

corporation. For example, when stock of an S corporation is held by a trust that ceases to be a subpart E trust upon the death of the deemed owner, and the trust is a permitted shareholder for a 60-day period (or a 2-year period if applicable) under section 1361(c)(2)(A)(ii), the trust (and not the estate of the deemed owner) is treated as the shareholder for purposes of sections 1366, 1367, and 1368, even though the estate is treated as the shareholder for purposes of section 1361(b)(1).

The final regulations provide that if a husband and wife file a joint return, are both U.S. citizens or residents, and are both designated beneficiaries of a trust, they are treated as one beneficiary for purposes of meeting the requirements of a qualified subchapter S trust (QSST). In addition, the final regulations add a rule that if any distribution from the trust satisfies the grantor's legal obligation to support the income beneficiary, the trust ceases to be a QSST as of the date of the distribution because under section 677(b) the grantor would be treated either as the owner of the ordinary income portion of the trust or as a beneficiary of the trust under section 662 and § 1.662(a)-4.

The proposed regulations provide the general rule that would deny a trust qualification as a QSST if the terms of the trust do not preclude the possibility that in the future the trust may not meet the requirements of section 1361(d)(3)(A). Commentators suggested that the general rule be deleted because it should be sufficient if a trust currently complies with those requirements. For example, it was suggested that if the income beneficiary has a lifetime special power to appoint the income and corpus of the trust to another person, the trust would qualify as a QSST until the power is exercised. The final regulations do not adopt this suggestion because the statute clearly requires that the terms of the trust instrument provide that, during the life of the current income beneficiary, there be only one income beneficiary, and that any corpus distributed may be distributed only to such beneficiary. The statute generally precludes the possibility of future non-compliance. However, because of the concern expressed that a trust instrument could not feasibly preclude the addition to a trust of a beneficiary that is mandated by a court of law, the final regulations provide for this exception to the general rule.

Commentators requested guidance as to whether a qualified terminable interest property (QTIP) trust qualifies as a permitted shareholder of an S

corporation. The final regulations provide that a trust treated as a QTIP trust under section 2056(b)(7) will qualify as a QSST, and a trust treated as a QTIP trust under section 2523(f) may qualify as a subpart E trust if wholly-owned by the grantor. In the latter case, the trust does not satisfy all of the QSST requirements because the grantor is treated as the owner of the income portion of the trust under sections 672(e) and 677.

Commentators also requested guidance as to whether an income beneficiary of a trust that meets the QSST requirements, and who is treated as the owner of all of the trust, or the portion of the trust that consists of S corporation stock under subpart E (and thus is a permitted shareholder under section 1361(c)(2)(A)(i)), may nevertheless make a protective QSST election. The final regulations add provisions for a protective QSST election for income beneficiaries of certain grantor trusts.

The final regulations also change the result in Rev. Rul. 92-84, 1992-2 C.B. 216. Rev. Rul. 92-84 holds that if a QSST sells its S corporation stock, the current income beneficiary and not the trust must recognize any gain or loss. After the publication of Rev. Rul. 92-84, practitioners expressed concern with respect to the sale of the stock by a QSST in an installment sale. Practitioners questioned whether the trust could effectively use the installment method under section 453 to report gain realized on the sale of the stock and expressed concern about how the IRS would treat an installment sale of S stock by a QSST. Practitioners suggested that since the income beneficiary was treated as the owner of the stock sold, the income beneficiary would be treated as the owner of the installment obligation received in exchange for the sale of the stock. However, concern was expressed that because the QSST ceases to be a QSST as to the S corporation stock that was sold, the income beneficiary would no longer be treated as the owner of the installment obligation held by the trust and there may have occurred a disposition of the installment obligation under section 453B(a).

On further consideration, the IRS and Treasury have determined that the income beneficiary of a QSST who is a section 678 deemed owner of the S corporation stock solely by reason of section 1361(d)(1) should not be treated as the owner of the consideration received by a QSST upon its disposition of S corporation stock. Under the final regulations, the consideration is treated as received by the trust in its status as

a separate taxpayer under section 641. Thus, for example, any gain recognized on a sale of the S corporation stock is the gross income of the trust. Similarly, the trust may report any gain realized upon the sale under section 453 if the sale otherwise qualifies as an installment sale. This provision of the final regulations reflects an interpretation of section 1361(d)(1) and has no bearing upon the operation or effect of the principles of sections 671 through 679 beyond the context of a QSST.

If a QSST has sold or otherwise disposed of all or a portion of its S corporation stock in a tax year that is open under the statutes for both the QSST and the income beneficiary but before the effective date of these final regulations, the QSST and the income beneficiary may treat the transaction under Rev. Rul. 92-84 or under these final regulations. However, the QSST and the income beneficiary must take consistent reporting positions. The final regulations require that the QSST and the income beneficiary must state on their respective returns that they are taking consistent reporting positions.

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

Rev. Rul. 92-84, 1992-2 C.B. 216 is obsolete as of July 21, 1995.

#### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a Regulatory Flexibility Analysis is not required.

*Drafting Information:* The principal author of these final regulations is Laura Howell, Office of Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

#### **List of Subjects**

##### **26 CFR Parts 1 and 18**

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, 18 and 602 are amended as follows: