

**Notice of Proposed Rulemaking;  
Notice of Proposed Rulemaking  
by Cross Reference to  
Temporary Regulations; and  
Notice of Public Hearing**

**Electing Small Business Trust**

**REG-251701-96**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking; notice of proposed rulemaking by cross reference to temporary regulations; and notice of public hearing.

**SUMMARY:** This document contains proposed regulations relating to the qualification and treatment of electing small business trusts (ESBTs). The proposed regulations interpret the rules added to the Internal Revenue Code (Code) by section 1302 of the Small Business Job Protection Act of 1996 and section 1601 of the Taxpayer Relief Act of 1997. In addition, the text of the temporary regulations published in T.D. 8915, page 359, also serves as the text of these proposed regulations with respect to an ESBT or a trust described in section 401(a) or section 501(c)(3) that is exempt from taxation under section 501(a) not being treated as a deferral entity for purposes of §1.444-2T. The proposed regulations affect S corporations and certain trusts that own S corporation stock. This document also provides notice of a public hearing on these regulations.

**DATES:** Written or electronic comments must be received by April 4, 2001. Requests to speak (with outlines of oral comments to be discussed) at a public hearing scheduled for April 25, 2001, at 10 a.m. must be received by April 4, 2001.

**ADDRESSES:** Send submissions to: CC:M&SP:RU (REG-251701-96), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG-251701-96), 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/tax\\_regs/regslst.html](http://www.irs.gov/tax_regs/regslst.html). The public hearing will be held in the Internal Revenue Building Auditorium, 1111 Constitution Avenue, NW., Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Concerning the proposed regulations, Bradford Poston or James A. Quinn, (202) 622-3060; concerning submissions and the hearing, Sonya M. Cruz, (202) 622-7190; (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

**Paperwork Reduction Act**

The collections of information in this notice of proposed rulemaking have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control numbers 1545-1523 and 1545-1591.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

**Background**

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) relating to S corporations and electing small business trusts (ESBTs). Section 1302 of the Small Business Job Protection Act of 1996, Public Law 104-188 (110 Stat. 1755) (August 20, 1996) (the 1996 Act), amended sections 641 and 1361 of the Code to permit an ESBT to be an S corporation shareholder. Further amendments were made to section 1361(e) by the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 1601(c)(1)) (August 5, 1997). Prior section 641(d) was redesignated as

section 641(c) by the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105-206 (112 Stat. 6007(f)(2)) (July 22, 1998).

**Explanation of Provisions**

*Overview*

Prior to the 1996 Act, the only trusts that were permitted S corporation shareholders were wholly-owned grantor trusts, voting trusts, certain grantor trusts after the grantor's death, and qualified subchapter S trusts (QSSTs). These trusts are not taxed at the trust level, and the deemed owner or owners are taxed directly on the tax items of the trusts, except for certain testamentary trusts described in §1.1361-1(j)(7)(ii). QSSTs are required to have a single income beneficiary, and all of the income must be currently distributed to such beneficiary. The 1996 Act created ESBTs to allow more flexibility in the types of trusts that are permitted S corporation shareholders and, in particular, to facilitate family financial planning. H. Rep. No. 586, 104<sup>th</sup> Cong., 2d Sess. 82 (1996), S. Rep. No. 281, 104<sup>th</sup> Cong., 2d Sess. 46 (1996). Unlike a QSST, an ESBT may have multiple beneficiaries and may also accumulate trust income.

Section 1361(e)(1) defines the term *electing small business trust* as any trust if: (1) the trust does not have as a beneficiary any person other than an individual, an estate, or an organization described in section 170(c)(2) through (5); (2) no interest in the trust was acquired by purchase; and (3) an election has been made with respect to the trust.

Section 1361(c)(2)(B)(v) provides that, for purposes of section 1361(b)(1) (the S corporation shareholder limitations), each potential current beneficiary of an ESBT will be treated as a shareholder. During any period that there is no potential current beneficiary of an ESBT, the trust shall be treated as the shareholder.

*ESBT Beneficiaries*

Notice 97-49 (1997-2 C.B. 304) clarifies the definitions of beneficiary (for purposes of section 1361(e)(1)(A)(i)) and potential current beneficiary (for purposes of section 1361(e)(2)) and also clarifies

the treatment of ESBT distributions. The proposed regulations, when finalized, will modify and replace the rules of Notice 97-49.

### *Beneficiary*

The proposed regulations provide guidance as to who is an ESBT beneficiary. Generally, a beneficiary includes any person who has a present, remainder, or reversionary interest in the trust other than a remote, contingent interest. If an ESBT makes distributions to another trust (the distributee trust), the distributee trust is not treated as a beneficiary of the ESBT. However, the beneficiaries of the distributee trust will be counted as beneficiaries of the ESBT. Persons whose future beneficial interest is so remote as to be negligible are not beneficiaries. Generally, when the probability that a person will receive any distribution from the trust is less than 5 percent, at a particular time, that person's interest would be so remote as to be negligible. Finally, the term *beneficiary* does not include a person in whose favor a power of appointment may be exercised until the power is actually exercised.

### *Interests Acquired by Purchase*

The proposed regulations provide guidance regarding the prohibition on acquiring an interest in an ESBT by purchase. The proposed regulations provide that the prohibition applies if any portion of a beneficiary's basis in the beneficiary's interest is determined under section 1012. Thus, a part-gift, part-sale of a beneficial interest will terminate the trust's status as an ESBT. Beneficiaries may not purchase interests in the trust, but the ESBT itself is allowed to purchase S corporation stock.

### *Grantor Trusts*

The proposed regulations provide that a trust, all or a portion of which is treated as owned by an individual under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code (Code) (a grantor trust), may elect to be an ESBT. The Treasury Department and the IRS believe that Congress did not intend to preclude this type of trust, which is a common family estate planning tool, from electing ESBT status. The proposed regulations

provide rules for the treatment of grantor trusts electing ESBT status.

### *Potential Current Beneficiaries*

The proposed regulations provide that 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. In general, a person who may receive a distribution from the ESBT under a currently exercisable power of appointment is a potential current beneficiary. In addition, in the case of an ESBT that is a grantor trust, the proposed regulations provide that the deemed owner of the grantor trust is also to be treated as a potential current beneficiary.

Under the definitions set forth in the proposed regulations, a potential current beneficiary is not necessarily a beneficiary of the trust and vice versa. For example, a person in whose favor property could currently be appointed, but to whom no such appointment has been made, is a potential current beneficiary, but not a beneficiary. Conversely, a person who is a non-contingent remainder beneficiary of a non-grantor trust is a beneficiary, but not a potential current beneficiary.

The proposed regulations provide special rules if current distributions can be made to a distributee trust. If the distributee trust does not qualify to be a shareholder of an S corporation under section 1361(c)(2)(A), then the trust is considered the potential current beneficiary and thus a shareholder. In that case, the corporation's S election terminates because the corporation has an ineligible shareholder. For this purpose, a trust is deemed to qualify to be a shareholder of an S corporation under section 1361(c)(2)(A) if it would be eligible to make a QSST or ESBT election if it owned S corporation stock.

If the distributee trust does qualify to be a shareholder of an S corporation under section 1361(c)(2)(A), in general, the potential current beneficiaries of the distributing ESBT will include the potential current beneficiaries of the distributee trust. However, if the distributee trust is a former grantor trust prior to the owner's death (that is, a trust described in section 1361(c)(2)(A)(ii)), or is a trust receiving a

distribution of S stock from a decedent's estate (that is, a trust described in section 1361(c)(2)(A)(iii)), the estate of the decedent is treated as the only potential current beneficiary of the trust. In no case will the same person be counted twice when determining the number of S corporation shareholders.

### *ESBT Election*

Notice 97-12 (1997-1 C.B. 385) provides the procedures for making the ESBT election. Under that notice, the ESBT election is required to contain certain information and representations, and is required to be filed with the service center where the S corporation files its income tax returns. These proposed regulations, when finalized, will modify and replace the rules in Notice 97-12.

Under the proposed regulations, the trustee of an ESBT makes a single ESBT election by filing a statement with the service center where the ESBT files its Form 1041, *U.S. Income Tax Return for Estates and Trusts*. This procedure will be more convenient for taxpayers than the procedures of Notice 97-12 if the ESBT holds stock in more than one S corporation. No trust documents are required to be attached to the election statement.

The proposed regulations provide that if a trust satisfies the ESBT requirements and makes an ESBT election, the trust will be treated as an ESBT for federal income tax purposes as of the effective date of the ESBT election. These effective dates generally follow the rules of §1.1361-1(j)(6)(iii) for qualified subchapter S trust (QSST) elections. Protective ESBT elections, which are intended to become effective only if the trust fails to satisfy the requirements for a trust described in section 1361(c)(2)(A)(i) through (iv), are prohibited. Unlike a protective QSST election, a protective ESBT election could result in a change in the incidence of taxation from the owner of the trust to the trust itself. If a trust fails to qualify as an eligible S corporation shareholder under section 1361(c)(2), and consequently the S corporation election is ineffective or terminated, relief may be available under section 1362(f) for an inadvertent ineffective S corporation election or an inadvertent S corporation termination.

## *Conversions of QSSTs and ESBTs*

Rev. Proc. 98-23 (1998-1 C.B. 662) provides procedures for the conversion of a QSST to an ESBT and an ESBT to a QSST. The proposed regulations, when finalized, will modify and replace the procedures of Rev. Proc. 98-23 and provide rules with respect to these conversions.

The conversion procedure provided in the proposed regulations differs from that provided in Rev. Proc. 98-23, in that the election must be filed with the service center where the trust files its income tax return, as well as with the service center where the S corporation files its income tax return. The election must be filed in both service centers if the service center for the trust is different from the service center for the S corporation because QSST elections are filed with the service center where the S corporation files its income tax return and ESBT elections will be filed where the trust files its income tax return under the new procedures set forth in these proposed regulations, when finalized. The IRS and the Treasury Department specifically request comments on whether the rules for filing QSST elections similarly should be changed to permit the filing of a QSST election with the service center where the trust files its return rather than with the service center for the S corporation(s).

### *Consent to the S Corporation Election*

Notice 97-12 provides that, for purposes of the ESBT's consent to the S corporation election under section 1362(a), only the trustee needs to consent to the S corporation election because the ESBT is taxed on the S corporation's income and the trustee makes the ESBT election. These proposed regulations, when finalized, will modify and replace the rules in Notice 97-12.

Under the proposed regulations, if the ESBT is also a grantor trust, the deemed owner must also consent to the S corporation election because such owner will be taxed on all or a portion of the S corporation's income. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must consent to the S corporation election.

### *ESBT Taxation*

The proposed regulations provide that, for federal income tax purposes, an ESBT

consists of an S portion, a non-S portion, and in some instances a grantor portion. The items of income, deduction, and credit attributable to any portion of the ESBT treated as owned by a person under the grantor trust rules of subpart E, including S corporation stock and other property (the grantor portion), are taken into account on that individual's tax return pursuant to the normal rules applicable to grantor trusts. Other items of income, deduction, and credit are, pursuant to these proposed regulations, attributed to either the S portion, which includes the S corporation stock, or the non-S portion, which includes all other assets of the trust. The S portion is subject to tax under the special rules of section 641(c), while the non-S portion is subject to the normal trust taxation rules of subparts A through D of subchapter J.

The proposed regulations provide that if an otherwise allowable deduction of the S portion is attributable to a charitable contribution paid by the S corporation, the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1). The other requirements of section 642(c)(1) must also be met for the contribution to be deductible by the S portion, and the deduction is limited to the amount of the gross income of the S portion. If a payment is made to a charitable organization by the ESBT pursuant to the terms of its governing instrument, such payment is deductible, subject to the provisions of section 642(c)(1), to the extent it is paid from the gross income of the non-S portion of the trust. Thus, if the ESBT contributes S corporation stock to a charitable organization, no deduction is allowed under section 642(c)(1) because the contribution is not paid out of the gross income of the non-S portion.

The proposed regulations provide guidance regarding the treatment of proceeds received by an ESBT from the sale of S corporation stock when income from the sale is reported on the installment method under section 453. The income recognized with respect to the installment proceeds is taken into account by the S portion. The interest on the installment obligation is taken into account by the non-S portion.

The proposed regulations provide that if a trust holds S corporation stock and is

already an eligible S corporation shareholder and the trust makes an ESBT election during the trust's taxable year, the electing trust will be treated as a separate taxpayer for purposes of allocating S corporation items under section 1377(a)(1). However, the ESBT election does not result in the prior trust being treated as terminating its entire interest in its S corporation stock for purposes of §1.1377-1(b), unless the prior trust is one described in section 1361(c)(2)(A)(ii) or (iii). Therefore, the S corporation is generally not permitted to make the election to terminate the taxable year under section 1377(a)(2). The trust will be treated as a single taxpayer for purposes of determining the taxation of distributions from the trust. Thus, distributions made after the effective date of the ESBT election may still carry out distributable net income of the trust earned during the taxable year before the effective date of the ESBT election.

The proposed regulations provide that for purposes of determining whether the exception to estimated taxes under section 6654(d)(1)(B) applies, the trust will not be considered a different taxpayer as a result of the ESBT election. Therefore, if the ESBT makes estimated tax payments equal to 100 percent of the prior year's tax liability, no penalties will apply.

The proposed regulations provide that interest expenses paid on loans used to purchase the S corporation stock must be allocated to the S portion of the ESBT but are not deductible by the S portion because they are not administrative expenses.

### *ESBT Terminations*

The proposed regulations provide that generally a trustee must seek the consent of the Commissioner to revoke its ESBT election by obtaining a private letter ruling. However, the Commissioner's consent is granted for revocations that occur on the conversion of an ESBT to a QSST under the procedures set forth in the proposed regulations.

The proposed regulations provide that if an ESBT fails to meet the definitional requirements of an ESBT under section 1361(e), the trust's ESBT status terminates immediately upon such failure to qualify. However, if an ESBT acquires an ineligible potential current beneficia-

ry, the ESBT has 60 days in which to dispose of all of its S corporation stock to prevent termination of the S corporation election. If the S corporation stock is not disposed of within the 60-day period, then the S corporation election will terminate as of the first day that the ineligible person became a potential current beneficiary.

Finally, the proposed regulations provide that an ESBT election generally is terminated if the ESBT fails to hold any S corporation stock. However, a trust will continue to be treated as an ESBT if it is reporting income from the sale of S corporation stock under the installment method of section 453.

#### *Section 444 Elections*

The text of the temporary regulations published in T.D. 8915 serves as the text of these proposed regulations with respect to an ESBT and a trust described in section 401(a) or section 501(c)(3) that is exempt from taxation under section 501(a). These temporary regulations provide that an ESBT and a trust described in section 401(a) or section 501(c)(3) that is exempt from taxation under section 501(a) are not deferral entities for purposes of §1.444-2T.

#### **Proposed Effective Date**

The regulations regarding ESBTs under §1.641-1(d) through (k), §1.1361-1(h)-(1)(vi), (h)(3)(i)(F), (j)(12), and (m), §1.1362-6(b)(2)(iv), §1.1377-1(a)(2)(iii) and (c) *Example 3* are proposed to apply on and after the date the final regulations are published in the **Federal Register**. The IRS and the Treasury Department have become aware of potentially abusive transactions involving ESBTs that assume the applicability of the rules of section 641(c) to the taxation of the grantor portion of such trusts. See Notice 2000-61, 2000-49 I.R.B. 1. Thus, the regulations regarding taxation of ESBTs under §1.641(c)-1(a), (b) and (c) are proposed to be applicable for taxable years of ESBTs that end on and after the proposed regulations are filed in the **Federal Register**.

#### **Effect on Other Documents**

The following documents are proposed to be superseded as of the date the final

regulations are published in the **Federal Register**:

Notice 97-12 (1997-1 C.B. 385).

Notice 97-49 (1997-2 C.B. 304).

Rev. Proc. 98-23 (1998-1 C.B. 662).

#### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in the regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the estimated average burden per trust in complying with the collections of information in §1.1361-1(m) is 1 hour. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the 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 Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are timely submitted to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 25, 2001, at 10:00 a.m. in the Internal Revenue Building Auditorium, 1111 Constitution Avenue NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by April 4, 2001, and submit an outline of the topics to be discussed and

the time to be devoted to each topic (signed original and eight (8) copies) by April 4, 2001.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

#### **Drafting Information**

The principal authors of these regulations are Bradford Poston and James A. Quinn of the Office of Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

#### **Proposed Amendments to the Regulations**

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

#### **PART I—INCOME TAXES**

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

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

Section 1.444-4 is also issued under 26 U.S.C. 444(g).

Par. 2. Section 1.444-4 is added to read as follows:

#### *§1.444-4 Tiered structure.*

[The text of this proposed section is the same as the text of §1.444-4T published T.D. 8915].

Par. 3. Sections 1.641(c)-0 and 1.641(c)-1 are added to read as follows:

#### *§ 1.641(c)-0 Table of contents.*

This section lists the following captions contained in §1.641(c)-1:

#### *§1.641(c)-1 Electing small business trust.*

- (a) In general.
- (b) Definitions.
  - (1) Grantor portion.
  - (2) S portion.
  - (3) Non-S portion.
- (c) Taxation of grantor portion.

(d) Taxation of S portion.

(1) In general.

(2) Section 1366 amounts.

(3) Gains and losses on disposition of S stock.

(4) State and local income taxes and administrative expenses.

(e) Tax rates and exemption of S portion.

(1) Income tax rate.

(2) Alternative minimum tax exemption.

(f) Taxation of non-S portion.

(1) In general.

(2) Dividend income under section 1368(c)(2).

(3) Interest on installment obligations.

(4) Charitable deduction.

(g) Allocation of state and local income taxes and administration expenses.

(h) Treatment of distributions from the trust.

(i) Termination or revocation of ESBT election.

(j) Effective date.

(k) Examples.

#### § 1.641(c)-1 Electing small business trust.

(a) *In general.* An electing small business trust (ESBT) within the meaning of section 1361(e) is treated as two separate trusts for purposes of determining income tax. The portion of an ESBT that consists of stock in one or more S corporations (the S portion) is treated as one trust. The portion of an ESBT that consists of all the other assets in the trust is treated as a separate trust. The grantor or another person may be treated as the owner of all or a portion of either or both such trusts under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code. In addition, the non-S portion may consist of more than one share pursuant to section 663(c). See § 1.1361-1(m) for the treatment of an ESBT as a single trust for administrative purposes.

(b) *Definitions*—(1) *Grantor portion.* The grantor portion of an ESBT is the portion of the trust that is treated as owned by the grantor or another person under subpart E.

(2) *S portion.* The S portion of an ESBT is the portion of the trust that consists of S corporation stock and that is not treated as owned by the grantor or another

person under subpart E.

(3) *Non-S portion.* The non-S portion of an ESBT is the portion of the trust that consists of all assets other than S corporation stock and that is not treated as owned by the grantor or another person under subpart E.

(c) *Taxation of grantor portion.* The grantor or another person who is treated as the owner of a portion of the ESBT includes in computing taxable income items of income, deductions, and credits against tax attributable to that portion of the ESBT under section 671.

(d) *Taxation of S portion*—(1) *In general.* The taxable income of the S portion is determined by taking into account only the items of income, loss, deduction, or credit specified in paragraphs (d)(2), (3), and (4) of this section, to the extent not attributable to the grantor portion.

(2) *Section 1366 amounts*—(i) *In general.* The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Normal rules applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. See § 1.1361-1(m)(3)(iv) for allocation of those items in the taxable year in which the ESBT election is made if, before the effective date of the election, the trust was a shareholder of the S corporation.

(ii) *Special rule for charitable contributions.* If a deduction described in paragraph (d)(2)(i) of this section is attributable to a charitable contribution paid by the S corporation, the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1). The other requirements of section 642(c)(1) must also be met for the contribution to be deductible in computing the taxable income of the S portion. Such a deduction cannot exceed the amount of gross income of the S portion.

(iii) *Multiple S corporations.* If an ESBT owns stock in more than one S corporation, items of income, loss, deduction, or credit from all the S corporations are aggregated for purposes of determining the S portion's taxable income.

(3) *Gains and losses on disposition of S stock*—(i) *In general.* The S portion takes into account any gain or loss from the disposition of S corporation stock. No deduction is allowed under section 1211(b)(1) and (2) for capital losses that exceed capital gains.

(ii) *Installment method.* If income from the sale or disposition of stock in an S corporation is reported by the trust on the installment method, the income recognized under this method is taken into account by the S portion. See paragraph (f)(3) of this section for the treatment of interest on the installment obligation. See § 1.1361-1(m)(5)(ii) regarding treatment of a trust as an ESBT upon the sale of all S corporation stock using the installment method.

(iii) *Distributions in excess of basis.* Gain recognized under section 1368(b)(2) from distributions in excess of the ESBT's basis in its S corporation stock is taken into account by the S portion.

(4) *State and local income taxes and administrative expenses*—(i) *In general.* State and local income taxes and administrative expenses directly related to the S portion and those allocated to that portion in accordance with paragraph (g) are taken into account by the S portion.

(ii) *Special rule for certain interest.* Interest paid by the trust on money borrowed by the trust to purchase stock in an S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion.

(e) *Tax rates and exemption of S portion*—(1) *Income tax rate.* Except for capital gains, the highest marginal trust rate provided in section 1(e) is applied to the taxable income of the S portion. See section 1(h) for the rates that apply to the S portion's net capital gain.

(2) *Alternative minimum tax exemption.* The exemption amount of the S portion under section 55(d) is zero.

(f) *Taxation of non-S portion*—(1) *In general.* The taxable income of the non-S portion is determined by taking into account all items of income, deduction, and credit to the extent not taken into account by either the grantor portion or the S portion. The items attributable to the non-S portion are taxed under subparts A through D of part I, subchapter J, chapter 1 of the Internal Revenue Code.

(2) *Dividend income under section 1368(c)(2)*. Any dividend income within the meaning of section 1368(c)(2) is includible in the gross income of the non-S portion.

(3) *Interest on installment obligations*. If income from the sale or disposition of stock in an S corporation is reported by the trust on the installment method, the interest on the installment obligation is includible in the gross income of the non-S portion. See paragraph (d)(3)(ii) of this section for the treatment of income from such a sale or disposition.

(4) *Charitable deduction*. For purposes of applying section 642(c)(1) to payments made by the trust for a charitable purpose, the amount of gross income of the trust is limited to the gross income of the non-S portion. See paragraph (d)(2)(ii) of this section for special rules concerning charitable contributions paid by the S corporation that are deemed to be paid by the S portion.

(g) *Allocation of state and local income taxes and administration expenses*. Whenever state and local income taxes or administration expenses relate to more than one portion of an ESBT, they must be allocated between or among the portions to which they relate. These items may be allocated in any manner

that is reasonable in light of all the circumstances, including the terms of the governing instrument, local law, and the practice of the trustee with respect to the trust if it is reasonable and consistent. The taxes and expenses apportioned to each portion of the ESBT are taken into account by that portion.

(h) *Treatment of distributions from the trust*. Distributions to beneficiaries from the S portion or the non-S portion, including distributions of the S corporation stock, are deductible under section 651 or 661 in determining the taxable income of the non-S portion, and are included in the gross income of the beneficiaries under section 652 or 662. However, the amount of the deduction or inclusion cannot exceed the amount of the distributable net income of the non-S portion. Items taken into account by the grantor portion or the S portion are excluded for purposes of determining the distributable net income of the non-S portion of the trust.

(i) *Termination or revocation of ESBT election*. If the ESBT election of the trust terminates pursuant to §1.1361-1(m)(5) or the ESBT election is revoked pursuant to §1.1361-1(m)(6), the rules contained in this section are thereafter not applicable to the trust. If, upon termination or revocation, the S portion has a net operating

loss under section 172; a capital loss carryover under section 1212; or deductions in excess of gross income; then any such loss, carryover, or excess deductions shall be allowed as a deduction, in accordance with the regulations under section 642(h), to the trust, or to the beneficiaries succeeding to the property of the trust if the entire trust terminates.

(j) *Effective date*. This section generally is applicable on and after the date the final regulations are published in the **Federal Register**. However, paragraphs (a), (b) and (c) of this section are applicable for taxable years of ESBTs that end on and after December 28, 2000.

(k) *Examples*. The following examples illustrate the rules of this section:

*Example 1. Comprehensive example.* (i) Trust has a valid ESBT election in effect. Under section 678, B is treated as the owner of a portion of Trust consisting of a 10% undivided fractional interest in Trust. No other person is treated as the owner of any other portion of Trust under subpart E, part I, subchapter J. Trust owns stock in X, an S corporation, and in Y, a C corporation. During 2000, Trust receives a distribution from X of \$5,100, of which \$5,000 is applied against Trust's adjusted basis in the X stock in accordance with section 1368(c)(1) and \$100 is a dividend under section 1368(c)(2). Trust makes no distributions to its beneficiaries during the year.

(ii) For 2000, Trust has the following items of income and deduction:

Ordinary income attributable to X under section 1366Y	\$5,000
Dividend income from Y	\$900
Dividend from X representing C corporation earnings and profits	\$100
Total trust income	\$6,000
Charitable contributions attributable to X under section 1366	\$300
Trustee fees	\$200
State and local income taxes	\$100

(iii) Trust's items of income and deduction are divided into a grantor portion, an S portion, and a non-S portion for purposes of determining the taxation of those items. Income is allocated to each portion as follows:

<i>B</i> must take into account the items of income attributable to the grantor portion, that is, 10% of each item, as follows:	
Ordinary income from X	\$500
Dividend income from Y	\$90
Dividend income from X	\$10
Total grantor portion income	\$600
The total income of the S portion is \$4,500, determined as follows:	
Ordinary income from X	\$5,000
Less: Grantor portion	(\$500)
Total S portion income	\$4,500
The total income of the non-S portion is \$900 determined as follows:	
Dividend income from Y (less grantor portion)	\$810
Dividend income from X (less grantor portion)	\$90
Total non-S portion income	\$900

(iv) The administrative expenses and the state and local income taxes relate to all three portions and under state law would be allocated ratably to the \$6,000 of trust income. Thus, these items would be allocated 10% (600/6000) to the grantor portion, 75% (4500/6000) to the S portion and 15% (900/6000) to the non-S portion.

(v) *B* must take into account the following deductions attributable to the grantor portion of the trust:

Charitable contributions from X	\$30
---------------------------------	------

Trustee fees	\$20
State and local income taxes	\$10

(vi) The taxable income of the S portion is \$4,005, determined as follows:

Ordinary income from X	\$4,500
Less: Charitable contributions from X (less grantor portion)	(\$270)
75% of trustee fees	(\$150)
75% of state and local income taxes	(\$75)
Taxable income of S portion	\$4,005

(vii) The taxable income of the non-S portion is \$755, determined as follows:

Dividend income from Y	\$810
Dividend income from X	\$90
Total non-S portion income	\$900
Less: 15% of trustee fees	(\$30)
15% state and local income taxes	(\$15)
Personal exemption	(\$100)
Taxable income of non-S portion	\$755

*Example 2. Sale of S stock.* Trust has a valid ESBT election in effect and owns stock in X, an S corporation. No person is treated as the owner of any portion of Trust under subpart E, part I, subchapter J. In 2001, Trust sells all of its stock in X and recognizes a capital gain of \$5,000. This gain is taken into account by the S portion and is taxed using the appropriate capital gain rate found in section 1(h).

*Example 3. (i) Sale of S stock for an installment note.* Assume the same facts as in *Example 2*, except that Trust sells its stock in X for a \$400,000 installment note payable with stated interest over ten years. After the sale, Trust does not own any S corporation stock.

(ii) *Loss on installment sale.* Assume Trust's basis in its X stock was \$500,000. Therefore, Trust sustains a capital loss of \$100,000 on the sale. Upon the sale, the S portion terminates and the excess loss, after being netted against the other items taken into account by the S portion, is made available to the entire trust as provided in section 641(c)(4).

(iii) *Gain on installment sale.* Assume Trust's basis in its X stock was \$300,000 and that the \$100,000 gain will be recognized under the installment method of section 453. Interest income will be recognized annually as part of the installment payments. The portion of the \$100,000 gain recognized annually is taken into account by the S portion. However, the annual interest income is includible in the gross income of the non-S portion.

*Example 4. Charitable lead annuity trust.* Trust is a charitable lead annuity trust which is not treated as owned by the grantor or another person under subpart E. Trust acquires stock in X, an S corporation, and elects to be an ESBT. During the taxable year, pursuant to its terms, Trust pays \$10,000 to a section 170(c)(2) charitable organization. The non-S portion of Trust receives an income tax deduction for the charitable contribution under section 642(c) only to the extent the amount is paid out of the gross income of the non-S portion. To the extent the amount is paid from the S portion, no charitable deduction is available to the S portion.

*Example 5. ESBT distributions.* (i) As of January 1, 2000, Trust owns stock in X, a C corporation. No portion of Trust is treated as owned by the grantor or another person under subpart E. X elects to be an S corporation effective January 1, 2001, and Trust elects to be an ESBT effective January 1, 2001. For

2001, Trust's share of X's section 1366 items is \$5,000 of ordinary income. For the year, Trust has no other income and no expenses or state or local taxes. On February 1, 2001, X makes an \$8,000 distribution to Trust, of which \$3,000 is treated as a dividend from accumulated earnings and profits under section 1368(c)(2) and the remainder is applied against Trust's basis in the X stock under section 1368(b). The trustee of Trust makes a distribution of \$4,000 to Beneficiary during 2001.

(ii) For 2001, Trust has \$5,000 of taxable income in the S portion. This income is taxed to Trust at the maximum rate provided in section 1(e). Trust also has \$3,000 of distributable net income (DNI) in the non-S portion. The non-S portion of Trust receives a distribution deduction under section 661(a) of \$3,000, which represents the amount distributed to the beneficiary during the year (\$4,000), not to exceed the amount of DNI (\$3,000). The beneficiary must include this amount in gross income under section 662(a). As a result, the non-S portion has no taxable income.

Par. 4. Section 1.1361-0 is amended by adding entries for § 1.1361-1(j)(12) and (m) to read as follows:

§ 1.1361-0 Table of contents.

\*\*\*\*\*

§1.1361-1 S corporation defined.

\*\*\*\*\*

(j) \*\*\*

(12) Converting a QSST to an ESBT.

\*\*\*\*\*

(m) Electing small business trust (ESBT).

- (1) Definition.
- (2) ESBT election.
- (3) Effect of ESBT election.
- (4) Potential current beneficiaries.
- (5) ESBT terminations.
- (6) Revocation of ESBT election.
- (7) Converting an ESBT to a QSST.
- (8) Effective date.
- (9) Examples.

\*\*\*\*\*

Par. 5. Section 1.1361-1 is amended by:

1. Adding paragraphs (h)(1)(vi), (h)(3)(i)(F), and (j)(12).
2. Adding a sentence to the end of paragraph (k)(2)(i).
3. Adding paragraph (m).

The additions read as follows:

§ 1.1361-1 S corporation defined.

\*\*\*\*\*

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

(vi) *Electing small business trusts.* An electing small business trust (ESBT) under section 1361(e). See paragraph (m) of this section for rules concerning ESBTs including the manner of making the election to be an ESBT under section 1361(e)(3).

\*\*\*\*\* (3) \*\*\* (i) \*\*\*

(F) If S corporation stock is held by an ESBT, each potential current beneficiary is treated as a shareholder. However, if for any period there is no potential current beneficiary of the ESBT, the ESBT is treated as the shareholder during such period. See paragraph (m)(4) of this section for the definition of potential current beneficiary.

\*\*\*\*\*

(j) \*\*\*

(12) *Converting a QSST to an ESBT.* For a trust that wishes to convert from a QSST to an ESBT, the consent of the Commissioner is hereby granted to revoke the QSST election as of the effective date of the ESBT election, if all the following requirements are met:

(i) The trust meets all of the requirements to be an ESBT under paragraph (m)(1) of this section except for the

requirement under paragraph (m)(1)(iv)(A) of this section that the trust not have a QSST election in effect.

(ii) The trustee and the current income beneficiary of the trust sign the ESBT election. The ESBT election must be filed with the service center where the S corporation files its income tax return and also with the service center where the trust files its income tax return. This ESBT election must state at the top of the document “ATTENTION ENTITY CONTROL—CONVERSION OF A QSST TO AN ESBT PURSUANT TO SECTION 1.1361-1(j)” and include all information otherwise required for an ESBT election under paragraph (m)(2) of this section. A separate election must be made with respect to the stock of each S corporation held by the trust.

(iii) 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.

(iv) The date on which the ESBT election is to be effective cannot be more than 15 days and two months prior to the date on which the election is filed and cannot be 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 prior to the date on which the election is filed, it will be effective 15 days and two months prior to the date on which it is 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 it is filed.

(k) \* \* \*

(2) \* \* \* (i) \* \* \* Paragraphs (h)(1)(vi), (h)(3)(i)(F), and (j)(12) of this section are applicable on and after the date the final regulations are published in the **Federal Register**.

\* \* \* \* \*

(m) *Electing small business trust (ESBT)*—(1) *Definition*—(i) *General rule*. An electing small business trust (ESBT) means any trust if it meets the following requirements: the trust does not have as a beneficiary any person other than an individual, an estate, or an organization described in section 170(c)(2) through (5); no interest in the trust has been acquired by purchase; and the trustee of the trust makes a timely ESBT election for the trust.

(ii) *Qualified beneficiaries*—(A) *In general*. For purposes of this section, a beneficiary includes a person who has a present, remainder, or reversionary interest in the trust other than a remote, contingent interest within the meaning of paragraph (m)(1)(ii)(D) of this section.

(B) *Distributee trusts*. Any person who has a beneficial interest in a distributee trust is a beneficiary of the ESBT. However, if the distributee trust is an organization described in section 170(c)(2) or (3), the distributee trust itself is the beneficiary of the ESBT. A distributee trust is a trust that is receiving or may receive a distribution from an ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred.

(C) *Powers of appointment*. A person in whose favor a power of appointment could be exercised is not a beneficiary of an ESBT until the holder of the power of appointment actually exercises the power in favor of such person.

(D) *Remote beneficiaries*. A person whose interest in the trust is so remote as to be negligible is not a beneficiary of an ESBT. With respect to any portion of the trust, a person’s interest in either the corpus or the income therefrom is, at any time, so remote as to be negligible when the probability that such person will ever receive a distribution from the trust is less than 5 percent, taking into consideration the interests of other entities and other individuals living at that time.

(E) *Nonresident aliens*. A nonresident alien as defined in section 7701(b)(1)(B) is an eligible beneficiary of an ESBT. However, see paragraph (m)(5)(iii) of this section if the nonresident alien is a potential current beneficiary of the ESBT.

(iii) *Interests acquired by purchase*. A trust does not qualify as an ESBT if any interest in the trust has been acquired by purchase. If any portion of a beneficiary’s basis in the beneficiary’s interest in the trust is determined under section 1012, such interest has been acquired by purchase. The trust itself may acquire S corporation stock by purchase.

(iv) *Ineligible trusts*. An ESBT does not include—

(A) Any qualified subchapter S trust (as defined in section 1361(d)(3)) if an election under section 1361(d)(2) applies with

respect to any corporation the stock of which is held by the trust;

(B) Any trust exempt from tax or not subject to tax under subtitle A; or

(C) Any charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)).

(2) *ESBT election*—(i) *In general*. The trustee of the trust must make the ESBT election by signing and filing, with the service center where the trust files its income tax return, a statement that meets the requirements of paragraph (m)(2)(ii) of this section. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must sign the election statement. Only one ESBT election is made for the trust, regardless of the number of S corporations whose stock is held by the ESBT.

(ii) *Election statement*. The election statement must include—

(A) 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;

(B) An identification of the election as an ESBT election made under section 1361(e)(3);

(C) The first date on which the trust owned stock in each S corporation;

(D) 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

(E) Representations signed by the trustee stating that—

(I) The trust meets the definitional requirements of section 1361(e)(1); and

(2) All potential current beneficiaries of the trust meet the shareholder requirements of section 1361(b)(1).

(iii) *Due date for ESBT election*. The ESBT election must be filed within the time requirements prescribed in paragraph (j)(6)(ii) of this section for filing a qualified subchapter S trust (QSST) election. If the trust and the corporation file their tax returns with the same service center, the trustee may attach the ESBT election to the Form 2553, “*Election by a Small Business Corporation*,” in the case of a newly electing S corporation.

(iv) *Election by a trust described in section 1361(c)(2)(A)(ii) or (iii)*. A trust that is a qualified S corporation shareholder under section 1361(c)(2)(A)(ii) or (iii)

may elect ESBT treatment at any time during the 2-year period described in those sections or the 16-day-and-2-month period beginning on the date after the end of the 2-year period. If the trust makes an ineffective ESBT election, the trust will continue to qualify as an eligible S corporation shareholder for the remainder of the period described in section 1361(c)(2)(A)(ii) or (iii).

(v) *No protective election.* A trust cannot make a protective ESBT election that would be effective in the event the trust fails to meet the requirements for an eligible trust described in section 1361(c)(2)(A)(i) through (iv). If a trust attempts to make a protective ESBT election and fails to qualify as an eligible S corporation shareholder under section 1361(c)(2)(A)(i) through (iv), the S corporation election will be ineffective or will terminate because the corporation will have an ineligible shareholder. Relief may be available under section 1362(f) for an inadvertent ineffective S corporation election or an inadvertent S corporation election termination.

(3) *Effect of ESBT election—(i) General rule.* If a trust makes a valid ESBT election, the trust will be treated as an ESBT for purposes of chapter 1 of the Internal Revenue Code as of the effective date of the ESBT election.

(ii) *Employer Identification Number.* An ESBT has only one employer identification number (EIN). If an existing trust makes an ESBT election, the trust continues to use the EIN it currently uses.

(iii) *Taxable year.* If an ESBT election is effective on a day other than the first day of the trust's taxable year, the ESBT election does not cause the trust's taxable year to close. The trust files one tax return for the taxable year.

(iv) *Allocation of S corporation items.* If an ESBT election is effective on a day other than the first day of the trust's taxable year, and the trust held S corporation stock and was an eligible S corporation shareholder under section 1361(c)(2)(A)(i) through (iv) prior to the effective date of the ESBT election, the S corporation items are allocated between the two eligible trusts under section 1377(a). For purposes of section 1377(a), the first day the ESBT is a shareholder is the effective date of the ESBT election, and the last day the other trust is a shareholder is the day

before the effective date of the ESBT election. See § 1.1377-1(a)(2)(iii).

(v) *Estimated taxes.* If an ESBT election is effective on a day other than the first day of the trust's taxable year, the trust is considered one trust for purposes of estimated taxes under section 6654.

(4) *Potential current beneficiaries—(i) In general.* For purposes of determining whether a corporation is a small business corporation within the meaning of section 1361(b)(1), each potential current beneficiary of an ESBT generally is treated as a shareholder of the corporation. Subject to the provisions of this section (m)(4), a potential current beneficiary generally is, 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.

(ii) *Grantor trusts.* If all or a portion of an ESBT is treated as owned by a person under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code, such owner is a potential current beneficiary in addition to persons described in paragraph (m)(4)(i) of this section.

(iii) *Special rule for dispositions of stock.* Notwithstanding the provisions of paragraph (m)(4)(i) of this section, if a trust disposes of all of its S corporation stock, any person who first met the definition of a potential current beneficiary during the 60-day period ending on the date of such disposition is not a potential current beneficiary with respect to that corporation.

(iv) *Distributee trusts—(A) In general.* This paragraph (m)(4)(iv) contains the rules for determining who are the potential current beneficiaries of an ESBT 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. A distributee trust does not include a trust that is not currently in existence. For this purpose, a trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit. Thus, if a trust instrument provides for a trust to be funded at some future time, the future trust is not a distributee trust.

(B) If the distributee trust is not a trust described in section 1361(c)(2)(A), then the distributee trust is the potential current beneficiary of the ESBT and the corporation's S corporation election terminates.

(C) If the distributee trust is a trust described in section 1361(c)(2)(A), the persons who would be its potential current beneficiaries (as defined in paragraph (m)(4)(i) and (ii) of this section) if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT. Notwithstanding the preceding sentence, however, if the distributee trust is a trust described in section 1361(c)(2)(A)(ii) or (iii), the estate described in section 1361(c)(2)(B) (ii) or (iii) is treated as the potential current beneficiary of the ESBT for the 2-year period for which such trust is permitted as a shareholder.

(D) For the purposes of paragraph (m)(4)(iv)(C) of this section, a trust will be deemed to be described in section 1361(c)(2)(A) if such trust would be eligible to make a QSST election under section 1361(d) or an ESBT election under section 1361(e) if it owned S corporation stock.

(v) *Contingent distributions.* 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.

(vi) *Current powers of appointment.* A person to whom a distribution is or may be made during a period pursuant to a power of appointment is a potential current beneficiary. Thus, if any person has a general lifetime power of appointment over the trust, the corporation's S corporation election will terminate because the number of potential current beneficiaries will exceed the 75-shareholder limit of section 1361(b)(1)(A).

(vii) *Number of shareholders.* Each potential current beneficiary of the ESBT, as defined in paragraphs (m)(4)(i) through (vi) of this section, is counted as a shareholder of any S corporation whose stock is owned by the ESBT. During any period in which the ESBT has no potential current beneficiaries, the ESBT is counted as the shareholder. A person is counted as only one shareholder of an S corporation even though that person may be treated as a shareholder of the S corporation by direct ownership and through one or more eligible trusts described in section 1361(c)(2)(A). Thus, for exam-

ple, if a person owns stock in an S corporation and is a potential current beneficiary of an ESBT that owns stock in the same S corporation, that person is counted as one shareholder of the S corporation. Similarly, if a husband owns stock in an S corporation and his wife is a potential current beneficiary of an ESBT that owns stock in the same S corporation, such husband and wife will be counted as one shareholder of the S corporation.

(viii) *Miscellaneous*. Payments made to a third party on behalf of a beneficiary are considered to be payments made directly to the beneficiary. The right of a beneficiary to assign the beneficiary's interest to a third party does not result in the third party being a potential current beneficiary until that interest is actually assigned.

(5) *ESBT terminations*—(i) *Ceasing to meet ESBT requirements*. A trust ceases to be an ESBT on the first day the trust fails to meet the definition of an ESBT under section 1361(e). The last day the trust is treated as an ESBT is the day before the date on which the trust fails to meet the definition of an ESBT.

(ii) *Disposition of S stock*. In general, a trust ceases to be an ESBT on the first day following the day the trust disposes of all S corporation stock. However, if the trust is using the installment method to report income from the sale or disposition of its stock in an S corporation, the trust ceases to be an ESBT on the day following the earlier of the day the last installment payment is received by the trust or the day the trust disposes of the installment obligation.

(iii) *Potential current beneficiaries that are ineligible shareholders*. If a potential current beneficiary of an ESBT is not an eligible shareholder of a small business corporation within the meaning of section 1361(b)(1), the S corporation election terminates. For example, the S corporation election will terminate if a nonresident alien becomes a potential current beneficiary of an ESBT. Such a potential current beneficiary is treated as an ineligible shareholder beginning on the day such person becomes a potential current beneficiary, and the S corporation election terminates on that date. However, see the special rule of paragraph (m)(4)(ii) of this section. If the S corporation election ter-

minates, relief may be available under section 1362(f).

(6) *Revocation of ESBT election*. An ESBT election may be revoked only with the consent of the Commissioner. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter ruling request under the appropriate revenue procedure.

(7) *Converting an ESBT to a QSST*. For a trust that wishes to convert from an ESBT to a QSST, the consent of the Commissioner is hereby granted to revoke the ESBT election as of the effective date of the QSST election, if all the following requirements are met:

(i) The trust meets all of the requirements to be a QSST under section 1361(d).

(ii) The trustee and the current income beneficiary of the trust sign the QSST election. The QSST election must be filed with the service center where the S corporation files its income tax return and also with the service center where the trust files its income tax return. This 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)" and include all information otherwise required for a QSST election under § 1.1361-1(j)(6). A separate election must be made with respect to the stock of each S corporation held by the trust.

(iii) 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.

(iv) The date on which the QSST election is to be effective cannot be more than 15 days and two months prior to the date on which the election is filed and cannot be 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 prior to the date on which the election is filed, it will be effective 15 days and two months prior to the date on which it is 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 it is filed.

(8) *Effective date*. This paragraph (m) is applicable on and after the date the final

regulations are published in the **Federal Register**.

(9) *Examples*. The provisions of this paragraph (m) are illustrated by the following examples in which it is assumed, unless otherwise specified, that all non-corporate persons are citizens or residents of the United States:

*Example 1. (i) ESBT election with section 663(c) separate shares*. On January 1, 2000, M contributes S corporation stock to Trust for the benefit of M's three children A, B, and C. Pursuant to section 663(c), each of Trust's separate shares for A, B, and C will be treated as separate trusts for purposes of determining the amount of distributable net income (DNI) in the application of sections 661 and 662. On January 15, 2000, the trustee of Trust files a valid ESBT election for Trust effective January 1, 2000. Trust will be treated as a single ESBT and will have a single S portion taxable under section 641(c).

(ii) *ESBT acquires stock of an additional S corporation*. On February 15, 2000, Trust acquires stock of an additional S corporation. Because Trust is already an ESBT, Trust does not need to make an additional ESBT election.

(iii) *Section 663(c) shares of ESBT convert to separate QSSTs*. Effective January 1, 2001, A, B, C, and Trust's trustee elect to convert each separate share of Trust into a separate QSST pursuant to paragraph (m)(7) of this section. They file a separate election for each S corporation the stock of which is held by Trust for each separate share. Each separate share will be treated as a separate QSST.

*Example 2. (i) Invalid potential current beneficiary*. Effective January 1, 2000, Trust makes a valid ESBT election. On January 1, 2001, A, a nonresident alien, becomes a potential current beneficiary of Trust. Trust does not dispose of all of its S corporation stock within 60 days after January 1, 2001. As of January 1, 2001, A is a potential current beneficiary of Trust, and therefore is treated as a shareholder of the S corporation. Because A is not an eligible shareholder of an S corporation under section 1361(b)(1), the S corporation election of any corporation in which Trust holds stock terminates effective January 1, 2001. Relief may be available under section 1362(f).

(ii) *Invalid potential current beneficiary and disposition of S stock*. Assume the same facts as in Example 2 (i) except that within 60 days after January 1, 2001, trustee of Trust disposes of all Trust's S corporation stock. A is not considered a potential current beneficiary of Trust and therefore is not treated as an S corporation shareholder of any S corporation in which Trust previously held stock.

*Example 3. Subpart E trust*. M transfers stock in X, an S corporation, and other assets to Trust, for the benefit of B and B's siblings. M retains no powers or interest in Trust. Under section 678(a), B is treated as the owner of a portion of Trust which includes a portion of the X stock. No beneficiary has acquired any portion of his or her interest in Trust by purchase and Trust is not an ineligible trust under paragraph (m)(1)(iv) of this section. Trust is eligible to make an ESBT election.

*Example 4. Determining ESBT beneficiaries*. Trust holds stock in an S corporation and makes an ESBT election. Trust's instrument provides that

income is to be paid to A for A's life. Upon A's death the remainder interest is to be paid to a separate trust for the benefit of A's three children. If on A's death none of A's children is alive, then the remainder is to be paid to A's ten grandchildren. If on A's death none of A's children or grandchildren is alive, the remainder will be paid to State exclusively for public purposes. A, A's children, and A's grandchildren are all beneficiaries of Trust. Assuming the probability that State will ever receive any distribution from Trust is less than 5 percent, State is not considered a beneficiary for purposes of paragraph (m)(1)(ii) of this section. If the probability that State will receive a distribution from Trust ever equals or exceeds 5 percent, State would then be considered a beneficiary of the ESBT. Because State is an organization described in section 170(c)(1), rather than section 170(c)(2) through (5), State would be an ineligible beneficiary and the corporation's S corporation election would terminate.

*Example 5. Potential current beneficiaries and distributee trusts.* (i) *Distributee trust holding S corporation stock.* Trust-1 has a valid ESBT election in effect. The trustee of Trust-1 has the power to distribute to A directly or to any trust created for the benefit of A. On January 1, 2000, M creates Trust-2 for the benefit of A. Also on January 1, 2000, the trustee of Trust-1 distributes some S corporation stock to Trust-2. The current income beneficiary of Trust-2 makes a timely and effective election to treat Trust-2 as a QSST. Because Trust-2 is a valid S corporation shareholder, the distribution to Trust-2 does not terminate the ESBT election of Trust-1. Trust-2 itself will not be counted toward the 75-shareholder limit of section 1361(b)(1)(A). Additionally, because A is already counted as an S corporation shareholder because of A's status as a potential current income beneficiary of Trust-1, A is not counted again by reason of A's status as the deemed owner of Trust-2.

(ii) *Distributee trust not holding S corporation stock.* Assume the same facts as in paragraph (i) of this *Example 5*, except that no S corporation stock is distributed to Trust-2. Because Trust-2 would be eligible to make a QSST election or an ESBT election if it owned S corporation stock, under paragraph (m)(4)(iv)(D) of this section it is deemed to be a trust described in section 1361(c)(2)(A). Under paragraph (m)(4)(iv)(C) of this section, the potential current beneficiaries of Trust-2 are considered the potential current beneficiaries of Trust-1. Because A, the potential current beneficiary of Trust-2, is already a potential current beneficiary of Trust-1, A is not counted twice for purposes of the 75-shareholder limit of the S corporation.

*Example 6. Potential current beneficiaries and distributee trust.* (i) *Distributee trust that would itself qualify as an ESBT.* Trust-1 holds stock in X, an S corporation, and has a valid ESBT election in effect. Under the terms of the governing instrument of Trust-1, the trustee has discretion to make distributions to A, B and Trust-2, a trust for the benefit of A and B's children, C, D and E. Trust-2 would qualify to be an ESBT, but it owns no S corporation stock and has made no ESBT election. Under paragraph (m)(4)(iv) of this section, Trust-2's potential current beneficiaries are treated as the potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Thus, A, B, C, D

and E are potential current beneficiaries of Trust-1 and are counted as shareholders for the purposes of section 1361(b)(1). Trust-2 itself will not be counted as a shareholder of Trust-1 for purposes of section 1361(b)(1).

(ii) *Distributee trust that would not qualify as an ESBT.* Assume the same facts as in *Example 6* (i) except that D is a non-resident alien. Trust-2 would not be eligible to make an ESBT or QSST election if it owned S corporation stock and therefore Trust-2 is a potential current beneficiary of Trust-1. Since Trust-2 is not an eligible shareholder, X's S corporation election terminates.

(iii) *Distributee trust that is a section 1361(c)(2)(A)(ii) trust.* Assume the same facts as in *Example 6* (i) except that Trust-2 is a trust treated as owned by A under section 676 because A had the power to revoke Trust-2 at any time prior to A's death. On January 1, 2001, A dies. Because Trust-2 is a trust described in section 1361(c)(2)(A)(ii) during the 2-year period beginning on the day of A's death, under paragraph (m)(4)(iv)(C) of this section, Trust-2's only potential current beneficiary is the person listed in section 1361(c)(2)(B)(ii), A's estate.

*Example 7. Potential current beneficiaries and powers of appointment.* M creates Trust for the benefit of A. A also has a current power to appoint income or principal to anyone except A, A's creditors, A's estate, and A's estate's creditors. The potential current beneficiaries of Trust will be A and all other persons except for A's creditors, A's estate, and A's estate's creditors. This number will exceed the 75-shareholder limit of section 1361(b)(1)(A). If Trust holds S corporation stock, the corporation's S election will terminate.

Par. 6. Section 1.1362-6 is amended by revising paragraph (b)(2)(iv) to read as follows:

*§ 1.1362-6 Election and consents.*

\* \* \* \* \*

(b) \* \* \*

(2) \* \* \*

(iv) *Trusts.* In the case of a trust described in section 1361(c)(2)(A) (including a trust treated under section 1361(d)(1)(A) as a trust described in section 1361(c)(2)(A)(i) and excepting an electing small business trust described in section 1361(c)(2)(A)(v) (ESBT)), only the person treated as the shareholder for purposes of section 1361(b)(1) must consent to the election. When stock of the corporation is held by a trust, both husband and wife must consent to any election if the husband and wife have a community interest in the trust property. See paragraph (b)(2)(i) of this section for rules concerning community interests in S corporation stock. In the case of an ESBT, the trustee and the owner of any portion of the trust that consists of the stock in one or more S corporations under subpart E, part

I, subchapter J, chapter 1 of the Internal Revenue Code must consent to the S corporation election. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must consent to the S corporation election.

\* \* \* \* \*

Par. 7. Section 1.1362-7 is amended by adding a sentence to the end of paragraph (a) to read as follows:

*§ 1.1362-7 Effective date.*

(a) \* \* \* Section 1.1362-6(b)(2)(iv) is applicable on and after the date the final regulations are published in the **Federal Register**.

\* \* \* \* \*

Par. 8. Section 1.1377-1 is amended by:

1. Adding paragraph (a)(2)(iii).
2. Adding *Example 3* to paragraph (c). The additions read as follows:

*§ 1.1377-1 Pro rata share.*

(a) \* \* \*

(2) \* \* \*

(iii) *Electing small business trust (ESBT) election.* If an ESBT election is effective on a day other than the first day of trust's taxable year, and the trust was already an eligible S corporation shareholder under a different provision of section 1361(c)(2), then section 1377 applies to allocate S corporation income between the two types of trusts. The first day the ESBT is treated as an S corporation shareholder is the effective date of the ESBT election. The ESBT election does not result in the prior trust being treated as terminating its entire interest in its S corporation stock for purposes of paragraph (b) of this section, unless the prior trust was described in section 1361(c)(2)(A)(ii) or (iii).

\* \* \* \* \*

(c) \* \* \*

*Example 3. Effect of conversion of a qualified subchapter S trust (QSST) to an electing small business trust (ESBT).* (i) On January 1, 2000, Trust receives 100% of the stock of S corporation. Trust's current income beneficiary makes a timely QSST election under section 1361(d)(2), effective January 1, 2000. Later, the trustee and current income beneficiary of Trust elect pursuant to § 1.1361-1(j)(12), to terminate the QSST election and convert to an ESBT, effective July 1, 2002. In 2002, Trust's *pro rata* share of S corporation's nonseparately computed income is \$100,000.

(ii) For purposes of computing the income allocable to the QSST and to the ESBT, Trust is treated

as a QSST through June 30, 2002, and Trust is treated as an ESBT beginning July 1, 2002. Pursuant to section 1377(a)(1), the *pro rata* share of S corporation income allocated to the QSST is \$49,589 ( $\$100,000 \times 181 \text{ days}/365 \text{ days}$ ), and the *pro rata* share of S corporation income allocated to the ESBT is \$50,411 ( $\$100,000 \times 184 \text{ days}/365 \text{ days}$ ).

Par. 9. Section 1.1377-3 is amended by revised to read as follows:

*§ 1.1377-3 Effective date.*

Section 1.1377-1 and 1.1377-2 apply to taxable years of an S corporation beginning after December 31, 1996, except that § 1.1377-1(a)(2)(iii) and (c) *Example 3* are applicable on and after the date the final regulations are published in the **Federal Register**.

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

(Filed by the Office of the Federal Register on December 28, 2000, 8:45 a.m., and published in the issue of the Federal Register for December 29, 2000, 65 F.R. 82963)