

# Electing Small Business Trusts

## Notice 97-49

### BACKGROUND

Section 1302 of the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (1996), amended § 1361 of the Internal Revenue Code to permit an electing small business trust (ESBT) to be a shareholder of an S corporation. This notice provides guidance regarding the definitions of beneficiary and potential current beneficiary under §§ 1361(e)(1)(A)(i) and 1361(e)(2) respectively, and the ordering of ESBT distributions under § 641(d).

Only a corporation that meets the definition of a small business corporation may be an S corporation. To be a small business corporation, the corporation may have as shareholders only those persons permitted by § 1361(b)(1), including trusts described in § 1361(c)(2). Section 1361(c)(2) contains two separate provisions. The first provision is a requirement that the trust holding stock in the corporation must be a trust listed in § 1361(c)(2)(A) (e.g., ESBT, qualified subchapter S trust, etc.). Under the second provision, the respective persons listed in § 1361(c)(2)(B) are treated as shareholders of the S corporation for purposes of the shareholder restrictions under § 1361(b)(1). To qualify as an ESBT (an eligible trust under § 1361(c)(2)(A)(v)), a trust must meet the requirements set forth in § 1361(e)(1) (including the limitation on the types of beneficiaries). Pursuant to § 1361(c)(2)(B)(v), the ESBT's potential current beneficiaries (as defined in § 1361(e)(2)) must be qualifying shareholders of the S corporation for purposes of § 1361(b)(1).

As used in this notice, the term "distributee trust" means a trust that is receiving or may receive a distribution from an intended ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred.

### ESBT BENEFICIARIES

Section 1361(e)(1)(A)(i) provides that an ESBT may not have as a beneficiary any

person other than (I) an individual, (II) an estate, or (III) an organization described in paragraph (2), (3), (4), or (5) of section 170(c), which holds a contingent interest and is not a potential current beneficiary. For tax years beginning after December 31, 1997, the clause "which holds a contingent interest and is not a potential current beneficiary" is deleted. Section 1361(e) does not provide a specific definition of the term "beneficiary".

Solely for purposes of section 1361(e)(1)(A)(i), the following rules apply in defining the term "beneficiary":

1. The term "beneficiary" does not include a distributee trust (other than a trust described in paragraphs (2) or (3) of § 170(c)), but does include those persons who have a beneficial interest in the property held by the distributee trust. For example, an intended ESBT's governing instrument provides for discretionary distributions of income or principal to A for life, and upon A's death the division of the remainder into separate trusts for the benefit of A's children. For purposes of § 1361(e)(1)(A)(i), the beneficiaries of the intended ESBT are A and A's children, and not the separate trusts for the benefit of A's children. Therefore, because all the beneficiaries of the intended ESBT are individuals, the intended ESBT meets the requirements of § 1361(e)(1)(A)(i).

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 actually 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 a State has under its laws pertaining to escheat would be considered negligible, and the State would not be considered a beneficiary of the intended ESBT.

### ESBT POTENTIAL CURRENT BENEFICIARIES

Section 1361(c)(2)(B)(v) provides that each potential current beneficiary of an ESBT shall be treated as a shareholder for

purposes of determining whether a corporation qualifies as a small business corporation, except that the trust is treated as the shareholder for any period in which there is no potential current beneficiary.

Section 1361(e)(2) provides that, for purposes of § 1361, the term "potential current beneficiary" means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. Section 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 § 1361, the following rules apply in defining the term "potential current beneficiary":

1. If a distributee trust becomes entitled to, or at the discretion of any person may receive, a distribution from principal or income of the intended ESBT, then the S corporation election will terminate unless the distributee trust is a trust described in § 1361(c)(2)(A) (e.g., ESBT, qualified subchapter S trust, etc.). In addition, if the distributee trust is a trust described in § 1361(c)(2)(A), the persons described in § 1361(c)(2)(B) are treated as shareholders of the corporation for purposes of determining whether the shareholder restrictions under § 1361(b)(1) are met. In the above example 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 (i) the distributee trusts are trusts described in § 1361(c)(2)(A), and (ii) the persons described in § 1361(c)(2)(B), with respect to the distributee trusts, satisfy the shareholder restrictions in § 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 are treated as shareholders of the corporation for purposes of satisfying the shareholder restrictions under § 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 such event. Whether a person to whom a distribution is or may be made during a period pursuant to a power of appointment is a potential current beneficiary is currently under study.

## **ESBT DISTRIBUTIONS**

Section 641(d)(1) provides that the portion of an ESBT that consists of stock in one or more S corporations (“S portion”) is taxed as a separate trust. Section 641(d)(2)(C) specifies that the only items of income, loss, deduction, or credit to be taken into account by the S portion (“S portion items”) are (i) the items required to be taken into account under § 1366; (ii) any gain or loss from the disposition of stock in an S corporation; and (iii) to the extent provided in regulations, State or

local income taxes or administrative expenses to the extent allocable to items described in clauses (i) and (ii).

Section 641(d)(3) provides that the S portion items are excluded for purposes of determining the amount of tax on the portion of the trust that is not treated as a separate trust under § 641(d)(1) (“non-S portion”) and are excluded in determining the distributable net income (DNI) of the entire trust. Section 641(d)(3) also provides that, except as otherwise provided, § 641(d) does not affect the taxation of any distribution from the trust.

Guidance has been requested on the treatment of distributions from an ESBT when the trust has fiduciary accounting income in both the S portion and the non-S portion of the trust. Section 641(d)(3) specifically provides that, except as otherwise specified, § 641(d) does not change the taxation of any distribution from the trust. Because the S portion items are not

included in the computation of the ESBT’s 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 (e.g., capital gains and losses allocated to corpus). For example, for the tax year an ESBT has \$40 of DNI from the non-S portion and \$70 of net fiduciary accounting income from the S portion. If the ESBT makes a distribution of \$100, the distribution includes \$40 of DNI.

## **DRAFTING INFORMATION**

The principal author of this notice is Steven R. Schneider of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice contact Steven R. Schneider at (202) 622-3060 (not a toll-free call).