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## ARGUMENT

### PROPOSITION OF LAW

**THE INCOME OF AN ELECTING SMALL BUSINESS TRUST IS TAXABLE, FOR OHIO INCOME TAX PURPOSES, TO THE GRANTOR OF SUCH ELECTING SMALL BUSINESS TRUST ONLY TO THE EXTENT THE TAX YEAR END OF THE ELECTING SMALL BUSINESS TRUST IS ON OR AFTER DECEMBER 29, 2000.**

The *Amici Curiae* submit this *Amicus* Brief to raise a critical issue that was not addressed in the Board of Tax Appeals opinion, and which was minimally addressed, if addressed at all, by the Appellate and Appellee herein. The outcome of this case and all other pending Electing Small Business Trusts (herein called "ESBT") cases is contingent upon whether or not the ESBT at issue in the specific case has a tax year ending on or after December 29, 2000. The Appellants could not focus on the significance of December 29, 2000 because the trust tax return filed for the Appellants' ESBTs indicates the tax year ended of such ESBTs to be the calendar year of 2000 (i.e., ending December 31, 2000). (See Supplement to Brief of Appellants, pg. 0000117). In contrast, the Appellee, other than a brief mention of the preceding tax return filed by the Appellants' ESBTs, did not focus on the significance of December 29, 2000 because a favorable ruling only applicable to ESBTs terminated on or after December 29, 2000 would limit the ability of the Appellee to impose Ohio tax relative to ESBTs terminated prior to December 29, 2000. For the reasons discussed in this *Amicus* Brief, it is only the income of an ESBT that has a tax year ending on/or after December 29, 2000 that is included in the grantor's (of such ESBT) income for Ohio income tax purposes.

For the reasons stated below, the *Amici Curiae* submit this *Amicus* Brief as interested taxpayers, who have a Petition for Reassessment pending with the Ohio Department of Taxation concerning the Ohio income taxation of income received by an ESBT established separately by

each *Amicus Curiae*. The *Amici Curiae*, like many other Ohio taxpayers, established ESBTs in accordance with the requirements set forth in the Internal Revenue Code of 1986, as may be amended (herein called the “Code”). At all times prior to January 1, 2000, an ESBT’s taxable income was not includible in a taxpayer’s Ohio taxable income. However, pursuant to an Information Release (dated January 19, 2000), the Ohio Department of Taxation announced its position that for tax years ending after January 1, 2000, an ESBT’s taxable income was taxable to the ESBT’s beneficial owner for Ohio income tax purposes, based upon the Department’s interpretation of the applicable provisions of the Code.

This *Amicus* Brief is not filed in support of either the Appellant and/or Appellee, since *Amici Curiae* do not believe that the analysis performed by the Ohio Board of Tax Appeals in arriving at its decision in the case at bar was necessary. As discussed below, the Appellants’ ESBTs, as with any other ESBT with a taxable year ending on or after December 29, 2000, is not exempt from the grantor trust provisions contained in the Code at Sections 671 *et seq.* Only ESBTs with tax years ending prior to December 29, 2000 are exempt from the grantor trust provisions of the Code. For example, if an ESBT terminated on December 28, 2000, its 2000 tax year would be for the period January 1, 2000 through December 28, 2000. Because its 2000 tax year ended prior to December 29, 2000 due to the ESBT’s termination, it would (for federal income tax purposes) be exempt from the grantor trust provisions. Although the opinion of the Board of Tax Appeals does not address the taxable year of the Appellants’ ESBTs, the Appellee’s Brief filed with the Board of Tax Appeals sets forth that “[t]he grantor trust filed federal income tax returns for the tax year 2000. . . they were filed for the calendar year 2000, with no date earlier than the end of that calendar year listed as the ending date for the return.” (Brief of Appellee, Board of Tax Appeals, pg. 2). To the extent the record was more fully

established as to the tax year end of the Appellants' ESBTs, then it very well may be that the tax year end was no earlier than December 31, 2000, as alleged by the Appellee. In such case, the ESBT would be subject to the Code grantor trust provisions, pursuant to Treasury Regulation Section 1.641(c)-1, thereby subjecting the ESBT's taxable income to Ohio tax liability in Tax Year 2000.

Notwithstanding the foregoing, as stated in the Merit Brief of Appellants, the Appellants' ESBTs' taxable year closed on February 26, 2000 (i.e., a date prior to December 29, 2000). Accordingly, the Appellants' ESBT may be exempt from the Internal Revenue Code grantor trust provisions. (See Appellants' Merit Brief, Supreme Court of Ohio, pg. 2.)

To determine whether the income of the Appellants' ESBTs are subject to Ohio income tax, the inconsistency between the Appellants' alleged termination date (i.e., February 26, 2000), and the Appellee's alleged termination date (December 31, 2000) must be reconciled. To the extent the termination date of Appellants' ESBTs is December 31, 2000, then (notwithstanding the Board of Tax Appeals erroneous analysis), the outcome reached by the Board of Tax Appeals was correct based upon the provisions of Treasury Regulations Section 1.641(c)-1, issued by the United States Treasury Department, effective as of December 29, 2000 (discussed below). However, if the Appellants ESBTs were terminated prior to December 29, 2000, then the Board of Tax Appeals analysis and conclusion are erroneous for the reasons stated below.

The necessity for this *Amicus* Brief is that to the extent the Board of Tax Appeals opinion applies to all Ohio ESBTs, including those with taxable years ending prior to December 29, 2000, then the *Amici Curiae* respectfully request this Court to reverse the decision of the Board of Tax Appeals. Despite the evidence asserted by the Appellee that the Appellants' ESBTs filed their final tax return indicating taxable year ending December 31, 2000, the Board of Tax

Appeals erroneously concluded that the taxable income of an ESBT (implying even those ESBTs with taxable years ending prior to December 29, 2000), is taxable to the beneficial owner of the ESBT, thereby requiring the beneficial owners of the ESBT to include the ESBT taxable income in their Ohio adjusted gross income. For the reasons stated herein, to the extent the Ohio Board of Tax Appeals' opinion extends to all ESBTs, even those with taxable years ending before December 29, 2000, then the *Amici Curiae* request that this Court reverse the decision of the Board of Tax Appeals; however, to the extent this Court finds that Board of Tax Appeals opinion is limited to ESBTs with taxable years ending on or after December 29, 2000, the *Amici Curiae* request that this Court affirm the decision of the Board of Tax Appeals on that ground solely.

The Appellants' case and the *Amici Curiae*'s pending Petition for Reassessment result from the Information Release (dated January 19, 2000) issued by the Ohio Department of Taxation. This release was issued by the Ohio Department of Taxation after two (2) failed attempts by the Ohio legislature to enact legislation which would have had the same effect as the Information Release. The Ohio Department of Taxation, through the Information Release, stated that a grantor trust cannot make an ESBT election. The impact of such Information Release was that S corporation taxable income received by an ESBT, which prior to January 1, 2000 (i.e., the retroactive effective date of the January 19, 2000 Information Release) was taxable to the ESBT and not its grantor under Code Section 641(c), to be taxable to the ESBT's grantor or beneficial owner under Code Section 671. The end result of this interpretation was to require the grantor of the ESBT to include in his or her Ohio adjusted gross income the ESBT's taxable income.

However, it was not until December 28, 2000 (almost one year after the Information Release) that the United States Treasury Department issued Treasury Regulations Section 1.641(c) concerning the taxation of grantor trusts that make ESBT elections. It is clear that the

rules established by these Treasury Regulations are only applicable to ESBTs with taxable years ending on or after December 29, 2000. For the reasons stated below, the *Amici Curiae* respectfully request that this Court hold that the Ohio Tax Commissioner is without authority to require the grantor of an ESBT (with a taxable year ending before December 29, 2000) to include in said grantor's Ohio taxable income S corporation income included in the ESBT's taxable income.

A. **A Grantor Trust that Makes an ESBT Election Is Taxed Pursuant to the Special Rules For Taxation of Electing Small Business Trusts Pursuant to IRC Section 641(c)**.

The Appellee's primary argument and the analysis of the Board of Tax Appeals asserts that a grantor trust, which makes an ESBT election pursuant to Code Section 1361(e)(3), is subject to taxation under Code Section 671.

A grantor trust is eligible to make an ESBT Election under Code Section 1361(e) (since Code Section 1361(e) specifically provides that any trust may make the ESBT election). Hence, the issue is whether the ESBT income is taxed to the grantor pursuant to Code Section 671. As an aside, the relevance of which will become apparent below, Code Section 671 is located in Chapter 1 of the Internal Revenue Code. Code Section 671 provides, in relevant part:

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income which are attributable to that portion of the trust to the extent that such items would be taken into account in computing taxable income...of an individual.

Code Section IRC Section 671, in the very next sentence, then states:

Any remaining portion of the trust shall be subject to subparts A through D.

It is in subpart A of Chapter 1 of the Internal Revenue Code where the United States Congress decided to enact “special rules,” not for the taxation of grantors of electing small business trusts; but, rather, for “electing small business trusts.” The effect of being subject to the “special rule” described in IRC Section 641(c) is that all income that becomes taxable to an ESBT thereunder is automatically taxed at “the highest rate set forth in Section 1(e).” Under the Appellee’s interpretation, it would seem that an Ohio taxpayer’s income is not taxable at the highest rate under Section 1(e); rather, it is taxed at graduated tax rates. The Appellee’s interpretation and that of the Board of Tax Appeals is contrary to the language drafted by the United State Congress in IRC Section 641(c), which provides, in relevant part:

For purposes of this Chapter-

(A) the portion of any electing small business trust which consists of stock in 1 or more corporations shall be treated as a separate trust, and

(B) the amount of the tax imposed by this chapter on such separate trust shall be determined with the modifications of paragraph (2).

Thus, a grantor trust having properly made an ESBT election, and having stock in a S corporation, shall “for purposes of this chapter” be taxed as a separate trust. Moreover, this “separate trust” is taxed in a specified manner (i.e., at the highest rates under Section 1(e)). Code Section 671 does not then require the grantor to include the “separate trust’s” income in the grantor’s gross income. The express language of IRC Section 671 provides that the grantor only include in gross income certain items to the extent such items would be taken into account under this chapter in computing taxable income of an individual. Code Section 641 computes items included in the income of a separate trust; in other words, no items of income of an ESBT would be taken into account in computing taxable income of an individual, as required by Code Section

671. Thus, Code Section 671 has no impact on the taxation of ESBTs (which are taxed in accordance with Code Section 641), nor is there any confusion as to the proper taxation of ESBT income. ESBT income is treated as income of a separate trust, taxed at the highest tax rates set forth in IRC Section 1(e).

**B. The Ohio Department of Taxation's Interpretation That, Under Federal Income Tax Laws, a Grantor Trust Is Not Eligible to Make an ESBT Election, and That Federal Adjusted Gross Income Includes ESBT Taxable Income, Is in Error.**

1. Assuming *arguendo* that the Ohio Department of Taxation ("Department") has the legal authority to interpret Federal income tax laws, the Department's interpretation of the ESBT/grantor trust issue is, nonetheless, clearly in error. In the Department's, January 19, 2000, Information Release, the Department proclaimed (without citing any supporting law) that a grantor trust is not eligible to make an ESBT election. Contrary to the Department's assertions, Treasury Regulations (issued subsequent to the Information Release) make it clear that a grantor trust is eligible to make an ESBT election. In this regard, the preamble to Treasury Decision 8994 provides, in a pertinent part, that: "The final regulations continue to provide that a grantor trust may elect to be an ESBT." Consistent with this statement, Treasury Regulations Section 1.1361-1(m) provides that a grantor trust is eligible to make an ESBT election. Of course, the Treasury Regulations are consistent with the express terms of Code Section 1361(e)(3) which states, in a pertinent part, that "any" trust, except a QSST or tax-exempt trust, may make an ESBT election.

2. Moreover, in the Information Release, the Department acknowledged that the Code does not contain any provisions which expressly state that an ESBT, which also qualifies as, and/or is described as, a grantor trust, is exempt from the grantor trust provisions of the Code. The Department then quickly concludes that, in light of no express provision concerning an

ESBT's exemption from the grantor trust provisions, an ESBT is not exempt from the grantor trust provisions. However, in making this proclamation, the Department cites absolutely no legal authority for his position. In support of its position, the Department references some type of "implicit" recognition by one of the advocates of the Federal government's ESBT legislation. Interestingly, the Department makes no reference to the clear language of the ESBT legislation itself (i.e., Code Section 1361(e)(3)), which provides that "any" trust may make the ESBT election. The only other allegedly authoritative sources cited by the Department in the Information Release consist of the opinions of three (3) private individuals—one sentence from an April 1997 issue of the Journal of Taxation, a correspondence to IRS assistant chief counsel, and an article by an Akron, Ohio accountant. Moreover, not only does the Department ignore the express language of Code Section 1361(e)(3), the Department also fails to reference other secondary sources (with much greater credibility than the private individuals referenced above) which support the proposition that an ESBT is exempt from the grantor trust provisions. In this regard, the nationally recognized tax treatise, *Tax Planning for S Corporations* (1997, Matthew Bender & Company, Inc.); Section 15.04 states:

... a grantor trust (See IRC Section 671-679) may elect to become an ESBT. The language of the statute specifies that "any" trust, except a QSST or tax- exempt trust, may make an ESBT election. If the ESBT election is made for a grantor trust, the trust, rather than the grantor, will be taxed on the trust's income. (Emphasis added.)

3. However, and most importantly, the Treasury Regulations (issued subsequent to the Information Release) establish the proposition that an ESBT with a taxable year ending before December 29, 2000, is exempt from the Internal Revenue Code grantor trust provisions. In this regard, Treasury Regulations Section 1.641(c)-1(a), (b), (c) and (1), Example 1, generally provide that an ESBT is to be divided into a "grantor portion," an "S portion" and a "non-S

portion.” The grantor portion of an ESBT is the portion of the trust that is treated as a grantor trust. The S portion of the ESBT is the portion of the trust that consists of S corporation stock and that is not treated as a grantor trust. Finally, the non-S portion of an ESBT is the portion of the trust that consists of all of the assets other than S corporation stock and is not treated as a grantor trust. However, Treasury Regulations Section 1.641(c)-1(k) states that:

. . . however, paragraphs (a), (b), (c), and (1), Example 1, of this section are applicable for taxable years of ESBTs that end on and after December 29, 2000 . . . .

In view of the effective date of these Treasury Regulations, an ESBT with a taxable year ending before December 29, 2000, is treated as being exempt from the Internal Revenue Code grantor trust provisions. Accordingly, for ESBTs with taxable years ending before December 29, 2000, the ESBT itself ( not the beneficiaries) is taxable on the ESBT’s income, regardless of whether the income is distributed to the grantor. The S portion of the ESBT is treated as a separate trust, the taxation of which is governed by Code Section 641(d)(1) and (2). See, also, IRC Section 1361(e)(4). The tax on the ESBT’s taxable income is imposed at the highest rate for trusts and estates under Code Section 1(e). See, IRC Section 641(d)(2)(A).

**C. ORC Section 5747.01(A) Does Not Permit an Add- Back Adjustment to Ohio Adjusted Gross Income for ESBT Taxable Income.**

1. As it existed during the year 2000, Ohio Revised Code (herein called “ORC”) Section 5747.02 provided, in pertinent part, that the Ohio income tax is to be “levied on every individual and every estate residing in or earning or receiving income in this state.” Thus, Ohio did not then impose an income tax on trusts.

2. In the case of an individual taxpayer, the starting point for computing the Ohio income tax is Federal adjusted gross income, subject to certain specified adjustments set forth in ORC Section 5747.01(A). The definition of “adjusted gross income” under ORC Section

5747.01(A) does not expressly or impliedly mandate an “add-back” to an individual’s Federal adjusted gross income for pass-through items of income, gain or loss from S corporations when such items are required to be reported for Federal income tax purposes on a trust’s fiduciary income tax return because the trust has elected to be treated as an ESBT under IRC Section 1361(e)(3). Accordingly, under Ohio’s income tax statutory scheme, ESBT taxable income is not included in an Ohio taxpayer’s adjusted gross income within the meaning of ORC Section 5747.01(A).

3. Nevertheless, without legislative support, the Department ignored the Ohio Revised Code and created a “new” add-back to Ohio adjusted gross income—namely, ESBT taxable income. In the absence of Ohio legislation amending ORC Section 5747.01(A), the Department has no legal basis for including ESBT taxable income in an Ohio taxpayer’s adjusted gross income. This proposition is not subject to challenge or ambiguity in that the definition of adjusted gross income in ORC Section 5747.01(A) is clear on its face.

**D. The Department’s January 19, 2000 Information Release Is An Improperly Adopted Rule and Therefore Invalid.**

1. Even assuming the result intended by the Department, can be achieved (i.e., add back to Ohio adjusted gross income of ESBT taxable income) in the absence of Ohio legislation amending ORC Section 5741.01(A), the Department failed to comply with strict statutory guidelines pertaining to the promulgation of rules. Under Ohio law, a rule promulgated improperly is invalid. See *Condee v. Lindley*, 12 Ohio St. 3d 90 (1984).

2. As defined in ORC Section 119.01(C), a “rule” is any rule, regulation or standard having a general and uniform operation, adopted, promulgated and enforced by any agency under the authority of the laws governing such agency; however, it does not include regulations concerning internal management of any agency unless such internal management rule affects

private rights. Even assuming the Department has authority pursuant to ORC Section 5703.05 to promulgate rules under ORC 5747.01(A) establishing additional “add-backs” to an individual’s federal adjusted gross income, the Department did not properly apply such authority.

Notwithstanding the preceding, other Sections of this *Amicus* Brief establish that the Information Release constitutes an impermissible enactment of legislation by the Department and/or exceeds powers granted to the Department under ORC 5703.05, as the Department impermissibly interprets the proper application of Federal tax law.

3. The Information Release constitutes a rule, since it articulates a general and uniform “add-back” to federal adjusted gross income “all relevant pass-through items of income . . . from S corporations when such items have been treated as reportable for federal income tax purposes on a trust’s fiduciary income tax return . . . because the trust has elected to be taxed as an ESBT” under IRC Section 1361(e)(3). This Court has repeatedly invalidated prior attempts by the Department to promulgate rules in a manner similar to that of Department’s Information Release. Two cases which require discussion are *McLean Trucking Co. v. Lindley*, 70 Ohio St. 2d 106 (1982) and *Condee v. Lindley*, 12 Ohio St. 3d 90 (1984).

a. *McLean Trucking Co. v. Lindley*. The Department determined the taxpayer’s therein, allocation method of gross receipts pursuant to ORC 5733.05 did not adequately represent the extent of gross receipts that should be allocated to Ohio. The taxpayer allocated receipts under ORC Section 5733.05 by equally dividing freight revenues between the state of origin and the state of destination; whereas the Department thought that additional revenues should be allocated to Ohio based upon freight that passed through or stopped to transfer cargo in Ohio. Fortunately, the relevant statute, ORC 5733.05(B)(2)(d), provided that the Department may require the taxpayer to use an alternate method to compute Ohio allocable

income if the allocation provisions of ORC 5733.05 do not fairly represent the extent of the taxpayer's business activities in Ohio. Subsequently, the Department issued Special Instruction 21, purportedly based on authority granted by ORC Sections 5733.05 and 5733.07, that required all interstate transportation companies to compute Ohio allocated income by utilizing a sales factor based on a system-wide mileage ratio. This Special Instruction 21 generated an additional \$250,000.00 of tax liability for the taxpayer.

The Supreme Court, in invalidating Special Instruction 21, stated the following:

- (i) ORC 5733.05(B)(2)(d) furnished no authority for the Department's apportionment of taxpayer's sales factor pursuant to Special Instruction 21;
- (ii) Special Instruction 21 is the functional equivalent of an ORC 119.01(C) rule, the terms of which could only have been properly issued as a rule; and
- (iii) Special Instruction 21 is the subject-matter of a rule because Special Instruction 21: articulates a general and uniform standard, and, is enforced under the authority of the laws governing the department of taxation.

Thus, even though the relevant statute stated the Department could require that taxpayer use a different allocation method, this does not mean that the Department is authorized to promulgate a rule, unless the provisions for adopting a rule are satisfied.

b. Condee v. Lindley. Pursuant to then-existing ORC Section 5727.15(B), the Department was granted authority to apportion the assessed value of the property of a public utility when such property is located in more than one county in Ohio. As reported in the Supreme Court's opinion, the Department, purportedly acting under the mandate of ORC Section 5727.15(B), informally advised all public utilities to report situsable property value at 70% of its true taxable value, and to report the remaining 30% of situsable property value as nonsitusable property value. The Supreme Court noted that the apportionment policy may meet the statutory

apportionment requirement, but the Department may not implement such a policy without a formally promulgated rule. The Supreme Court determined that since the apportionment policy was uniformly applied to all public utility property, the policy is within the definition of a “rule” as set forth in ORC 119.01(C). Moreover, the Supreme Court stated “the rule making requirements set forth in ORC Section 119 are designed to permit a full and fair analysis of the impact and validity of a proposed rule”; to the extent the Department “desires to continue application of the policy in question, only compliance with” ORC Section 119 and ORC Section 5703.14 may permit him to do so.

4. The instant case is indistinguishable from the *McLean* case and the *Condee* case since the Department promulgated a rule (this time through an Information Release) without complying with ORC Section 5703.14. Moreover, the Information Release is an even greater abuse of authority than evidenced in the *McLean* case and *Condee* case as the Department therein at least had statutory authorization to issue guidelines. The relevant statute in the present case, ORC Section 5747.01, provides no similar statutory authorization for the Department to make additional adjustments to an individual's federal adjusted gross income other than as already provided in ORC Section 5747.01. Notably absent from the list of permissible adjustments to federal adjusted gross income is an “add-back” relative to income from “all relevant pass through items of income. . .from S corporations when such items have been treated as reportable for federal income tax purposes on a . . .Form 1041. . .because the trust has elected to be taxed as an ESBT” under IRC Section 1361(e)(3). Thus, assuming *arguendo* ORC 5747.01 could be amended without involvement of the legislator, relevant Supreme Court precedent requires the Commissioner to adhere to the procedures set forth in ORC Section 5703.14 when promulgating a rule.

E. **The Issuance of Treasury Regulations by the United States Treasury Department Establishes the Taxation of Grantor Trusts that Made an ESBT Election .**

1. The Department readily admits in the Information Release, “various tax practitioners have differing interpretations of how the ESBT provisions interplay with the grantor trust provisions of the Internal Revenue Code. Some have advocated the ESBT provisions should take precedence over the grantor trust provisions while others believe that a grantor trust can not make the ESBT election.” Obviously, the “various tax practitioners” were applying a reasonable interpretation of the Internal Revenue Code, in the absence of any guidance from the Treasury Department, as IRC Section 1361(e)(3) provides that any trust may make the ESBT election. This express language of this federal income tax statute conflicts with the position asserted by the Department in its Information Release; namely, “the Income Tax Audit Division’s position is that a grantor trust cannot make the ESBT election.” Interestingly, this pronouncement of the Department is based on a mere “tax practitioners” statement in The Ohio CPA Journal. See FN4 in Information Release, dated January 19, 2000.

2. “Laws must give the person of ordinary intelligence a reasonable opportunity to know what is prohibited, so that he may act accordingly, and laws must provide explicit standards” to apply them. *Buckley v. Wilkins*, 105 Ohio St.3d 350 (2005). As the preceding paragraph illustrates, at the time of the Information Release, the legal community was split (i.e., “various tax practitioners” v. Department and accountant Apple, FN 4 of Information Release), as to the coordination of the grantor trust provisions with the ESBT provisions of the Code. The clear implication of this proposition was that the express language of the Code did not provide a clear meaning concerning the relationship between the grantor trust provisions and the ESBT provisions.

3. Fortunately, Code Section 7805(a) grants authority to the Secretary (of the Treasury Department) to prescribe “all needful rules and regulations for the enforcement of this title,” which “title” includes the grantor trust provisions and the ESBT provisions. The Secretary, being aware of the public’s need for immediate guidance, issued Temporary Treasury Regulation 1.641(c)-1 by filing the same with the Federal Register on December 28, 2000. As Temporary Treasury Regulations are subject to public comment prior to becoming Final Regulations, the possibility existed that the Temporary Regulation could have been modified or withdrawn by the Secretary following December 28, 2000. Though history has proven that the Temporary Treasury Regulation was in final form when issued, the Temporary Treasury Regulation only had the effect of law post-December 28, 2000. Stated differently, only after such time that the Secretary issued the Temporary Treasury Regulation on December 28, 2000, did the interrelationship between the grantor trust provisions and the ESBT provisions have a clear and explicit standard with which taxpayer’s could comply.

4. Even though prescribing rules relevant to applying the provisions of the Code is vested pursuant to Code Section 7805 in the Treasury Secretary, the Department’s Information Release purports to establish rules concerning the application of the Code provisions. The Department even goes so far as to say that effective January 1, 2000 (i.e., a retroactive application date), certain individuals must include certain additional amounts in their federal adjusted gross income; notwithstanding that the Code did not require this inclusion in federal adjusted gross income until the issuance of the Temporary Treasury Regulation on December 28, 2000 (moreover, the Code did not require this inclusion in federal adjusted gross income at all if the ESBT’s tax year ended before December 29, 2000).

F. The Department's Position on the Taxation of ESBTs Violates Public Policy.

1. In view of the lack of legal authority for the Department's position, it is clear what is occurring. On two (2) separate occasions, the Department requested that the Ohio legislature change Ohio income tax law so that an ESBT's taxable income would be subject to Ohio income tax. In this regard, on February 2, 1999, House Bill 139 was introduced into the Ohio House of Representatives; it was assigned to the House Ways and Means Committee (a similar Bill was introduced on July 13, 1998, but never made it out of the Ways and Means Committee). The Bill proposed to tax income received by an ESBT on account of the distributive share of income or gain from an S corporation at the highest marginal tax rate. As stated in that Bill "currently, trusts are not subject to the state's personal income tax: only individuals and estates are taxed."

(Emphasis added.) The language of the Bill further acknowledges that:

Since, under federal law, the federal adjusted gross income of beneficiary of an electing small business trust does not include income from an S corporation that is passed through (or accumulated by) the trust, beneficiaries do not have to pay Ohio income taxes on that income. (Emphasis added.)

2. The express language of the Bill establishes a recognition that, under current Ohio income tax rules, an ESBT's taxable income is not subject to Ohio income taxation.

Moreover, the failure of the Ohio legislature to pass this Bill shows that the Ohio legislature could tax ESBTs with taxable years ending before December 29, 2000.

3. As noted above, the Department on two (2) separate occasions requested that the Ohio legislature change the law so that an ESBT's taxable income is subject to Ohio income tax. On both occasions, the Department's efforts were unsuccessful. Obviously, frustrated by this series of events, and not satisfied with allowing this matter to be addressed through proper legislative channels, the Department has decided to "legislate" Ohio's tax laws by threatening the

Ohio citizens with its own interpretation of the law. It is clear that the Information Release was intended to create a “chilling effect” for taxpayers who (in proper compliance with Federal income tax laws) were not including in Federal adjusted gross income the taxable income of a grantor trust which had made a proper ESBT election. This chilling effect was intended to be accomplished through the Department’s threat in the Information Release that the Department would impose not only an assessment for unpaid tax, but also related failure-to-timely-pay and failure-to-timely-file penalties. Further, the Department issued an Information Release, dated July 3, 2002, stating that the Department will also assess statutory fraud penalties on taxpayers.

4. The citizens of Ohio elect a legislator based upon a variety of beliefs, promises and philosophies. Those legislators clearly have had at least two (2) opportunities to change Ohio law as it relates to the taxation of ESBTs; in each instance, those legislators chose not to make any changes. The Department does not have the legal authority to “override” the Ohio legislature and make changes to Ohio law which the legislature has failed to enact.

5. The arbitrary and capricious nature of the Information Release is illustrated by its effective date. The Information Release applies to individuals and estates with taxable years beginning after December 31, 1999. There is no basis in logic or reason for this effective date. The ESBT provisions have been part of Federal income tax laws since 1997. Therefore, ESBTs have existed in Ohio since that date. The Department arbitrarily selected the year 2000 as the first year in which Ohio would attempt to tax grantor trusts/ESBTs. It defies logic that a taxpayer may have a grantor trust/ESBT for the tax years 1997, 1998 and 1999 which may be exempt from Ohio income taxation, but then face taxes and penalties for the year 2000, even though there has been no change in Ohio law. In other words, an Ohio citizen would have to ask himself or herself, “If an ESBT was taxed a certain way in Ohio for the years 1997 through 1999, and if

there has been no legislative change in Ohio's tax laws, then why is Ohio now taxing me on the  
ESBT taxable income?"

Respectfully submitted,  
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**CERTIFICATE OF SERVICE**

The undersigned hereby certifies that a true copy of the foregoing *Amicus Brief of Amici Curiae Rome P. Busa, Jr. and Anthony J. Busa* was served via regular U.S. Mail, postage prepaid, on this 25<sup>th</sup> day of January, 2006 upon the following:

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IN THE SUPREME COURT OF OHIO

DAVID G. KNUST AND SUSAN L. ) Case No. 2005-2084  
PURKRABEK, )  
)  
Appellants, )  
) ON APPEAL FROM THE BOARD OF  
v. ) TAX APPEALS  
)  
WILLIAM W. WILKINS )  
Tax Commissioner, )  
)  
Appellee. )

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APPENDIX PART I TO *AMICUS BRIEF OF AMICI CURIAE*  
ROME P. BUSA, JR. AND ANTHONY J. BUSA  
NOT EXPRESSLY IN SUPPORT OF EITHER PARTY

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**OHIO**  
Department of  
**Taxation**  
Income Tax Audit Division

**INDIVIDUAL INCOME TAX INFORMATION RELEASE-Grantor Trust Provisions Take Precedence Over ESBT Provisions January 19, 2000**

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Effective for individual and estate taxable years beginning after December 31, 1999, the Income Tax Audit Division will require certain individuals and estates to include in their federal adjusted gross income ("FAGI") and Ohio taxable income all relevant pass-through items of income, gain or loss from S corporations when such items have been treated as reportable for federal income tax purposes on a trust's fiduciary income tax return (Form 1041) because the trust has elected to be taxed as an Electing Small Business Trust ("ESBT") under Internal Revenue Code ("IRC") section 1361(e)(3). Specifically, if an individual or estate would be treated as the owner of all or a portion of a trust pursuant to IRC section 671 et seq., then such individual or estate shall include in his, her or its FAGI or Ohio taxable income all relevant S corporation pass-through items as if the individual or estate were itself the actual owner of the S corporation stock owned by the trust.<sup>1</sup>

Furthermore, because the Income Tax Audit Division will treat such trusts as grantor trusts rather than as ESBT's, the trust cannot qualify as an electing small business trust excluded, under Ohio Revised Code ("ORC") section 5733.40(l)(1), from the definition of a "qualifying investor." As such, for taxable years beginning after December 31, 1999, an S corporation must pay the 5% pass-through entity withholding tax and related estimated tax (ORC sections 5747.41 and 5747.43) with respect to "adjusted qualifying amounts" (ORC section 5733.40(A)(1)(a)) which pass through to such trusts.

For taxable years beginning after December 31, 1999, assessments for unpaid tax and all related failure-to-timely-pay and failure-to-timely-file charges will apply (i) to such individuals and estates who do not adjust their FAGI and Ohio taxable income (and timely pay tax and related estimated tax thereon) in accordance with this information release and (ii) to S corporations which do not timely pay the 5% withholding tax and the related estimated tax with respect to such S corporation distributive shares.

### Discussion

The Internal Revenue Code does not contain any provisions which expressly state that an ESBT which also qualifies as and/or is described as a grantor trust is exempt from the grantor trust provisions. Neither does the "Blue Book" provide or address any such exemption.<sup>2</sup> In fact, the principal advocate of the ESBT legislation has cautioned that the provisions of an ESBT's governing instruments ". . . should be limited so that no power would result in the inclusion of trust assets or revenue in the trustee's own estate or income."<sup>3</sup> Thus, even the principal advocate of the ESBT legislation implicitly recognizes

that an ESBT which also qualifies as and/or is described as a grantor trust is, in fact, subject to the grantor trust provisions for taxation rather than qualifying for the special rules for taxation of ESBT's under IRC section 641(c).

The Income Tax Audit Division recognizes that various tax practitioners have differing interpretations of how the ESBT provisions interplay with the grantor trust provisions of the Internal Revenue Code. Some have advocated that the ESBT provisions should take precedence over the grantor trust provisions, while others believe that a grantor trust cannot make the ESBT election.<sup>4</sup> In light of the fact that neither the U.S. Treasury Department nor the Internal Revenue Service has issued any guidance in this area, and barring any change in the federal tax law or issuance of new U.S. Treasury regulations to the contrary, the Income Tax Audit Division's position is that a grantor trust cannot make the ESBT election.

If you have questions regarding this information release, please contact the Income Tax Audit Division at 614-433-7610 (TTY: 1-800-750-0750).

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<sup>1</sup>Of course, individuals and estates will not have to make these adjustments to the extent these individuals and estates have already done so on their federal income tax returns.

<sup>2</sup>Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress.

<sup>3</sup>See the last sentence of Frederick G. Corneel's article, "The Electing Small Business Trust: Subchapter S's User-Friendly Estate Planning Tool" beginning on page 215 of the April, 1997 issue of the Journal of Taxation. The "Editor's Note" appearing in that article states as follows:

"Mr. Corneel was the principal advocate on Capitol Hill for ESBTs, and he worked with the staffs of both the Joint Committee and Treasury in drafting the legislation. . . . Moreover, until there is Treasury guidance or further legislation, his analysis of the law stands as uniquely important to any potential users of this new estate plan-ning tool."

<sup>4</sup>See item number 4 in the American Institute of Certified Public Accountants December 21, 1999 correspondence to IRS Assistant Chief Counsel Paul F. Kugler. That letter is reproduced in the December 29, 1999 edition of BNA, Inc.'s TaxCore. The letter is available on the Internet at <http://subscript.bna.com/LNNPUBS/t...ae76b85256856001/23ad/OpenDocument> But see Apple, "Ohio Income Tax Treatment of The Newest "S" Corporation Shareholder: The Electing Small Business Trust," The Ohio CPA Journal, April - June, 1998 on page 29, 4th line down: "Grantor trusts cannot elect to be treated as an ESBT."

[Sec. 671]

**SEC. 671. TRUST INCOME, DEDUCTIONS, AND CREDITS ATTRIBUTABLE TO GRANTORS AND OTHERS AS SUBSTANTIAL OWNERS.**

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

## SECTION 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 chapter 1 of the Internal Revenue Code. The portion of an ESBT that consists of stock in one or more S corporations 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. The ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return. See Sec. 1.1361-1(m).

## (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. Rules otherwise 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 Sec. 1.1361-1(m) (3) (iv) for allocation of those items in the taxable year of the S corporation in which the trust is an ESBT for part of the year and an eligible shareholder under section 1361(a) (2) (A) (i) through (iv) for the rest of the year.

(ii) SPECIAL RULE FOR CHARITABLE CONTRIBUTIONS. If a deduction described in paragraph (d) (2) (i) of this section is attributable to an amount of the S corporation's gross income that is paid by

the S corporation for a charitable purpose specified in section 170(c) (without regard to section 170(c)(2)(A)), 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 limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable 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 (g)(3) of this section for the treatment of interest on the installment obligation. See Sec. 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 (h) 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) ADJUSTMENTS TO BASIS OF STOCK IN THE S PORTION UNDER SECTION 1367. The basis of S corporation stock in the S portion must be adjusted in accordance with section 1367 and the regulations thereunder. If the ESBT owns stock in more than one S corporation, the adjustments to the basis in the S corporation stock of each S corporation must be determined separately with respect to each S corporation. Accordingly, items of income, loss, deduction, or credit of an S corporation that are taken into account by the ESBT under section 1366 can only result in an adjustment to the basis of the stock of that S corporation and cannot affect the basis in the stock of the other S corporations held by the ESBT.

(g) 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. The non-S portion may consist of more than one share pursuant to section 663(c).

(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.

(h) 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, applicable 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.

(i) 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 includible 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 of income, loss, deduction, or credit 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.

(j) **TERMINATION OR REVOCATION OF ESBT ELECTION.** If the ESBT election of the trust terminates pursuant to Sec. 1.1361-1(m)(5) or the ESBT election is revoked pursuant to Sec. 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.

(k) **EFFECTIVE DATE.** This section generally is applicable for taxable years of ESBTs beginning on and after May 14, 2002. However, paragraphs (a), (b), (c), and (l) Example 1 of this section are applicable for taxable years of ESBTs that end on and after December 29, 2000. ESBTs may apply paragraphs (d)(4) and (h) of this section for taxable years of ESBTs beginning after December 31, 1996.

(l) **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. 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 1366	\$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:

B 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. In 2003, Trust sells all of its stock in X to a person who is unrelated to Trust and its beneficiaries and realizes 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 charitable organization described in section 170(c)(2). 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 by distributing S corporation stock, no charitable deduction is available to the S portion.

EXAMPLE 5. ESBT distributions.

(i) As of January 1, 2002, 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, 2003, and Trust elects to be an ESBT effective January 1, 2003. On February 1, 2003, 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 2003. For 2003,

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.

(ii) For 2003, 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 Beneficiary during the year (\$4,000), not to exceed the amount of DNI (\$3,000). Beneficiary must include this amount in gross income under section 662(a). As a result, the non-S portion has no taxable income. \*COM019\*

[Added by TD 8994, 67 FR 34388, May 14, 2002]

## SECTION 641. IMPOSITION OF TAX

642(d)(2)(A)

## (a) APPLICATION OF TAX

The tax imposed by section 1(e) shall apply to the taxable income of estates or of any kind of property held in trust, including--

- (1) income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income accumulated or held for future distribution under the terms of the will or trust;
- (2) income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;
- (3) income received by estates of deceased persons during the period of administration or settlement of the estate; and
- (4) income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

## (b) COMPUTATION AND PAYMENT

The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part. The tax shall be computed on such taxable income and shall be paid by the fiduciary. For purposes of this subsection, a foreign trust or foreign estate shall be treated as a nonresident alien individual who is not present in the United States at any time.

(c) SPECIAL RULES FOR TAXATION OF ELECTING SMALL BUSINESS TRUSTS.--

## (1) IN GENERAL.--

For purposes of this chapter--

(A) the portion of any electing small business trust which consists of stock in 1 or more S corporations shall be treated as a separate trust, and

(B) the amount of the tax imposed by this chapter on such separate trust shall be determined with the modifications of paragraph (2).

## (2) MODIFICATIONS.--

For purposes of paragraph (1), the modifications of this paragraph are the following:

(A) Except as provided in section 1(h), the amount of the tax imposed by section 1(e) shall be determined by using the highest rate of tax set forth in section 1(e).

(B) The exemption amount under section 55(d) shall be zero.

(C) The only items of income, loss, deduction, or credit to be taken into account are the following:

(i) The items required to be taken into account under section 1366.

(ii) Any gain or loss from the disposition of stock in an S corporation.

(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).

No deduction or credit shall be allowed for any amount not described in this paragraph, and no item described in this paragraph shall be apportioned to any beneficiary.

(D) No amount shall be allowed under paragraph (1) or (2) of section 1211(b).

(3) TREATMENT OF REMAINDER OF TRUST AND DISTRIBUTIONS.--

For purposes of determining--

(A) the amount of the tax imposed by this chapter on the portion of any electing small business trust not treated as a separate trust under paragraph (1), and

(B) the distributable net income of the entire trust, the items referred to in paragraph (2)(C) shall be excluded. Except as provided in the preceding sentence, this subsection shall not affect the taxation of any distribution from the trust.

(4) TREATMENT OF UNUSED DEDUCTIONS WHERE TERMINATION OF SEPARATE TRUST.--

If a portion of an electing small business trust ceases to be treated as a separate trust under paragraph (1), any carryover or excess deduction of the separate trust which is referred to in section 642(h) shall be taken into account by the entire trust.

(5) ELECTING SMALL BUSINESS TRUST.--

For purposes of this subsection, the term "electing small business trust" has the meaning given such term by section 1361(e)(1).

<<BACKGROUND/EFFECTIVE DATES>>

AMENDMENTS

1998

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Subsection (c). -- Pub. L. 105-206, Section 6007(f), struck subsection (c) and redesignated subsection (d) as subsection (c). [Effective as if

included in the provisions of the Taxpayer Relief Act of 1997]

Prior to amendment, subsection (c) read as follows:

"(c) EXCLUSION OF INCLUDIBLE GAIN FROM TAXABLE INCOME

"(1) GENERAL RULE

"For purposes of this part, the taxable income of a trust does not include the amount of any includible gain as defined in section 644(b) reduced by any deductions properly allocable thereto.

"(2) CROSS REFERENCE

"For the taxation of any includible gain, see section 644."

1997

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Subsection (b). -- Pub. L. 105-34, Section 1601(i)(3)(B), added at the end a new sentence. [Effective for provisions of the Small Business Job Protection Act of 1996 to which they relate.]

1996

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Subsection (d). -- Pub. L. 104-188, Section 1302(d), added a new subsection, relating to "Special Rules for Taxation of Electing Small Business trusts". [Effective for taxable years beginning after December 31, 1996.]

1977

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Subsection (a). -- Pub. L. 95-30 substituted "section 1(e)" for "section 1(d)" in introductory provisions.

1976

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Subsection (c). -- Pub. L. 94-455 added subsec. (c).

1969

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Subsection (a). -- Pub. L. 91-172 substituted "The tax imposed by section 1(d)" for "The taxes imposed by this chapter on individuals".

EFFECTIVE DATE OF 1977 AMENDMENT

Amendment by Pub. L. 95-30 applicable to taxable years beginning after Dec. 31, 1976, see section 106(a) of Pub. L. 95-30, set out as a note under section 1 of this title.

EFFECTIVE DATE OF 1976 AMENDMENT

Amendment by Pub. L. 94-455 applicable to transfers in trust made after

May 21, 1976, see section 701(h) of Pub. L. 94-455, set out as a note under section 667 of this title.

#### EFFECTIVE DATE OF 1969 AMENDMENT

Amendment by Pub. L. 91-172 applicable to taxable years beginning after Dec. 31, 1970, see section 803(f) of Pub. L. 91-172, set out as a note under section 1 of this title.

#### CROSS REFERENCES

Charitable trusts subject to tax, see section 511 of this title.

Income from an interest in an estate or trust as gross income, see section 61 of this title.

Rates of tax on individuals, see section 1 of this title.

Returns---

Estates and trusts, see section 6012 of this title.

Joint fiduciaries, see section 6012 of this title.

Taxable income defined, see section 63 of this title.

#### PUBLIC LAWS AMENDING THIS SECTION

(Aug. 16, 1954, ch. 736, 68A Stat. 215; Dec. 30, 1969, Pub. L. 91-172, title VIII, Section 803(d)(3), 83 Stat. 684; Oct. 4, 1976, Pub. L. 94-455, title VII, Section 701(e)(2), 90 Stat. 1579; May 23, 1977, Pub. L. 95-30, title I, Section 101(d)(8), 91 Stat. 134; August 20, 1996, Pub. L. 104-188, title I, Section 1302; August 5, 1997, Pub. L. 105-34, title XVI, Section 1601; July 22, 1998, Pub. L. 105-206, Section 6007.)

SECTION 1361. S CORPORATION DEFINED

(a) S CORPORATION DEFINED

(1) IN GENERAL

For purposes of this title, the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.

(2) C CORPORATION

For purposes of this title, the term "C corporation" means, with respect to any taxable year, a corporation which is not an S corporation for such year.

(b) SMALL BUSINESS CORPORATION

(1) IN GENERAL

For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not--

(A) have more than 75 shareholders,

(B) have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual,

(C) have a nonresident alien as a shareholder, and

(D) have more than 1 class of stock.

(2) INELIGIBLE CORPORATION DEFINED

For purposes of paragraph (1), the term "ineligible corporation" means any corporation which is--

(A) a financial institution which uses the reserve method of accounting for bad debts described in section 585,

(B) an insurance company subject to tax under subchapter L,

(C) a corporation to which an election under section 936 applies, or

(D) a DISC or former DISC.

(3) TREATMENT OF CERTAIN WHOLLY OWNED SUBSIDIARIES

(A) IN GENERAL

Except as provided in regulations prescribed by the Secretary, for purposes of this title--

(i) a corporation which is a qualified subchapter S subsidiary shall not be treated as a separate corporation, and

(ii) all assets, liabilities, and items of income, deduction, and credit of a qualified subchapter S subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation.

(B) QUALIFIED SUBCHAPTER S SUBSIDIARY

For purposes of this paragraph, the term "qualified subchapter S subsidiary" means any domestic corporation which is not an ineligible corporation (as defined in paragraph (2)), if--

(i) 100 percent of the stock of such corporation is held by the S corporation, and

(ii) the S corporation elects to treat such corporation as a qualified subchapter S subsidiary.

(C) TREATMENT OF TERMINATIONS OF QUALIFIED SUBCHAPTER S SUBSIDIARY STATUS

For purposes of this title, if any corporation which was a qualified subchapter S subsidiary ceases to meet the requirements of subparagraph (B), such corporation shall be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before such cessation from the S corporation in exchange for its stock.

(D) ELECTION AFTER TERMINATION

If a corporation's status as a qualified subchapter S subsidiary terminates, such corporation (and any successor corporation) shall not be eligible to make--

(i) an election under subparagraph (B)(ii) to be treated as a qualified subchapter S subsidiary, or

(ii) an election under section 1362(a) to be treated as an S corporation,

before its 5th taxable year which begins after the 1st taxable year for which such termination was effective, unless the Secretary consents to such election.

(c) SPECIAL RULES FOR APPLYING SUBSECTION (b)

(1) HUSBAND AND WIFE TREATED AS 1 SHAREHOLDER

For purposes of subsection (b)(1)(A), a husband and wife (and their estates) shall be treated as 1 shareholder.

(2) CERTAIN TRUSTS PERMITTED AS SHAREHOLDERS

(A) IN GENERAL

For purposes of subsection (b)(1)(B), the following trusts may be shareholders:

(i) A trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States.

(ii) A trust which was described in clause (i) immediately before the death of the deemed owner and which continues in existence after such death, but only for the 2-year period beginning on the day of the deemed owner's death.

(iii) A trust with respect to stock transferred to it pursuant to the terms of a will, but only for the 2-year period beginning on the day on which such stock is transferred to it.

(iv) A trust created primarily to exercise the voting power of stock transferred to it.

(v) An electing small business trust.

This subparagraph shall not apply to any foreign trust.

(B) TREATMENT AS SHAREHOLDERS

For purposes of subsection (b)(1)--

(i) In the case of a trust described in clause (i) of subparagraph (A), the deemed owner shall be treated as the shareholder.

(ii) In the case of a trust described in clause (ii) of subparagraph (A), the estate of the deemed owner shall be treated as the shareholder.

(iii) In the case of a trust described in clause (iii) of subparagraph (A), the estate of the testator shall be treated as the shareholder.

(iv) In the case of a trust described in clause (iv) of subparagraph (A), each beneficiary of the trust shall be treated as a shareholder.

(v) In the case of a trust described in clause (v) of subparagraph (A), each potential current beneficiary of such trust shall be treated as a shareholder; except that, if for any period there is no potential current beneficiary of such trust, such trust shall be treated as the shareholder during such period.

(3) ESTATE OF INDIVIDUAL IN BANKRUPTCY MAY BE SHAREHOLDER

For purposes of subsection (b)(1)(B), the term "estate" includes the estate of an individual in a case under title 11 of the United States Code.

(4) DIFFERENCES IN COMMON STOCK VOTING RIGHTS DISREGARDED

For purposes of subsection (b)(1)(D), a corporation shall not be treated as having more than 1 class of stock solely because there are differences in voting rights among the shares of common stock.

(5) STRAIGHT DEBT SAFE HARBOR

(A) IN GENERAL

For purposes of subsection (b)(1)(D), straight debt shall not be treated as a second class of stock.

(B) STRAIGHT DEBT DEFINED

For purposes of this paragraph, the term "straight debt" means any written unconditional promise to pay on demand or on a specified date a sum certain in money if--

(i) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors,

(ii) there is no convertibility (directly or indirectly) into stock, and

(iii) the creditor is an individual (other than a nonresident alien), an estate, a trust described in paragraph (2), or a person which is actively and regularly engaged in the business of lending money.

(C) REGULATIONS

The Secretary shall prescribe such regulations as may be necessary or appropriate to provide for the proper treatment of straight debt under this subchapter and for the coordination of such treatment with other provisions of this title.

(6) CERTAIN EXEMPT ORGANIZATIONS PERMITTED AS SHAREHOLDERS.--

For purposes of subsection (b)(1)(B), an organization which is--

(A) described in section 401(a) or 501(c)(3), and

(B) exempt from taxation under section 501(a),

may be a shareholder in an S corporation.

(d) SPECIAL RULE FOR QUALIFIED SUBCHAPTER S TRUST

(1) IN GENERAL

In the case of a qualified subchapter S trust with respect to which a beneficiary makes an election under paragraph (2)--

(A) such trust shall be treated as a trust described in subsection (c)(2)(A)(i), and

(B) for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under paragraph (2) is made.

(2) ELECTION

(A) IN GENERAL

A beneficiary of a qualified subchapter S trust (or his legal representative) may elect to have this subsection apply.

(B) MANNER AND TIME OF ELECTION

(i) SEPARATE ELECTION WITH RESPECT TO EACH CORPORATION

An election under this paragraph shall be made separately with respect to each corporation the stock of which is held by the trust.

(ii) ELECTIONS WITH RESPECT TO SUCCESSIVE INCOME BENEFICIARIES

If there is an election under this paragraph with respect to any beneficiary, an election under this paragraph shall be treated as made by each successive beneficiary unless such beneficiary affirmatively refuses to consent to such election.

(iii) TIME, MANNER, AND FORM OF ELECTION

Any election, or refusal, under this paragraph shall be made in such manner and form, and at such time, as the

Secretary may prescribe.

(C) ELECTION IRREVOCABLE

An election under this paragraph, once made, may be revoked only with the consent of the Secretary.

(D) GRACE PERIOD

An election under this paragraph shall be effective up to 15 days and 2 months before the date of the election.

(3) QUALIFIED SUBCHAPTER S TRUST

For purposes of this subsection, the term "qualified subchapter S trust" means a trust--

(A) the terms of which require that--

(i) during the life of the current income beneficiary, there shall be only 1 income beneficiary of the trust,

(ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary,

(iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust, and

(iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary, and

(B) all of the income (within the meaning of section 643(b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States.

A substantially separate and independent share of a trust within the meaning of section 663(c) shall be treated as a separate trust for purposes of this subsection and subsection (c).

(4) TRUST CEASING TO BE QUALIFIED

(A) FAILURE TO MEET REQUIREMENTS OF PARAGRAPH (3)(A)

If a qualified subchapter S trust ceases to meet any requirement of paragraph (3)(A), the provisions of this subsection shall not apply to such trust as of the date it ceases to meet such requirement.

(B) FAILURE TO MEET REQUIREMENTS OF PARAGRAPH (3)(B)

If any qualified subchapter S trust ceases to meet any requirement of paragraph (3)(B) but continues to meet the requirements of paragraph (3)(A), the provisions of this subsection shall not apply to such trust as of the first day of the first taxable year beginning after the first taxable year for which it failed to meet the requirements of paragraph (3)(B).

(e) ELECTING SMALL BUSINESS TRUST DEFINED

(1) ELECTING SMALL BUSINESS TRUST

For purposes of this section--

(A) IN GENERAL

Except as provided in subparagraph (B), the term "electing small business trust" means any trust if--

(i) such trust does not have as a beneficiary any person other than--

(I) an individual,

(II) an estate,

(III) an organization described in paragraph (2), (3), (4), or (5) of section 170(c), or

(IV) an organization described in section 170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary,

(ii) no interest in such trust was acquired by purchase, and

(iii) an election under this subsection applies to such trust.

(B) CERTAIN TRUSTS NOT ELIGIBLE

The term "electing small business trust" shall not include--

(i) any qualified subchapter S trust (as defined in subsection (d)(3)) if an election under subsection (d)(2) applies to any corporation the stock of which is held by such trust,

(ii) any trust exempt from tax under this subtitle, and

(iii) any charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)).

(C) PURCHASE

For purposes of subparagraph (A), the term "purchase" means any acquisition if the basis of the property acquired is determined under section 1012.

(2) POTENTIAL CURRENT BENEFICIARY

For purposes of this section, 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. If a trust disposes of all of the stock which it holds in an S corporation, then, with respect to such corporation, the term "potential current beneficiary" does not include any person who first met the requirements of the preceding sentence during the 60- day period ending on the date of such disposition.

(3) ELECTION

An election under this subsection shall be made by the trustee. Any such election shall apply to the taxable year of the trust for which made and all subsequent taxable years of such trust unless revoked with the consent of the Secretary.

(4) CROSS REFERENCE

For special treatment of electing small business trusts, see section 641(c).

<<BACKGROUND/EFFECTIVE DATES>>

AMENDMENTS

2000

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Subsection (e)(1). -- Pub. L. 106-554, Section 316(b), amended clause (i) of subparagraph (A) by inserting "or" before "(III)" and by adding new subclause (IV). [Effective as if included in Section 1302 of the Small Business Job Protection Act of 1996]

1998

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Subsection (e)(4). -- Pub L. 105-206, Section 6007(f), struck "section 641(d)" and inserted "section 641(c)" in its place. [Effective as if included in the provisions of the Taxpayer Relief Act of 1997]

1997

Subsection (b)(1)(B). -- Pub. L. 105-34, Section 1601(c)(4)(C), struck 'subsection (c)(7)' and inserted 'subsection (c)(6)'. [Effective for provisions of the Small Business Job Protection Act of 1996 to which they relate.]

Subsection (b)(3)(A). -- Pub. L. 105-34, Section 1601(c)(3), struck 'For purposes of this title' and inserted 'Except as provided in regulations prescribed by the Secretary, for purposes of this title'. [Effective for provisions of the Small Business Job Protection Act of 1996 to which they relate.]

Subsection (c)(6) and (7). -- Pub. L. 105-34, Section 1601(c)(4)(B), redesignated paragraph (7) as paragraph (6). [Effective for provisions of the Small Business Job Protection Act of 1996 to which they relate.]

Subsection (e)(1)(B). -- Pub. L. 105-34, Section 1601(c)(1), struck 'and' at the end of clause (i), struck the period at the end of clause (ii) and inserted ', and', and added a new clause (iii). [Effective for provisions of the Small Business Job Protection Act of 1996 to which they relate.]

1996

Subsection (b)(1)(A). -- Pub. L. 104-188, Section 1301, struck "35 shareholders" and inserted "75 shareholders". [Effective for taxable years beginning after December 31, 1996]

Subsection (b)(1)(B). -- Pub. L. 104-188, Section 1316(a)(1), amended subparagraph (B). [Effective for taxable years beginning after December 31, 1997]

Prior to amendment, subparagraph (B) read as follows:

"(B) have as a shareholder a person (other than an estate and other than a trust described in subsection (c)(2)) who is not an individual,"

Subsection (b)(2). -- Pub. L. 104-188, Section 1308(a), struck subparagraph (A) and redesignated subparagraphs (B), (C), (D), and (E) as subparagraphs (A), (B), (C), and (D). [Effective for taxable years beginning after December 31, 1996]

Subsection (b)(2)(A). -- Pub. L. 104-188, Section 1315, amended subparagraph (A). [Effective for taxable years beginning after December 31, 1996]

Prior to amendment, subparagraph (A) read as follows:

"(A) a member of an affiliated group (determined under section 1504 without regard to the exceptions contained in subsection (b) thereof),"

Subsection (b)(2)(B). -- Pub. L. 104-188, Section 1616(b)(15), struck "or to which section 593 applies". [Effective for taxable years beginning after December 31, 1995]

Subsection (b)(3). -- Pub. L. 104-188, Section 1308(b), added a new paragraph (3). [Effective for taxable years beginning after December 31, 1996]

Subsection (c)(2). -- Pub. L. 104-188, Section 1316(a)(2), added new paragraph (7). [Effective for taxable years beginning after December 31, 1997]

Subsection (c)(2)(A). -- Pub. L. 104-188, Section 1303, struck "60-day period" each place it appears in clauses (ii) and (iii) and inserted "2-year period", and struck the last sentence in clause (ii). [Effective for taxable years beginning after December 31, 1996]

Subsection (c)(2)(A)(v). -- Pub. L. 104-188, Section 1302(a), inserted a new clause (v). [Effective for taxable years beginning after December 31, 1996.]

Subsection (c)(2)(B)(v). -- Pub. L. 104-188, Section 1302(b), added a new clause (v). [Effective for taxable years beginning after December 31, 1996.]

Subsection (c)(5)(B)(iii). -- Pub. L. 104-188, Section 1304, struck "or a trust described in paragraph (2)" and inserted "a trust described in paragraph (2), or a person which is actively and regularly engaged in the business of lending money". [Effective for taxable years beginning after December 31, 1996]

Subsection (c)(6). -- Pub. L. 104-188, Section 1308(d), struck paragraph (6). [Effective for taxable years beginning after December 31, 1996]

Subsection (e). -- Pub. L. 104-188, Section 1302(a), inserted a new subsection, relating to "Electing Small Business Trust Defined". [Effective for taxable years beginning after December 31, 1996.]

Subsection (e)(1)(A)(i). -- Pub. L. 104-188, Section 1316(e), struck "which holds a contingent interest and is not a potential current beneficiary". [Effective for taxable years beginning after December 31, 1997]

1989  
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Subsection (b)(2)(B). -- Pub. L. 101-239 amended subpar. (B) generally. Prior to amendment, subpar. (B) read as follows: "a financial institution which is a bank (as defined in section 585(a)(2)) or to which section 593 applies,".

1988  
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Subsection (d)(3). -- Pub. L. 100-647 substituted "within the meaning of" for "treated as a separate trust under" in last sentence.

1986  
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Subsection (b)(2)(B). -- Pub. L. 99-514, Section 901(d)(4)(G), substituted "which is a bank (as defined in section 585(a)(2)) or to which section 593 applies" for "to which section 585 or 593 applies".

Subsection (d)(3). -- Pub. L. 99-514, Section 1879(m)(1)(A), inserted at end "A substantially separate and independent share of a trust treated as a separate trust under section 663(c) shall be treated as a separate trust for purposes of this subsection and subsection (c)."

1984  
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Subsection (c)(6). -- Pub. L. 98-369, Section 721(c), amended par. (6) generally, substituting "during any period within a taxable year" for "during any taxable year" in provisions preceding subpar. (A), and substituting "on or before the close of such period" for "on or after the date of its incorporation and before the close of such taxable year" in subpar. (A), and "does not have gross income for such period" for "does not have taxable income for the period included within such taxable year" in subpar. (B).

Subsection (d)(2)(B)(i). -- Pub. L. 98-369, Section 721(f)(3), substituted "corporation" for "S corporation" in heading and text.

Subsection (d)(2)(D). -- Pub. L. 98-369, Section 721(f)(1), substituted "15 days and 2 months" for "60 days".

Subsection (d)(3). -- Pub. L. 98-369, Section 721(f)(2), in amending par. (3) generally, redesignated subpar. (C) as (A), substituted a period for ",and" at end of subpar. (B), and struck out former subpar. (A) which read "which owns stock in 1 or more S corporations".

Subsection (d)(4). -- Pub. L. 98-369, Section 721(f)(2), in amending par. (4) generally, redesignated existing provisions as subpar. (A), inserted "Failure to meet requirements of paragraph (3)(A)" as subpar. (A) heading, substituted "of paragraph (3)(A)" for "under paragraph (3)", and added subpar. (B).

#### EFFECTIVE DATE OF 1989 AMENDMENT

Amendment by Pub. L. 101-239 effective, except as otherwise provided, as if included in the provision of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, to which such amendment relates, see section 7817 of Pub. L. 101-239, set out as a note under section 1 of this title.

#### EFFECTIVE DATE OF 1988 AMENDMENT

Amendment by Pub. L. 100-647 effective, except as otherwise provided, as if included in the provision of the Tax Reform Act of 1986, Pub. L. 99-514, to which such amendment relates, see section 1019(a) of Pub. L. 100-647, set out as a note under section 1 of this title.

#### EFFECTIVE DATE OF 1986 AMENDMENT

Amendment by section 901(d)(4)(G) of Pub. L. 99-514 applicable to taxable years beginning after Dec. 31, 1986, see section 901(e) of Pub. L. 99-514, set out as a note under section 166 of this title.

Section 1879(m)(2) of Pub. L. 99-514 provided that: "The amendments made by this subsection [amending sections 1361 and 1368 of this title] shall apply to taxable years beginning after December 31, 1982."

#### EFFECTIVE DATE OF 1984 AMENDMENT

Section 721(y) of Pub. L. 98-369, as amended by Pub. L. 99-514, Section 2, Oct. 22, 1986, 100 Stat. 2095, provided that:

"(1) IN GENERAL.--Except as otherwise provided in this subsection, any amendment made by this section [amending sections 48, 108, 267, 318, 465, 1361 to 1363, 1367, 1368, 1371, 1374, 1375, 1378, 1379, 6362, and 6659 and provisions set out as a note under section 1361 of this title] shall take effect as if included in the Subchapter S Revision Act of 1982 [Pub. L. 97-354].

"(2) AMENDMENT MADE BY SUBSECTION (b)(2).--Subparagraph (C) of section 108(d)(7) of the Internal Revenue Code of 1986 [formerly I.R.C. 1954] (as amended by subsection (b)(2)) shall apply to contributions to capital after December 31, 1980, in taxable years ending after such date.

"(3) AMENDMENT MADE BY SUBSECTION (g)(1).--If--

"(A) any portion of a qualified stock purchase is pursuant to a binding contract entered into on or after October 19, 1982, and before the date of the enactment of this Act [July 18, 1984], and

"(B) the purchasing corporation establishes by clear and convincing evidence that such contract was negotiated on the contemplation that, with respect to the deemed sale under section 338 of the Internal Revenue Code of 1986, paragraph (2) of section 1362(e) of such Code would apply,

then the amendment made by paragraph (1) of subsection (g) [amending section 1362 of this title] shall not apply to such qualified stock purchase.

"(4) AMENDMENTS MADE BY SUBSECTION (1).--The amendments made by subsection (1) [amending section 1362 of this title] shall apply to any election under section 1362 of the Internal Revenue Code of 1986 (or any corresponding provision of prior law) made after October 19, 1982.

"(5) AMENDMENT MADE BY SUBSECTION (t).--If--

"(A) on or before the date of the enactment of this Act [July 18, 1984] 50 percent or more of the stock of an S corporation has been sold or exchanged in 1 or more transactions, and

"(B) the person (or persons) acquiring such stock establish by clear and convincing evidence that such acquisitions were negotiated on the contemplation that paragraph (2) of section 1362(e) of the Internal Revenue Code of 1986 would apply to the S termination year in which such sales or exchanges occur,

then the amendment made by subsection (t) [amending section 1362 of this title] shall not apply to such S termination year."

EFFECTIVE DATE

Section 6 of Pub. L. 97-354, as amended by Pub. L. 97-448, title III, Section 305(d)(1)(A), Jan. 12, 1983, 96 Stat. 2399; Pub. L. 98-369, div. A, title VII, Section 721(i), (k), July 18, 1984, 98 Stat. 969; Pub. L. 99-514, Section 2, Oct. 22, 1986, 100 Stat. 2095, provided that:

"(a) IN GENERAL.--Except as otherwise provided in this section, the amendments made by this Act [enacting sections 1361 to 1363, 1366 to 1368, 1371 to 1375, 1377 to 1379, and 6241 to 6245 of this title, amending sections 31, 44D to 44F, 46, 48, 50A, 50B, 52, 53, 55, 57, 58, 62, 108, 163, 168, 170, 172, 179, 183, 189, 194, 267, 280, 280A, 291, 447, 464, 465, 613A, 992, 1016, 1101, 1212, 1251, 1254, 1256, 3453, 3454, 4992, 4996, 6037, 6042, 6362, and 6661 of this title and section 1108 of Title 29, Labor, omitting section 1376 of this title, and enacting provisions set out as a note under section 1 of this title] shall apply to taxable years beginning after December 31, 1982.

"(b) TRANSITIONAL RULES.--

"(1) SECTIONS 1379 AND 62(9) CONTINUE TO APPLY FOR 1983.-- Sections 1379 and 62(9) of the Internal Revenue Code of 1986 [formerly I.R.C. 1954] (as in effect before the date of the enactment of this Act [Oct. 19, 1982]) shall remain in effect for years beginning before January 1, 1984.

"(2) ALLOWANCE OF EXCLUSION OF DEATH BENEFIT.--Notwithstanding section 241(b) of the Tax Equity and Fiscal Responsibility Act of 1982 [section 241(b) of Pub. L. 97-248, set out as a note under section 416 of this title] in the case of amounts received under a plan of an S corporation, the amendment made by section 239 of such Act [section 239 of Pub. L. 97-248, amending section 101 of this title] shall apply with respect to decedents dying after December 31, 1982.

"(3) NEW PASSIVE INCOME RULES APPLY TO TAXABLE YEARS BEGINNING DURING 1982.--In the case of a taxable year beginning during 1982--

"(A) sections 1362(d)(3), 1366(f)(3), and 1375 of the

Internal Revenue Code of 1986 (as amended by this Act [Pub. L. 97-354]) shall apply, and

"(B) section 1372(e)(5) of such Code (as in effect on the day before the date of the enactment of this Act [Oct. 19, 1982]) shall not apply.

The preceding sentence shall not apply in the case of any corporation which elects (at such time and in such manner as the Secretary of the Treasury or his delegate shall prescribe) to have such sentence not apply. Subsection (e) shall not apply to any termination resulting from an election under the preceding sentence.

"(c) GRANDFATHER RULES.--

"(1) SUBSIDIARIES WHICH ARE FOREIGN CORPORATIONS OR DISC'S.--In the case of any corporation which on September 28, 1982, would have been a member of the same affiliated group as an electing small business corporation but for paragraph (3) or (7) of section 1504(b) of the Internal Revenue Code of 1986, subparagraph (A) of section 1361(b)(2) of such Code (as amended by section 2) shall be applied by substituting 'without regard to the exceptions contained in paragraphs (1), (2), (4), (5), and (6) of subsection (b) thereof' for 'without regard to the exceptions contained in subsection (b) thereof'.

"(2) CASUALTY INSURANCE COMPANIES.--

"(A) IN GENERAL.--In the case of any qualified casualty insurance electing small business corporation--

"(i) the amendments made by this Act shall not apply, and

"(ii) subchapter S (as in effect on July 1, 1982) of chapter 1 of the Internal Revenue Code of 1986 [former sections 1371 to 1379 of this title] and part III of subchapter L of chapter 1 of such Code [section 831 et seq. of this title] shall apply.

"(B) QUALIFIED CASUALTY INSURANCE ELECTING SMALL BUSINESS CORPORATION.--The term 'qualified casualty insurance electing small business corporation' means any corporation described in section 831(a) of the Internal Revenue Code of 1986 if--

"(i) as of July 12, 1982, such corporation was an electing small business corporation and was described in section 831(a) of such Code,

"(ii) such corporation was formed before April 1, 1982, and proposed (through a written private offering first circulated to investors before such date) to elect to be taxed as a subchapter S corporation and to

be operated on an established insurance exchange, or

"(iii) such corporation is approved for membership on an established insurance exchange pursuant to a written agreement entered into before December 31, 1982, and such corporation is described in section 831(a) of such Code as of December 31, 1984.

A corporation shall not be treated as a qualified casualty insurance electing small business corporation unless an election under subchapter S of chapter 1 of such Code is in effect for its first taxable year beginning after December 31, 1984.

"(3) CERTAIN CORPORATIONS WITH OIL AND GAS PRODUCTION.--

"(A) IN GENERAL.--In the case of any qualified oil corporation--

"(i) the amendments made by this Act shall not apply, and

"(ii) subchapter S (as in effect on July 1, 1982) of chapter 1 of the Internal Revenue Code of 1986 [former sections 1371 to 1379 of this title] shall apply.

"(B) QUALIFIED OIL CORPORATION.--For purposes of this paragraph, the term 'qualified oil corporation' means any corporation if--

"(i) as of September 28, 1982, such corporation--

"(I) was an electing small business corporation, or

"(II) was a small business corporation which made an election under section 1372(a) after December 31, 1981, and before September 28, 1982,

"(ii) for calendar year 1982, the combined average daily production of domestic crude oil or natural gas of such corporation and any one of its substantial shareholders exceeds 1,000 barrels, and

"(iii) such corporation makes an election under this subparagraph at such time and in such manner as the Secretary of the Treasury or his delegate shall prescribe.

"(C) AVERAGE DAILY PRODUCTION.--For purposes of subparagraph (B), the average daily production of domestic crude oil or domestic natural gas shall be determined under section 613A(c) (2) of such Code without regard to the last sentence thereof.

"(D) SUBSTANTIAL SHAREHOLDER.--For purposes of subparagraph (B), the term 'substantial shareholder' means any person who on July 1, 1982, owns more than 40 percent (in value) of the stock of the corporation.

"(4) CONTINUITY REQUIRED.--

"(A) IN GENERAL.--This subsection shall cease to apply with respect to any corporation after--

"(i) any termination of the election of the corporation under subchapter S of chapter 1 of such Code, or

"(ii) the first day on which more than 50 percent of the stock of the corporation is newly owned stock within the meaning of section 1378(c)(2) of such Code (as amended by this Act [Pub. L. 97-354]).

"(B) SPECIAL RULES FOR PARAGRAPH (2).--

"(i) Paragraph (2) shall also cease to apply with respect to any corporation after the corporation ceases to be described in section 831(a) of such Code.

"(ii) For purposes of determining under subparagraph (A)(ii) whether paragraph (2) ceases to apply to any corporation, section 1378(c)(2) of such Code (as amended by this Act [Pub. L. 97-354]) shall be applied by substituting 'December 31, 1984' for 'December 31, 1982' each place it appears therein.

"(d) TREATMENT OF EXISTING FRINGE BENEFIT PLANS.--

"(1) IN GENERAL.--In the case of existing fringe benefits of a corporation which as of September 28, 1982, was an electing small business corporation, section 1372 of the Internal Revenue Code of 1986 (as added by this Act [Pub. L. 97-354]) shall apply only with respect to taxable years beginning after December 31, 1987.

"(2) REQUIREMENTS.--This subsection shall cease to apply with respect to any corporation after whichever of the following first occurs:

"(A) the first day of the first taxable year beginning after December 31, 1982, with respect to which the corporation does not meet the requirements of section 1372(e)(5) of such Code (as in effect on the day before the date of the enactment of this Act [Oct. 19, 1982]),

"(B) any termination after December 31, 1982, of the election of the corporation under subchapter S of chapter 1 of such Code, or

"(C) the first day on which more than 50 percent of the

stock of the corporation is newly owned stock within the meaning of section 1378(c)(2) of such Code (as amended by this Act [Pub. L. 97-354]).

"(3) EXISTING FRINGE BENEFIT.--For purposes of this subsection, the term 'existing fringe benefit' means any employee fringe benefit of a type which the corporation provided to its employees as of September 28, 1982.

"(e) TREATMENT OF CERTAIN ELECTIONS UNDER PRIOR LAW.--For purposes of section 1362(g) of the Internal Revenue Code of 1986, as amended by this Act [Pub. L. 97-354] (relating to no election permitted within 5 years after termination of prior election), any termination or revocation under section 1372(e) of such Code (as in effect on the day before the date of the enactment of this Act [Oct. 19, 1982]) shall not be taken into account.

"(f) TAXABLE YEAR OF S CORPORATIONS.--Section 1378 of the Internal Revenue Code of 1986 (as added by this Act [Pub. L. 97-354]) shall take effect on the day after the date of the enactment of this Act [Oct. 19, 1982]. For purposes of applying such section, the reference in subsection (a)(2) of such section to an election under section 1362(a) shall include a reference to an election under section 1372(a) of such Code as in effect on the day before the date of the enactment of this Act [Oct. 19, 1982]."

#### PLAN AMENDMENTS NOT REQUIRED UNTIL JANUARY 1, 1989

For provisions directing that if any amendments made by subtitle A or subtitle C of title XI [Sections 1101-1147 and 1171-1177] or title XVIII [Sections 1800-1899A] of Pub. L. 99-514 require an amendment to any plan, such plan amendment shall not be required to be made before the first plan year beginning on or after Jan. 1, 1989, see section 1140 of Pub. L. 99-514, as amended, set out as a note under section 401 of this title.

#### TRANSITIONAL PROVISIONS

Pub. L. 97-448, title III, Section 305(d)(1)(B), Jan. 12, 1983, 96 Stat. 2399, as amended by Pub. L. 99-514, Section 2, Oct. 22, 1986, 100 Stat. 2095, provided that: "If--

"(i) after September 30, 1982, and on or before the date of the enactment of this Act [Jan. 12, 1983], stock or securities were transferred to a small business corporation (as defined in section 1361(b) of the Internal Revenue Code of 1986 [formerly I.R.C. 1954] as amended by the Subchapter S Revision Act of 1982 [Pub. L. 97-354]) in a transaction to which section 351 of such Code applies, and

"(ii) such corporation is liquidated under section 333 of such Code before March 1, 1983,

then such stock or securities shall not be taken into account under section 333(e)(2) of such Code."

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#### SECTION REFERRED TO IN OTHER SECTIONS

This section is referred to in sections 280G, 678, 1362 of this title.

#### PUBLIC LAWS AMENDING THIS SECTION

(Added Pub. L. 97-354, Section 2, Oct. 19, 1982, 96 Stat. 1669, and amended Pub. L. 98-369, div. A, title VII, Section 721(c), (f), July 18, 1984, 98 Stat. 967; Pub. L. 99-514, title IX, Section 901(d)(4)(G), title XVIII, Section 1879(m)(1)(A), Oct. 22, 1986, 100 Stat. 2380, 2910; Pub. L. 100-647, title I, Section 1018(q)(2), Nov. 10, 1988, 102 Stat. 3585; amended Pub. L. 101-239, title VII, Section 7811(c)(6), Dec. 19, 1989, 103 Stat. 2407; August 20, 1996, Pub. L. 104-188, title I, Sections 1301, 1302, 1303, 1304, 1308, 1315, 1316, 1616; August 5, 1997, Pub. L. 105-34, title XVI, Section 1601; July 22, 1998, Pub. L. 105-206, Section 6007; December 21, 2000, Pub. L. 2000, title III, section 316(b).)

#### PRIOR PROVISIONS

A prior section 1361, act Aug. 16, 1954, as amended, which constituted subchapter R, was repealed by Pub. L. 89-389, Section 4(b)(1), Apr. 14, 1966, 80 Stat. 116. For further details, see matter set out preceding subchapter S.

(e) ESTATES AND TRUSTS

There is hereby imposed on the taxable income of--

- (1) every estate, and
- (2) every trust,

taxable under this subsection a tax determined in accordance with the following table:

If taxable income is:	The tax is:
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Not over \$1,500	15% of taxable income.
Over \$1,500 but not over \$3,500	\$225, plus 28% of the excess over \$1,500.
Over \$3,500 but not over \$5,500	\$785, plus 31% of the excess over \$3,500.
Over \$5,500 but not over \$7,500	\$1,405, plus 36% of the excess over \$5,500.
Over \$7,500	\$2,125, plus 39.6% of the excess over \$7,500.

[AMENDED. Pub. L. 107-16, Section 302(b), amended the heading for subsection (f), effective for taxable years beginning after December 31, 2004. For the wording of the heading of subsection (f) after that date, see Background/Effective Dates below. -- Kleinrock Publishing]

IN THE SUPREME COURT OF OHIO

DAVID G. KNUST AND SUSAN L. ) Case No. 2005-2084  
PURKRABEK, )  
 )  
Appellants, )  
 ) ON APPEAL FROM THE BOARD OF  
v. ) TAX APPEALS  
 )  
WILLIAM W. WILKINS )  
Tax Commissioner, )  
 )  
Appellee. )

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APPENDIX PART II TO *AMICUS* BRIEF OF *AMICI CURIAE*  
ROME P. BUSA, JR. AND ANTHONY J. BUSA  
NOT EXPRESSLY IN SUPPORT OF EITHER PARTY

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# Treasury Decision Preambles

## TD 8994, 67 FR \_\_\_\_\_

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[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 8994].

RIN 1545-AU76

Electing Small Business Trust

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations relating to the qualification and treatment of electing small business trusts (ESBTs). The final regulations interpret the rules added to the Internal Revenue Code (Code) by section 1302 of the Small Business Job Protection Act of 1996, section 1601 of the Taxpayer Relief Act of 1997, and section 316 of the Community Renewal Tax Relief Act of 2000. In addition, the final regulations provide that an ESBT, or a trust described in section 401(a) of the Code or section 501(c)(3) of the Code and exempt from taxation under section 501(a) of the Code, is not treated as a deferral entity for purposes of '1.444-2T. The final regulations affect S corporations and certain trusts that own S corporation stock.

DATES: Effective Date: These regulations are effective May 14, 2002.

Dates of Applicability: The regulations regarding ESBTs under §1.641(c)-1(d) through (k), (l) Examples 2 - 5, '1.1361-1(h) (1) (vi), (h) (3) (i) (F), (h) (3) (ii), (j) (12), and (m), '1.1362-6(b) (2) (iv), '1.1377-1(a) (2) (iii) and (c) Example 3 apply for taxable years beginning on and after May 14, 2002. The regulations regarding taxation of ESBTs under '1.641(c)-1(a), (b), (c), and (l) Example 1 are applicable for taxable years of ESBTs that end on and after December 29, 2000. The regulations under §1.444-4 are applicable to taxable years beginning on or after December 29, 2000.

FOR FURTHER INFORMATION CONTACT: Concerning the final regulations, Bradford Poston or James A. Quinn, (202) 622-3060; specifically concerning §1.444-4, Michael F. Schmit, (202) 622-4960 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information in these final regulations have been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) and assigned control number 1545-1591.

The collections of information in these final regulations are in §1.1361-1(j) (12), §1.1361-1(m), and §1.444-4(c). The

information required by §1.1361-1(j)(12) and §1.1361-1(m) is needed to allow trusts to elect to be ESBTs and to allow for the conversion of a qualified subchapter S trust (QSST) to an ESBT and the conversion of an ESBT to a QSST. The likely respondents are trusts.

The information required by §1.444-4(c) is needed to allow certain S corporations to reinstate their previous taxable year that was terminated under §1.444-2T. The likely respondents are businesses and other for-profit institutions.

Comments on the collections of information should be sent to the Office of Management and Budget, Attn.: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503 with copies to the Internal Revenue Service, Attn.: IRS Reports Clearance Officer, W:CAR:MP:FP:S, Washington, DC 20224. Comments on the collection of information should be received by July 15, 2002. Comments are specifically requested concerning:

Whether the collections of information are necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the collections of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs of operation, maintenance, and purchase of service to provide information.

The burden contained in §1.444-4 is reflected in the burden of Form 8716.

Estimated total annual reporting burden: 7,500 hours.

Estimated annual burden per respondent: 1 hour.

Estimated number of respondents: 7,500.

Estimated annual frequency of responses: On occasion.

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

On December 29, 2000, proposed regulations (REG-251701-96) were published in the Federal Register (65 FR 82963) containing 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), and the Community Renewal Tax Relief Act of 2000, Public Law 106-554 (114 Stat. 2763) (December 21, 2000). 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).

On December 29, 2000, proposed and temporary regulations were also published in the Federal Register (65 FR 82963) and (65 FR 82926) containing amendments to the Income Tax Regulations (26 CFR Part 1) relating to the election of a taxable year other than the required taxable year.

A public hearing was held on the proposed and temporary regulations on April 25, 2001. Written comments were received on the proposed and temporary regulations. The proposed regulations, with certain changes in response to the comments, are adopted as final regulations, and the temporary regulations are removed.

Summary of Comments and Explanation of Revisions

Beneficiaries and Potential Current Beneficiaries

For a trust to qualify as an electing small business trust (ESBT) and as a shareholder in a subchapter S corporation, only certain types of persons are permitted to be beneficiaries of the trust. Once a trust makes the ESBT election, each potential current beneficiary (PCB) of the trust is treated as a shareholder of the S corporation. Thus, the identity of the beneficiaries affects whether a trust can be an ESBT, while the identity and number of PCBs affect whether the corporation can be a S corporation. It is possible under certain circumstances for a person to be a PCB, as that term is defined in section 1361(e)(2) and the proposed regulations, without being a beneficiary, as that term is defined in the proposed regulations. For example, a person who may receive a distribution from an ESBT under a currently exercisable power of appointment is a PCB but is not treated as a beneficiary until the power is actually exercised.

Some commentators expressed concerns about the possible adverse effects of the definition of PCBs, especially in situations involving potential recipients of a currently exercisable power of appointment. Some commentators suggested that a person should have to meet the definition of a beneficiary before the person could be considered a PCB. Commentators also suggested that a person who may receive a distribution under a currently exercisable power of appointment should not be treated as a PCB until exercise of the power. Several commentators

suggested that a temporary waiver or release of a broad power of appointment should be sufficient to limit the number of PCBs during a period of time.

The final regulations do not change the basic definition of PCBs. While there is no statutory definition of beneficiary in section 1361(e), there is a statutory definition of PCB. Under section 1361(e)(2), a PCB is, "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." The IRS and the Treasury Department believe that it would be inconsistent with this statutory definition not to treat a person as a PCB until an actual distribution is made to that person pursuant to the exercise of a power of appointment. The final regulations provide that an attempt to temporarily waive, release, or limit a power of appointment would not be effective to limit the PCBs because of uncertainty as to the effectiveness of a temporary waiver, release, or limitation on the power of appointment under state law and the potential to manipulate a temporary waiver, release, or limitation on a power of appointment to avoid the S corporation shareholder limitation rules. However, a permanent release of a power of appointment that is effective under local law may reduce the number of PCBs of an ESBT.

Another commentator suggested that the separate share provisions of section 663(c) should apply so that beneficiaries

or PCBs of the share holding the assets other than the S corporation stock would not be counted as beneficiaries or PCBs of the S portion. There is no authority to ignore beneficiaries and PCBs of a portion of a trust holding assets other than S corporation stock. The statutory definitions of an ESBT and of a PCB look to all the persons who are beneficiaries or PCBs of the trust, not just the S portion. In addition, the separate share provisions of section 663(c) are not applicable because they generally apply only for purposes of allocating distributable net income under sections 661 and 662.

Two commentators requested guidance on what period of time is considered in determining who are PCBs in light of the statutory definition. They suggested that period means any moment in time. Thus, if an event occurs during a taxable year that changes who the PCBs are, the PCBs before and after the event would not be counted cumulatively for purposes of the 75-shareholder limit. The shareholder limitation in section 1361(b)(1)(A) means that an S corporation may not have more than 75 shareholders at any particular time during the taxable year. See Rev. Rul. 78-390 (1978-2 C.B. 220). The final regulations clarify that a person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may, receive a distribution of principal or income of the trust. The final regulations also provide that a person who, after the exercise of

a power of appointment, receives only a future interest in the trust is not a PCB.

One commentator was concerned about the statement in the proposed regulations that if a person holds a general lifetime power of appointment, the corporation will exceed the 75-shareholder limit and thus the corporation's S election will terminate. The commentator pointed out that a beneficiary's power to withdraw assets from a trust is considered a general power of appointment but the beneficiary is the only one who can receive those assets. The final regulations clarify that the potential recipients of current distributions pursuant to an exercise of the power are considered, not whether the power is a general or special power of appointment.

The proposed regulations provide that a person with a future beneficial interest is not a beneficiary of an ESBT if that interest is so remote as to be negligible. This provision permitted trusts to qualify as ESBTs even though there was a remote possibility that all the named beneficiaries would die and the trust assets would escheat to the state, an impermissible beneficiary of an ESBT. The Community Renewal Tax Relief Act of 2000 eliminated this potential problem by changing the statutory definition of permissible beneficiaries to include an organization described in section 170(c)(1) that holds a contingent interest in the trust and is not a PCB. The final regulations, therefore, remove the provision regarding remote

beneficiaries and the accompanying example.

#### Interests in Trust Acquired by Purchase

Two commentators requested clarification on whether a trust is eligible to be an ESBT if it acquires property in a part-gift, part-sale transaction, such as a gift of encumbered property or a net gift, in which the donor transfers property to a trust provided the trust pays the resulting gift tax. Section 1361(e)(1)(A)(ii) provides that a trust is eligible to be an ESBT only if "no interest in the trust was acquired by purchase." Section 1361(e)(1)(C) defines purchase as "any acquisition if the basis of the property acquired is determined under section 1012." The proposed regulations provide that if any portion of a beneficiary's basis in the beneficiary's interest is determined under section 1012, the beneficiary's interest was acquired by purchase. The final regulations clarify that the prohibition on purchases applies to purchases of a beneficiary's interest in the trust, not to purchases of property by the trust. A net gift of a beneficial interest in a trust, where the donee pays the gift tax, would be treated as a purchase of a beneficial interest under these rules, while a net gift to the trust itself, where the trustee of the trust pays the gift tax, would not.

#### Grantor Trusts

Most commentators praised the position in the proposed regulations that a trust, all or a portion of which is treated as owned by an individual (deemed owner) under subpart E, part I,

subchapter J, chapter 1 of the Code (grantor trust), may elect to be an ESBT. One commentator, however, suggested that grantor trusts should not be permitted to make ESBT elections. The final regulations continue to provide that a grantor trust may elect to be an ESBT.

The proposed regulations provide that if a grantor trust makes an ESBT election, the trust consists of a grantor portion, an S portion, and a non-S portion. The items of income, deduction, and credit attributable to the grantor portion are taxed to the deemed owner of that portion. The S portion is taxed 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.

Commentators made several suggestions regarding the taxation of a grantor trust that elects to be an ESBT. Some suggested that the taxation rules of section 641(c) should override the grantor trust rules of section 671, and thus all tax items attributable to the trust's shares in the S corporation should be taxed to the trust, not the deemed owner. Some suggested the grantor trust rules should not apply to any tax items of a trust that makes an ESBT election. According to these commentators, this approach would eliminate administrative complexity in determining what portion of the trust is treated as owned by the deemed owner. Others suggested that the trustee should be permitted to elect to have all items attributable to the S

corporation taxed to the trust, not to the deemed owner. Others suggested that none of the S items should be taxed to the deemed owner but that ESBTs should be subject to additional reporting requirements to ensure the collection of the proper tax. Another suggested that the deemed owner should be taxed on the items from an ESBT only if the deemed owner is treated as owning the entire trust, not just a portion of the trust. Other commentators agreed with the taxation regime set forth in the proposed regulations.

The IRS and the Treasury Department believe that the qualification and taxation of ESBTs are two separate issues and that the proposed regulations take the correct position regarding the taxation of grantor trusts that make ESBT elections. Section 1361(e)(1) expands the permissible shareholders of an S corporation to include trusts that meet the definition of an ESBT. Grantor trusts are not excluded from the definition of an ESBT and, therefore, are permitted to make ESBT elections. Making an ESBT election, however, does not alter the long established treatment of tax items attributable to the portion of a trust treated as owned by the grantor or another. Section 671 requires that items of income, deduction, and credit attributable to the portion of the trust treated as owned by a grantor or another must be taken into account by that deemed owner. Only remaining items of the trust are subject to the provisions of subparts A through D of subchapter J. The special taxation rules

for ESBTs are contained in subpart A and, therefore, only apply to any portion of the trust that is not treated as owned by the grantor or another under subpart E.

As pointed out by one of the commentators, the issue of determining what portion, if any, of a trust is treated as owned by the grantor or another has existed for years in a much broader context than in the application of the ESBT rules. The special taxation rules of section 641(c) would apply only to S items, while normal trust taxation rules clearly apply to non-S items. As a result, taxing all the S items to the trust would not eliminate the need to determine what portion of the trust is a grantor trust and the resulting administrative difficulties with respect to the non-S tax items of the trust.

Some commentators requested clarification of the effect of an ESBT election by a grantor trust. One commentator suggested that if a wholly-owned grantor trust makes an ESBT election, only the deemed owner should be treated as the shareholder of the S corporation. Another commentator made a similar suggestion where the grantor has retained the power to amend or revoke the trust or to make gifts from the trust. The IRS and the Treasury Department believe that the definitional and qualification requirements of section 1361(e) apply to any trust that makes an ESBT election irrespective of whether it is a grantor trust.

Therefore, the final regulations continue to provide that the deemed owner is treated as a PCB along with others who meet the

definition of a PCB.

#### Charitable Contributions

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 and will be deductible if the other requirements of section 642(c)(1) are met. Several commentators requested clarification concerning the other requirements of section 642(c)(1), the application of the limitations under section 681, and the election to treat charitable payments made after the close of a taxable year as made during the taxable year. One commentator suggested that the S portion should be entitled to a deduction for its share of any charitable contribution made by the S corporation because it is a separately stated item under section 1366 that the S portion takes into account under section 641(c)(2)(C)(i).

Section 641(c)(2)(C) specifies the items of income, loss, deduction, or credit that the S portion is required to take into account in determining its tax. These items include items required to be taken into account under section 1366, that is, the trust's pro rata share of the S corporation's items passed through to it as a shareholder. Both section 641(c)(2)(C) and section 1366(a) reference items that must be taken into account but do not themselves provide the authority to include in income,

deduct from income, or claim a credit with respect to those items. That authority comes from other Code sections. A charitable contribution made by an S corporation is required to be a separately stated item under section 1366 because whether the item is deductible depends on the identity of the shareholder and the provisions of the Code applicable to charitable contributions made by that type of shareholder. Thus, for an individual shareholder, the contribution is deductible only in accordance with the provisions of section 170, while for a trust or estate, the contribution is deductible only in accordance with the provisions of section 642(c).

The final regulations continue to provide that the S portion's share of a charitable contribution made by the S corporation is deductible only if it meets the requirements of section 642(c)(1). The final regulations clarify how those requirements apply to such a contribution. If a contribution is paid from the S corporation's gross income, the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument. The limitations of section 681, regarding unrelated business income, apply to determine whether the contribution is deductible by the S portion. The final regulations also clarify that the charitable contribution is deductible by the S portion, if at all, only in the year that it is an item required to be taken into account by the trust under section 1366. The trustee may not make the election to

treat a contribution made by the S corporation after the close of the taxable year as made during the taxable year. This election is available only for charitable payments actually made by the trust, not for the trust's share of contributions made by another entity.

One commentator suggested that if the trust contributes S corporation stock to a charitable organization, the S portion should be entitled to a charitable deduction with respect to the contribution. Deductions available to the S portion are limited by section 641(c)(2)(C) to S corporation items required to be taken into account under section 1366 and the S portion's share of state and local income taxes and administrative expenses. Charitable contributions by the trust are not items included in the list of items that may be taken into account by the S portion under section 641(c)(2)(C). Therefore, the final regulations do not change the rule that no deduction is available to either the S portion or the non-S portion with respect to a contribution of S corporation stock to charity.

#### Interest Paid on Loans to Acquire S Corporation Stock

The proposed regulations provide that interest expense incurred by the trust to purchase S corporation stock is allocated to the S portion but is not an administrative expense. Therefore, the interest is not an allowable deduction of the S portion under section 641(c)(2)(C)(iii). Several commentators suggested that the interest should be deductible. Some thought

the interest should be allocated to the non-S portion and deducted under the investment interest limitations of section 163(d). Others thought the interest should be allocated to the S portion but should be considered a deductible administrative expense. One commentator suggested that if the shareholders are required to buy the stock of a departing shareholder pursuant to the terms of a stock purchase agreement, any interest expense incurred as a result of financing the stock purchase with a loan should be deductible when paid by an ESBT. Another commentator suggested that if interest paid on a loan to acquire S corporation stock is not deductible, it should be added to the basis of the acquired stock.

Because the purchase of S corporation stock increases the S portion, rather than the non-S portion, of the trust, interest expenses incurred in the purchase should be allocated to the S portion. These interest expenses would be deductible by the S portion only if they are "administrative expenses" under section 641(c)(2)(C)(iii). The IRS and the Treasury Department believe that, for purposes of section 641(c)(2)(C)(iii), "administrative expenses" include the traditional expenses necessary for the management and preservation of trust assets, but do not include expenses incurred to acquire additional assets. The final regulations, therefore, continue to provide that, in all cases, interest incurred to purchase S corporation stock is a nondeductible expense allocable to the S portion. Because there

is no authority to permit nondeductible interest expenses to increase the basis of assets, the final regulations do not adopt this suggestion.

#### Tax Credit Carryovers

Section 641(c)(4) and the proposed regulations provide that if a trust is no longer an ESBT, any loss carryover or excess deductions of the S portion that are referred to in section 642(h) are taken into account by the entire trust or by the beneficiaries if the entire trust terminates. One commentator suggested that any tax credit carryovers of the S portion should receive similar treatment. Section 641(c)(4) permits the entire trust to take into account only those items specified in section 642(h), which does not include tax credit carryovers. The S portion's tax credit carryovers and any other items not listed in section 642(h) are forfeited once the trust is no longer an ESBT, just as they are upon the termination of a trust or estate. The final regulations, therefore, do not adopt the commentator's suggestion.

#### Distributions From the ESBT

One commentator suggested that the tax treatment of distributions to beneficiaries in the proposed regulations is inconsistent with section 641(c)(1)(A), which provides that the portion of an ESBT consisting of the S corporation stock is treated as a separate trust. The proposed regulations provide that distributions to beneficiaries from the S portion or the non-

S portion, including distributions of the S corporation stock, are, to the extent of the distributable net income of the non-S portion, deductible under section 651 or 661 in determining the taxable income of the non-S portion, and are includible in the gross income of the beneficiaries under section 652 or 662. The commentator recommended that, because the S portion and the non-S portion are treated as separate trusts, the source of the distribution should determine its tax treatment.

The final regulations do not adopt the commentator's suggestion because section 641(c)(3) provides that section 641(c) does not affect the taxation of any distribution from the trust except for the exclusion of the S portion items from the distributable net income of the entire trust. Thus, the rules otherwise applicable to trust distributions apply to ESBTs.

#### ESBT Election

The proposed regulations provide that the ESBT election is filed with the service center where the trust files its income tax returns. The election to be a qualified subchapter S trust (QSST) is filed with the service center where the S corporation files its income tax returns. The preamble to the proposed regulations requested comments on whether the rules for filing the QSST election should be changed so the election is filed with the service center where the trust files its returns. One commentator suggested there should be consistent filing locations for QSST elections, ESBT elections, and conversions from QSST to

ESBT or ESBT to QSST. The commentator, therefore, suggested that all these documents be filed with the service center(s) where the trust and the S corporation file their returns.

The final regulations provide that the ESBT election and the election to convert from an ESBT to a QSST or from a QSST to an ESBT are all filed with the service center where the S corporation files its income tax returns. Thus, the rule in the final regulations will establish a consistent filing location for QSST and ESBT elections and conversions.

One commentator suggested that grantor trusts should be permitted to make protective ESBT elections in light of the uncertain status of some trusts that may be grantor trusts under section 674. The IRS and the Treasury Department continue to believe that a conditional ESBT election that only becomes effective in the event the trust is not a wholly-owned grantor trust should not be available. A conditional ESBT election should not be allowed because the ESBT election must have a fixed effective date. If, in the absence of a conditional ESBT election, the trust is an ineligible shareholder, relief under section 1362(f) may be available for an S corporation. In addition, a trust that qualifies as an ESBT may make an ESBT election notwithstanding that the trust is a wholly-owned grantor trust.

Expedited Section 1362(f) Relief

In several contexts, commentators requested some form of

expedited relief if an S corporation's election is inadvertently ineffective or is inadvertently terminated. In all these situations, the S corporation may seek relief under section 1362(f). The facts and circumstances of a particular situation are considered in determining whether relief is available, and the procedures for obtaining this relief are well established.

#### Effect under Section 1377 of Change in Status of a Trust

A commentator suggested that a trust's conversion to an ESBT should result in a complete termination of the trust's interest in the S corporation for purposes of section 1377(a)(2) because the incidence of taxation with respect to S corporation items will change as a result of the ESBT election. The proposed regulations provide that the election would result in a termination only if, prior to the election, the trust was described in section 1361(c)(2)(A)(ii) or (iii). The commentator also recommended that the regulations address the conversion from an ESBT to another type of trust and the availability of an election under §1.1368-1(g) to treat the S corporation's taxable year as two separate years in the case of a qualifying disposition.

The final regulations do not adopt the suggestion that all conversions of a trust to an ESBT should be treated as a complete termination of the trust's interest in the S corporation for purposes of section 1377(a)(2). The final regulations expand on the rule in the proposed regulations to cover all types of



2T(a) (prior to the issuance of the temporary regulations) as a result of an ESBT or certain tax-exempt trusts becoming a shareholder of the corporation under the auspices of the 1996 Act. The commentator believes that failure to provide such relief would result in inequitable treatment of such S corporations because, under the rules of section 444, once their elections are terminated, they are precluded from again making a section 444 election.

The IRS and the Treasury Department believe that it is appropriate to allow S corporations under these circumstances to request that the IRS disregard the termination and permit the S corporation to continue to use the same fiscal year that it used previously under section 444. However, for reasons of administrative convenience, and in order to reduce the burden on taxpayers of having to file amended returns and make retroactive payments under section 7519, the prior termination will be disregarded only at the S corporation's request, and on a prospective basis.

The final regulations provide a procedure for such requests. To illustrate the procedure, assume that, prior to 1997, an S corporation had made a section 444 election to use a taxable year ending on September 30th. On January 1, 1997, an ESBT acquired a shareholder interest in the S corporation. The S corporation treated its 444 election as terminated under §1.444-2T(a) as a result of the ESBT's shareholder interest. The S corporation

changed to its required taxable year for the short period beginning October 1, 1996, and ending December 31, 1996, and filed Form 1120S, "U.S. Income Tax Return for an S Corporation," on the basis of a calendar year for all subsequent taxable years.

Under the final regulations, the S corporation may request that the IRS disregard the prior termination by filing Form 8716, "Election to Have a Tax Year Other Than a Required Tax Year," with the appropriate Service Center by October 15, 2002, and by designating on the form "CONTINUATION OF SECTION 444 ELECTION UNDER §1.444-4." The Form 8716 must indicate that under the S corporation's prior section 444 election, it used a taxable year ending September 30th. The request will be effective for the taxable year beginning January 1, 2002. No amended returns, no retroactive payments under section 7519, and no returns under §1.7519-2T(a) for previous years in which the S corporation used its required year are required as a result of the request.

Moreover, the S corporation need not make a required payment under section 7519 for its taxable year ending September 30, 2002; its first required payment for the taxable year beginning October 1, 2002, is due on May 15, 2003. The S corporation will be required to file a return under §1.7519-2T for each taxable year beginning on or after January 1, 2002.

#### Effective Dates

The portion of the regulations involving the taxation of the grantor, S, and non-S portions of an ESBT was proposed to be

applicable for taxable years of ESBTs that end on or after December 29, 2000, the date that the proposed regulations were published in the Federal Register. The remainder of the regulations involving ESBTs was proposed to be applicable on or after the date that final regulations are published in the Federal Register. Several commentators expressed concerns about the proposed applicability with regard to the taxation of the grantor portion of an ESBT. One commentator suggested that the proposed effective date discriminated against trusts with a situs in Guam. Others suggested that the rules regarding taxation of the grantor portion should not be applicable before the date the final regulations are published. One commentator suggested that these rules should only apply either to trusts created after the final regulations are published or after a substantial transition period.

The IRS and the Treasury Department believe that the applicable date for the rules concerning the taxation of an ESBT with a grantor portion is reasonable and appropriate. These rules do not discriminate against trusts with a particular situs because they apply to all trusts wherever situated. In the case of a grantor trust that made an ESBT election, the tax treatment of the grantor portion set forth in the proposed regulations may be different from the tax treatment that the trust and the grantor had thought was available. The proposed regulations, however, were published before the end of the 2000 taxable year

and before income from that taxable year was required to be included on any person's income tax return. Thus, prior to the filing of income tax returns for 2000, it was known that the income from the grantor portion of the trust was to be taken into account by the deemed owner, not by the trust. In some situations, the trust, rather than the deemed owner, may have made estimated tax payments. Recognizing that the payment of estimated tax by the trust might subject the deemed owner to a penalty for underpayment of estimated taxes, the IRS and the Treasury Department provided relief by issuing Notice 2001-25 (2001-13 I.R.B. 941). That Notice provides procedures for a trust to elect to have its estimated tax payments credited to the account of the deemed owner and provides that, for purposes of calculating any underpayment of estimated tax, income attributable to the S corporation was to be taken into account on the last day of the deemed owner's 2000 taxable year.

Some commentators were concerned that existing ESBTs with currently exercisable, broad powers of appointments have resulted in S corporations exceeding the shareholder limit and have caused the termination of the S corporations' elections. The regulations regarding the definition of PCBs are applicable only for taxable years of ESBTs that begin on or after May 14, 2002. Therefore, persons who may receive a distribution from an ESBT pursuant to a currently exercisable power of appointment will not be considered PCBs of the ESBT until the first day of the ESBT's

first taxable year that begins on or after May 14, 2002, and the S corporation's election will not terminate before that date. In addition, under section 1361(e)(2) if the trust disposes of all its stock in the S corporation within 60 days after that date, the persons, who would first meet the definition of PCBs on that date, will not be PCBs and the corporation's S status will not be affected.

One commentator was concerned by the applicability date of the regulations involving the deductibility of state and local income taxes and administrative expenses. Section 641(c)(2)(C)(iii) provides that the S portion may take into account its allocable share of state and local income taxes and administrative expenses, but only to the extent provided in the regulations. The commentator noted that before final regulations are issued there is no authority for an ESBT to deduct any of these items. Therefore, the commentator requested that trusts be allowed to rely on the regulatory provisions regarding these items for taxable years beginning after December 31, 1996. The effective date provisions have been modified based on this suggestion.

#### Additional Provisions

The final regulations clarify that the basis of S corporation stock in the S portion must be adjusted in accordance with section 1367 and the regulations thereunder. If the ESBT owns stock in more than one S corporation, the adjustments to the

basis in the S corporation stock of each S corporation must be determined separately.

#### Effect on other documents

The following documents are superseded for taxable years of ESBTs beginning on and after May 14, 2002.

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 Analysis

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 has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collections 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 (1) the estimated average burden per trust in complying with the collections of information in '1.1361-1(m) is 1 hour, and (2) the requirement for S corporations to comply with § 1.444-4(c) will affect very few taxpayers and the associated burden is minimal. 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, the notice of proposed rulemaking

preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the regulations' impact on small business.

#### 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 the Treasury Department participated in their development.

#### List of Subjects

##### 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

##### 26 CFR Part 602

Reporting and recordkeeping requirements.

#### Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are 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.

(a) Electing small business trusts. For purposes of §1.444-2T, solely with respect to an S corporation shareholder, the term

deferral entity does not include a trust that is treated as an electing small business trust under section 1361(e). An S corporation with an electing small business trust as a shareholder may make an election under section 444. This paragraph is applicable to taxable years beginning on and after December 29, 2000; however, taxpayers may voluntarily apply it to taxable years of S corporations beginning after December 31, 1996.

(b) Certain tax-exempt trusts. For purposes of §1.444-2T, solely with respect to an S corporation shareholder, the term deferral entity does not include a trust that is described in section 401(a) or 501(c)(3), and is exempt from taxation under section 501(a). An S corporation with a trust as a shareholder that is described in section 401(a) or section 501(c)(3), and is exempt from taxation under section 501(a) may make an election under section 444. This paragraph is applicable to taxable years beginning on and after December 29, 2000; however taxpayers may voluntarily apply it to taxable years of S corporations beginning after December 31, 1997.

(c) Certain terminations disregarded--(1) In general. An S corporation that is described in this paragraph (c)(1) may request that a termination of its election under section 444 be disregarded, and that the S corporation be permitted to resume use of the year it previously elected under section 444, by following the procedures of paragraph (c)(2) of this section. An

S corporation is described in this paragraph if the S corporation is otherwise qualified to make a section 444 election, and its previous election was terminated under §1.444-2T(a) solely because - -

(i) In the case of a taxable year beginning after December 31, 1996, a trust that is treated as an electing small business trust became a shareholder of such S corporation; or

(ii) In the case of a taxable year beginning after December 31, 1997, a trust that is described in section 401(a) or 501(c)(3), and is exempt from taxation under section 501(a) became a shareholder of such S corporation.

(2) Procedure--(i) In general. An S corporation described in paragraph (c)(1) of this section that wishes to make the request described in paragraph (c)(1) of this section must do so by filing Form 8716, "Election To Have a Tax Year Other Than a Required Tax Year," and typing or printing legibly at the top of such form -- "CONTINUATION OF SECTION 444 ELECTION UNDER §1.444-4." In order to assist the Internal Revenue Service in updating the S corporation's account, on Line 5 the Box "Changing to" should be checked. Additionally, the election month indicated must be the last month of the S corporation's previously elected section 444 election year, and the effective year indicated must end in 2002.

(ii) Time and place for filing Form 8716. Such form must be filed on or before October 15, 2002, with the service center

where the S corporation's returns of tax (Forms 1120S) are filed. In addition, a copy of the Form 8716 should be attached to the S corporation's short period Federal income tax return for the first election year beginning on or after January 1, 2002.

(3) Effect of request--(i) Taxable years beginning on or after January 1, 2002. An S corporation described in paragraph (c)(1) of this section that requests, in accordance with this paragraph, that a termination of its election under section 444 be disregarded will be permitted to resume use of the year it previously elected under section 444, commencing with its first taxable year beginning on or after January 1, 2002. Such S corporation will be required to file a return under §1.7519-2T for each taxable year beginning on or after January 1, 2002. No payment under section 7519 will be due with respect to the first taxable year beginning on or after January 1, 2002. However, a required payment will be due on or before May 15, 2003, with respect to such S corporation's second continued section 444 election year that begins in calendar year 2002.

(ii) Taxable years beginning prior to January 1, 2002. An S corporation described in paragraph (c)(1) of this section that requests, in accordance with this paragraph, that a termination of its election under section 444 be disregarded will not be required to amend any prior Federal income tax returns, make any required payments under section 7519, or file any returns under §1.7519-2T, with respect to taxable years beginning on or after

the date the termination of its section 444 election was effective and prior to January 1, 2002.

(iii) Section 7519: required payments and returns. The Internal Revenue Service waives any requirement for an S corporation described in paragraph (c)(1) of this section to file the federal tax returns and make any required payments under section 7519 for years prior to the taxable year of continuation as described in paragraph (c)(3)(i) of this section, if for such years the S corporation filed its federal income tax returns on the basis of its required taxable year.

§1.444-4T [Removed]

Par. 3. Section 1.444-4T is removed.

Par. 4. 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 major 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) Adjustments to basis of stock in the S portion under section 1367.
- (g) Taxation of non-S portion.
- (1) In general.
- (2) Dividend income under section 1368(c)(2).
- (3) Interest on installment obligations.
- (4) Charitable deduction.
- (h) Allocation of state and local income taxes and administration expenses.
- (i) Treatment of distributions from the trust.
- (j) Termination or revocation of ESBT election.
- (k) Effective date.
- (1) 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 chapter 1 of the Internal Revenue Code. The portion of an ESBT that consists of stock in one or more S corporations 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. The ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return. See '1.1361-1(m).

(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. Rules otherwise 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 of the S corporation in which the trust is an ESBT for part of the year and an eligible shareholder under section 1361(a)(2)(A)(i) through (iv) for the rest of the year.

(ii) Special rule for charitable contributions. If a deduction described in paragraph (d)(2)(i) of this section is attributable to an amount of the S corporation's gross income that is paid by the S corporation for a charitable purpose specified in section 170(c) (without regard to section 170(c)(2)(A)), the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust governing instrument within the meaning of section 642(c)(1). The limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable 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 (g)(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 (h) 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) Adjustments to basis of stock in the S portion under section 1367. The basis of S corporation stock in the S portion must be adjusted in accordance with section 1367 and the regulations thereunder. If the ESBT owns stock in more than one S corporation, the adjustments to the basis in the S corporation stock of each S corporation must be determined separately with respect to each S corporation. Accordingly, items of income, loss, deduction, or credit of an S corporation that are taken into account by the ESBT under section 1366 can only result in an adjustment to the basis of the stock of that S corporation and cannot affect the basis in the stock of the other S corporations held by the ESBT.

(g) 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. The non-S portion may consist of more than one share pursuant to section 663(c).

(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.

(h) 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, applicable 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.

(i) 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 includible 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 of income, loss, deduction, or credit 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.

(j) 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.

(k) Effective date. This section generally is applicable for taxable years of ESBTs beginning on and after May 14, 2002. However, paragraphs (a), (b), (c), and (1) Example 1 of this section are applicable for taxable years of ESBTs that end on and

after December 29, 2000. ESBTs may apply paragraphs (d)(4) and (h) of this section for taxable years of ESBTs beginning after December 31, 1996.

(1) 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. 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.....	Y.....	YYY...\$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:

B 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  
 incomeYYY.....\$600

The total income of the S portion is \$4,500, determined as follows:

Ordinary income from  
 X.....\$5,000  
 Less: Grantor  
 portionYYYYYY.....(\$500)  
 Total S portion  
 income.....Y..\$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  
 incomeYYYYY.....YYYYYYYYYYYYYYYYY..\$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).....YYY.....(\$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.....Y.....\$90  
Total non-S portion  
income.....\$900  
Less: 15 % of trustee  
fees.....Y.....(\$30)  
15% state and local income  
taxes.....YY.....(\$15)  
Personal  
exemptionYY.....(\$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. In  
2003, Trust sells all of its stock in X to a person who is

unrelated to Trust and its beneficiaries and realizes 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 charitable organization described in section 170(c)(2). 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 by distributing S corporation stock, no charitable deduction is available to the S portion.

Example 5. ESBT distributions. (i) As of January 1, 2002, 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, 2003, and Trust elects to be an ESBT effective January 1, 2003. On February 1, 2003, 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 2003. For 2003, 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.

(ii) For 2003, 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 Beneficiary during the year (\$4,000), not to exceed the amount of DNI (\$3,000). Beneficiary must include this amount in gross income under section 662(a). As a result, the non-S portion has no taxable income.

Par. 5. 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) Examples.

(9) Effective date.

\* \* \* \* \*

Par. 6. Section 1.1361-1 is amended by:

1. Adding paragraphs (h) (1) (vi) and (h) (3) (i) (F).

2. Adding a sentence to the beginning of paragraph (h)(3)(ii) introductory text.

3. Adding paragraph (j)(12).

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

5. 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.

(ii) \* \* \* See §1.641(c)-1 for the rules for the taxation of an ESBT. \* \* \*

\* \* \* \* \*

(j) \* \* \*

(12) Converting a QSST to an ESBT. For a trust that seeks 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. This ESBT election must state at the top of the document AATTENTION 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 on the day that is 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 on the day that is 12 months after the date it is filed.

(k) \* \* \*

(2) \* \* \* (i) \* \* \* Paragraphs (h) (1) (vi), (h) (3) (i) (F), (h) (3) (ii), and (j) (12) of this section are applicable for taxable years beginning on and after May 14, 2002.

\* \* \* \* \*

(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, an organization described in section 170(c) (2) through (5), or an organization described in section 170(c) (1) that holds a contingent interest in such trust and is not a potential current beneficiary; 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.

(B) Distributee trusts. A distributee trust is the

beneficiary of the ESBT only if the distributee trust is an organization described in section 170(c)(2) or (3). In all other situations, any person who has a beneficial interest in a distributee trust is a beneficiary of the ESBT. A distributee trust is a trust that receives 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) Nonresident aliens. A nonresident alien as defined in section 7701(b)(1)(B) is an eligible beneficiary of an ESBT. However, see paragraph (m)(4)(i) and (m)(5)(iii) of this section if the nonresident alien is a potential current beneficiary of the ESBT (which would result in an ineligible shareholder and termination of the S corporation election).

(iii) Interests acquired by purchase. A trust does not qualify as an ESBT if any interest in the trust has been acquired by purchase. Generally, if a person acquires an interest in the trust and thereby becomes a beneficiary of the trust as defined in paragraph (m)(1)(ii)(A), and any portion of the basis in the acquired interest in the trust is determined under section 1012, such interest has been acquired by purchase. This includes a net gift of a beneficial interest in the trust, in which the person

acquiring the beneficial interest pays the gift tax. The trust itself may acquire S corporation stock or other property by purchase or in a part-gift, part-sale transaction.

(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 S corporation 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. If any one of several trustees can legally bind the trust, only one trustee needs to sign the election statement. Generally, only one ESBT election is made for the trust, regardless of the number of S corporations whose stock is held by the ESBT. However, if the ESBT holds stock in multiple S corporations that file in different service centers, the ESBT election must be filed with all the relevant service

centers where the corporations file their income tax returns. This requirement applies only at the time of the initial ESBT election; if the ESBT later acquires stock in an S corporation which files its income tax return at a different service center, a new ESBT election is not required.

(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--

(1) 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)(iii) of this section for filing a qualified subchapter S

trust (QSST) election.

(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 nevertheless 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 conditional ESBT election that would be effective only 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 such a conditional ESBT election and it 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. In addition, a trust that qualifies as an ESBT may make an ESBT election notwithstanding that the trust is a wholly-owned grantor trust.

(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 termination of the ESBT election (including a termination caused by a conversion of the ESBT to a QSST) other than on the last day of the trust's taxable year also does not cause the trust's taxable year to close. In either case, the trust files one tax return for the taxable year.

(iv) Allocation of S corporation items. If, during the taxable year of an S corporation, a trust is an ESBT for part of the year and an eligible shareholder under section 1361(c)(2)(A)(i) through (iv) for the rest of the year, the S corporation items are allocated between the two types of trusts under section 1377(a). 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 paragraph (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. A person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may, receive a distribution of principal or income of the trust. No person is treated as a potential current beneficiary solely because that person holds any future interest in 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 and thus is not a shareholder of 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 currently 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 paragraphs (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 during which such trust would be 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 qualify for 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) Currently exercisable powers of appointment--(A) In general. 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 lifetime power of appointment that would permit distributions from the trust to be made to more than 75 persons, 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). Also, the S corporation election will terminate if the currently exercisable power of appointment allows distributions to be made to an ineligible shareholder as defined

in section 1361(b)(1)(B) and (C).

(B) Waiver or release. If the holder of a power of appointment permanently releases the power in a manner that is valid under applicable local law, the persons that would be potential current beneficiaries solely because of the power will not be potential current beneficiaries after the effective date of the release. An attempt to temporarily waive, release, or limit a currently exercisable power of appointment will be ignored in determining who are potential current beneficiaries of the trust.

(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 example, 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, the husband and wife will be counted as one shareholder of the S corporation.

(viii) Miscellaneous. Payments made by an ESBT 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)(iii) of this section. If the S corporation election terminates, 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 seeks 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. This QSST election must state at the top of the

document AATTENTION 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 QSST 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 on the day that is 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 on the day that is 12 months after the date it is filed.

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

Example 1. (i) ESBT election with section 663(c) separate shares. On January 1, 2003, 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, 2003, the trustee of Trust files a valid ESBT election for Trust effective January 1, 2003. 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, 2003, 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, 2004, 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. For each separate share, they file a separate election for each S corporation whose stock is held by Trust. Each separate share will be treated as a separate QSST.

Example 2. (i) Invalid potential current beneficiary. Effective January 1, 2003, Trust makes a valid ESBT election. On January 1, 2004, 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, 2004. As of January 1, 2004, 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, 2004. 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, 2004, 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 a 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 that 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. Subpart E trust continuing after grantor's death. On January 1, 2003, M transfers stock in X, an S corporation, and other assets to Trust. Under the terms of Trust, the trustee of Trust has complete discretion to distribute the income or principal to M during M's lifetime and to M's children upon M's death. During M's life, M is treated as the owner of Trust under section 677. The trustee of Trust makes a valid election to treat Trust as an ESBT effective January 1, 2003. On March 28, 2004, M dies. Under applicable local law, Trust does not terminate on M's death. Trust continues to be an ESBT after M's death, and no additional ESBT election needs to be filed for Trust after M's death.

Example 5. Potential current beneficiaries and distributee trust holding S corporation stock. Trust-1 has a valid ESBT election in effect. The trustee of Trust-1 has the power to make distributions to A directly or to any trust created for the benefit of A. On January 1, 2003, M creates Trust-2 for the benefit of A. Also on January 1, 2003, the trustee of Trust-1 distributes some S corporation stock to Trust-2. A, as 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.

Example 6. Potential current beneficiaries and distributee trust not holding S corporation stock. (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 Trust-1, the trustee has discretion to make distributions to A, B, and Trust-2, a trust for the benefit of 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 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 or a QSST. Assume the same facts as in paragraph (i) of this Example 6 except that D is a nonresident 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 paragraph (i) of this Example 6 except that Trust-2 is a trust treated as owned by A under section 676 because A has the power to revoke Trust-2 at any time prior to A=s death. On January 1, 2003, 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. Thus, B and A=s estate are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1).

Example 7. Potential current beneficiaries and powers of appointment. M creates Trust for the benefit of A. A also has a currently exercisable power to appoint income or principal to anyone except A, A's creditors, A's estate, and the creditors of A's estate. The potential current beneficiaries of Trust will be A and all other persons except for A's creditors, A's estate, and the creditors of A's estate. 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.

(9) Effective date. This paragraph (m) is applicable for taxable years of ESBTs beginning on and after May 14, 2002.

Par. 7. 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. 8. Section 1.1362-7 is amended by:

1. Revising the section heading.
2. Adding a sentence to the end of paragraph (a).

The revision and addition read as follows:

'1.1362-7 Effective dates.

(a) \* \* \* Section 1.1362-6(b)(2)(iv) is applicable for taxable years beginning on and after May 14, 2002.

\* \* \* \* \*

Par. 9. Section 1.1377-0 is amended by adding an entry for

§1.1377-1(a)(2)(iii) to read as follows:

§1.1377-0 Table of contents.

\* \* \* \* \*

§1.1377-1 Pro rata share.

(a) \* \* \*

(2) \* \* \*

(iii) Shareholder trust conversions.

\* \* \* \* \*

Par. 10. 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) Shareholder trust conversions. If, during the taxable year of an S corporation, a trust that is an eligible shareholder of the S corporation converts from a trust described in section 1361(c)(2)(A)(i), (ii), (iii), or (v) for the first part of the year to a trust described in a different subpart of section 1361(c)(2)(A)(i), (ii), or (v) for the remainder of the year, the trust's share of the S corporation items is allocated between the two types of trusts. The first day that a qualified subchapter S trust (QSST) or an electing small business trust (ESBT) is treated as an S corporation shareholder is the effective date of the QSST or ESBT election. Upon the conversion, the trust is not

treated as terminating its entire interest in the S corporation for purposes of paragraph (b) of this section, unless the trust was a trust described in section 1361(c)(2)(A)(ii) or (iii) before the conversion.

\* \* \* \* \*

(c) \* \* \*

Example 3. Effect of conversion of a qualified subchapter S trust (QSST) to an electing small business trust (ESBT). (i) On January 1, 2003, Trust receives stock of S corporation. Trust's current income beneficiary makes a timely QSST election under section 1361(d)(2), effective January 1, 2003. Subsequently, 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, 2004. The taxable year of S corporation is the calendar year. In 2004, 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, 2004, and Trust is treated as an ESBT beginning July 1, 2004. Pursuant to section 1377(a)(1), the pro rata share of S corporation income allocated to the QSST is \$49,727 ( $\$100,000 \times 182 \text{ days} / 366 \text{ days}$ ), and the pro rata share of S corporation income allocated to the ESBT is \$50,273 ( $\$100,000 \times 184 \text{ days} / 366 \text{ days}$ ).

Par. 11. Section 1.1377-3 is revised to read as follows:

1.1377-3 Effective dates.

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 for taxable years beginning on and after May 14, 2002.

PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 12. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 13. In §602.101, paragraph (b) is amended by adding an entry for 1.444-4 and revising the entry for 1.1361-1 in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

\* \* \* \* \*

(b) \* \* \*

CFR part or section where  
Current OMB  
identified and described  
control No.

\* \* \* \* \*

1.444-4. . . . .	1545-1591	* *
. . . . .		
* * *		
1.1361-1. . . . .	1545-0731	
. . . . .		

1545-1591

\* \* \* \* \*

Robert E. Wenzel  
Deputy Commissioner of Internal Revenue.

Approved: May 3, 2002

Pamela F. Olson  
Acting Assistant Secretary of the Treasury.

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