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DEPARTMENT OF THE TREASURY

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Internal Revenue Service

26 CFR Part 1

TD 9078

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Qualified Subchapter S Trust Election for Testamentary Trusts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final 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. The final regulations affect S corporations and their shareholders.

DATES: Effective Date: These regulations are effective July 17, 2003.

Applicability Date: For dates of applicability of these regulations, see §1.1361-1(k)(2)(i) and (ii).

FOR FURTHER INFORMATION CONTACT: Concerning the final regulations, Deane M. Burke, (202) 622-3070 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document amends section 1361 of the Income Tax Regulations (26 CFR part 1) regarding a qualified subchapter S trust (QSST) election for testamentary trusts and the definition of testamentary trusts.

On August 24, 2001, a notice of proposed rulemaking (REG-106431-01, 2001-2 C.B. 272) relating to QSST elections for testamentary trusts and the period for which former qualified subpart E trusts and testamentary trusts may be permitted shareholders under section 1361 was published in the **Federal Register** (66 FR 44565). No public hearing was requested. Comments responding to the proposed regulations were received. After consideration of the comments, the proposed regulations are adopted as revised by this Treasury decision.

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 that is not an ineligible corporation and that does not have as a shareholder a person (other than an estate, a trust described in section 1361(c)(2), or an organization described in section 1361(c)(6)) who is not an individual. Under section 1361(c)(2), qualified 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 the trust.

Summary of Comments and Explanation of Provisions

These final regulations are substantially the same as the proposed regulations, but reflect certain revisions based on the comments that were received. The revisions are discussed below.

The proposed regulations provide that a former qualified subpart E trust is a permitted shareholder of an S corporation for the 2-year period beginning on the day of the deemed owner's death. In addition, the proposed regulations provide that a testamentary trust is also a permitted shareholder of an S corporation for the 2-year period beginning on the day the stock is transferred to the testamentary trust. If a former qualified subpart E trust or a testamentary trust continues to own stock after the expiration of the 2-year period during which it is a permitted shareholder, the corporation's S election will terminate unless the trust otherwise qualifies as a permitted shareholder. The trust might otherwise qualify as a permitted shareholder if, for example, the trust is a QSST that has an election under section 1361(d)(2) in effect at the end of the 2-year period (an electing QSST).

One commentator suggested that certain sections of the proposed regulations should be clarified because those sections indicate that if a former qualified subpart E trust or a testamentary trust continues to own stock of an S corporation after the 2-year period and is not otherwise a qualified subpart E trust or an electing QSST, the trust is not a permitted shareholder. The commentator noted that a former qualified subpart E trust or a testamentary trust that continues to own stock after the 2-year period could also be a

permitted shareholder if the trust is an electing small business trust (ESBT) at the end of the 2-year period. The sections of the proposed regulations for which the commentator suggested clarification, however, address rules regarding QSSTs. Section 1.1361-1(m) of the Income Tax Regulations addresses rules regarding ESBTs. The final regulations clarify that if a former qualified subpart E trust or a testamentary trust continues to own stock of an S corporation after the 2-year period and is not otherwise a qualified subpart E trust, an electing QSST, or an ESBT, the trust is not a permitted shareholder. Additionally, the final regulations clarify that a QSST or an ESBT election may be made for a former qualified subpart E trust or a testamentary trust that qualifies as a QSST or an ESBT.

Another commentator suggested that after August 5, 1997, the effective date of section 645, a testamentary trust should also include a trust that receives S corporation stock from a qualified revocable trust for which an election under section 645 has been made (an electing trust). Under section 645, an electing trust is treated and taxed as part of the decedent's estate (and not as a separate trust) for purposes of subtitle A of the Code for all taxable years of the estate during the section 645 election period. The section 645 election period begins on the date of the decedent's death and generally terminates on the day before the applicable date described in section 645(b)(2). Section 1.645-1(h)(1) provides that on the close of the last day of the election period the share comprising the electing trust is deemed to be distributed to a new trust.

Thus, according to the commentator, the final regulations should clarify that testamentary trusts include trusts to which S corporation stock is transferred pursuant to the terms of the electing trust during the section 645 election period as well as new trusts

to which S corporation stock is deemed to be distributed at the end of the section 645 election period. The commentator noted that the purpose of section 645 is to create parity between electing trusts and wills. In furtherance of this purpose, the commentator reasoned that if an electing trust transfers or is deemed to distribute S corporation stock to a new trust, the new trust should be a permitted shareholder for the 2-year period beginning on the day the stock is transferred or deemed distributed to the new trust. The final regulations adopt the commentator's suggestion to clarify that a testamentary trust also includes a trust that receives S corporation stock from an electing trust.

The IRS is considering issuing guidance on whether a trust that has a QSST or an ESBT election in effect may make an election under section 645.

Effective Date

Except where otherwise specifically provided, these final regulations are applicable on and after July 17, 2003. In addition, the IRS will not challenge the treatment of certain testamentary trusts that receive S corporation stock from an electing trust under section 645 as permitted shareholders of the S corporation for periods after August 5, 1997, and before the earlier of July 17, 2003, or the effective date of any QSST or ESBT election for the trust.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. 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, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Deane M. Burke, Office of the Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is 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. Paragraphs (b)(1)(ii), (f), (h)(1)(ii), (h)(1)(iv), (h)(3)(i)(B), (h)(3)(i)(D), (h)(3)(ii)(A), (h)(3)(ii)(B), (j)(6)(iii)(C), (j)(7)(ii), the fourth and last sentences of paragraph (k)(1) Example 2(ii), (k)(1) Examples 3 and 4(iii), and (k)(2)(i) are revised.

2. The undesignated paragraph following paragraph (h)(3)(i)(B) is removed.

3. Paragraph (j)(6)(iii)(D) is redesignated as paragraph (j)(6)(iii)(E).
4. New paragraph (j)(6)(iii)(D) is added.
5. Paragraph (k)(2)(ii) is redesignated as paragraph (k)(2)(iii).
6. New paragraph (k)(2)(ii) is added.

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 that was a qualified subpart E trust immediately before the death

of the deemed owner and that 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 pursuant to the terms of the will or the trust agreement, or if the trust continues to hold the stock during a period reasonably necessary to wind up the affairs of the trust. See §1.641(b)-3 for rules concerning the termination of 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) to which S corporation stock is—

(A) 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 except as otherwise provided in paragraph (h)(3)(i)(D) of this section; or

(B) Transferred pursuant to the terms of an electing trust as defined in §1.645-1(b)(2) during the election period as defined in §1.645-1(b)(6), or deemed to be distributed at the close of the last day of the election period pursuant to §1.645-1(h)(1), but in each case only for the 2-year period beginning on the day the stock is transferred or deemed distributed to the trust except as otherwise provided in paragraph (h)(3)(i)(D) of this section.

* * * * *

(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 the 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 paragraphs (h)(3)(i)(F) and (h)(3)(ii) of this section as of the effective date of the ESBT election, and the rules provided in paragraph (m) of this section apply.

* * * * *

(D) If stock is transferred or deemed distributed 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 or deemed distributed 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 paragraphs (h)(3)(i)(F) and (h)(3)(ii) of this section as

of the effective date of the ESBT election, and the rules provided in paragraph (m) of this section apply.

* * * * *

(ii)* * *

(A) If stock is held by a trust as defined in paragraph (h)(1)(ii) of this section (other than 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 is otherwise a permitted shareholder.

(B) If stock is transferred or deemed distributed 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.

* * * * *

(j)* * *

(6)* * *

(iii)* * *

(C) If a trust ceases to be a qualified subpart E trust, satisfies the requirements of a QSST, and intends to become 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, satisfies the requirements of a QSST, and intends to become 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 day 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, is not a qualified subpart E trust, and does not qualify as an ESBT, 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 and does not otherwise qualify as a permitted shareholder, 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 or ESBT election if the trust qualifies as a QSST or ESBT.* * * If no QSST or ESBT election is made effective upon the expiration of the 2-year period, the corporation ceases to be an S corporation, but the trust continues as the shareholder of a C corporation.

* * * * *

Example 3.(i) 2-year rule under section 1361(c)(2)(A)(ii) and (iii). F owns stock of Corporation 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, 2003. The trust continues in existence after F's death but is no longer a qualified subpart E trust. On August 1, 2003, 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 the trust could be treated as a permitted shareholder of Corporation P is July 31, 2005 (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 the trust could be treated as a permitted shareholder of Corporation O is June 30, 2005 (that is, the last day of the 2-year period that begins on the date of F's death).

(ii) Section 645 electing trust and successor trust. Assume the same facts as in paragraph (i) of this Example 3, except that F's trust is a qualified revocable trust for which a valid section 645 election is made on October 1, 2003 (electing trust). Because under section 645 the electing trust is treated and taxed for purposes of subtitle A of the Code as part of F's estate, the trust may continue to hold the O stock pursuant to §1361(b)(1)(B), without causing the termination of Corporation O's S election, for the duration of the section 645 election period. However, on January 1, 2004, during the election period, the shares of stock in Corporation O are transferred pursuant to the terms of the electing trust to a successor trust. Because the successor trust satisfies the definition of a testamentary trust under paragraph (h)(1)(iv) of this section, the successor trust is a permitted shareholder until the earlier of the expiration of the 2-year period beginning on January 1, 2004, or the effective date of a QSST or ESBT election for the successor trust.

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 the events occur in 2003 and H dies on November 1, 2003, and the trust does not qualify as an ESBT. Under the terms of the trust, after H's death, L is the income beneficiary of the trust and the trustee is authorized to distribute trust corpus to L as well as to J. The trust ceases to be a QSST as of November 1, 2003, 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, 2003. 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 on or before October 31, 2005, (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 general. Paragraph (a) of this section, and paragraphs (c) through (k) of this section (as contained in the 26 CFR edition revised April 1, 2003) apply to taxable years of a corporation beginning after July 21, 1995. For taxable years beginning on or before July 21, 1995, to which paragraph (a) of this section and paragraphs (c) through (k) of this section (as contained in the 26 CFR edition revised April 1, 2003) do not apply, see §18.1361-1 of this chapter (as contained in the 26 CFR edition revised April 1, 1995). However, paragraphs (h)(1)(vi), (h)(3)(i)(F), (h)(3)(ii), and (j)(12) of this section (as contained in the 26 CFR edition revised April 1, 2003) are applicable for taxable years beginning on and after May 14, 2002. Otherwise, paragraphs (b)(1)(ii), (f), (h)(1)(ii), (h)(1)(iv), (h)(3)(i)(B), (h)(3)(i)(D), (h)(3)(ii)(A), (h)(3)(ii)(B), (j)(6)(iii)(C), (j)(6)(iii)(D), (j)(7)(ii),

and (k)(1) Example 2(ii) fourth and last sentences, Example 3, and Example 4(iii) of this section apply on and after July 17, 2003.

(ii) Transition rules. Taxpayers may apply paragraph (h)(1)(iv)(B) of this section on and after December 24, 2002, and before July 17, 2003, to treat a trust as a testamentary trust, but not during any period for which a QSST or ESBT election was in effect for the trust. In addition, the Internal Revenue Service will not challenge the treatment of a trust described in paragraph (h)(1)(iv)(B) of this section as a permitted shareholder of an S corporation for periods after August 5, 1997, and before the earlier of July 17, 2003, or the effective date of any QSST or ESBT election for that trust.

* * * * *

Deputy Commissioner for Services and Enforcement.

Approved:

Assistant Secretary of the Treasury.