier of the transfer of the stock by the trust or the expiration of the grace period that began on the day of the deemed owner’s death. If the trust becomes an electing QSST, the beneficiary of the QSST, and not the estate, is treated as the shareholder as of the effective date of the QSST election. If the trust becomes an ESBT, then the ESBT rules will apply. See ¶105.3E.

Final regulations in the July 17, 2003 Federal Register provide that the QSST election must be filed within the 16 day and 2 month period beginning on the date on which the trust ceases to be a qualified subpart E trust. Alternatively, the trustee of the trust may make an ESBT election if the trust qualifies. Requirements for QSST status are discussed at ¶105.3A and requirements for ESBTs are discussed beginning at ¶105.3E.

Generally, the two types of qualified Subpart E trusts are so-called “grantor trusts” in which the grantor is treated as the deemed owner of the trust property, and trusts in which someone other than the grantor is treated as the deemed owner. See ¶1007 for tax return reporting requirements.

**Grantor Trusts:** A trust, all of which is treated as owned by the grantor under the rules of Sections 671–677, is a permitted shareholder. The grantor must be a U.S. citizen or resident, and is treated as the shareholder.
(Sections 1361(c)(2)(A)(i) and 1361(c)(2)(B)(i)) A so-called defective trust, which is treated as owned by the grantor (Sections 671-677) may be a shareholder of an S corporation. Several private letter rulings have been issued covering this point.

Letter Ruling 9037011 involved a trust that gave the grantor the right, "...exercisable in a nonfiduciary capacity without approval or consent of any person acting in a fiduciary or nonfiduciary capacity, to acquire any property then held in trust (or any succeeding trust) by substituting property of equivalent value." Section 675(4) treats the grantor as the owner of a portion of the trust over which he has a power of administration exercisable in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity. Because the power to reacquire trust corpus by substituting other property of equivalent value is considered a power of administration under Section 675(4)(C), the trust can be treated as a grantor trust for purposes of qualifying as an S corporation shareholder.

In Letter Ruling 9048027, the grantor retained the right to income for ten years and to a reversionary interest that exceeded 5 percent of the trust's value when created, if she died during the first ten years of the trust's existence. Under Section 673(a), the grantor is treated as the owner of the trust corpus because she has a reversionary interest greater than 5 percent of the trust's initial value; under Section 677(a)(1), the grantor is treated as the owner of the income portion of the trust because the income is distributed to her without the approval or consent of any adverse party. Thus, the grantor is the owner of the entire trust for income tax purposes, and the trust is permitted to be an S corporation shareholder. See also Letter Ruling 9152034 for the same result when the grantor retained an annuity of an amount equal to 12 percent of the initial value of the trust for a period ending on the earlier of eight years from the creation of the trust or the grantor's death.

Letter Ruling 9504021 held that the trust was a grantor trust and thus able to be a shareholder in an S corporation. The trust provided an annuity payable to the grantor for a term of seven years or until his earlier death. The trust reserved to the grantor, individually and in a nonfiduciary capacity, without the approval or consent of any person or entity in a fiduciary capacity, the right to reacquire all or any part of any trust's corpus by substituting other property of an equivalent value. The ruling cited Section 677(a), which provides that the grantor is treated as the owner of any portion of a trust whose income, without the approval or consent of any adverse party, is, or at the discretion of the grantor or a non-adverse party (or both) may be, distributed to the grantor or the grantor's spouse or held or accumulated for future distribution to the grantor or the grantor's spouse.

Letter Ruling 9508007 involved two trusts that were also held to be grantor trusts. Each of the trusts contained a provision authorizing the trustee, "to make payments to or among the beneficiaries of the trust, to
the exclusion of any one or more of them, in such proportions and at such
time or times as the trustee, in its sole discretion, may determine to be in
their best interests, and also provides that no distribution of income or
principal shall be deemed an advancement of any beneficiary's share upon
termination." The trusts also contained a provision that: "expressly stip-
ulated that any exercise of such power shall be binding and conclusive
upon all persons at any time interested in any trust under the trust agree-
ment." The letter ruling cited Section 674(a), which provides that the
grantor is treated as the owner of any portion of a trust for which the
beneficial enjoyment of its corpus or income is subject to a power of dis-
position, exercisable by the grantor or a non-adverse party (or both),
without the approval or consent of any adverse party. The trustee of
each trust was the brother of the grantor. The ruling found that the trustees
were not adverse parties and that the power was not limited by a reason-
ably definite standard set forth in the trust agreement, since the trust
agreement provided that the trustees' determination should be conclusive
with respect to the exercise or non-exercise of the trustees' powers.

Trust of Which Someone Other Than Grantor Is Substantial Owner: In
certain situations, someone other than the grantor will be treated as the
owner of a trust. Section 678 provides that if the grantor trust rules of
Sections 671 through 677 and 679 do not apply, a person other than the
grantor will be treated as the owner of any portion of the trust with respect
to which:

(1) such person has a power exercisable solely by himself to vest the corpus
or the income therefrom in himself, or
(2) such person has previously partially released or otherwise modified such a
power and after the release or modification retains such control as would,
within the principles of sections 671 to 677, inclusive, subject a grantor of a
trust to treatment as the owner thereof.

Thus, if one individual, who is not the grantor, is deemed to be the
owner of the entire trust under Section 678, then that trust will qualify as
an S corporation shareholder under Section 1361(c)(2)(A)(i). As long as
that individual is deemed the owner of all the trust property under Section
678, that person will be treated as the shareholder of the S corporation
stock that is owned by the trust.

This provision has been applied to the withdrawal powers that were first
validated under Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).
Crummey withdrawal powers typically authorize the beneficiary of a trust
to withdraw any assets donated to the trust in an amount not to exceed the
annual gift tax exclusion. The annual gift tax exclusion, which is currently
$12,000 per donee, is only available for present interest gifts. Because gifts
to trusts are not usually considered present interest gifts, the Crummey
withdrawal power, which gives a beneficiary a limited right (typically one to three months) to withdraw amounts added to the trust, converts what might otherwise be a future interest into a present interest so as to allow it to qualify for the gift tax annual exclusion. If the power is limited to the greater of $5,000 or 5 percent of the aggregate value of the assets from which the power could be satisfied, the lapse of that power would not be considered a gift under Section 2514(e).

In Letter Ruling 9232013, a trust was formed providing a 30-day noncumulative, withdrawal right to the beneficiary of the trust. The trust agreement provided none of the circumstances that would cause the grantor to be treated as the owner of the trust under Sections 671 through 677. Especially important was the fact that the trust provided that “no payment to or for the benefit of the beneficiary shall be made so as to reduce, diminish or discharge the legal liability of any person (including the trustor and the trustee) for the support of the beneficiary.” If payments to the beneficiary could discharge a parent’s obligation to support the beneficiary, then the parent would also be a beneficiary, thus violating the single-beneficiary requirement.

The letter ruling pointed out that the beneficiary had the power, exercisable solely by himself, to vest the corpus in himself, and that the beneficiary’s failure to exercise that power constituted a release of the power. Because the income would be distributed, or accumulated for future distribution, to the beneficiary, the beneficiary would be treated as the owner of the corpus and income portion of the trust and would be taxed on all items of income, deduction, and credit attributable to the property transferred (citing as authority Section 678 and Reg. § 1.671–3). Accordingly, the letter ruling held that the trust was qualified to be an S corporation shareholder. See also Letter Ruling 9140047 for a similar fact pattern and result.

Letter Rulings 9448018 and 9450014 cover the same point. The latter ruling sets forth the conditions for finding that the Crummey power causes the beneficiary to be treated as the owner of the entire trust, thus qualifying as a shareholder under Section 1361(c)(2)(A)(i), provided that all of the following facts are present:

1. The contributions to the trust do not exceed the power of the beneficiary to withdraw those amounts;
2. The donor may not restrict the beneficiary’s power to withdraw any contribution;
3. The grantor may not have, acquire, or exercise a power that would result in the grantor being treated as the owner of the trust under Sections 671 through 677; and
4. The trustee may not apply or distribute trust income in satisfaction of someone’s legal obligation to support or maintain the beneficiary.
Trust Receiving S Corporation Stock Under the Terms of a Will: If, pursuant to the provisions of a will, S corporation stock is transferred to a trust, the trust may continue to hold that stock for a grace period beginning on the day that the stock is transferred to it. (Section 1361 (c)(2)(A)(iii)) For tax years beginning after December 31, 1996, the grace period is two years. Before the effective date of that provision which was added by the Small Business Job Protection Act of 1996, the grace period was only 60 days. During that grace period, the estate of the testator, under whose will the stock was transferred to the trust, is treated as the shareholder. (Section 1361(c)(2)(B)(iii) and Reg. § 1.1361-1(h)(3)(i)) However, for purposes of Sections 1366 (relating to the pass-through of items of income, loss, deduction, or credit), 1367 (relating to adjustments to basis of shareholders' stock), and 1368 (relating to distributions), the trust is treated as the shareholder pursuant to Reg. § 1.1361-1(h)(3)(ii)(B).

Final Regulations Section 1.1361-1(j)(6)(iii)(D), appearing in the Federal Register dated July 17, 2003, provide that if the trust also satisfies the requirements of a QSST, the QSST election may be filed at any time, but not later than the end of the 16-day and 2-month period beginning on the day after the end of the 2-year period. Alternatively, the trustee may make an ESBT election effective at the end of the 2-year grace period.

Section 645 Election: A qualified revocable trust may elect under Code Section 645 to be treated as part of a decedent's estate and not as a separate trust for all taxable years of the estate ending after the date of the decedent's death and before the applicable date. The term qualified revocable trust means any trust (or portion thereof) which was treated under Code Section 676 as owned by the decedent of the estate by reason of the power of the grantor to revoke the trust and re vest in the grantor title to all or a portion of the trust exercisable by the grantor, a nonadverse party, or both. The applicable date means two years after the death of the decedent if no estate tax return is required or, if an estate tax return is required, six months after the date of a final determination of the estate tax liability.

Regulations issued in 2003 provide that such an election can even be made when there is no probate estate. The requirements of the election are set forth in Reg. § 1.645-1. The election is made by filing Form 8855—Election to Treat a Qualified Revocable Trust as Part of an Estate. After the applicable date, the trust would have a two year grace period similar to that of a trust receiving S corporation stock under the terms of a will, discussed above. An example illustrating this point appears in Reg. § 1.1361-1(k)(1), Example 3(ii).

Qualified Subchapter S Trust: The beneficiary of a "qualified Subchapter S trust" (see ¶105.3A) may elect to have the trust qualify as a grantor trust and thus as a permitted S corporation shareholder. (Section 1361
(d)(2)(A)) If the trust owns stock in more than one S corporation, its beneficiary must make a separate election for each S corporation whose stock is held. (Section 1361(d)(2)(B)(i)) The beneficiary of the qualified Subchapter S trust is treated as the shareholder. If the beneficiary who made the election dies, the election continues in effect for a successor beneficiary (if there is only one successor beneficiary) unless the successor beneficiary affirmatively refuses to consent. The election is irrevocable and may be retroactive for up to two months and 15 days. (See ¶105.3B.)

Because the beneficiary of the qualified Subchapter S trust is treated as the shareholder, the beneficiary reports all of the S corporation income on his or her individual income tax return. Thus, it is clear that undistributed taxable income of an S corporation owned by a QSST will be taxed to the beneficiary. But who is taxed when a qualified Subchapter S trust sells all or part of its stock in an S corporation? In Rev. Rul. 92–84, 1992–2 CB 216, the IRS ruled that it was the beneficiary and not the trust that was required to recognize the taxable gain or loss on the sale of stock even if under local trust law the gain or loss on the sale would be allocable to corpus and not to income.

The holding in Rev. Rul. 92–84 caused concern because it might have had the effect of precluding installment sale treatment. Under Section 453, the sale of S corporation stock may be made in exchange for installment payments, with the tax on that gain also being paid in installments. However, if the installment obligations are disposed of before payment, then unrealized gain is recognized upon the disposition. There is authority to the effect that when a grantor trust ceases to be a grantor trust, installment obligations held by the trust will be considered to have been disposed of, thus causing recognition of the unrealized gain. Many practitioners urged the IRS to revoke this ruling, and they finally did.

Reg. § 1.1361–1(j)(8), issued in 1995, reversed Rev. Rul 92–84 and declared it obsolete as of July 21, 1995. Under that regulation, an income beneficiary who has made a QSST election 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. Thus, beginning July 21, 1995, 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 recognized by the trust, not the income beneficiary. Reg. § 1.1361–1(k)(2)(ii), dealing with effective dates, provides a special exception for dispositions of S corporation stock held by a QSST. Under that exception, if a QSST had sold or otherwise disposed of all or a portion of its S corporation stock on or before July 21, 1995, in a tax year that was open for the QSST and for the income beneficiary, they had a choice. Both of them could treat the transaction as if the beneficiary was the owner of the stock sold or disposed of and thus have the beneficiary recognize any gain or loss; or they could treat the QSST as the owner of the stock sold or disposed of as described above pursuant to
Reg. § 1.1361–1(j)(8). This special exception applied only if the QSST and the income beneficiary took consistent reporting positions. The QSST and the income beneficiary had to disclose by a statement on their respective returns (or amended returns) that they were taking consistent reporting positions.

In Letter Ruling 199905011, the IRS held that the adoption of a plan of complete liquidation followed by the sale of a corporation's assets and the complete liquidation of the corporation results in a disposition of stock by the shareholders within the meaning of Reg. § 1.1361–1(j)(8). Therefore, the pro rata share of gain or loss resulting from the sale of the S corporation's assets pursuant to the plan of liquidation was allocated to the trust (the QSST) and not to the individual beneficiary. In addition, any gain or loss recognized on the liquidation on the S corporation under Section 331 and Section 336 as a result of distributions from the S corporation to the QSST will be treated as that of the trust and not of the beneficiary.

In Letter Ruling 199920007, the taxpayer obtained a ruling from the IRS that the S corporation's gain from the deemed sale of its assets resulting from a Section 338(h)(10) election attributable to the shares of the S corporation stock held by a QSST are taxed to the trust and not to the beneficiary. Reg. § 1.338(h)(10)-1(a) provides that, if a Section 338(h)(10) election is made, the corporation is generally deemed to sell all of its assets and distribute the proceeds to its shareholders in complete liquidation. By treating the transaction as a sale of stock by the trust, the IRS allocated gain to the trust instead of to the beneficiary.

Although the trust, and not the beneficiary, is treated as the owner of the S corporation stock for purposes of determining the tax consequences of a disposition of the S corporation stock by the trust, for transfers made after December 31, 2004, the American Jobs Creation Act of 2004 provides that the beneficiary of a QSST is generally allowed to deduct suspended losses under the at risk rules of Section 465 and the passive activity loss rules of Section 469 when the trust disposes of the S corporation stock. See ¶ 1007.2 for tax return reporting requirements of a QSST.

¶ 105.3A Requirements for Qualified Subchapter S Trust Status

A trust is eligible to elect qualified Subchapter S trust (QSST) status under the following conditions:

- All the trust income is distributed (or is required to be distributed) currently to one individual who is a U.S. citizen or resident (Section 1361(d)(3)(B)); and
- The terms of the trust: (1) permit only one income beneficiary at a time during the current beneficiary's life; (2) allow corpus distributions only to the income beneficiary; (3) provide that the income interest in the trust terminates on the earlier of the death of the income beneficiary or...
the termination of the trust; and (4) provide that, upon termination of the trust during an income beneficiary’s life, all trust assets must be distributed to the income beneficiary. (Section 1361(d)(3)(A))

The IRS narrowly construes the requirements regarding the terms of the trust. For example, if the trust contains an “after-born” provision, it will not qualify as a QSST. The IRS has looked at a trust provision that stated that a new trust would be established, with a newborn grandchild as its sole beneficiary, each time a grandchild of the grantor was born after the creation of the original trust. The new trust was to be funded by transferring shares of the S corporation to the new trust from each existing trust. The original trust was not a grantor trust, so it could only hold S corporation stock if it qualified as a QSST. That was before the advent of the ESBT discussed at ¶ 105.3E. The IRS ruled that the “after-born” provision required distribution of corpus to a person other than the current income beneficiary, thereby violating the provisions of Section 1361(d). (Rev. Rul. 89-45, 1989-2 CB 267)

Another ruling involved a trust instrument that provided that corpus could be distributed only upon the termination of the trust and that the trust could terminate only during the life of the income beneficiary. However, if the trust no longer held any shares of the S corporation, the trust could terminate and distribute its assets to the income beneficiary, the grantor’s other child, or to their issue. The trust did not qualify as a QSST because it could distribute its corpus to persons other than the current income beneficiary during the current income beneficiary’s lifetime. (Rev. Rul. 89-55, 1989-2 CB 268)

Rev. Rul. 92—20, 1992-1 CB 301, clarified Rev. Rul. 89-55 and held that a trust may qualify as a QSST if the trustee is authorized to accumulate trust income instead of distributing it during any periods when the trust does not hold S corporation stock. The distinction is made between the requirements of Section 1361(d)(3)(A), which relate to required terms of the trust, and Section 1361(d)(3)(B), which relate to trust income. The subsection (B) requirement indicates that the terms of the trust may permit accumulation of income when the trust does not hold S corporation stock.

According to Rev. Rul. 92-64, 1992-2 CB 214, the terms of a trust will not violate the QSST distribution requirement if they require the trustee to distribute trust income for the period after the last distribution date and before the date of the beneficiary’s death to the estate of the deceased beneficiary so long as the trust income is being distributed annually. The ruling also holds that a QSST may distribute income for the period after the last distribution date and before the date of the beneficiary’s death to the

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successor beneficiary so long as the trust income is being distributed annually.

An interesting twist on the distribution requirement arose in Letter Ruling 9349009. In that ruling, the stock of an S corporation was held by several QSSTs for the benefit of descendants of the corporation’s founders. The corporation wanted to make a substantial distribution to its shareholders, but for estate planning purposes, its shareholders prefer that distribution be treated as principal of the trusts rather than income distributable to the beneficiaries. They came up with a clever method of accomplishing that purpose. They proposed a redemption of shares from all shareholders so that after the redemption, each shareholder would own the same percentage of stock as before the redemption. For tax law purposes Code Section 302(d) would treat this as a redemption essentially equivalent to a dividend, and the dividend distribution rules of Code Section 1368 discussed in ¶802 would apply. But for state law purposes, the proceeds of the redemption would be allocated to principal of the trusts rather than income. The IRS agreed. Citing Rev. Rul. 92-84, 1992-2 CB 216, and Rev. Rul. 72-471, 1972-2 CB 201, the private letter ruling held that for tax purposes, the trust would be disregarded as a shareholder, and the beneficiaries would be treated as having received the cash distributions. The fact that state law would treat those distributions as allocated to principal and not fiduciary accounting income within the meaning of Code Section 643(b) means that the trust would not have to distribute the cash proceeds received. Furthermore, since the distribution will qualify as a redemption essentially equivalent to a dividend under Code Section 302(d), the distribution provisions of Code Sections 1368(b) and 1368(c), discussed at ¶802, will apply for purposes of determining the taxation of the distributions to the corporation’s shareholders. The ruling specifically holds that the treatment of those distributions as principal rather than income will not cause the trust to fail the QSST current income distribution requirement of Section 1361(d)(3). Two similar rulings were issued in Letter Ruling 200401009 and Letter Ruling 200402009 involving pro rata redemptions that were treated as principal instead of fiduciary accounting income under local law.

Letter Ruling 200451021 also involved pro rata redemptions. In that ruling, the terms of the trust gave broad discretionary power to the trustee to allocate trust receipts between income and principal. Moreover, under state law, a corporate distribution in excess of 20% of corporate assets is allocated to principal. Accordingly, based on the information submitted and representations made, the IRS concluded that the distribution of the redemption proceeds did not constitute fiduciary accounting income and therefore were not required to be distributed to the beneficiaries.

Likewise, Letter Ruling 200446007 determined that the election to make a deemed dividend under Reg. §1.1368-1(f)(3) discussed at ¶802.2A (with a sample form at ¶802.2C) was held not to be fiduciary accounting income. For federal income tax purposes, the deemed dividend is treated as a cash
distribution to shareholders and then a recontribution of the cash back to the corporation. It results in a distribution of the Subchapter C earnings and profits of the corporation. This is often useful for corporations that want to eliminate possible problems with passive investment income that are discussed in ¶401. Because no actual distribution was made, there was no fiduciary accounting income and thus no requirement to make distributions to the income beneficiaries of the QSSTs.

Questions have also arisen as to whether certain other kinds of trusts would meet the QSST requirements. Rev. Rul. 92-48, 1992-1 CB 301, held that a charitable remainder trust under Section 664 could not be a QSST because of the incompatible tax treatment of trust income under subparts C and E of part I of Subchapter J. Under Section 664(d), a section within subpart C of part I of Subchapter J, a charitable remainder trust is one in which an annuity or unitrust amount determined under a specified formula is payable at least annually for the life or lives of a named individual or individuals or for a term of years not to exceed 20 years. No amount, other than the annuity or unitrust amount, may be paid to or for the use of any person other than a charitable organization described in Section 170(c). Any amount earned by the trust in excess of the amount distributed to the beneficiaries is accumulated for eventual payment for the use of the Section 170(c) organization. The remainder interest in the trust is payable on the termination of the annuity or unitrust payments. The ruling points out that in some instances it is possible for the character and amount of trust income that is to be taken into account by the beneficiary to be the same whether the trust was governed by the charitable remainder trust rules or the QSST rules. However, the identity of treatment under such circumstances would be coincidental. The ruling holds that the two schemes of taxation are incompatible and, therefore, a charitable remainder trust cannot be a QSST.

Rev. Rul. 92-73, 1992-2 CB 224, holds that a trust that qualifies as an individual retirement account under Section 408(a) is not a QSST because the rules that apply to a QSST are incompatible with the rules that apply to a Section 408(a) trust. Section 408(d)(1) provides generally that any amount paid or distributed out of an individual retirement account must be included in the gross income of the payee or distributee in the manner provided under Section 72 relating to the taxation of annuity. Thus, the beneficiary of an individual retirement account trust is taxed only when distributions are made from the trust in the manner provided under Section 72. This is incompatible with the treatment of a beneficiary of a QSST: The QSST beneficiary is treated as the owner of the S corporation stock and is taxed on the corporation's income regardless of whether it is distributed.

In Rev. Rul. 93-79, 1993-2 CB 269, the IRS ruled that the retroactive reformation of a trust to meet the requirements for QSST status is ineffective for tax purposes. While the reformation of the trust provisions may be
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Effective for state law purposes, the IRS will not recognize a retroactive reformation for tax purposes. Because the original terms of the trust before the reformation did not satisfy the QSST requirements, the trust was ineligible to be an S corporation shareholder. However, the reformation will be effective for future years.

Regulations promulgated in 1995 under Section 1361 provide additional guidance. Reg. §1.1361-1(j)(1)(iii) provides that the terms of the trust requirements must be met from the date the QSST election is made or from the effective date of the QSST election, whichever is earlier, throughout the entire period that the current income beneficiary or any successor income beneficiary is the income beneficiary of the trust. If the terms of the trust do not preclude the possibility of failure to meet the terms of the trust requirements, the trust will fail to qualify as a QSST. For example, the regulations provide that, if the terms of the trust are silent on corpus distributions, and distributions of corpus to a person other than the current income beneficiary are provided under local law during the life of the current income beneficiary, then the terms of the trust do not preclude the possibility that corpus may be distributed to someone other than the current income beneficiary, and, therefore, the trust fails to qualify as a QSST.

Reg. §1.1361-1(j)(2)(i) provides a special rule for spouses. If husband and wife are income beneficiaries of the same trust, they file a joint return, and each is a U.S. citizen or resident, then they will be treated as one beneficiary for purposes of the QSST requirements. If this provision applies, any action required to be taken by an income beneficiary must be taken by both of them.

Reg. §1.1361-1(j)(2)(ii) states that determining whether the terms of the trust meet all of the requirements of a QSST depends upon not only the terms of the trust instrument but also applicable local law. For example, a trust whose governing instrument provides that A is the sole income beneficiary of the trust is considered to have two income beneficiaries if, under applicable local law, A and B are considered to be the income beneficiaries of the trust.

Reg. §1.1361-1(j)(2)(ii)(B) provides that, if under local law a distribution to the income beneficiary is in satisfaction of the grantor's legal obligation of support to that income beneficiary, the trust will not qualify as a QSST as of the date of distribution because, if income is distributed, the grantor will be treated as the owner of the ordinary income portion of the trust under Section 677(b), or, if corpus is distributed, the grantor will be treated as a beneficiary under Section 662. This position is similar to one previously expressed in Letter Ruling 9028013. The letter ruling also pointed out that the use of trust income to satisfy a parental support obligation is considered a distribution of income to the parent under Section 671 and Reg. §1.671-1(c).
Additional special rules are provided by the regulations. Reg. §1.1361-1(j)(2)(iv) provides that, if the terms of a trust or local law do not preclude the current income beneficiary from transferring his or her interest in the trust, or do not preclude another person from being treated as a beneficiary of the trust under Reg. §1.643(c)-1, the trust will still qualify as a QSST. However, if the income beneficiary actually transfers or assigns the interest or a portion of that income interest to someone else, the trust may no longer qualify as a QSST, depending on the facts and circumstances, because any transferee of the current income beneficiary’s income interest and any person treated as a beneficiary under Reg. §1.643(c)-1 will be treated as a current income beneficiary for purposes of the regulations.

Reg. §1.1361-1(j)(2)(v) states that, if the terms of the trust do not preclude a person other than the current income beneficiary from being awarded an interest in the trust by a court order, the trust will still qualify as a QSST, assuming that it meets the other requirements. If, however, as a result of the court order, the trust no longer meets the QSST requirements, the trust will no longer qualify as a QSST, and the Subchapter S election will terminate.

Reg. §1.1361-1(j)(2)(vi) provides that a trust may still qualify as a QSST even if a person other than the current income beneficiary is treated under Subpart E as the deemed owner of a part or all of the portion of the trust that does not consist of the S corporation stock, provided that the entire trust meets the QSST requirements. Thus it is possible to have someone treated as the deemed owner of a portion of a trust not consisting of the S corporation stock, and yet have the trust meet the requirements of a QSST, so that the beneficiary may elect to treat the trust as a qualified shareholder of the S corporation stock.

Additional examples of how the IRS construes the QSST requirements appear in various private letter rulings. Letter Ruling 9444059 raises the question of whether the income distribution requirement is met when the income is distributable to a disability trust. The income beneficiary of several QSSTs was legally incompetent and was expected to remain so throughout his lifetime. A court-appointed guardian created a disability trust on behalf of the incompetent income beneficiary. Under the terms of the disability trust, income and principal are to be “used as the trustees determine to be necessary for the health, support, best interests, maintenance, education, and welfare” of the incompetent income beneficiary. The IRS ruled that distributions made from the QSSTs to the disability trust will meet the income distribution requirements of Section 1361(d).

Letter Ruling 9014008 holds that the payment of the generation skipping transfer tax by the trust caused by a taxable termination under Section 2603(b) does not disqualify QSST status. Also, it holds that income must be paid directly to the beneficiary to satisfy the income distribution requirement.
Letter Ruling 9040019 deals with a trust that contained a spendthrift provision providing that: “if by bankruptcy, insolvency, execution, levy, attachment or seizure of any assets of the trust under claims of creditors or otherwise, all or any part of income or principal might fail to be enjoyed by the beneficiary, then such beneficiary’s interest shall terminate.” Thereafter, the trustees would have the right, but not the obligation, to pay income or corpus to or for the benefit of the beneficiary and/or his descendants. The spendthrift provision was deleted by court reformation and the ruling held that the trust, as reformed by the court, would meet the requirements of a QSST.

Letter Ruling 9016087 involves a trust in which the income beneficiary’s three children had Crummey withdrawal rights with respect to contributions of cash or property by the grantor during his life for a period of 30 days from the date of each contribution. The trust was not eligible to be a QSST because an individual other than the current income beneficiary was permitted to withdraw corpus during the income beneficiary’s life.

Separate Share Rule: Separate shares of a single trust may be treated as separate trusts, for purposes of qualifying a trust as a QSST, if the shares are treated as separate trusts under Section 663(c). This rule, added by the Tax Reform Act of 1986, is retroactive to all taxable years beginning after December 31, 1982. Under Section 663(c), a single trust having more than one beneficiary may be treated as separate trusts for distribution purposes when the beneficiaries have substantially separate and independent shares.

Rev. Rul. 93-31, 1993-1 CB 186, discusses the question of whether a substantially separate and independent share of a trust, within the meaning of Section 663(c), can be a QSST if there is a remote possibility that the corpus of the trust will be distributed during the lifetime of the current income beneficiary to someone other than that beneficiary. Under the fact pattern of that ruling, the terms of a trust instrument provide that income is payable in equal shares to B and C. Upon the death of either B or C, one-half of the remaining trust corpus is to be distributed to whomever that beneficiary has appointed or, in the absence of an appointee, to that beneficiary’s estate. The trust instrument further provides that, in general, distributions from the trust are to be made in substantially the same manner as if separate trusts had been created. However, the trust instrument also authorizes the trustee to distribute all or a portion of the trust corpus to B if necessary for B’s health, education, support, or maintenance after taking into account all of the other income. B does have other income that is so substantial that the possibility of exercise of the power to distribute corpus by the trustee is remote.

The ruling points out the differences between the requirements under the regulations for the separate share rule and the requirements for qualified Subchapter S trust treatment. The regulations under the separate share rule, Reg. §1.663(c), provide that the applicability of the separate share rule
generally depends upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. Those regulations further provide that separate share treatment will not be applied to a trust or a portion of a trust that is subject to a power to distribute corpus to or for one or more beneficiaries within a class of beneficiaries, unless payment of corpus to one beneficiary cannot affect the proportionate share of corpus of any shares of the other beneficiaries, or unless substantially proper adjustments must be made under the trust so that substantially separate and independent shares exist. However, the Section 663 regulations further provide that separate share treatment may still apply to a trust even if the trust is subject to a power to pay out to a beneficiary an amount of corpus that is more than that beneficiary's proportionate share of the trust corpus, if the possibility of exercise of that power is remote.

In the fact pattern described in Rev. Rul. 93-31, the possibility that B will receive more than his proportionate share of the trust corpus is ignored for purposes of the separate share rule of Section 663(c) because it is remote. Thus, the shares of B and C in the trust will be treated as separate trusts under both the separate share rule of Section 663(c) and the qualified Subchapter S trust rule of Section 1361(d)(3). Then, each of the two separate shares of the trust must meet the qualified Subchapter S requirements of

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Section 1361(d)(3) for the trust to be an eligible shareholder after the transfer of the S corporation shares to the trust.

Rev. Rul. 93-31 points out that the cross-reference in Section 1361(d)(3) to the separate share rule under Section 663(c) does not modify the express statutory requirements discussed above which are necessary for a trust to be a QSST. The applicability of the separate share rule does not override the QSST requirement in Section 1361(d)(3) that the terms of the trust must provide that there be only one income beneficiary and that any corpus distributed during the life of that current income beneficiary may be distributed only to that beneficiary. Because the trust instrument in this fact pattern provides for the possibility (however remote) that corpus allocable to C's separate share will be distributed to B, C's share of the trust does not meet the qualified Subchapter S trust requirements that any corpus distributed during the life of the current income beneficiary may be distributed only to that beneficiary. Therefore, the transfer of stock to the trust caused a termination of the corporation status as an S corporation. The ruling points out that inadvertent termination relief (discussed at ¶201.3) may be available.

Reg. §1.1361-1(j)(3) repeats the statutory rule and states that, for a separate share of the trust that holds S corporation stock to qualify as a QSST, the terms of the trust applicable to that separate share must meet the QSST requirements. The regulations can be distinguished from the ruling discussed above because it is possible for S corporation stock to be owned by one share under the separate share rule while the other share or shares do not own any S corporation stock. If that is the case, only the shares that own S corporation stock must meet the QSST requirements. In the ruling discussed above, both shares owned S corporation stock and, therefore, the failure of one of the shares to meet the QSST requirements caused the corporation to have an ineligible shareholder, thus terminating its Subchapter S status.

**Subsequent Ineligibility:** If the trust fails to meet the distribution requirement, but still meets the terms of the trust requirement, then the trust will cease to be a QSST on the first day of the next taxable year. (Section 1361(d)(4)) If the QSST ceases to meet the requirements dealing with the terms of the trust, the trust will no longer be a QSST, and the election will terminate as of the date it fails to meet that requirement. Thus, if the single beneficiary of a trust meeting the terms of the trust requirement should die and, under the terms of the trust, the trustee could sprinkle income to more than one successor beneficiary, the trust would cease to qualify, and the election would terminate as of the date the income beneficiary died.
Election for Qualified Subchapter S Trusts

As explained at ¶105.3, the beneficiary of a qualified Subchapter S trust (QSST) may elect to treat the QSST as if it were a qualified Subpart E trust of the stock of a particular S corporation, and thus a permitted shareholder with respect to that corporation. The election must be made separately for each S corporation whose stock is held by the trust for which a beneficiary wants the trust to be a qualified shareholder. It is not necessary that the beneficiary make the QSST election for all S corporation shares owned by the trust.

Example: A trust that meets all of the requirements of a QSST owns shares in three corporations, S1, S2, and S3. The beneficiary makes the QSST election for S1 and S3, but not for S2. As a result, S2 may not be an S corporation because it has a disqualified shareholder. S1 and S3 have a qualified shareholder because the trust meets the QSST requirements and the beneficiary has made the QSST election.

The QSST election by beneficiaries is discussed in Section 1361(d)(2). For taxable years beginning on or before July 21, 1995, Temp. Reg. §18.1361-1 will apply. For taxable years of a corporation beginning after July 21, 1995, Reg. §1.1361-1(j)(6) applies to the QSST election.

Who Makes the Election: The current income beneficiary, or his or her legal representative, makes the election. If the beneficiary is a minor, the election is made by his or her appointed legal representative, and if no legal representative has been appointed, by his or her natural or adoptive parent. (Reg. §1.1361-1(j)(6)(i))

Contents of Election: A separate signed statement for each S corporation for which the trust is to be a QSST is filed with the Service Center where the corporation files its tax return. Under Reg. §1.1361-1(j)(6)(ii) each statement must contain:

- The name, address, and taxpayer identification number of the current beneficiary, the trust, and the corporation;
- A statement that this is an election under Section 1361(d)(2);
- The date on which the election is to become effective (not earlier than 15 days and 2 months before the date on which the election is filed);
- The date (or dates) on which the stock of the corporation was transferred to the trust; and
- All information and representations necessary to show that:
  1. Under the terms of the trust and applicable local law—
     a. During the life of the current income beneficiary, there will be only one income beneficiary of the trust (or, if husband and wife are beneficiaries, they will file joint returns and both are U.S. residents or citizens);
b. Any corpus distributed during the life of the current income beneficiary may be distributed only to that beneficiary;
c. The current beneficiary's income interest in the trust will terminate on the earlier of the beneficiary's death or upon termination of the trust; and
d. Upon the termination of the trust during the life of the income beneficiary, the trust will distribute all of its assets to that beneficiary.

2. The trust is required to distribute all of its income currently; or if the terms of the trust do not require income to be distributed currently, the trustee will actually distribute all of the trust income currently.

3. No distribution of income or corpus by the trust will be in satisfaction of the grantor's legal obligation to support or maintain the income beneficiary.

A sample form of the QSST election appears at §105.3C.

When to File the QSST Election: Section 1361 (d)(2)(D) provides a grace period for the QSST election, so that it may be effective up to 15 days and 2 months before the date of the election. This has been interpreted in the regulations to mean that the election may be made within a 2-month-and-16-day period (the QSST election period) from its effective date. The effective date will depend upon the facts of each individual situation. Reg. § 1.1361-1(i)(6)(iii) sets forth these rules.

If S corporation stock is transferred to a trust, the QSST election period begins on the day that the stock is transferred to the trust.

If a C corporation has made a Subchapter S election and, before that corporation's S election is in effect, stock of that corporation is transferred to a trust, the QSST election period begins on the day that the stock is transferred to the trust.

If a trust holds C corporation stock, and that C corporation makes an S election effective for the first day of the taxable year for which the election is made, the QSST election period begins on the day that the S election is to be effective.

If a trust holds C corporation stock, and that C corporation makes an S election effective for the first day of the taxable year following the taxable year in which the S election is made, the QSST election period begins on the day that the S election is made.

If a trust holds C corporation stock, and the corporation makes an S election intending it to be effective for the first day of the taxable year during which the election is made, but the election is subsequently treated as effective for the first day of the following tax year, the fact that the QSST election states the earlier effective date will not cause the QSST
election to be ineffective for the first year in which the corporation's S election is effective.

If a trust ceases to be a qualified Subpart E trust but also satisfies the requirements of a QSST, the QSST election period begins on the date on which the trust ceases to be a qualified Subpart E trust.

If the estate of the deemed owner of a qualified Subpart E trust is treated as the shareholder for the two-year period beginning on the day of the deemed owner's death, the QSST election period begins on the date on which the estate of the deemed owner ceases to be treated as a shareholder (i.e., the end of the two-year period beginning on the day of the deemed owner's death).

The trust must own the stock in order to make the election, and it must make a separate election for each corporation for which it is to be treated as a QSST. (Section 1361 (d)(2)(B)(i) and Reg. § 1.1361-1(j))

Late Filings and Impact on S Corporation Status: The IRS has been liberal about timely filings. It has issued a number of private letter rulings allowing S corporation status although a trust beneficiary has failed to file a timely QSST election. Typically, these rulings find a failure to follow procedural directions in the regulations, with which literal compliance is not always required (citing Hewlett-Packard Company, 67 TC 736 (1977), acq. in result, 1979-1 CB 1 and Columbia Iron & Metal Company, 61 TC 5 (1973), acq., 1979-2 CB 1). Most of these rulings involve situations in which the beneficiary intended to consent in compliance with Section 1361(d)(2) but failed to file the QSST election within the time limits set forth in Temp. Reg. § 18.1361-1(a). Many of them involved situations in which the beneficiary signed Form 2553 in his or her individual capacity as an individual shareholder or trustee, but not as a beneficiary. In these cases, the IRS usually holds that the failure to sign again in the capacity of income beneficiary of the trust is not a substantive omission. (See, e.g., Letter Rulings 9316015, 8952055, 8952052, 8932039, and 8931010.)

Letter Ruling 9450026 held that the election requirements under Sections 1362(a) and 1361(d)(2) were substantially complied with even though the trustees of the qualified Subchapter S trusts signed instead of the beneficiaries. Since the beneficiaries were minors who had no court-appointed guardians, their parents should have signed as natural guardians. In fact, their parents did sign in their individual capacities, although not as guardians for the minor children. The ruling held that the parents demonstrated their intentions to comply with the requirements on behalf of the trusts and the minor beneficiaries by signing Form 2553 and the consents in their individual capacities. This was held to be substantial compliance and was treated as satisfying the requirements.

In Rev. Proc. 94-23, 1994-1 CB 609, the IRS provides automatic inadvertent termination relief for corporations whose stock was owned by a QSST...
PERMITTED SHAREHOLDERS ¶105.3B

whose beneficiary inadvertently failed to file a timely QSST election. The request for automatic relief must be made within two years of the original due date and the beneficiary must file an election pursuant to the terms of the revenue procedure. Rev. Proc. 94-23 was amplified and superseded by Rev. Proc. 98-55, 1998-2 CB 645. Rev. Proc. 98-55 was superseded by Rev. Proc. 2003-43, 2002-23 IRB 998 (June 9, 2003). The procedure for requesting the automatic inadvertent termination relief is set forth at ¶201.3B.

Successive Beneficiaries: If an income beneficiary of a QSST makes an election to be treated as the shareholder of S corporation stock, each successive beneficiary is automatically treated as consenting to that election unless that successive beneficiary affirmatively refuses to consent. (Section 1361(d)(2)(B)(ii) and Reg. §1.1361-1(j)(9)) The affirmative refusal must be filed with the Service Center where the corporation files its tax return within 15 days and two months after the date on which the successive beneficiary became the income beneficiary. It is effective as of the date the successive income beneficiary became the income beneficiary. It must contain the following information:

* The name, address, and taxpayer identification number of the successive beneficiary, the trust, and the corporation;
* A statement that this is an affirmative refusal to consent under Section 1361(d)(2); and
* The date on which the successive beneficiary became the income beneficiary.

A sample form of the election appears at ¶105.3D.

Revocation of Election: A trust beneficiary’s election under Section 1361(d)(2) may be revoked only with the consent of the IRS. (Section 1361(d)(2)(C)) For taxable years of an S corporation beginning after July 21, 1995, Reg. §1.1361-1(j)(11) governs the revocation of a QSST election. It provides that the IRS will not grant a revocation when one of its purposes is the avoidance of federal income taxes or when the taxable year is closed. The application for consent to revoke the election must be submitted to the IRS National Office in the form of a letter ruling request under the appropriate revenue procedure. The application must be signed by the current income beneficiary and must:

* Contain the name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation for which the QSST election was made;
* Identify the election being revoked as an election made under Section 1361(d)(2); and
* Explain why the current income beneficiary seeks to revoke the QSST election and indicate that the beneficiary understands the consequences of the revocation.
For taxable years of an S corporation beginning on or before July 21, 1995, Temp. Reg. §18.1361-1 provided that an application for IRS consent to revoke the election was required to be signed by the current income beneficiary and filed with the Service Center where the corporation filed its tax returns. The information required for those earlier years by the temporary regulation was as follows:

- The name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation;
- Identification of the election to be revoked under Section 1361(d)(2); and
- The reason the current beneficiary seeks to revoke the election.

Conversion of a QSST to an ESBT: Rev. Proc. 98-23, 1998-10 IRB 30, provided guidance on the conversion of a QSST to an electing small business trust (ESBT) discussed at §105.3E for taxable years beginning after December 31, 1996. For taxable years beginning on and after May 14, 2002 Reg. §1.1361-1(j)(12) supersedes Rev. Proc. 98-23. A trust is eligible to convert from a QSST to an ESBT if:

1. The trust meets all the requirements to be an ESBT under Section 1361(e), except for the requirement that the trust not have a QSST election in place;
2. The trustee and the current income beneficiary of the trust make the ESBT election with respect to the stock of each S corporation held by the trust; and
3. The trust has not converted from an ESBT to a QSST within the 36-month period preceding the effective date of the new ESBT election.

The effective date of the conversion of a QSST to an ESBT cannot be more than 15 days and two months before the date on which the election is filed nor more than 12 months after the date on which the election is filed. If the election specifies an effective date more than 15 days and two months before the date on which it is filed, it will be effective 15 days and two months before the date on which it was filed. If the election specifies an effective date more than 12 months after the date on which it is filed, it will be effective 12 months after the date it was filed. A special exception applied for elections made by May 25, 1998. Such elections may be effective as of any date on or after January 1, 1997 and before March 9, 1998.

The procedural requirements for conversion from a QSST to an ESBT require that an ESBT election be filed with the Service Center where the S corporation files its income tax return. The ESBT election will be similar to the sample form at §105.3F, except that the election must be signed by the current income beneficiary and the trustee of the trust. In addition, the ESBT
A separate election must be made with respect to the stock of each S corporation held by the trust.

Regulations §1.1361-1(j)(12) grants the consent of the IRS to revoke a QSST election as of the effective date of the ESBT election to any QSST that satisfies the requirements stated above. For purposes of Code Section 1377(a), the QSST will be treated as terminating its interest in the S corporation and the new ESBT will be treated as a new shareholder of the S corporation. The last day the QSST will be a shareholder is the day before the effective date of the ESBT election. The new ESBT will be a shareholder beginning on the effective date of the new ESBT election.

A trust that wants to convert from QSST status to ESBT status or vice versa within 36 months of a previous conversion must submit an application for consent to revoke the QSST or ESBT election to the IRS National Office in the form of a letter ruling request. The application must be signed by the current income beneficiary and the trustee.

(Text continues on page 1:25.)
Sam Bennet  
9 Locust Cove Lane  
Brooklyn, N.Y. 13155  
[Date]  

Internal Revenue Service Center  
Atlanta, Georgia 31101  

Re: Election to Treat Qualified Subchapter S Trust  
as a Trust Described in Section 1361(d)(2)  

Gentlemen:  

I hereby make the election under Internal Revenue Code Section  
1361(d)(2) effective on [Date] to have the trust of which I am  
sole income beneficiary qualify as a trust described in Section  
1361(c)(2)(A)(i). In support of this election I submit the follow-  
ing information.  

Current income beneficiary's name, address, and Social Security  
number:  
Sam Bennet  
9 Locust Cove Lane  
Brooklyn, New York 13155  

Qualified trust's name, address, and EID number:  
Sam Bennet Irrevocable Trust dated 5/22/70  
455 Schenectady Avenue  
Troy, New York 21540  
EID Number 13-0000000  

S corporation's name, address, and EID number:  
Winter Corporation  
1-6138 Rigel Court  
Miami, Florida 33133  
EID Number 59-0000000  

Date on which S corporation stock was transferred to the trust: [Date]  

The trust owns stock in the Winter Corporation, which is an S corpo-  
ration. All of the trust income is distributed currently to me and I  
am a citizen of the USA. The terms of the trust require the following:  
during my life I shall be the only income beneficiary; any corpus may  
be distributed only to the current income beneficiary; each income in-  
terest terminates on the earlier of the current income beneficiary's  
death or the termination of the trust; and upon the termination of the  
trust during the current income beneficiary's life all trust assets are  
to be distributed to the income beneficiary. The trust is required to  
distribute all of its income currently. [or alternatively: The trust is  
not required to distribute all of its income currently, but the trustee  
will make actual distributions of all trust income on a current basis.]  

No distribution of income or corpus by the trust will be in satis-  
faction of the grantor's legal obligation to support or maintain the  
income beneficiary.  

Please stamp the enclosed copy of this election with your "RECEIVED"  
stamp and return it to me in the enclosed envelope. Thank you very much.  

Very truly yours,  
Sam Bennet
Sample Form of Successor Beneficiary's Affirmative Refusal to Consent to Election as Qualified Subchapter S Trust

J. William Bennet
5 Grand Avenue
Bellmore, New York 11165

[Date]

Internal Revenue Service Center
Atlanta, Georgia 31101

Re: Affirmative Refusal to Consent to Qualified Subchapter S Trust Election

Gentlemen:

I hereby affirmatively refuse to consent to the election previously made under Internal Revenue Code Section 1361(d)(2). On [Date], I became the sole income beneficiary of the trust described hereinbelow. As the successive beneficiary, I am entitled to affirmatively refuse to consent to this election. The following additional information is submitted:

Successive income beneficiary's name, address, and Social Security number:

J. William Bennet
5 Grand Avenue
Bellmore, New York 11165

Social Security Number
000-00-0000

Qualified trust's name, address, and EID number:

J.W. Bennet Irrevocable Trust dated 5/22/70
455 Schenectady Avenue
Troy, New York 21540

EID Number 13-000000

S corporation's name, address, and EID number:

Winter Corporation
1-6138 Rigel Court
Miami, Florida 33133

EID Number 59-000000

Please stamp the enclosed copy of this letter with your "RECEIVED" stamp and return it to me in the enclosed envelope. Thank you.

Very truly yours,

J.W. Bennet
ELECTING SMALL BUSINESS TRUSTS (ESBTs)

For taxable years beginning after December 31, 1996, the Small Business Job Protection Act of 1996 added a new type of trust as a permitted shareholder. The new type of trust is called an “electing small business trust.” To qualify for this treatment, all beneficiaries of the trust must be individuals, estates, or organizations described in paragraph (2), (3), (4), or (5) of Section 170(c). For tax years beginning after December 31, 1996 but beginning before 1998, the Section 170(c) organizations could only hold a contingent interest and could not be potential current beneficiaries. For tax years beginning after December 31, 1997, this restriction was removed. However, Section 1361(e) does not provide a specific definition of the term “beneficiary.”

Regulations adopted in the Federal Register on May 14, 2002 provide guidance with respect to years beginning on and after May 14, 2002. These regulations indicate that the definition of a beneficiary is not necessarily the same as the definition of a potential current beneficiary. Regulations Section 1.1361-1(m)(1)(ii)(A) defines a beneficiary as a person who has a present, remainder, or reversionary interest in the trust. Regulations Section 1.1361-1(m)(4) defines potential current beneficiaries as, 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. Each potential current beneficiary is considered a shareholder of the S corporation for purposes of the number of shareholders test. No person will be treated as a potential current beneficiary solely because that person holds a future interest in the trust. If all or a portion of an ESBT is treated as owned by a person under subpart E, part 1, subchapter J, chapter 1 of the Internal Revenue Code, each such owner is also a potential current beneficiary in addition to the other persons described above.

For tax years beginning before January 1, 2005, a problem with respect to the number of beneficiaries test could arise in the event that someone had the power to cause an ESBT to distribute to any number of beneficiaries, without limitation. In this case, the unlimited number of potential current beneficiaries would have caused the S corporation status to be terminated.

Example 1: For a tax year before 2005, a trust authorizes the trustee to make charitable contributions to any charities so long as they qualify for charitable contribution deductions. Because the number of charities was not limited, the number of potential current beneficiaries exceeded the number of shareholders limit and caused termination of the S corporation status.

A possible solution to the problem would have been for the trustee to irrevocably give up the right to distribute to more than a certain number of specified charities, listing all of them, so that the total number of charities plus the other shareholders of the corporation will not exceed the permitted limit. This is
specifically permitted by regulation Section 1.1361-1(m)(4)(vi)(B). That section provides that if the holder of a power of appointment permanently releases the power in a manner that is valid under applicable local law, the persons who would be potential current beneficiaries solely because of the power will not be potential current beneficiaries after the effective date of the release. An attempt to temporarily waive, release, or limit a currently exercisable power of appointment will be ignored in determining who are potential current beneficiaries of the trust. Letter Ruling 200401011 relied on that provision. In the letter ruling, the trustees were authorized to distribute sums from the trust to potential charitable beneficiaries as the trustees deemed advisable. The trustees permanently disclaimed that power prior to the Subchapter S election and the ruling held that if the disclaimers are valid under the trust instrument and local law, that the ESBT status would not be jeopardized.

Another possible solution to this problem was for the trust to permit distributions to a specifically named donor advised charitable fund where the trustee is given the authority to make suggestions to the fund as to which charities should receive grants from that fund.

Letter Ruling 200516002 permitted this type of solution in which a donor advised fund was named as a designated charity to which payments could be made by the trustees in their sole discretion.

For taxable years beginning after December 31, 2004, Section 1361(e)(2) defining "potential current beneficiary" is amended by excluding any power of appointment to the extent that such power remains unexercised at the end of the tax year. Thus, the problem described above will no longer exist for unexercised powers of appointment. Moreover, proposed Regulation §1.1361-1(m)(vi)(B) appearing in the September 28, 2007, Federal Register would specifically provide that if a trustee or other fiduciary has a power to make distributions from the trust to one or more members of a class of charitable organizations, that these organizations would be counted collectively as only one potential current beneficiary, except that each organization actually receiving a distribution will be counted as a separate potential current beneficiary. Under the proposal, this would only apply to charitable beneficiaries not named. Each organization that is specifically named in the trust instrument would be a potential current beneficiary of the trust.

Letter Rulings 200522003, 200522004, and 200522005 presented a situation where a nonresident alien could receive distributions from the trust after a certain year or after substantially all of the assets in his foreign country that are available for distribution are distributed. Citing Reg. §1.1361-1(m)(4)(v) which provides that a person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of a power of appointment) is not a potential current beneficiary until such time or the occurrence of such event,
the IRS ruled that the nonresident alien is not a potential current beneficiary until the year named or until the event occurred, that is when substantially all of the assets in the foreign country available for distribution to him are distributed. Thus the trust could make an ESBT election.

To prevent the loss of ESBT status when a disqualified shareholder becomes a "potential income beneficiary," the term "potential current beneficiary" does not include a person who would otherwise be included in the definition if the trust disposes of all of the S corporation stock which

(Text continues on page 1:26-3.)
it holds within a certain period of time. For years prior to 2005, the period of
time is 60 days. For years beginning after December 31, 2004, the 60 day
period is amended to one year.

For years prior to the adoption of the final regulations, guidance was
provided by Notice 97-12 (1997-1 CB 385), Notice 97-49 (1997-2 CB 304),

Notice 97-49, 1997-2 CB 304, set forth rules to apply in defining the term
"beneficiary" solely for purposes of Section 1361(e)(1)(A)(i):

1. The term “beneficiary” does not include a distributee trust (other
than a trust described in paragraphs (2) or (3) of Section 170(c), but
does include those persons who have a beneficial interest in the
property held by the distributee trust. For example, if a trust’s gov-
erning instrument provides for discretionary distributions of income
or principal to A for life, and upon A’s death the remainder is
divided into separate trusts for the benefit of A’s children, the
trust will qualify to be an ESBT. The notice states that, for purposes
of Section 1361(e)(1)(A)(i), the beneficiaries of the trust are
and
A’s children, and not the separate trusts for the benefit of A’s chil-
dren. Therefore, because all of the beneficiaries of the trust are
individuals, the trust could qualify as an ESBT.

2. The term “beneficiary” does not include a person in whose favor a
power of appointment could be exercised. Such a person becomes a
beneficiary only when the holder of the power of appointment ac-
tually exercises the power of appointment in such person’s favor.

3. The term “beneficiary” does not include a person whose contingent
interest is so remote as to be negligible. For example, except in
unusual circumstances, the contingent interest that a state has
under its laws pertaining to escheat would be considered negligible
and the state would not be considered a beneficiary of an intended
ESBT.

No interest in the trust may be acquired by purchase (i.e., property
acquired with a cost basis determined under Code Section 1012). Thus,
interests in the trust must be acquired by gift or bequest. The trust must file
an election to be treated as an electing small business trust.

The Taxpayer Relief Act of 1997 clarifies that neither a charitable re-
mainder annuity trust nor a charitable remainder unitrust may be an elect-
ing small business trust.

Each potential current beneficiary of the trust will be counted as a share-
holder for purposes of the number-of-shareholders test. If there are no
potential current beneficiaries, the trust will be treated as the shareholder.
A potential current income beneficiary is defined as any person who is
entitled to, or at someone’s discretion may receive, a distribution from the principal or income of the trust.

Section 7701(a)(1) defines “person” to include a trust for all purposes of the Code where not otherwise distinctly expressed or manifestly incompatible with the intent of the specific provision. For purposes of Section 1361, Notice 97-49, 1997-2 CB 304, set forth the following rules in defining the term “potential current beneficiary”:

1. If a distributee trust becomes entitled to, or at the discretion of any person may receive, the distribution of principal or income from the intended ESBT, the S corporation election will terminate because of a disqualified shareholder unless the distributee trust is a trust that would be permitted as a shareholder, described in Section 1361(c)(2)(A). Those trusts are limited to a Subpart E trust, a Subpart E trust after the death of the deemed owner for the two-year period beginning on the date of death, a trust for the two-year period beginning on the day on which S corporation stock is transferred to it under the terms of a will, a voting trust, an electing small business trust, or a qualified Subchapter S trust whose beneficiary has made the QSST election. In addition, the notice points out that, if the distributee trust is one of those qualified trusts, the persons described in Section 1361(c)(2)(B) are treated as shareholders of the corporation for purposes of determining whether the shareholder limitations under Section 1361(b)(1) are met. In the earlier example in this section involving the distributee trusts for A’s children, the distributee trusts for A’s children will become entitled to receive distributions from the ESBT upon A’s death. At such time, the S corporation election will terminate unless the distributee trusts are the kind of trusts described in Section 1361(c)(2)(A), and the persons described in Section 1361(c)(2)(B) with respect to the distributee trusts satisfy the shareholder limitations in Section 1361(b)(1). If, for example, the distributee trusts are qualified Subchapter S trusts, and A’s children are the current income beneficiaries, A’s children would be treated as shareholders of the corporation for purposes of satisfying the shareholder restrictions under Section 1361(b)(1).

2. A person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of the power of appointment) is not a potential current beneficiary until such time or the occurrence of the event. Whether a person to whom a distribution is, or may be, made during a period pursuant to a power of appointment should be treated as a potential current beneficiary is currently under study by the IRS.

As discussed previously, current law Section 1361(e)(2) defines potential current beneficiaries to exclude unexercised powers of appointment.
Letter Ruling 199930035 deals with the definition of an ESBT. The trust document in question gave the trustee discretion to make distributions to descendants of the settlor, either outright or in trust. Citing Notice 97-49, the letter ruling noted that the term beneficiary does not include a distributee trust, but does include those persons who have a beneficial interest in the property held by the distributee trust. Furthermore, the notice provides that for purposes of the definition of a potential current beneficiary under Code Section 1361(e)(2) if a distributee trust becomes entitled to, or at the discretion of any person may receive, a distribution from principal or income of an ESBT, then the trust will become a potential current beneficiary and the S corporation election will terminate unless the distributee trust is a grantor type trust described in Section 1361(c)(2)(A). Accordingly, the letter ruling concluded that for purposes of the ESBT definition, the beneficiaries of the trust are individuals and are qualified beneficiaries. Furthermore, the ruling concluded that the power given to the trustee to subdivide the trust into subtrusts does not affect the trust’s qualification as an ESBT. This conclusion is based on the assumption that the division of the trust is not considered a sale or exchange under Section 1001. However, if the trustee does subdivide the trust, any sub-trust created must qualify as a trust described under Section 1361(c)(2)(A) and the beneficiary of the resulting trust must satisfy the shareholder restrictions of Section 1361(b)(1).

The ruling states that the power given to the trustee to make distributions either directly to beneficiaries or in trust for the benefit of any of the grantor’s children and/or their issue is a power to make a distribution for purposes of Section 1361(e)(2). However, since there are currently no distributee trusts identified or currently in existence, the power to distribute to these trusts will be disregarded for purposes of Section 1361(e)(2). Thus, there is no distributee trust that is a potential current beneficiary. If a distributee trust is identified or otherwise comes into existence in any period, then the distributee trust will become a potential current beneficiary at that time and the S corporation election will terminate unless the distributee trust is a trust described in Section 1361(c)(2)(A). And, the beneficiary of any new trust must satisfy the shareholder restrictions of Section 1361(b)(1).

Who Makes the Election? The trustee of the ESBT must make the ESBT election pursuant to Section 1361(e)(3) by signing and filing with the Service Center with which the corporation files its income tax return a statement that contains certain information. Before the issuance, of regulations, the contents of the statement were governed by Notice 97-12, 1997-1 CB 385.

Regulations Section 1.1361-1(m)(2) contains the requirements for the ESBT election. If there is more than one trustee, the trustee or trustees
with authority to legally bind the trust must sign the election statement. If
any one of several trustees can legally bind the trust, only one trustee needs to
sign the election statement. Generally, only one ESBT election is made for
the trust, regardless of the number of S corporations whose stock is held by
the ESBT. However, if the ESBT holds stock in several S corporations that
file in different service centers, the ESBT election must be filed with all the
relevant service centers where the corporations file their income tax returns.
This requirement applies only at the time of the initial ESBT election. If an
ESBT later acquires stock in a different S corporation which files its income
tax return at another service center, a new ESBT election is not required.

**Contents of Election:** Reg. Section 1.1361-1 (m)(2)(ii) provides that the
election statement must include the following:

1. The name, address, and taxpayer identification number of the trust,
   the potential current beneficiaries, and the S corporations in which
   the trust currently owns stock;
2. An identification of the election as an ESBT election made under
   Section 1361(e)(3);
3. The first date on which the trust owned stock in each S corporation;
4. The date on which the election is to become effective (not earlier than 15
days and two months before the date on which the election is filed); and
5. Representations signed by the trustee stating that
   a. The trust meets the definitional requirements of Section 1361 (e)(1); and
   b. All potential current beneficiaries of the trust meet the shareholder requirements of Section 1361(b)(1).

The trustee of the ESBT must file the ESBT election within the same
time requirements as those prescribed in Reg. § 1.1361-1(l)(6)(iii) for filing
qualified Subchapter S trust (QSST) elections (generally within the 16-day
and two-month period beginning on the day that the stock is transferred to
the trust). The trustee may attach the ESBT election to Form 2553 in the
case of a newly electing S corporation.

2003-23 IRB 998 (June 9, 2003), the IRS provided automatic inadvertent
termination relief for corporations whose stock was owned by an ESBT
whose trustee inadvertently failed to file a timely ESBT election. The
request for automatic relief had to be made within two years of the original
due date, and the trustee had to file an election pursuant to Rev. Proc. 98-
55. This revenue procedure was superseded by Rev. Proc. 2003-43, 2003-23
IRB 998 (June 9, 2003). The procedure for requesting the automatic
inadvertent termination relief is set forth at §201.3B.
An ESBT election applies to the taxable year of the trust for which it is made and for all subsequent taxable years of the trust unless revoked with the consent of the IRS. (Section 1361(e)(3))

Conversion of an ESBT to a QSST: Prior to the publication of Final Regulations § 1.1361(m) on May 14, 2002, Rev. Proc. 98-23, 1998-1 CB 662, provided guidance on the conversion of an ESBT to a QSST. A trust is eligible to convert from an ESBT to a QSST for taxable years beginning after December 31, 1996 if:

1. The trust meets all of the requirements under Section 1361(d) to be a QSST;
2. The trustee and the current income beneficiary of the trust make the QSST election with respect to the stock of each S corporation held by the trust; and
3. The trust has not converted from a QSST to an ESBT within the 36-month period preceding the effective date of the new QSST election.

The date on which the QSST election is to be effective cannot be more than 15 days and two months before the date on which the election was filed nor more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 15 days and two months before the date on which the election is filed, it will be effective 15 days and two months before the date on which it was filed. If an election specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date on which it was filed. A special exception applied to elections filed on or before May 25, 1998. Such elections could have been made effective as of any date on or after January 1, 1997 and before March 9, 1998.

The procedural requirements for conversion of an ESBT to a QSST require that a QSST election be filed with the Service Center where the S corporation files its income tax return. The election must be signed by the current income beneficiary of the trust and by the trustee. A separate election must be made with respect to the stock of each S corporation held by the trust. Each QSST election must state at the top of the document: “ATTENTION: ENTITY CONTROL—CONVERSION OF AN ESBT TO A QSST PURSUANT TO SECTION 1.1361-1 (m).” The election must also include all information otherwise required for a QSST election. A sample form for an ordinary QSST election (not converting from an ESBT) appears at ¶105.3C.

Reg. §1.1361-1(m)(7) grants the consent of the IRS to revoke an ESBT election as of the effective date of the QSST election effecting the conversion of the ESBT to a QSST for those corporations that satisfy the requirements stated above. For purposes of Section 1377(a), the ESBT will be treated as terminating its interest in the S corporation and the new
QSST will be treated as a new shareholder of the S corporation. The last day the ESBT will be a shareholder is the day before the effective date of the QSST election. The new QSST will be a shareholder beginning on the effective date of the QSST election.

A trust that wants to convert from QSST status to ESBT status or vice versa within 36 months of a previous conversion must submit an application for consent to revoke the QSST or ESBT election to the IRS National Office in the form of a letter ruling request. The application must be signed by the current income beneficiary and the trustee.

ESBT Consent to S Corporation Election: If the trust is a shareholder of a corporation at the time that it makes its Subchapter S election on Form 2553, the question arises as to who signs the shareholder consent portion of Form 2553 on behalf of the ESBT. Section 1361(c)(2)(B) generally provides that all potential current beneficiaries of the ESBT are treated as shareholders for purposes of determining whether the corporation has eligible shareholders, and for whether the number of shareholders exceeds the maximum number of permitted shareholders, as provided by Section 1361(b)(1). However, for purposes of the ESBT's consent to the S corporation election under Section 1362(a), Notice 97-12 provides that it is the trustee who consents to the election on behalf of the ESBT. The rationale expressed in the notice is that the ESBT itself is taxed on the S corporation's income (not the beneficiaries), and it is the trustee who makes the ESBT election (not the beneficiaries); therefore, only the trustee needs to consent to the S corporation election. Reg. §1.1361-1(m) follows the same rule.

¶105.3F Sample Form for ESBT Election

MARK AND SUSAN TRUST
55 MICHAEL STREET
DENEEN, FLORIDA 33133

May 22, 2002

Internal Revenue Service Center
Ogden, Utah 84201-0013

Re: ESBT Election

Gentlemen & Ladies:

The undersigned trustee of the Mark and Susan Trust does hereby elect to have the trust treated as an Electing Small Business Trust (ESBT) pursuant to Internal Revenue Code Section 1361(e)(3). In support of said election, the following information is submitted:

(Form continues on page 1:26-9.)
1. A. Name, address and taxpayer identification number of all potential current beneficiaries:

   Mark Elliot  
   Klein Building, Room 704  
   Miami, Florida 33131  
   S.S.N. 000-00-0000

   Susan Sira  
   8A-11 61st Drive  
   Rego Park, New York  
   S.S.N. 111-00-1111

B. Name, address and taxpayer identification number of the trust:

   Mark and Susan Trust  
   55 Michael Street  
   Deneen, Florida 33133  
   E.I.N. 59-1111111

C. Name, address and taxpayer identification number of the corporations in which the trust currently owns stock:

   Dutchy, Inc.  
   11 Cemetery Drive  
   Miami, Florida 33131  
   E.I.N. 59-0000000

   Libby, Inc.  
   22 Oriole Drive  
   Miami, Florida 33132  
   EIN 59-195R213

2. This election is made under Section 1361(e)(1).

3. The date on which the stock of both corporations was transferred to the trust was January 6, 1997.

4. The date on which the election is to become effective is July 1, 2002.

5. The following information and representations are made to show that all potential current beneficiaries meet the shareholder requirements of Section 1361(b)(1), and that the trust meets the definitional requirements of an ESBT under Section 1361(e)(1):

   A. All potential current beneficiaries are individuals who are qualified to be S corporation shareholders;

   B. No interest in the trust was acquired by purchase;

   C. The trust does not own any S corporation stock for which a QSST election under Internal Revenue Code Section 1361(d)(2) applies; and

   D. The trust is not exempt from income taxes.

Please stamp the enclosed copy of this election with your "RECEIVED" stamp and return it to me in the enclosed envelope.

Thank you very much.

Very truly yours,

MICHAEL ELIHU, Trustee
Taxation of an ESBT

The portion of the trust that consists of stock in one or more S corporations will be treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. The trust will be taxed at the highest individual income tax rate on ordinary income and on net long-term capital gains on this portion of the trust’s income. The taxable income attributable to this portion of the trust includes all flow-through items from all S corporations owned by the trust under the rules of Subchapter S, gain or loss from the sale of S corporation stock, and to the extent provided in regulations, any state or local income taxes and administrative expenses properly allocable to S corporation stock. Otherwise, allowable capital losses are allowed only to the extent of capital gains. In computing the trust’s income tax on this portion of the trust, no deduction is allowed for distributions to beneficiaries, and no deduction or credit is allowed for any item other than those described above, except that a deduction for interest paid or accrued on indebtedness to acquire S corporation stock may be deducted effective for taxable years beginning after December 31, 2006. The alternative minimum tax (AMT) of Section 55 may apply to the ESBT. Section 641(d)(2)(B) provides that the AMT exemption amount applying to an ESBT will be zero. The income from the ESBT is not included in the distributable net income of the other part of the trust and thus is not included in the beneficiaries’ income. No item relating to the S corporation stock may be apportioned to any beneficiary. On the termination of all or any portion of an ESBT, the loss carryovers or excess deductions referred to in Code Section 642(h) are taken into account by the entire trust, subject to the usual rules on termination of the entire trust. If the trust terminates before the end of the S corporation’s taxable year, the trust takes into account its pro rata share of S corporation items for its final year.

CCA 200734019, a Chief Counsel Advice Memorandum, considered the following question with regard to the allocation of items between the S corporation portion of the ESBT and the non-S corporation portion. An individual owned stock of an S corporation prior to his death. During the administration of his estate, there were S corporation losses that flowed through to the estate that were deductible by the estate since it had sufficient basis in the S corporation stock for the losses to flow through. However, the estate did not have sufficient income to utilize those losses and that gave rise to a net operating loss (NOL) as defined in Code Section 172. The NOL carryover remained unused on the termination of the individual’s estate. The trust was a residuary testamentary beneficiary of the estate and was funded with various assets including stock of the S corporation. As a residuary testamentary beneficiary of the estate, the trust succeeded to the NOL carryover that was unused by the estate at the time it terminated pursuant to
PERMITTED SHAREHOLDERS

Code Section 642(h)(l). The trust qualified as a permissible S corporation shareholder under Section 1361(c)(2)(A)(iii) during the two year period beginning on the date the stock was transferred to the trust pursuant to the individual’s will. In order to remain an eligible trust following the two year period, the trustee made an election for the trust to be an ESBT under Section 1361(c)(3). The IRS position is that Section 641(c)(2)(C) provides a complete list of the items of income, loss, deduction, or credit that the S portion of an ESBT may take it to account. The NOLs that the trust succeeded to under Section 642(h)(1) are not described in Section 641(c)(2)(C). Therefore, the IRS concludes that the NOLs should be available only as a deduction to the non-S portion of the trust following its ESBT election.

The Chief Counsel Advice Memorandum arose in response to a private letter ruling request from the trust requesting a ruling that the NOLs to which it succeeded from the terminating estate would be available to the trust following the ESBT election. When the IRS informed the taxpayer’s representative of its position, the taxpayer withdrew its ruling request. The taxpayer’s position was that the NOL should be allocated to the S portion of the trust because the NOL is attributable to losses created by the S corporation whose stock is held within the S portion of the trust. Until a court rules on this matter, there can be no certainty as to the result.

Reg. §1.641(c)-1(l) and previously Notice 97-49, 1997-2 CB 304, gives guidance on the treatment of distributions from an ESBT when the trust has fiduciary accounting income in both the S portion of the trust and the non-S portion of the trust. Section 641(d)(3) specifically provides that, except as otherwise specified, Section 641(d) does not change the taxation of any distribution from the trust. According to these authorities, because the S portion items are not included in the computation of the ESBT’s distributable net income (DNI), they are treated for purposes of determining the treatment of trust distributions in the same manner as any other item that does not enter into the DNI computation, such as capital gains and losses allocated to corpus. For example, if an ESBT has $40 of DNI from the non-S portion of the trust and $70 of net fiduciary accounting income from the S portion of the trust in a tax year, if the ESBT makes a distribution of $100, the distribution will include $40 of DNI.

In determining the tax liability on the remaining portion of the trust, the items taken into account by the Subchapter S portion of the trust (ESBT) are disregarded. The trust’s distributable income does not include any income attributable to the S corporation stock. Distributions from the trust are deductible in computing the taxable income on the remaining portion of the trust, under the usual rules of Subchapter J.

Example from Regulations: The following example is adapted from Treasury Regulations §1.641(c)-1(l). Example 1.
QUALIFYING AN S CORPORATION

Facts of Example: The trust has a valid ESBT election in effect. Under Section 678, an individual (grantor) is treated as the owner of a 10 percent undivided fractional interest in the trust. No other person is treated as the owner of any other portion of the trust under Subpart E, Part I, Subchapter J. The trust owns stock in an S corporation and also in a C corporation. During the year 2000, the trust received a $5,100 distribution from the S corporation of which $5,000 is a subchapter S distribution, applied against the trust’s adjusted basis in the stock under Section 1368(c)(1), and $100 is a dividend from earnings and profits under Section 1368(c)(2). The trust made no distributions to its beneficiaries during the year 2000.

For the year 2000 the trust had the following items of income and deduction:

<table>
<thead>
<tr>
<th>INCOME</th>
<th>AMOUNT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary income flowing through from S corporation under Section 1366</td>
<td>$5,000</td>
</tr>
<tr>
<td>Dividend income from C corporation</td>
<td>900</td>
</tr>
<tr>
<td>Dividend from S corporation representing C corporation earnings and profits</td>
<td>100</td>
</tr>
<tr>
<td>Total Trust Income</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

(Text continues on page 127.)
PERMITTED SHAREHOLDERS  § 105.3G

DEDUCTIONS
Charitable contributions attributable to S corporation under Section 1366 $300
Trustee fees 200
State and local income taxes 100
Total Trust Deductions $600

Under state law the administrative expenses and the state and local income taxes relate to all portions of the trust and would be allocated ratably to the $6,000 of trust income.

The following chart shows the allocation of income and deduction items among the 10 percent grantor portion, the S portion, and the non-S portion of the trust.

<table>
<thead>
<tr>
<th></th>
<th>10% Grantor Portion</th>
<th>S Portion</th>
<th>Non-S Portion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Flow-thru income from S corp</td>
<td>$5,000</td>
<td>$500</td>
<td>$4,500</td>
</tr>
<tr>
<td>Dividend income from C corp</td>
<td>$900</td>
<td>$90</td>
<td>810</td>
</tr>
<tr>
<td>Dividend from S corp E &amp; P</td>
<td>$100</td>
<td>$10</td>
<td>90</td>
</tr>
<tr>
<td>Total income</td>
<td>$6,000</td>
<td>$600</td>
<td>$4,500</td>
</tr>
</tbody>
</table>

S corp flow-thru charitable contributions | $300 | 30 | 270 |
Trustee fees* | $200 | 20 | 150 |
State and local income taxes* | $100 | $10 | 75 |
Total deductions | $600 | $60 | 495 |

Exemption | $100 |
Net Taxable income | $5,300 | $540 | $4,000 | $755 |

* allocated ratably according to state law: grantor portion 600/6,000 = 10%; S portion 4,500/6,000 = 75%; and non-S portion 900/6000 = 15%

Estimated Tax Payments: Prior to the issuance of the proposed ESBT regulations discussed above, some taxpayers took the position that an ESBT election could be made for a grantor trust and that the rules relating to the taxation of ESBTs applied to the entire S portion of the trust. Consistent with this position, these ESBTs made estimated tax payments for the 2000 taxable year under the trusts' employer identification numbers (EINs) and the deemed owners did not take into account the S corporation income in calculating their estimated tax payments for the 2000 taxable year.

Notice 2001-25, 2001-13 IRB 941 (March 26, 2001) provided a method for having the estimated tax payments that were made by an ESBT under the trust's EIN credited to the deemed owner's account for estimated tax payments.
purposes. The Notice applies only for taxable years of ESBTs and of the
deeled owners of those ESBTs ending on December 29, 30, or 31, 2000.

The method for crediting estimated tax payments to a deemed owner
specified in the Notice requires the filing of a Form 1041-T, Allocation of
Estimated Tax Payments to Beneficiaries, in the time and manner specified
in the instructions to Form 1041-T with the following modifications. At
the top of the Form 1041-T, the following statement should be written,
"FILED PURSUANT TO NOTICE 2001-25." Each reference in the
Form 1041-T to beneficiary is deemed to refer to the deemed owner of
the ESBT solely for purposes of this Notice. The trust's estimated tax
payments included on Form 1041-T will be treated as a payment of esti-
mated tax made by the deemed owner of the ESBT on January 15, 2001.

If the deemed owner of the ESBT is required to file Form 2210, Under-
payment of Estimated Tax by Individuals, Estates and Trusts, the deemed
owner may use Schedule AI, Annualized Income Installment Method. For
this purpose, the deemed owner may take into account, as of the last day of
the deemed owner's 2000 taxable year, all S corporation items allocable to
the grantor portion of the ESBT.

§105.4 Voting Trusts

A voting trust may hold stock in an S corporation. In determining
the number of shareholders in the S corporation, each trust beneficiary of
the voting trust is counted as a separate shareholder. (Sections
1361(c)(2)(A)(iv) and 1361(c)(2)(B)(iv))

Reg. § 1.1361-1(h)(1)(v) defines a qualified voting trust as a trust created
primarily to exercise the voting power of S corporation stock transferred
to it. To be a qualified voting trust, the beneficial owners must be treated as
the owners of their respective portions of the trust under Subpart E of the
Code, and the trust must have been created pursuant to a written trust
agreement entered into by the shareholders. The agreement must do all of
the following:

1. Delegates to one or more trustees the right to vote;
2. Requires all distributions with respect to the corporate stock held
by the trust to be paid to, or on behalf of, the beneficial owners of
that stock;
3. Requires title and possession of the stock to be delivered to the
beneficial owners upon termination of the trust; and
4. Terminates on or before a specific date or event, under the terms of
the trust or by state law.


\section*{\textbf{\section*{PERMITTED SHAREHOLDERS}} \textbf{\textnumero 105.5}}

\textbf{\textnumero 105.5 Unexpected Trusts}

Transfers by wills and from estates, and certain other transactions, can create S corporation qualification problems.

In the following cases (decided prior to enactment of the exceptions to the prohibition of trusts holding S corporation stock) it was determined that the stock had in effect been transferred by an estate to a trust. Thus, the S corporation election was nullified. Had these situations arisen under the current law, it would seem that for a two-year period these trusts could have continued as S corporation shareholders. (See \textnumero 105.3.) However, since the parties did not realize that the transfer had been made to a trust, they would not have acted within the two-year period anyway.

In one case, a decedent's estate, which was a shareholder in an S corporation, was transmuted into a testamentary trust by prolonging the period of estate administration beyond a reasonable length of time. \textit{(Old Virginia Brick Co., Inc.,} 367 F. 2d 276 (4th Cir. 1966), \textit{aff}g 44 TC 69 (1965)) In this case, a decedent had left to his wife a life income from his estate (including the corporate stock), with the remainder to his children. Presumably his will contemplated that his executors would serve as testamentary trustees upon the closing of his estate. The court, citing Reg. \textsection{} 1.641(b)-3(a), held that the estate terminated once the period necessary for the performance of the ordinary duties of estate administration had ended, and that the assets of the estate forthwith passed to the testamentary trustees, even though no probate court order was given or requested for discharge of the executors and termination of the estate. Thus, the consent filed by the executors to the corporation's S corporation election was invalid, inasmuch as the "executors" were then testamentary trustees.

Similarly, a testamentary trust was held to be a shareholder in the corporation, thus making the corporation ineligible for S corporation status, even though the decedent-shareholder's executrixes (who were also named as trustees of the testamentary trust) completely disregarded the trust's existence and the named beneficiaries of the trust never attempted to enforce its provisions. The court stated, "The trust existed and continues to exist independently of the action of the parties and solely on the authority of the instrument creating it." \textit{(Fulk & Needham, Inc.,} 288 F. Supp. 39 (D. Ct. NC 1968), \textit{aff}d, 411 F. 2d 1403 (4th Cir. 1969))

But in a situation involving the use of Section 6166 (which permits installment payment of estate taxes for up to 15 years), the IRS has held that the period of administration of the estate will not be deemed to be unduly prolonged. \textit{(Rev. Rul. 76-23,} 1976-1 CB 264) The estate will continue to be an eligible shareholder if the sole purpose of holding the stock in the estate, instead of distributing it, is to comply with the provisions of Section 6166. Letter Ruling 9247035 cited Rev. Rul. 76-23 with approval, thus indicating
that IRS still agrees with it. In appropriate cases, this might be used to prolong the period during which a corporation will be able to use Subchapter S when the proceeds of the estate are payable to a trust.

*Planning Pointer:* Wills and estate plans should be reviewed when an S corporation election is made. Shareholders’ agreements can also help prevent these problems. (See ¶506.)

*Other Unexpected Trust Situations:* Another aspect of this problem concerns the question of whether stock held in escrow is deemed held in trust. While the decision in *A.N. Hoffm an, 47 TC 218 (1966)*, touched on this problem somewhat, the Tax Court never really came to grips with the issue, since it decided that the escrowee was not a shareholder.

A taxpayer who had no beneficial interest in, but owned one share of stock under an “acknowledgement of trust” as an accommodation for another to meet the requirements of state law, was characterized as a nominee and not as a trustee. (*Rev. Rul. 70-615, 1970-2 CB 169, as clarified by Rev. Rul. 75-261, 1975-2 CB 350*)

But in *Friend’s Wine Cellars, Inc., TC Memo 1972-149*, the Tax Court held that shares were owned by a trust even though the stock certificates and the stock record book of the corporation indicated that they were owned by an individual. The court found that the individual was acting as trustee and consequently the corporation did not qualify for S corporation status.

¶105.6 Split Interests

A question that arises is whether one person who has a life estate in the stock, with the remainder over to another, may own S corporation stock. Under the law before the Subchapter S Revision Act of 1982, the IRS had ruled that an individual “usufructuary” under the Louisiana law (a civil code jurisdiction) could hold shares in an S corporation. (*Rev. Rul. 64-249, 1964-2 CB 332*) (Under Louisiana law, a “usufruct” is roughly comparable to a legal life estate in property in a common-law jurisdiction.) However, regulations proposed in 1980 under old Section 1371 would have disqualified S corporations that had shareholders whose ownership consisted of a legal life estate, usufruct interest, remainder, or interest for a term of years. But those proposed regulations were never adopted.

Regulations proposed on October 7, 1986, took a different position. Under the proposal (Prop. Reg. § 1.1361-1 A(f)), a corporation having a shareholder whose interest in the stock was that of a legal life estate or a usufruct interest for life created before January 1, 1983, would qualify as an S corporation. For purposes of this rule, an interest would have been considered created before January 1, 1983 if it was created under the terms of a will signed before that date and the decedent died before January 1, 1986, without having republished the will after December 31, 1982. But, if a shareholder’s
interest in the stock was a legal life estate or usufruct interest for life that came into existence after December 31, 1982, the corporation would qualify as an S corporation only if certain requirements were met with respect to that interest. These requirements somewhat resembled those for a qualified Subchapter S trust (discussed at ¶105.3A). Under those proposed regulations, requirements for qualification of the legal life estate or usufruct interest for life were as follows:

1. The interest is owned by only one individual, who is a citizen or resident of the United States;
2. The individual for whom that interest was created has not transferred that interest to any other person; and
3. That interest must terminate upon the death of the individual for whom it was created.

If any one of these three requirements was not met, the proposed regulations said that the S corporation election would terminate as of the first date on which the requirement ceased to be met.

Final Regulations under Section 1361 were adopted on July 21, 1995. In the Preamble to these Regulations, the IRS made the following comment:

"The proposed regulations provide a special rule for a corporation having a shareholder who has a legal life estate or usufruct interest in the stock. The proposed regulations provide requirements for such shareholder to qualify as an eligible shareholder. Upon further consideration by the IRS and Treasury, the final Regulations remove this special rule from the proposed regulations. The issue will be addressed in other published guidance."

Letter Ruling 200247030 discussed the situation where a life estate was created under a decedent's will. Under the provisions of the will, the life tenant had the right to income but no right to invade or make disposition of any part of the principal. He could sell, transfer, or assign the property for purposes of administering it only, and for that purpose he could invest or reinvest the property and any proceeds in investments deemed advisable provided the principal remains intact. The taxpayer represented that under state law, a life tenant with the power to sell or dispose of property devised to him or her for life with remainder to designated persons is a trustee or quasi-trustee and occupies a fiduciary relationship to the remaindermen. In the exercise of that power, the life tenant owes to the remaindermen the highest duty to act honorably and in good faith. A life tenant is a trustee in the sense that he cannot injure or dispose of property to the injury of the rights of the remaindermen, but differs from a pure trustee in that he may use property for his exclusive benefit and take all income and profits. It was further represented that if the arrangement created under the will with respect to the stock of the corporation is treated as a trust then the arrange-
QUALIFYING AN S CORPORATION

A QSST election would satisfy the requirements of a qualified Subchapter S trust (QSST) under Section 1361(d)(3).

Based on the facts presented in the ruling request and provided that the life tenant makes a timely QSST election, the IRS concluded that the arrangement created under the will may be treated as a QSST, and the QSST may be a permitted shareholder of the S corporation. The ruling was based on the information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement. The IRS did not verify any of the material submitted in support of the ruling request and pointed out that it is subject to verification on examination.

TAX-EXEMPT ORGANIZATIONS

For tax years beginning after December 31, 1997, the Small Business Job Protection Act of 1996 permits certain tax-exempt organizations to be shareholders of S corporations. Under Section 1361(c)(6) an organization that is described in Section 401(a) or 501(c)(3) and is exempt from tax under Section 501(a) may be a shareholder in an S corporation. The committee reports indicate that a qualified tax-exempt shareholder will count as one shareholder in determining the number-of-shareholders test for the number of shareholders described in ¶104. Section 401(a) includes qualified stock bonus, pension, and profit sharing plans of an employer for the exclusive benefit of its employees or their beneficiaries. It does not include an individual retirement account (IRA) described in Section 408. It does include an employee stock ownership plan (ESOP) described in Section 409 because an ESOP is a defined contribution plan which meets the requirements of Section 401(a) that is designed to invest primarily in employer securities. See ¶103.4.

The American Jobs Creation Act of 2004 created an exception to the general rule. It allows an IRA (including a Roth IRA) to be a shareholder of a bank that is an S corporation, but only to the extent of bank stock held by the IRA on the date of enactment, October 22, 2004. The Act also provides an exemption from the prohibited transaction rules for the sale by an IRA to its beneficiary of bank stock held on the date of enactment if the following conditions are met:

1. The sale is pursuant to an S corporation election by the bank;
2. The sale is for fair market value (as established by an independent appraiser) and is on terms at least as favorable to the IRA as the terms would be on a sale to an unrelated party;
3. The IRA incurs no commissions, costs, or other expenses in connection with the sale; and
4. The stock is sold in a single transaction for cash not later than 120 days after the S corporation election is made.

The general rule is that the items of income or loss of an S corporation will flow through to a qualified tax-exempt shareholder as unrelated business taxable income (UBTI) subject to the unrelated business income tax (UBIT), regardless of the source or nature of the income or loss. Thus, even dividends and interest received by an S corporation that flow through to the qualified tax-exempt shareholder will be taxed as UBTI. In addition, gain or loss on the sale or other disposition of the stock of an S corporation held by a qualified tax-exempt shareholder will be treated as UBTI. An exception to the UBIT rules applies to employee stock ownership plans.

In Letter Ruling 200122034, the IRS ruled that a company’s Subchapter S election will not terminate under the circumstances described below. The corporation had formed an employee stock ownership plan (ESOP) that owned some of its shares. The terms of the ESOP provide that distributions can be made to plan participants in the form of cash or corporation stock, but while the corporation has a Subchapter S election in effect, the corporation must immediately repurchase any distributed stock. The terms of the ESOP also provide that every participant who receives a distribution can direct that the distribution be paid in a direct rollover to an Individual Retirement Account (IRA) or to another qualified retirement plan as required in Section 401(a)(31). Alternatively, a participant who receives and sells company stock to the company may, within 60 days, roll the sale proceeds over to an IRA or a qualified retirement plan in an “indirect rollover.” In the case of a stock distribution, the participant or the participant’s IRA or plan custodian or trustee will complete an irrevocable stock transfer form that identifies the number of shares and the dollar value of these shares to be sold back to the corporation immediately following the distribution from the ESOP. The corporation prepares a stock certificate and a check for each distributee and the stock certificate is retired once the check is mailed. Because the stock distribution and the repurchase of the stock occur on the same day, the stock certificate never leaves the corporation’s premises. The corporation represents that by monitoring the timing of stock distributions from the ESOP, it can insure that it will never have more than 75 shareholders. The IRS held that in the case of a direct rollover of stock, the momentary designation of the custodian of the IRA as the owner of the stock will not cause the corporation’s Subchapter S election to terminate, provided that the stock is immediately repurchased by the company using the procedure described above. See also Letter Ruling 200240038.

After several private letter rulings similar to the ones above, the IRS issued Rev. Proc. 2003-23, 2003-11 IRB 599. The revenue procedure indicated that it is consistent with the purposes of, and policies underlying,
employee stock ownership plans (ESOPs) to enable an ESOP to rollover distributions of S corporation stock to an individual retirement plan (IRA) in accordance with a distributee's election without terminating the corporation's Subchapter S election. Accordingly, if the requirements of the revenue procedure are satisfied, the IRS will not treat a corporation's Subchapter S election as terminated when an ESOP distributes stock of that corporation to a participant's IRA in a direct rollover.

The criteria were further expanded by Rev. Proc. 2004-14, 2004-7 IRB 489 (2/17/04), which modified and superseded Rev. Proc. 2003-23. Under the previous revenue procedure, the S corporation was required to actually repurchase the S corporation stock contemporaneously with, and effective on the same day as, the distribution. In the new revenue procedure, an additional choice is added. Now, either the S corporation can actually repurchase the stock, or, the ESOP can assume the S corporation's rights and obligations to repurchase this stock. In order to qualify for such treatment under the new revenue procedure, the following factors must be present:

1. The terms of the ESOP require that the S corporation repurchase its stock immediately upon the ESOP's distribution of the stock to an IRA;
2. Either, pursuant to the terms of the ESOP, the S corporation actually repurchases the S corporation stock contemporaneously with, and effective on the same day as, the distribution, or, pursuant to the terms of the ESOP, the ESOP is permitted to assume the rights and obligations of the S corporation to repurchase the S corporation stock immediately upon the ESOP's distribution of the stock to an IRA and the ESOP actually repurchases the S corporation stock contemporaneously with, and effective on the same day as, the distribution; and
3. No income (including tax-exempt income), loss, deduction, or credit attributable to the distributed S corporation stock under Section 1366 is allocated to the participant's IRA.

Thus, it will no longer be necessary to apply for a private letter ruling in such situations and taxpayers will not be required to pay a private letter ruling user fee.
¶1007 TAX RETURN REPORTING REQUIREMENTS FOR GRANTOR TRUSTS AND QSSTs OWNING S CORPORATION STOCK

Code Section 1361(b)(1)(B) provides that trusts described in Code Section 1361(c)(2) may be shareholders of Subchapter S corporations. Code Section 1361(c)(2)(A)(i) and Reg. §1.1361-1(h)(1)(i) provide that a qualified Subpart E trust is a permitted shareholder of S corporation stock (see ¶105.3). Under the provisions of Subpart E (Sections 671 and following), Part I, Subchapter J, Chapter 1 of the Internal Revenue Code, one or more persons (either the grantor or another person or persons) would be treated as the deemed owner of the assets owned by the trust for income tax purposes. A different rule is applicable for estate and gift tax purposes (see Code Sections 2036, 2037, and 2038). A person who is treated as the deemed owner of all of the assets of a trust for income tax purposes must report all items of income, deduction, and credit attributable to the trust on that person’s income tax return.

Code Section 1361(d)(i) and Reg. §1.1361-1(h)(1)(iii) permit a qualified Subchapter S trust (QSST) to be treated as a qualified Subpart E trust and thus to be a shareholder of an S corporation if the beneficiary makes a special election (see ¶105.3). Under these rules, the beneficiary is treated as the deemed owner of only that portion of the QSST that consists of S corporation stock. In such cases, the portion of the trust consisting of S corporation stock is treated as a qualified Subpart E trust.

¶1007.1 Reporting for Qualified Subpart E Trusts

The qualified Subpart E trust, as indicated in ¶105.3, is one in which the grantor or one or more other persons are treated as the deemed owners of
all of the trust assets for income tax purposes. These trusts are sometimes referred to as grantor type trusts, even when someone other than the grantor is treated as the deemed owner of the trust property.

Reg. §1.671-4, as amended in final form on December 20, 1995, provides a general rule and also alternative methods for income tax reporting by some of these trusts. This revision is effective for taxable years beginning on or after January 1, 1996.

**General Rule:** Under the general rule, set forth in Reg. §1.671-4(a), all items of income, deduction, and credit attributable to any portion of the trust which is treated as owned by the grantor or another person or persons are not reported on the trust’s Form 1041. Instead, they are shown on a separate statement attached to that form. Only the trust’s name, address, and taxpayer identification number are listed on Form 1041. The box at the top-left-hand corner of the form entitled “Grantor type trust” is to be checked. All items of income, deductions, and credit are shown on a separate statement with the name, address, and identification number of the deemed owner or owners on whose income tax return or returns these items will be reported.

**Alternatives:** Certain of these grantor-type trusts have the option to use one of the methods described below. However, pursuant to Reg. §1.671-4(b)(6) the alternative methods are not available to certain trusts. These include, among others, the following:

1. A trust that has its situs or any of its assets located outside the United States;
2. A trust that is a QSST; and
3. A trust all of which is treated as owned by one person whose taxable year is a fiscal year.

For purposes of Reg. §1.671-4(b), a trust all of which is owned by a husband and wife who file a joint return for the taxable year is considered to be owned by one person.

**Alternative A—A Trust All of Which Is Treated as Owned by One Person:** If the person treated as the owner of the trust provided the trustee with a completed Form W-9 or acceptable substitute, signed under the penalties of perjury, Reg. §1.671-4(b) provides that the trustee may use this alternative. If this alternative is used, all payors must be furnished with the name and taxpayer identification number (TIN) of the deemed owner of the trust, but with the address of the trust. For purposes of the regulations, the term “payor” is defined as anyone who is required by the Internal Revenue Code or the regulations to make any type of information return (i.e., Form 1099 or Schedule K-1) with respect to the trust for the taxable year, including middlemen. In addition, if the deemed owner of the trust is not a trustee or a co-trustee, then the trustee must furnish that person with a statement that:
1. Shows all items of income, deduction, and credit of the trust for the taxable year;
2. Identifies the payor of each item of income, deduction, and credit;
3. Provides the deemed owner with the information necessary to take the items into account in computing such person's taxable income; and
4. Informs the deemed owner of the trust that the items of income, deduction, and credit and other information shown on the statement must be included in computing the taxable income and credits of that person on that person's income tax return.

When Alternative A is used, the trustee is not required to file any type of return with the IRS.

Alternative B—A Trust All of Which Is Treated as Owned by One Person: Under this alternative, the trustee furnishes the name, TIN, and address of the trust to all payors during the taxable year. When this method is followed, the trustee is obligated to file with the IRS all appropriate Forms 1099, reporting the income or gross proceeds paid to the trust during the taxable year, and showing the trust as the payor and the person who is treated as the owner of the trust as the payee of such items. The trustee has the same obligations for filing the appropriate Forms 1099 as would any payor making reportable payments, except that the trustee reports each type of income in the aggregate, and each item of gross proceeds separately. In addition, if the person treated as the deemed owner of the trust is not trustee or co-trustee of the trust, the trustee must furnish that person with a statement that:

1. Shows all items of income, deduction, and credit of the trust for the taxable year;
2. Provides the deemed owner of the trust with the information necessary to take the items into account in computing the person's taxable income; and
3. Informs the deemed owner of the trust that the items of income, deduction, and credit and other information shown on the statement must be included in computing the taxable income and credits of that person.

By furnishing that statement to the deemed owner, the trustee satisfies the obligation to furnish statements to recipients with respect to the Forms 1099 filed by the trustee.

Alternative C—A Trust All of Which Is Treated as Owned by Two or More Persons: Reg. §1.671-4(b)(3) provides an alternative for a trust, all of which is treated as owned by two or more persons. Under this method, the trustee must furnish the name, TIN, and address of the trust to all payors for the taxable year. In addition, the trustee must file with the IRS the appropriate Forms 1099, reporting the items of income paid to the trust by
all payors during the taxable year attributable to the portion of the trust treated as owned by each deemed owner. The Forms 1099 must show the trust as the payor and each person treated as a deemed owner of the trust as a payee. The trustee has the same obligations for filing the appropriate Forms 1099 as would any payor making reportable payments, except that the trustee must report each type of income in the aggregate and each item of gross proceeds separately. The amounts required to be included on the Forms 1099 and filed by the trustee do not include any amounts that are reportable by a payor on an information return other than Form 1099. This means that the trust's distributive share of income and gain from an S corporation is not includible on any Forms 1099 because the distributive share is reportable by the S corporation on Schedule K-1 (Form 1120S) and not on Form 1099.

In addition to filing the Forms 1099, the trustee must also furnish each person treated as a deemed owner of the trust with a statement that:

1. Shows all items of income, deduction, and credit of the trust for the taxable year attributable to the portion of the trust treated as owned by that person;
2. Provides each person treated as a deemed owner of the trust with the information necessary to take the items into account in computing that person's taxable income; and
3. Informs each deemed owner of the trust that the items of income, deduction, and credit and other information shown on the statement must be included in computing the taxable income and credits of that person on that person's income tax return.

By furnishing the above statement to each deemed owner, the trustee satisfies the obligation to furnish statements to recipients with respect to the Forms 1099 filed by the trustee, except for any backup withholding requirements imposed by Section 3406.

§ 1007.2 Reporting for Qualified Subchapter S Trusts

Under the prior version of Reg. §1.671-4, if a person was the deemed owner of the trust and a trustee, Form 1041 was not filed at all; the deemed owner furnished his or her social security number to payors and reported all items of income and the like on his or her tax return.

Before the revision of Reg. §1.671-4 in December of 1995, however, there was some confusion about the proper income tax reporting for QSSTs. Two methods were generally used, although no authority indicated which was correct.

Before the New Regulations: Under the first method, the Schedule K-1 (Form 1120S) showed the name, address, and social security number of the
beneficiary of the QSST. A copy of the Schedule K-1 was sent to the trustee and to the beneficiary. The beneficiary reported the Subchapter S items on his or her income tax return and, if the S corporation stock was the only asset of the QSST, the trustee did not even file a Form 1041.

Under the second method, the Schedule K-1 of the S corporation showed the name, address, and taxpayer identification number of the trust. The trustee filed a Form 1041 for a grantor-type trust, with a schedule showing all of the income, deductions, credits, and the like, from the S corporation that the beneficiary was required to report on his or her income tax return. A copy of this was furnished to the beneficiary, so that he or she would have knowledge of the items to report.

Current Situation: In view of the recent revision of Reg. §1.671-4, there seems to only one permissible method for reporting with respect to an S corporation that has a QSST as a shareholder. That would be only under the general rule.

As indicated above, the portion of the QSST that consists of S corporation stock is treated as a qualified Subpart E trust. Thus, the grantor-type trust rules discussed above would seem to be applicable to the S corporation portion of the trust, or to the entire trust if its only asset is the stock of an S corporation.

Under Reg. §1.671-4(b)(6)(iii), a QSST may not use the alternative methods discussed above. Thus, absent some other guidance from the IRS, the general rule of Reg. §1.671-4(a) would apply. In that case, the portion of the trust that consists of S corporation stock would reflect all of its items of income, deduction, and credit attributable to the S corporation on a separate statement attached to the Form 1041 and not on the Form 1041 itself.

Reg. §301.6109-1(a)(2), also amended in final form on December 20, 1995, provides that if the trustee has not already obtained a TIN for the trust, the trustee must obtain a TIN in order to report under the general rule of Reg. §1.671-4(a).

Summary: Under the present version of Reg. §1.671-4, the method of reporting for QSSTs must follow the general rule for grantor-type trusts. Other grantor-type trusts may be eligible for alternative methods of reporting. These may be summarized in the following table:

<table>
<thead>
<tr>
<th>GRANTOR TYPE TRUSTS METHODS OF REPORTING—REG. §1.671-4</th>
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<tr>
<td><strong>Trust with One Deemed Owner (Other Than a QSST):</strong></td>
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<tr>
<td>General rule</td>
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<tr>
<td>Alternative A</td>
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10:38
Alternative B
1. Furnish payors with name, ID #, and address of trust.
2. File Forms 1099.

Trust with Two or More Deemed Owners (QSSTs Cannot Have More Than One Beneficiary):
General rule
File Form 1041 with a schedule showing all items of income, etc., attached to the return.
Alternative C
1. Furnish payors with name, ID #, and address of trust.
2. File Forms 1099.

Qualified Subchapter S Trust:
General rule
File Form 1041 with a schedule showing all items of income, etc., attached to the return.