

Notice of Proposed Rulemaking

Qualified Subchapter S Trust Election for Testamentary Trusts

REG-106431-01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to a qualified subchapter S trust election for testamentary trusts under section 1361 of the Internal Revenue Code. The Small Business Job Protection Act of 1996 and the Taxpayer Relief Act of 1997 made changes to the applicable law. These proposed regulations affect S corporations and their shareholders.

DATES: Written or electronic comments and requests for a public hearing must be received by November 23, 2001.

ADDRESSES: Send submissions to: CC:IT&A:RU (REG-106431-01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:IT&A:RU (REG-106431-01), Courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at <http://www.irs.gov/taxregs/regslst.html>.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Deane M. Burke (202) 622-3070; concerning submissions of comments, Sonya Cruse (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document proposes to amend section 1361 of the Income Tax Regulations

(26 CFR part 1) regarding a qualified subchapter S trust (QSST) election for testamentary trusts.

Section 1361(a) defines an S corporation as a small business corporation for which an election under section 1362(a) is in effect for the year. Section 1361(b) provides, in part, that a small business corporation is a domestic corporation which is not an ineligible corporation and which does not have as a shareholder a person (other than a trust described in section 1361(c)(2)) who is not an individual. Under section 1361(c)(2), subpart E trusts and testamentary trusts are permitted S corporation shareholders. A qualified subpart E trust is a trust, all of which is treated (under subpart E of part I of subchapter J, chapter 1) as owned by an individual who is a citizen or resident of the United States. A qualified subpart E trust that continues in existence after the death of the deemed owner (former qualified subpart E trust) is a permitted shareholder, but only for the 2-year period beginning on the day of the deemed owner's death. A testamentary trust is a trust to which S corporation stock is transferred pursuant to the terms of a will, but only for the 2-year period beginning on the day the stock is transferred to it.

Section 1303 of the Small Business Job Protection Act of 1996, Public Law 104-188 (110 Stat. 1779) (August 20, 1996) (1996 Act) amended section 1361 for taxable years beginning after December 31, 1996. Prior to the 1996 Act, a former qualified subpart E trust was a permitted shareholder for a 60-day period beginning on the day of the deemed owner's death. However, if the entire corpus of the trust was includible in the gross estate of the deemed owner, the trust was a permitted shareholder for a 2-year period beginning on the day of the deemed owner's death. Under the regulations, special rules applied if the trust consisted of community property. A testamentary trust was a permitted shareholder of an S corporation for a 60-day period beginning on the day that the S corporation stock was transferred to the trust.

After the 1996 Act, both a testamentary trust and a former qualified subpart E trust, whether or not the entire corpus is included in the deemed owner's gross estate, are permitted shareholders for a

2-year period. Because the entire corpus of a former qualified subpart E trust is not required to be included in the deemed owner's estate, it is no longer relevant whether the trust consists of community property for purposes of the trust's qualifying as a permitted shareholder for a 2-year period. However, whether a former qualified subpart E trust consists of community property is still relevant for purposes of determining the shareholders of S corporation stock held by the trust.

Explanation of Provisions

A. Incorporation of Changes from the 1996 Act

The proposed regulations incorporate changes from the 1996 Act regarding section 1361 to provide that a testamentary trust may be a permitted shareholder for a 2-year period. The proposed regulations also provide that a former qualified subpart E trust is a permitted shareholder for a 2-year period whether or not the entire corpus is included in the deemed owner's gross estate. The proposed regulations thus eliminate the special rules for determining whether trusts consisting of community property qualify for the 2-year period.

The proposed regulations also incorporate additional changes made to section 1361 by the 1996 Act. Section 1302 of the 1996 Act added a new type of trust, the electing small business trusts (ESBTs), to the types of trusts permitted to be S corporation shareholders under section 1361(c)(2). Section 1601(c) of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 1086) (August 5, 1997) made technical amendments to section 1361 affecting ESBTs and S corporation shareholders. A notice of proposed rulemaking (REG-251701-96, 2001-4 I.R.B. 396) regarding ESBTs was published in the **Federal Register** (65 FR 82963) on December 29, 2000. The proposed regulations refer to ESBTs and provide that certain former qualified subpart E trusts and testamentary trusts can continue as permitted shareholders after the end of the 2-year period by becoming ESBTs.

Section 1316 of the 1996 Act allowed certain exempt organizations to be S cor-

poration shareholders for taxable years beginning after December 31, 1997, and section 1301 increased the number of permissible S corporation shareholders from 35 to 75. The proposed amendments incorporate these additional changes.

B. QSST Election for Testamentary Trusts

Section 1.1361-1(j)(6)(iii)(C) of the Income Tax Regulations provides guidance regarding when a QSST election is made for a former qualified subpart E trust that also satisfies the requirements of a QSST. Under the provision, a QSST election may be made for a former qualified subpart E trust at any time, but no later than the end of the 16-day-and-2-month period beginning on the date on which the estate of the deemed owner ceases to be treated as a shareholder (as late as the end of the 2-year period). Thus, a former qualified subpart E trust can continue as a permitted shareholder after the end of the 2-year period by electing to be a QSST.

Section 1.1361-1(h)(3)(ii)(B) provides that if a testamentary trust continues to own S corporation stock after the expiration of the 60-day period (now 2-year period), the corporation's S election will terminate unless the trust otherwise qualifies as a permitted shareholder. The trust otherwise qualifies as a permitted shareholder if it satisfies the requirements of a QSST under section 1361(d)(3) and the trust income beneficiary makes a timely QSST election under section 1361(d)(2). The regulations, promulgated before 1996, do not address when a QSST election may be made for a testamentary trust during its 2-year period as a permitted shareholder. The IRS and the Treasury Department believe that the regulations should provide guidance similar to that for former qualified subpart E trusts clarifying when an income beneficiary of a testamentary trust may make a QSST election.

Accordingly, the proposed regulations clarify that a current income beneficiary of a testamentary trust that satisfies the QSST requirements may make a QSST election at any time during the 2-year period that the trust is a permitted shareholder or the 16-day-and-2-month period beginning on the date after the 2-year period ends. Under this provision, a testamentary trust continues as a permitted

shareholder after the end of the 2-year period by becoming an electing QSST. Once the trust becomes an electing QSST, the beneficiary is treated as the shareholder of the S corporation as of the effective date of the QSST election.

Proposed Effective Date

The regulations are proposed to apply on and after the date that final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. It also has been determined that section 533(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Request for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic and written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and the Treasury Department specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Deane M. Burke, Office of the Associate Chief Counsel (Pass-throughs & Special Industries). However,

other personnel from the IRS and the Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.1361-1 is amended as follows:

1. Revising paragraphs (b)(1)(ii), (f), (h)(1)(ii), (h)(1)(iv), (h)(3)(i)(B), and (h)(3)(i)(D). The undesignated paragraph following (h)(3)(i)(B) is removed.

2. Revising the second sentence of paragraph (h)(3)(ii)(A).

3. Revising paragraphs (h)(3)(ii)(B) and (j)(6)(iii)(C).

4. Redesignating paragraph (j)(6)(iii)(D) as paragraph (j)(6)(iii)(E).

5. Adding new paragraph (j)(6)(iii)(D).

6. Revising paragraph (j)(7)(ii).

7. Revising the fourth sentence of paragraph (k)(1) *Example 2*(ii).

8. Revising paragraph (k)(1) *Examples 3 and 4*(iii).

9. Adding a sentence to the end of paragraph (k)(2)(i).

The revisions and additions read as follows:

§1.1361-1 S corporation defined.

* * * * *

(b)* * *(1)* * *

(ii) As a shareholder, a person (other than an estate, a trust described in section 1361(c)(2), or, for taxable years beginning after December 31, 1997, an organization described in section 1361(c)(6)) who is not an individual;

* * * * *

(f) *Shareholder must be an individual or estate.* Except as otherwise provided in paragraph (e)(1) of this section (relating to nominees), paragraph (h) of this section (relating to certain trusts), and, for taxable years beginning after December 31, 1997, section 1361(c)(6) (relating to certain exempt organizations), a corporation in which any shareholder is a corporation, partnership, or trust does not qualify as a small business corporation.

* * * * *

(h) * * * (1) * * *

(ii) *Subpart E trust ceasing to be a qualified subpart E trust after the death of deemed owner.* A trust which was a qualified subpart E trust immediately before the death of the deemed owner and which continues in existence after the death of the deemed owner, but only for the 2-year period beginning on the day of the deemed owner's death. A trust is considered to continue in existence if the trust continues to hold the stock of the S corporation during the period of administration of the decedent's estate or if, after the period of administration, the trust continues to hold the stock pursuant to the terms of the will or the trust agreement. See §1.641(b)-3 for rules concerning the termination of estates and trusts for federal income tax purposes.

* * * * *

(iv) *Testamentary trusts.* A trust (other than a qualified subpart E trust, an electing QSST, or an electing small business trust (ESBT)) to which S corporation stock is transferred pursuant to the terms of a will, but only for the 2-year period beginning on the day the stock is transferred to the trust.

* * * * *

(3) * * *

(i) * * *

(B) If stock is held by a trust defined in paragraph (h)(1)(ii) of this section, the estate of the deemed owner is generally treated 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 ordinarily will cease to be treated as the shareholder upon the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day of the deemed owner's death. If the trust qualifies and becomes an electing QSST, the beneficiary and not the estate is treated as the shareholder as of the effective date of the QSST election, and the rules provided in paragraph (j)(7) of this section apply. If the trust qualifies and becomes an ESBT, the shareholders

are determined under provisions of REG-251701-96 in 2001-4 I.R.B. 396 (see §601.601(d)(2) of this chapter) as of the effective date of the ESBT election.

* * * * *

(D) If stock is transferred to a testamentary trust described in paragraph (h)(1)(iv) of this section (other than a qualified subpart E trust, an electing QSST, or an ESBT), the estate of the testator is treated as the shareholder until the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day that the stock is transferred to the trust. If the trust qualifies and becomes an electing QSST, the beneficiary and not the estate is treated as the shareholder as of the effective date of the QSST election, and the rules provided in paragraph (j)(7) of this section apply. If the trust qualifies and becomes an ESBT, the shareholders are determined under provisions of REG-251701-96 in 2001-4 I.R.B. 396 (see §601.601(d)(2) of this chapter) as of the effective date of the ESBT election.

* * * * *

(ii) * * *

(A) * * * If the trust continues to own the stock after the expiration of the 2-year period, the corporation's S election will terminate unless the trust is otherwise a permitted shareholder. * * *

(B) If stock is transferred to a testamentary trust described in paragraph (h)(1)(iv) of this section (other than a qualified subpart E trust, an electing QSST, or an ESBT), the trust is treated as the shareholder. If the trust continues to own the stock after the expiration of the 2-year period, the corporation's S election will terminate unless the trust otherwise qualifies as a permitted shareholder. If the trust qualifies as a QSST described in section 1361(d) and the income beneficiary of the trust makes a timely QSST election, the beneficiary and not the trust is treated as the shareholder from the effective date of the QSST election.

* * * * *

(j) * * *

(6) * * *

(iii) * * *

(C) If a trust ceases to be a qualified subpart E trust but also satisfies the requirements of a QSST, 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. If the estate of the deemed owner of the trust is treated as the shareholder under paragraph (h)(3)(i) of this section, the QSST election may be filed at any time, but no later than the end of the 16-day-and-2-month period beginning on the date on which the estate of the deemed owner ceases to be treated as a shareholder.

(D) If a testamentary trust is a permitted shareholder under paragraph (h)(1)(iv) of this section and also satisfies the requirements of a QSST, the QSST election may be filed at any time, but no later than the end of the 16-day-and-2-month period beginning on the date after the end of the 2-year period.

* * * * *

(7) * * *

(ii) If, upon the death of an income beneficiary, the trust continues in existence, continues to hold S corporation stock but no longer satisfies the QSST requirements, and is not a qualified subpart E trust, then, solely for purposes of section 1361(b)(1), as of the date of the income beneficiary's death, the estate of that income beneficiary is treated as the shareholder of the S corporation with respect to which the income beneficiary made the QSST election. The estate ordinarily will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day of the income beneficiary's death. During the period that the estate is treated as the shareholder for purposes of section 1361(b)(1), the trust is treated as the shareholder for purposes of sections 1366, 1367, and 1368. If, after the 2-year period, the trust continues to hold S corporation stock, the corporation's S election terminates. If the termination is inadvertent, the corporation may request relief under section 1362(f).

* * * * *

(k)(1) * * *

Example 2. * * *

(ii) * * * A's estate will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of the Corporation M stock by the trust (other than to A's estate), the expiration of the 2-year period beginning on the day of A's death, or the effective date of a QSST election if the trust qualifies as a QSST. * * *

* * * * *

Example 3. 2-year rule under section 1361(c)(2)(A)(ii) and (iii). F owns stock of Corpo-

ration P, an S corporation. In addition, F is the deemed owner of a qualified subpart E trust that holds stock in Corporation O, an S corporation. F dies on July 1, 2001. The trust continues in existence after F's death but is no longer a qualified subpart E trust. On August 1, 2001, F's shares of stock in Corporation P are transferred to the trust pursuant to the terms of F's will. Because the stock of Corporation P was not held by the trust when F died, section 1361(c)(2)(A)(ii) does not apply with respect to that stock. Under section 1361(c)(2)(A)(iii), the last day on which F's estate could be treated as a permitted shareholder of Corporation P is July 31, 2003, (that is, the last day of the 2-year period that begins on the date of the transfer from the estate to the trust). With respect to the shares of stock in Corporation O held by the trust at the time of F's death, section 1361(c)(2)(A)(ii) applies and the last day on which F's estate could be treated as a permitted shareholder of Corporation O is June 30, 2003, (that is, the last day of the 2-year period that begins on the date of F's death).

Example 4. * * *

(iii) *QSST when a person other than the current income beneficiary may receive trust corpus.* Assume the same facts as in paragraph (i) of this *Example 4*, except that H dies on November 1, 2001. Under the terms of the trust, after H's death, L is the income beneficiary of the trust and the trustee is au-

thorized to distribute trust corpus to L as well as to J. The trust ceases to be a QSST as of November 1, 2001, because corpus distributions may be made to someone other than L, the current (successive) income beneficiary. Under section 1361(c)(2)(B)(ii), H's estate (and not the trust) is considered to be the shareholder for purposes of section 1361(b)(1) for the 2-year period beginning on November 1, 2001. However, because the trust continues in existence after H's death and will receive any distributions from the corporation, the trust (and not H's estate) is treated as the shareholder for purposes of sections 1366, 1367, and 1368, during that 2-year period. After the 2-year period, the S election terminates and the trust continues as a shareholder of a C corporation. If the termination is inadvertent, Corporation Q may request relief under section 1362(f). However, the S election would not terminate if the trustee distributed all Corporation Q shares to L, J, or both before October 31, 2003 (the last day of the 2-year period), assuming that neither L nor J becomes the 76th shareholder of Corporation Q as a result of the distribution.

* * * * *

(2)* * *(i)* * * In addition, paragraphs (h)(1)(ii), (h)(1)(iv), (h)(3)(i)(B), (h)(3)(i)(D), (h)(3)(ii)(A) second sentence, (h)(3)(ii)(B), (j)(6)(iii)(C),

(j)(6)(iii)(D), (j)(7)(ii), and (k)(1) *Example 2(ii)* fourth sentence, *Example 3*, and *Example 4(iii)* of this section apply on and after the date that final regulations are published in the **Federal Register**.

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Robert E. Wenzel,
*Deputy Commissioner
of Internal Revenue.*

(Filed by the Office of the Federal Register on August 23, 2001, 8:45 a.m. and published in the issue of the Federal Register for August 24, 2001, 66 F.R. 44565)