

**§ 1.1361-1 S corporation defined.**

(a) *In general.* For purposes of this title, with respect to any taxable year—

(1) The term *S corporation* means a small business corporation (as defined in paragraph (b) of this section) for which an election under section 1362(a) is in effect for that taxable year.

(2) The term *C corporation* means a corporation that is not an S corporation for that taxable year.

(b) *Small business corporation defined—*

(1) *In general.* For purposes of subchapter S, chapter 1 of the Code and the regulations thereunder, the term *small business corporation* means a domestic corporation that is not an ineligible corporation (as defined in section 1361(b)(2)) and that does not have—

(i) More than the number of shareholders provided in section 1361(b)(1)(A);

(ii) As a shareholder, a person (other than an estate, a trust described in section 1361(c)(2), or, for taxable years beginning after December 31, 1997, an organization described in section 1361(c)(6)) who is not an individual;

(iii) A nonresident alien as a shareholder; or

(iv) More than one class of stock.

(2) *Estate in bankruptcy.* The term *estate*, for purposes of this paragraph, includes the estate of an individual in a case under title 11 of the United States Code.

(3) *Treatment of restricted stock.* For purposes of subchapter S, stock that is issued in connection with the performance of services (within the meaning of § 1.83-3(f)) and that is substantially nonvested (within the meaning of § 1.83-3(b)) is not treated as outstanding stock of the corporation, and the holder of that stock is not treated as a shareholder solely by reason of holding the stock, unless the holder makes an election with respect to the stock under section 83(b). In the event of such an election, the stock is treated as outstanding stock of the corporation, and the holder of the stock is treated as a shareholder for purposes of subchapter S. See paragraphs (1) (1) and (3) of this section for rules for determining whether substantially nonvested stock with respect to which an election under section 83(b) has been

made is treated as a second class of stock.

(4) *Treatment of deferred compensation plans.* For purposes of subchapter S, an instrument, obligation, or arrangement is not outstanding stock if it—

(i) Does not convey the right to vote;

(ii) Is an unfunded and unsecured promise to pay money or property in the future;

(iii) Is issued to an individual who is an employee in connection with the performance of services for the corporation or to an individual who is an independent contractor in connection with the performance of services for the corporation (and is not excessive by reference to the services performed); and

(iv) Is issued pursuant to a plan with respect to which the employee or independent contractor is not taxed currently on income.

A deferred compensation plan that has a current payment feature (e.g., payment of dividend equivalent amounts that are taxed currently as compensation) is not for that reason excluded from this paragraph (b)(4).

(5) *Treatment of straight debt.* For purposes of subchapter S, an instrument or obligation that satisfies the definition of straight debt in paragraph (1)(5) of this section is not treated as outstanding stock.

(6) *Effective date provision.* Section 1.1361-1(b) generally applies to taxable years of a corporation beginning on or after May 28, 1992. However, a corporation and its shareholders may apply this § 1.1361-1(b) to prior taxable years. In addition, substantially nonvested stock issued on or before May 28, 1992, that has been treated as outstanding by the corporation is treated as outstanding for purposes of subchapter S, and the fact that it is substantially nonvested and no section 83(b) election has been made with respect to it will not cause the stock to be treated as a second class of stock.

(c) *Domestic corporation.* For purposes of paragraph (b) of this section, the term *domestic corporation* means a domestic corporation as defined in § 301.7701-5 of this chapter, and the term *corporation* includes an entity

that is classified as an association taxable as a corporation under § 301.7701-2 of this chapter.

(d) *Ineligible corporation*—(1) *General rule*. Except as otherwise provided in this paragraph (d), the term *ineligible corporation* means a corporation that is—

(i) For taxable years beginning on or after January 1, 1997, a financial institution that uses the reserve method of accounting for bad debts described in section 585 (for taxable years beginning prior to January 1, 1997, a financial institution to which section 585 applies (or would apply but for section 585(c)) or to which section 593 applies);

(ii) An insurance company subject to tax under subchapter L;

(iii) A corporation to which an election under section 936 applies; or

(iv) A DISC or former DISC.

(2) *Exceptions*. See the special rules and exceptions provided in sections 6(c) (2), (3) and (4) of Public Law 97-354 that are applicable for certain casualty insurance companies and qualified oil corporations.

(e) *Number of shareholders*—(1) *General rule*. A corporation does not qualify as a small business corporation if it has more than the number of shareholders provided in section 1361(b)(1)(A). Ordinarily, the person who would have to include in gross income dividends distributed with respect to the stock of the corporation (if the corporation were a C corporation) is considered to be the shareholder of the corporation. For example, if stock (owned other than by a husband and wife or members of a family described in section 1361(c)(1)) is owned by tenants in common or joint tenants, each tenant in common or joint tenant is generally considered to be a shareholder of the corporation. (For special rules relating to stock owned by husband and wife or members of a family, see paragraphs (e)(2) and (3) of this section, respectively; for special rules relating to restricted stock, see paragraphs (b)(3) and (6) of this section.) The person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation for purposes of this paragraph (e) and paragraphs (f) and (g) of this section. For example, a

partnership may be a nominee of S corporation stock for a person who qualifies as a shareholder of an S corporation. However, if the partnership is the beneficial owner of the stock, then the partnership is the shareholder, and the corporation does not qualify as a small business corporation. In addition, in the case of stock held for a minor under a uniform transfers to minors act or similar statute, the minor and not the custodian is the shareholder. Except as otherwise provided in paragraphs (h) and (j) of this section, and for purposes of this paragraph (e) and paragraphs (f) and (g) of this section, if stock is held by a decedent's estate or a trust described in section 1361(c)(2)(A)(ii) or (iii), the estate or trust (and not the beneficiaries of the estate or trust) is considered to be the shareholder; however, if stock is held by a subpart E trust (which includes a voting trust) or an electing QSST described in section 1361(d)(1), the deemed owner of the trust is considered to be the shareholder. If stock is held by an ESBT described in section 1361(c)(2)(A)(v), each potential current beneficiary of the trust shall be treated as a shareholder, except that the trust shall be treated as the shareholder during any period in which there is no potential current beneficiary of the trust. If stock is held by a trust described in section 1361(c)(2)(A)(vi), the individual for whose benefit the trust was created shall be treated as the shareholder. See paragraph (h) of this section for special rules relating to trusts.

(2) *Special rules relating to stock owned by husband and wife*. For purposes of paragraph (e)(1) of this section, stock owned by a husband and wife (or by either or both of their estates) is treated as if owned by one shareholder, regardless of the form in which they own the stock. For example, if husband and wife are owners of a subpart E trust, they will be treated as one individual. Both husband and wife must be U.S. citizens or residents, and a decedent spouse's estate must not be a foreign estate as defined in section 7701(a)(31). The treatment described in this paragraph (e)(2) will cease upon dissolution of the marriage for any reason other than death.

(3) *Special rules relating to stock owned by members of a family*—(i) *In general.* For purposes of paragraph (e)(1) of this section, stock owned by members of a family is treated as owned by one shareholder. Members of a family include a common ancestor, any lineal descendant of the common ancestor (without any generational limit), and any spouse (or former spouse) of the common ancestor or of any lineal descendants of the common ancestor. An individual shall not be considered to be a common ancestor if, on the applicable date, the individual is more than six generations removed from the youngest generation of shareholders who would be members of the family determined by deeming that individual as the common ancestor. For purposes of this six-generation test, a spouse (or former spouse) is treated as being of the same generation as the individual to whom the spouse is or was married. This test is applied on the latest of the date the election under section 1362(a) is made for the corporation, the earliest date that a member of the family (determined by deeming that individual as the common ancestor) holds stock in the corporation, or October 22, 2004. For this purpose, the date the election under section 1362(a) is made for the corporation is the effective date of the election, not the date it is signed or received by any person. The test is only applied as of the applicable date, and lineal descendants (and spouses) more than six generations removed from the common ancestor will be treated as members of the family even if they acquire stock in the corporation after that date. The members of a family are treated as one shareholder under this paragraph (e)(3) solely for purposes of section 1361(b)(1)(A), and not for any other purpose, whether under section 1361 or any other provision. Specifically, each member of the family who owns or is deemed to own stock must meet the requirements of sections 1361(b)(1)(B) and (C) (regarding permissible shareholders) and section 1362(a)(2) (regarding shareholder consents to an S corporation election). Although a person may be a member of more than one family under this paragraph (e)(3), each family (not all of whose members are also members of

the other family) will be treated as one shareholder. For purposes of this paragraph (e)(3), any legally adopted child of an individual, any child who is lawfully placed with an individual for legal adoption by that individual, and any eligible foster child of an individual (within the meaning of section 152(f)(1)(C)), shall be treated as a child of such individual by blood.

(ii) *Certain entities treated as members of a family.* For purposes of this paragraph (e)(3), the estate or trust (described in section 1361(c)(2)(A)(ii) or (iii)) of a deceased member of the family will be considered to be a member of the family during the period in which the estate or such trust (if the trust is described in section 1361(c)(2)(A)(ii) or (iii)), holds stock in the S corporation. The members of the family also will include—

(A) In the case of an ESBT, each potential current beneficiary who is a member of the family;

(B) In the case of a QSST, the income beneficiary who makes the QSST election, if that income beneficiary is a member of the family;

(C) In the case of a trust created primarily to exercise the voting power of stock transferred to it, each beneficiary who is a member of the family;

(D) The individual for whose benefit a trust described in section 1361(c)(2)(A)(vi) was created, if that individual is a member of the family;

(E) The deemed owner of a trust described in section 1361(c)(2)(A)(i) if that deemed owner is a member of the family; and

(F) The owner of an entity disregarded as an entity separate from its owner under § 301.7701-3 of this chapter, if that owner is a member of the family.

(f) *Shareholder must be an individual or estate.* Except as otherwise provided in paragraph (e)(1) of this section (relating to nominees), paragraph (h) of this section (relating to certain trusts), and, for taxable years beginning after December 31, 1997, section 1361(c)(6) (relating to certain exempt organizations), a corporation in which any shareholder is a corporation, partnership, or trust does not qualify as a small business corporation.

(g) *Nonresident alien shareholder*—(1) *General rule.* (i) A corporation having a shareholder who is a nonresident alien as defined in section 7701(b)(1)(B) does not qualify as a small business corporation. If a U.S. shareholder's spouse is a nonresident alien who has a current ownership interest (as opposed, for example, to a survivorship interest) in the stock of the corporation by reason of any applicable law, such as a state community property law or a foreign country's law, the corporation does not qualify as a small business corporation from the time the nonresident alien spouse acquires the interest in the stock. If a corporation's S election is inadvertently terminated as a result of a nonresident alien spouse being considered a shareholder, the corporation may request relief under section 1362(f).

(ii) The following examples illustrate this paragraph (g)(1)(i):

*Example 1.* In 1990, W, a U.S. citizen, married H, a citizen of a foreign country. At all times H is a nonresident alien under section 7701(b)(1)(B). Under the foreign country's law, all property acquired by a husband and wife during the existence of the marriage is community property and owned jointly by the husband and wife. In 1996 while residing in the foreign country, W formed X, a U.S. corporation, and X simultaneously filed an election to be an S corporation. X issued all of its outstanding stock in W's name. Under the foreign country's law, X's stock became the community property of and jointly owned by H and W. Thus, X does not meet the definition of a small business corporation and therefore could not file a valid S election because H, a nonresident alien, has a current interest in the stock.

*Example 2.* Assume the same facts as *Example 1*, except that in 1991, W and H filed a section 6013(g) election allowing them to file a joint U.S. tax return and causing H to be treated as a U.S. resident for purposes of chapters 1, 5, and 24 of the Internal Revenue Code. The section 6013(g) election applies to the taxable year for which made and to all subsequent taxable years until terminated. Because H is treated as a U.S. resident under section 6013(g), X does meet the definition of a small business corporation. Thus, the election filed by X to be an S corporation is valid.

(2) *Special rule for dual residents.* [Reserved]

(h) *Special rules relating to trusts*—(1) *General rule.* In general, a trust is not a permitted small business corporation shareholder. However, except as pro-

vided in paragraph (h)(2) of this section, the following trusts are permitted shareholders:

(i) *Qualified subpart E trust.* A trust all of which is treated (under subpart E, part I, subchapter J, chapter 1) as owned by an individual (whether or not the grantor) who is a citizen or resident of the United States (a qualified subpart E trust). This requirement applies only during the period that the trust holds S corporation stock.

(ii) *Subpart E trust ceasing to be a qualified subpart E trust after the death of deemed owner.* A trust that was a qualified subpart E trust immediately before the death of the deemed owner and that continues in existence after the death of the deemed owner, but only for the 2-year period beginning on the day of the deemed owner's death. A trust is considered to continue in existence if the trust continues to hold the stock pursuant to the terms of the will or the trust agreement, or if the trust continues to hold the stock during a period reasonably necessary to wind up the affairs of the trust. See § 1.641(b)-3 for rules concerning the termination of trusts for federal income tax purposes.

(iii) *Electing qualified subchapter S trusts.* A qualified subchapter S trust (QSST) that has a section 1361(d)(2) election in effect (an electing QSST). See paragraph (j) of this section for rules concerning QSSTs including the manner for making the section 1361(d)(2) election.

(iv) *Testamentary trusts.* A trust (other than a qualified subpart E trust, an electing QSST, or an electing small business trust) to which S corporation stock is—

(A) Transferred pursuant to the terms of a will, but only for the 2-year period beginning on the day the stock is transferred to the trust except as otherwise provided in paragraph (h)(3)(i)(D) of this section; or

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

distributed to the trust except as otherwise provided in paragraph (h)(3)(i)(D) of this section.

(v) *Qualified voting trusts.* A trust created primarily to exercise the voting power of S corporation stock transferred to it. To qualify as a voting trust for purposes of this section (a qualified voting trust), the beneficial owners must be treated as the owners of their respective portions of the trust under subpart E and the trust must have been created pursuant to a written trust agreement entered into by the shareholders, that—

(A) Delegates to one or more trustees the right to vote;

(B) Requires all distributions with respect to the stock of the corporation held by the trust to be paid to, or on behalf of, the beneficial owners of that stock;

(C) Requires title and possession of that stock to be delivered to those beneficial owners upon termination of the trust; and

(D) Terminates, under its terms or by state law, on or before a specific date or event.

(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).

(vii) *Individual retirement accounts.* In the case of a corporation which is a bank (as defined in section 581) or a depository institution holding company (as defined in section 3(w)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(w)(1)), a trust which constitutes an individual retirement account under section 408(a), including one designated as a Roth IRA under section 408A, but only to the extent of the stock held by such trust in such bank or company as of October 22, 2004. Individual retirement accounts (including Roth IRAs) are not otherwise eligible S corporation shareholders.

(2) *Foreign trust.* For purposes of paragraph (h)(1) of this section, in any case where stock is held by a foreign trust as defined in section 7701(a)(31), the trust is considered to be the shareholder and is an ineligible shareholder. Thus, even if a foreign trust qualifies

as a subpart E trust (e.g., a qualified voting trust), any corporation in which the trust holds stock does not qualify as a small business corporation.

(3) *Determination of shareholders—(i) General rule.* For purposes of paragraph (b) of this section (qualification as a small business corporation), and, except as provided in paragraph (h)(3)(ii) of this section, for purposes of sections 1366 (relating to the pass-through of items of income, loss, deduction, or credit), 1367 (relating to adjustments to basis of shareholder's stock), and 1368 (relating to distributions), the shareholder of S corporation stock held by a trust that is a permitted shareholder under paragraph (h)(1) of this section is determined as follows:

(A) If stock is held by a qualified subpart E trust, the deemed owner of the trust is treated as the shareholder.

(B) If stock is held by a trust defined in paragraph (h)(1)(ii) of this section, the estate of the deemed owner is generally treated as the shareholder as of the day of the deemed owner's death. However, if stock is held by such a trust in a community property state, the decedent's estate is the shareholder only of the portion of the trust included in the decedent's gross estate (and the surviving spouse continues to be the shareholder of the portion of the trust owned by that spouse under the applicable state's community property law). The estate ordinarily will cease to be treated as the shareholder upon the earlier of the transfer of the stock by the trust or the expiration of the 2-year period beginning on the day of the deemed owner's death. If the trust qualifies and becomes an electing QSST, the beneficiary and not the estate is treated as the shareholder as of the effective date of the QSST election, and the rules provided in paragraph (j)(7) of this section apply. If the trust qualifies and becomes an ESBT, the shareholders are determined under paragraphs (h)(3)(i)(F) and (h)(3)(ii) of this section as of the effective date of the ESBT election, and the rules provided in paragraph (m) of this section apply.

(C) If stock is held by an electing QSST, see paragraph (j)(7) of this section for the rules on who is treated as the shareholder.

(D) If stock is transferred or deemed distributed to a testamentary trust described in paragraph (h)(1)(iv) of this section (other than a qualified subpart E trust, an electing QSST, or an ESBT), the estate of the testator is treated as the shareholder until the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day that the stock is transferred or deemed distributed to the trust. If the trust qualifies and becomes an electing QSST, the beneficiary and not the estate is treated as the shareholder as of the effective date of the QSST election, and the rules provided in paragraph (j)(7) of this section apply. If the trust qualifies and becomes an ESBT, the shareholders are determined under paragraphs (h)(3)(i)(F) and (h)(3)(ii) of this section as of the effective date of the ESBT election, and the rules provided in paragraph (m) of this section apply.

(E) If stock is held by a qualified voting trust, each beneficial owner of the stock, as determined under subpart E, is treated as a shareholder with respect to the owner's proportionate share of the stock held by the trust.

(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.

(G) If stock in an S corporation bank or depository institution holding company is held by an individual retirement account (including a Roth IRA) described in paragraph (h)(1)(vii) of this section, the individual for whose benefit the trust was created shall be treated as the shareholder.

(ii) *Exceptions.* See §1.641(c)-1 for the rules for the taxation of an ESBT. Solely for purposes of section 1366, 1367, and 1368 the shareholder of S corporation stock held by a trust is determined as follows—

(A) If stock is held by a trust as defined in paragraph (h)(1)(ii) of this section (other than an electing QSST or an ESBT), the trust is treated as the shareholder. If the trust continues to

own the stock after the expiration of the 2-year period, the corporation's S election will terminate unless the trust is otherwise a permitted shareholder.

(B) If stock is transferred or deemed distributed to a testamentary trust described in paragraph (h)(1)(iv) of this section (other than a qualified subpart E trust, an electing QSST, or an ESBT), the trust is treated as the shareholder. If the trust continues to own the stock after the expiration of the 2-year period, the corporation's S election will terminate unless the trust otherwise qualifies as a permitted shareholder.

(i) [Reserved]

(j) *Qualified subchapter S trust—(1) Definition.* A qualified subchapter S trust (QSST) is a trust (whether inter vivos or testamentary), other than a foreign trust described in section 7701(a)(31), that satisfies the following requirements:

(i) All of the income (within the meaning of §1.643(b)-1) of the trust is distributed (or is required to be distributed) currently to one individual who is a citizen or resident of the United States. For purposes of the preceding sentence, unless otherwise provided under local law (including pertinent provisions of the governing instrument that are effective under local law), income of the trust includes distributions to the trust from the S corporation for the taxable year in question, but does not include the trust's pro rata share of the S corporation's items of income, loss, deduction, or credit determined under section 1366. See §§1.651(a)-2(a) and 1.663(b)-1(a) for rules relating to the determination of whether all of the income of a trust is distributed (or is required to be distributed) currently. If under the terms of the trust income is not required to be distributed currently, the trustee may elect under section 663(b) to consider a distribution made in the first 65 days of a taxable year as made on the last day of the preceding taxable year. See section 663(b) and §1.663(b)-2 for rules on the time and manner for making the election. The income distribution requirement must be satisfied for the taxable year of the trust or for that part of the trust's taxable year during which it holds S corporation stock.

(ii) The terms of the trust must require that—

(A) During the life of the current income beneficiary, there will be only one income beneficiary of the trust;

(B) Any corpus distributed during the life of the current income beneficiary may be distributed only to that income beneficiary;

(C) The current income beneficiary's income interest in the trust will terminate on the earlier of that income beneficiary's death or the termination of the trust; and

(D) Upon termination of the trust during the life of the current income beneficiary, the trust will distribute all of its assets to that income beneficiary.

(iii) The terms of the trust must satisfy the requirements of paragraph (j)(1)(ii) of this section from the date the QSST election is made or from the effective date of the QSST election, whichever is earlier, throughout the entire period that the current income beneficiary and any successor income beneficiary is the income beneficiary of the trust. If the terms of the trust do not preclude the possibility that any of the requirements stated in paragraph (j)(1)(ii) of this section will not be met, the trust will not qualify as a QSST. For example, if the terms of the trust are silent with respect to corpus distributions, and distributions of corpus to a person other than the current income beneficiary are permitted under local law during the life of the current income beneficiary, then the terms of the trust do not preclude the possibility that corpus may be distributed to a person other than the current income beneficiary and, therefore, the trust is not a QSST.

(2) *Special rules*—(i) If a husband and wife are income beneficiaries of the same trust, the husband and wife file a joint return, and each is a U.S. citizen or resident, the husband and wife are treated as one beneficiary for purposes of paragraph (j) of this section. If a husband and wife are treated by the preceding sentence as one beneficiary, any action required by this section to be taken by an income beneficiary requires joinder of both of them. For example, each spouse must sign the QSST election, continue to be a U.S. citizen

or resident, and continue to file joint returns for the entire period that the QSST election is in effect.

(ii)(A) *Terms of the trust and applicable local law.* The determination of whether the terms of a trust meet all of the requirements under paragraph (j)(1)(ii) of this section depends upon the terms of the trust instrument and the applicable local law. For example, a trust whose governing instrument provides that A is the sole income beneficiary of the trust is, nevertheless, considered to have two income beneficiaries if, under the applicable local law, A and B are considered to be the income beneficiaries of the trust.

(B) *Legal obligation to support.* If under local law a distribution to the income beneficiary is in satisfaction of the grantor's legal obligation of support to that income beneficiary, the trust will not qualify as a QSST as of the date of distribution because, under section 677(b), if income is distributed, the grantor will be treated as the owner of the ordinary income portion of the trust or, if trust corpus is distributed, the grantor will be treated as a beneficiary under section 662. See § 1.677(b)-1 for rules on the treatment of trusts for support and § 1.662(a)-4 for rules concerning amounts used in discharge of a legal obligation.

(C) *Example.* The following example illustrates the rules of paragraph (j)(2)(ii)(B) of this section:

*Example:* F creates a trust for the benefit of F's minor child, G. Under the terms of the trust, all income is payable to G until the trust terminates on the earlier of G's attaining age 35 or G's death. Upon the termination of the trust, all corpus must be distributed to G or G's estate. The trust includes all of the provisions prescribed by section 1361(d)(3)(A) and paragraph (j)(1)(ii) of this section, but does not preclude the trustee from making income distributions to G that will be in satisfaction of F's legal obligation to support G. Under the applicable local law, distributions of trust income to G will satisfy F's legal obligation to support G. If the trustee distributes income to G in satisfaction of F's legal obligation to support G, the trust will not qualify as a QSST because F will be treated as the owner of the ordinary income portion of the trust. Further, the trust will not be a qualified subpart E trust because the trust will be subject to tax on the income allocable to corpus.

(iii) If, under the terms of the trust, a person (including the income beneficiary) has a special power to appoint, during the life of the income beneficiary, trust income or corpus to any person other than the current income beneficiary, the trust will not qualify as a QSST. However, if the power of appointment results in the grantor being treated as the owner of the entire trust under the rules of subpart E, the trust may be a permitted shareholder under section 1361 (c)(2)(A)(i) and paragraph (h)(1)(i) of this section.

(iv) If the terms of a trust or local law do not preclude the current income beneficiary from transferring the beneficiary's interest in the trust or do not preclude a person other than the current income beneficiary named in the trust instrument from being treated as a beneficiary of the trust under § 1.643(c)-1, the trust will still qualify as a QSST. However, if the income beneficiary transfers or assigns the income interest or a portion of the income interest to another, the trust may no longer qualify as a QSST, depending on the facts and circumstances, because any transferee of the current income beneficiary's income interest and any person treated as a beneficiary under § 1.643(c)-1 will be treated as a current income beneficiary for purposes of paragraph (j)(1)(ii) of this section and the trust may no longer meet the QSST requirements.

(v) If the terms of the trust do not preclude a person other than the current income beneficiary named in the trust instrument from being awarded an interest in the trust by the order of a court, the trust will qualify as a QSST assuming the trust meets the requirements of paragraphs (j)(1) (i) and (ii) of this section. However, if as a result of such court order, the trust no longer meets the QSST requirements, the trust no longer qualifies as a QSST and the corporation's S election will terminate.

(vi) A trust may qualify as a QSST even though a person other than the current income beneficiary is treated under subpart E as the owner of a part or all of that portion of a trust which does not consist of the S corporation stock, provided the entire trust meets

the QSST requirements stated in paragraphs (j)(1) (i) and (ii) of this section.

(3) *Separate and independent shares of a trust.* For purposes of sections 1361 (c) and (d), a substantially separate and independent share of a trust, within the meaning of section 663(c) and the regulations thereunder, is treated as a separate trust. For a separate share which holds S corporation stock to qualify as a QSST, the terms of the trust applicable to that separate share must meet the QSST requirements stated in paragraphs (j)(1) (i) and (ii) of this section.

(4) *Qualified terminable interest property trust.* If property, including S corporation stock, or stock of a corporation that intends to make an S election, is transferred to a trust and an election is made to treat all or a portion of the transferred property as qualified terminable interest property (QTIP) under section 2056(b)(7), the income beneficiary may make the QSST election if the trust meets the requirements set out in paragraphs (j)(1) (i) and (ii) of this section. However, if property is transferred to a QTIP trust under section 2523(f), the income beneficiary may not make a QSST election even if the trust meets the requirements set forth in paragraph (j)(1)(ii) of this section because the grantor would be treated as the owner of the income portion of the trust under section 677. In addition, if property is transferred to a QTIP trust under section 2523(f), the trust does not qualify as a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section (a qualified subpart E trust), unless under the terms of the QTIP trust, the grantor is treated as the owner of the entire trust under sections 671 to 677. If the grantor ceases to be the income beneficiary's spouse, the trust may qualify as a QSST if it otherwise satisfies the requirements under paragraphs (j)(1) (i) and (ii) of this section.

(5) *Ceasing to meet the QSST requirements.* If a QSST for which an election under section 1361(d)(2) has been made (as described in paragraph (j)(6) of this section) ceases to meet any of the requirements specified in paragraph (j)(1)(ii) of this section, the provisions of this paragraph (j) will cease to apply

as of the first day on which that requirement ceases to be met. If such a trust ceases to meet the income distribution requirement specified in paragraph (j)(1)(i) of this section, but continues to meet all of the requirements in paragraph (j)(1)(ii) of this section, the provisions of this paragraph (j) will cease to apply as of the first day of the first taxable year beginning after the first taxable year for which the trust ceased to meet the income distribution requirement of paragraph (j)(1)(i) of this section. If a corporation's S election is inadvertently terminated as a result of a trust ceasing to meet the QSST requirements, the corporation may request relief under section 1362(f).

(6) *Qualified subchapter S trust election*—(i) *In general.* This paragraph (j)(6) applies to the election provided in section 1361(d)(2) (the QSST election) to treat a QSST (as defined in paragraph (j)(1) of this section) as a trust described in section 1361(c)(2)(A)(i), and thus a permitted shareholder. This election must be made separately with respect to each corporation whose stock is held by the trust. The QSST election does not itself constitute an election as to the status of the corporation; the corporation must make the election provided by section 1362(a) to be an S corporation. Until the effective date of a corporation's S election, the beneficiary is not treated as the owner of the stock of the corporation for purposes of section 678. Any action required by this paragraph (j) to be taken by a person who is under a legal disability by reason of age may be taken by that person's guardian or other legal representative, or if there be none, by that person's natural or adoptive parent.

(ii) *Filing the QSST election.* The current income beneficiary of the trust must make the election by signing and filing with the service center with which the corporation files its income tax return the applicable form or a statement that—

(A) Contains the name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation;

(B) Identifies the election as an election made under section 1361(d)(2);

(C) Specifies 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);

(D) Specifies the date (or dates) on which the stock of the corporation was transferred to the trust; and

(E) Provides all information and representations necessary to show that:

(1) Under the terms of the trust and applicable local law—

(i) During the life of the current income beneficiary, there will be only one income beneficiary of the trust (if husband and wife are beneficiaries, that they will file joint returns and that both are U.S. residents or citizens);

(ii) Any corpus distributed during the life of the current income beneficiary may be distributed only to that beneficiary;

(iii) The current beneficiary's income interest in the trust will terminate on the earlier of the beneficiary's death or upon termination of the trust; and

(iv) Upon the termination of the trust during the life of such income beneficiary, the trust will distribute all its assets to such beneficiary.

(2) The trust is required to distribute all of its income currently, or that the trustee will distribute all of its income currently if not so required by the terms of the trust.

(3) No distribution of income or corpus by the trust will be in satisfaction of the grantor's legal obligation to support or maintain the income beneficiary.

(iii) *When to file the QSST election.* (A) If S corporation stock is transferred to a trust, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust. If a C corporation has made an election under section 1362(a) to be an S corporation (S election) and, before that corporation's S election is in effect, stock of that corporation is transferred to a trust, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust.

(B) If a trust holds C corporation stock and that C corporation makes an S election effective for the first day of

the taxable year in which the S election is made, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the S election is effective. If a trust holds C corporation stock and that C corporation makes an S election effective for the first day of the taxable year following the taxable year in which the S election is made, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the S election is made. If a trust holds C corporation stock and that corporation makes an S election intending the S election to be effective for the first day of the taxable year in which the S election is made but, under § 1.1362-6(a)(2), such S election is subsequently treated as effective for the first day of the taxable year following the taxable year in which the S election is made, the fact that the QSST election states that the effective date of the QSST election is the first day of the taxable year in which the S election is made will not cause the QSST election to be ineffective for the first year in which the corporation's S election is effective.

(C) If a trust ceases to be a qualified subpart E trust, satisfies the requirements of a QSST, and intends to become a QSST, the QSST election must be filed within the 16-day-and-2-month period beginning on the date on which the trust ceases to be a qualified subpart E trust. If the estate of the deemed owner of the trust is treated as the shareholder under paragraph (h)(3)(i) of this section, the QSST election may be filed at any time, but no later than the end of the 16-day-and-2-month period beginning on the date on which the estate of the deemed owner ceases to be treated as a shareholder.

(D) If a testamentary trust is a permitted shareholder under paragraph (h)(1)(iv) of this section, satisfies the requirements of a QSST, and intends to become a QSST, the QSST election may be filed at any time, but no later than the end of the 16-day-and-2-month period beginning on the day after the end of the 2-year period.

(E) If a corporation's S election terminates because of a late QSST election, the corporation may request inadvertent termination relief under sec-

tion 1362(f). See § 1.1362-4 for rules concerning inadvertent terminations.

(iv) *Protective QSST election when a person is an owner under subpart E.* If the grantor of a trust is treated as the owner under subpart E of all of the trust, or of a portion of the trust which consists of S corporation stock, and the current income beneficiary is not the grantor, the current income beneficiary may not make the QSST election, even if the trust meets the QSST requirements stated in paragraph (j)(1)(ii) of this section. See paragraph (j)(6)(iii)(C) of this section as to when the QSST election may be made. See also paragraph (j)(2)(vi) of this section. However, if the current income beneficiary (or beneficiaries who are husband and wife, if both spouses are U.S. citizens or residents and file a joint return) of a trust is treated under subpart E as owning all or a portion of the trust consisting of S corporation stock, the current income beneficiary (or beneficiaries who are husband and wife, if both spouses are U.S. citizens or residents and file a joint return) may make the QSST election. See *Example 8* of paragraph (k)(1) of this section.

(7) *Treatment as shareholder.* (i) The income beneficiary who makes the QSST election and is treated (for purposes of section 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) If, upon the death of an income beneficiary, the trust continues in existence, continues to hold S corporation stock but no longer satisfies the QSST requirements, is not a qualified subpart E trust, and does not qualify as an ESBT, then, solely for purposes of section 1361(b)(1), as of the date of the income beneficiary's death, the estate of that income beneficiary is treated as the shareholder of the S corporation with respect to which the income beneficiary made the QSST election. The estate ordinarily will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day of the income beneficiary's death. During the period

that the estate is treated as the shareholder for purposes of section 1361(b)(1), the trust is treated as the shareholder for purposes of sections 1366, 1367, and 1368. If, after the 2-year period, the trust continues to hold S corporation stock and does not otherwise qualify as a permitted shareholder, the corporation's S election terminates. If the termination is inadvertent, the corporation may request relief under section 1362(f).

(8) *Coordination with grantor trust rules.* If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made. However, solely for purposes of applying the preceding sentence to a QSST, an income beneficiary who is a deemed section 678 owner only by reason of section 1361(d)(1) will not be treated as the owner of the S corporation stock in determining and attributing the Federal income tax consequences of a disposition of the stock by the QSST. For example, if the disposition is a sale, the QSST election terminates as to the stock sold and any gain or loss recognized on the sale will be that of the trust, not the income beneficiary. Similarly, if a QSST distributes its S corporation stock to the income beneficiary, the QSST election terminates as to the distributed stock and the consequences of the distribution are determined by reference to the status of the trust apart from the income beneficiary's terminating ownership status under sections 678 and 1361(d)(1). The portions of the trust other than the portion consisting of S corporation stock are subject to subparts A through D of subchapter J of chapter 1, except as otherwise required by subpart E of the Internal Revenue Code. However, solely for purposes of applying sections 465 and 469 to the income beneficiary, a disposition of S corporation stock by a QSST shall be treated as a disposition by the income beneficiary.

(9) *Successive income beneficiary.* (i) If the income beneficiary of a QSST who made a QSST election dies, each successive income beneficiary of that trust is treated as consenting to the

election unless a successive income beneficiary affirmatively refuses to consent to the election. For this purpose, the term *successive income beneficiary* includes a beneficiary of a trust whose interest is a separate share within the meaning of section 663(c), but does not include any beneficiary of a trust that is created upon the death of the income beneficiary of the QSST and which is a new trust under local law.

(ii) The application of this paragraph (j)(9) is illustrated by the following examples:

*Example 1.* Shares of stock in Corporation X, an S corporation, are held by Trust A, a QSST for which a QSST election was made. B is the sole income beneficiary of Trust A. On B's death, under the terms of Trust A, J and K become the current income beneficiaries of Trust A. J and K each hold a separate and independent share of Trust A within the meaning of section 663(c). J and K are successive income beneficiaries of Trust A, and they are treated as consenting to B's QSST election.

*Example 2.* Assume the same facts as in *Example 1*, except that on B's death, under the terms of Trust A and local law, Trust A terminates and the principal is to be divided equally and held in newly created Trust B and Trust C. The sole income beneficiaries of Trust B and Trust C are J and K, respectively. Because Trust A terminated, J and K are not successive income beneficiaries of Trust A. J and K must make QSST elections for their respective trusts to qualify as QSSTs, if they qualify. The result is the same whether or not the trustee of Trusts B and C is the same as the trustee of Trust A.

(10) *Affirmative refusal to consent—(i) Required statement.* A successive income beneficiary of a QSST must make an affirmative refusal to consent by signing and filing with the service center where the corporation files its income tax return a statement that—

(A) Contains the name, address, and taxpayer identification number of the successive income beneficiary, the trust, and the corporation for which the election was made;

(B) Identifies the refusal as an affirmative refusal to consent under section 1361(d)(2); and

(C) Sets forth the date on which the successive income beneficiary became the income beneficiary.

(ii) *Filing date and effectiveness.* The affirmative refusal to consent must be

filed within 15 days and 2 months after the date on which the successive income beneficiary becomes the income beneficiary. The affirmative refusal to consent will be effective as of the date on which the successive income beneficiary becomes the current income beneficiary.

(11) *Revocation of QSST election.* A QSST election may be revoked only with the consent of the Commissioner. The Commissioner will not grant a revocation when one of its purposes is the avoidance of Federal income taxes or when the taxable year is closed. 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. The application must be signed by the current income beneficiary and must—

(i) Contain the name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation with respect to which the QSST election was made;

(ii) Identify the election being revoked as an election made under section 1361(d)(2); and

(iii) Explain why the current income beneficiary seeks to revoke the QSST election and indicate that the beneficiary understands the consequences of the revocation.

(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 “ATTENTION ENTITY CONTROL—CONVERSION OF A QSST TO AN ESBT PURSUANT TO SECTION 1.1361-

1(j)” and include all information otherwise required for an ESBT election under paragraph (m)(2) of this section. A separate election must be made with respect to the stock of each S corporation held by the trust.

(iii) The trust has not converted from an ESBT to a QSST within the 36-month period preceding the effective date of the new ESBT election.

(iv) The date on which the ESBT election is to be effective cannot be more than 15 days and two months prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 15 days and two months prior to the date on which the election is filed, it will be effective 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)(1) *Examples.* The provisions of paragraphs (h) and (j) of this section are illustrated by the following examples in which it is assumed that all noncorporate persons are citizens or residents of the United States:

*Example 1.* (i) *Terms of the trust.* In 1996, A and A's spouse, B, created an intervivos trust and each funded the trust with separately owned stock of an S corporation. Under the terms of the trust, A and B designated themselves as the income beneficiaries and each, individually, retained the power to amend or revoke the trust with respect to the trust assets attributable to their respective trust contributions. Upon A's death, the trust is to be divided into two separate parts: one part attributable to the assets A contributed to the trust and one part attributable to B's contributions. Before the trust is divided, and during the administration of A's estate, all trust income is payable to B. The part of the trust attributable to B's contributions is to continue in trust under the terms of which B is designated as the sole income beneficiary and retains the power to amend or revoke the trust. The part attributable to A's contributions is to be divided into two separate trusts both of which have B as the sole income beneficiary for life. One trust, the *Credit Shelter Trust*, is to be funded with an amount that can pass free of estate tax by reason of A's available estate tax unified credit. The terms of the Credit Shelter Trust meet the requirements of section 1361(d)(3) as

a QSST. The balance of the property passes to a Marital Trust, the terms of which satisfy the requirements of section 1361(d)(3) as a QSST and section 2056(b)(7) as QTIP. The appropriate fiduciary under § 20.2056(b)-7(b)(3) is directed to make an election under section 2056(b)(7).

(ii) *Results after deemed owner's death.* On February 3, 1997, A dies and the portion of the trust assets attributable to A's contributions including the S stock contributed by A, is includible in A's gross estate under sections 2036 and 2038. During the administration of A's estate, the trust holds the S corporation stock. Under section 1361(c)(2)(B)(ii), A's estate is treated as the shareholder of the S corporation stock that was included in A's gross estate for purposes of section 1361(b)(1); however, for purposes of sections 1366, 1367, and 1368, the trust is treated as the shareholder. B's part of the trust continues to be a qualified subpart E trust of which B is the owner under sections 676 and 677. B, therefore, continues to be treated as the shareholder of the S corporation stock in that portion of the trust. On May 13, 1997, during the continuing administration of A's estate, the trust is divided into separate trusts in accordance with the terms of the trust instrument. The S corporation stock that was included in A's gross estate is distributed to the Marital Trust and to the Credit Shelter Trust. A's estate will cease to be treated as the shareholder of the S corporation under section 1361(c)(2)(B)(ii) on May 13, 1997 (the date on which the S corporation stock was transferred to the trusts). B, as the income beneficiary of the Marital Trust and the Credit Shelter Trust, must make the QSST election for each trust by July 28, 1997 (the end of the 16-day-and-2-month period beginning on the date the estate ceases to be treated as a shareholder) to have the trusts become permitted shareholders of the S corporation.

*Example 2.* (i) *Qualified subpart E trust as shareholder.* In 1997, A, an individual established a trust and transferred to the trust A's shares of stock of Corporation M, an S corporation. A has the power to revoke the entire trust. The terms of the trust require that all income be paid to B and otherwise meet the requirements of a QSST under section 1361(d)(3). The trust will continue in existence after A's death. The trust is a qualified subpart E trust described in section 1361(c)(2)(A)(i) during A's life, and A (not the trust) is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *Trust ceasing to be a qualified subpart E trust on deemed owner's death.* Assume the same facts as paragraph (i) of this *Example 2*, except that A dies without having exercised A's power to revoke. Upon A's death, the trust ceases to be a qualified subpart E trust described in section 1361(c)(2)(A)(i). A's es-

tate (and not the trust) is treated as the shareholder for purposes of section 1361(b)(1). A's estate will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of the Corporation M stock by the trust (other than to A's estate), the expiration of the 2-year period beginning on the day of A's death, or the effective date of a QSST or ESBT election if the trust qualifies as a QSST or ESBT. However, until that time, because the trust continues in existence after A's death and will receive any distributions with respect to the stock it holds, the trust is treated as the shareholder for purposes of sections 1366, 1367, and 1368. If no QSST or ESBT election is made effective upon the expiration of the 2-year period, the corporation ceases to be an S corporation, but the trust continues as the shareholder of a C corporation.

(iii) *Trust continuing to be a qualified subpart E trust on deemed owner's death.* Assume the same facts as paragraph (ii) of this *Example 2*, except that the terms of the trust also provide that if A does not exercise the power to revoke before A's death, B will have the sole power to withdraw all trust property at any time after A's death. The trust continues to qualify as a qualified subpart E trust after A's death because, upon A's death, B is deemed to be the owner of the entire trust under section 678. Because the trust does not cease to be a qualified subpart E trust upon A's death, B (and not A's estate) is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368. Since the trust qualifies as a QSST, B may make a protective QSST election under paragraph (j)(6)(iv) of this section.

*Example 3.* (i) *2-year rule under section 1361(c)(2)(A)(ii) and (iii).* F owns stock of Corporation P, an S corporation. In addition, F is the deemed owner of a qualified subpart E trust that holds stock in Corporation O, an S corporation. F dies on July 1, 2003. The trust continues in existence after F's death but is no longer a qualified subpart E trust. On August 1, 2003, F's shares of stock in Corporation P are transferred to the trust pursuant to the terms of F's will. Because the stock of Corporation P was not held by the trust when F died, section 1361(c)(2)(A)(ii) does not apply with respect to that stock. Under section 1361(c)(2)(A)(iii), the last day on which the trust could be treated as a permitted shareholder of Corporation P is July 31, 2005 (that is, the last day of the 2-year period that begins on the date of the transfer from the estate to the trust). With respect to the shares of stock in Corporation O held by the trust at the time of F's death, section 1361(c)(2)(A)(ii) applies and the last day on which the trust could be treated as a permitted shareholder of Corporation O is June 30, 2005 (that is, the last day of the 2-year period that begins on the date of F's death).

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

*Example 4. (i) QSST when terms do not require current distribution of income.* Corporation Q, a calendar year corporation, makes an election to be an S corporation effective for calendar year 1996. On July 1, 1996, G, a shareholder of Corporation Q, transfers G's shares of Corporation Q stock to a trust with H as its current income beneficiary. The terms of the trust otherwise satisfy the QSST requirements, but authorize the trustee in its discretion to accumulate or distribute the trust income. However, the trust, which uses the calendar year as its taxable year, initially satisfies the income distribution requirement because the trustee is currently distributing all of the income. On August 1, 1996, H makes a QSST election with respect to Corporation Q that is effective as of July 1, 1996. Accordingly, as of July 1, 1996, the trust is a QSST and H is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *QSST when trust income is not distributed currently.* Assume the same facts as in paragraph (i) of this *Example 4*, except that, for the taxable year ending on December 31, 1997, the trustee accumulates some trust income. The trust ceases to be a QSST on January 1, 1998, because the trust failed to distribute all of its income for the taxable year ending December 31, 1997. Thus, Corporation Q ceases to be an S corporation as of January 1, 1998, because the trust is not a permitted shareholder.

(iii) *QSST when a person other than the current income beneficiary may receive trust corpus.* Assume the same facts as in paragraph (i) of this *Example 4*, except that the events occur in 2003 and H dies on November 1, 2003, and the trust does not qualify as an ESBT. Under the terms of the trust, after H's death, L is the income beneficiary of the trust and the trustee is authorized to distribute trust

corpus to L as well as to J. The trust ceases to be a QSST as of November 1, 2003, because corpus distributions may be made to someone other than L, the current (successive) income beneficiary. Under section 1361(c)(2)(B)(ii), H's estate (and not the trust) is considered to be the shareholder for purposes of section 1361(b)(1) for the 2-year period beginning on November 1, 2003. However, because the trust continues in existence after H's death and will receive any distributions from the corporation, the trust (and not H's estate) is treated as the shareholder for purposes of sections 1366, 1367, and 1368, during that 2-year period. After the 2-year period, the S election terminates and the trust continues as a shareholder of a C corporation. If the termination is inadvertent, Corporation Q may request relief under section 1362(f). However, the S election would not terminate if the trustee distributed all Corporation Q shares to L, J, or both on or before October 31, 2005, (the last day of the 2-year period) assuming that neither L nor J becomes the 76th shareholder of Corporation Q as a result of the distribution.

*Example 5. QSST when current income beneficiary assigns the income interest to a person not named in the trust.* On January 1, 1996, stock of Corporation R, a calendar year S corporation, is transferred to a trust that satisfies all of the requirements to be a QSST. Neither the terms of the trust nor local law preclude the current income beneficiary, K, from assigning K's income interest in the trust. K files a timely QSST election that is effective January 1, 1996. On July 1, 1996, K assigns the income interest in the trust to N. Under applicable state law, the trustee is bound as a result of the assignment to distribute the trust income to N. Thus, the QSST will cease to qualify as a QSST under section 1361(d)(3)(A)(iii) because N's interest will terminate on K's death (rather than on N's death). Accordingly, as of the date of the assignment, the trust ceases to be a QSST and Corporation R ceases to be an S corporation.

*Example 6. QSST when terms fail to provide for distribution of trust assets upon termination during life of current income beneficiary.* A contributor S corporation stock to a trust the terms of which provide for one income beneficiary, annual distributions of income, discretionary invasion of corpus only for the benefit of the income beneficiary, and termination of the trust only upon the death of the current income beneficiary. Since the trust can terminate only upon the death of the income beneficiary, the governing instrument fails to provide for any distribution of trust assets during the income beneficiary's life. The governing instrument's silence on this point does not disqualify the trust under section 1361(d)(3)(A) (ii) or (iv).

*Example 7. QSST when settlor of trust retains a reversion in the trust.* On January 10, 1996, M

transfers to a trust shares of stock in corporation X, an S corporation. D, who is 13 years old and not a lineal descendant of M, is the sole income beneficiary of the trust. On termination of the trust, the principal (including the X shares) is to revert to M. The trust instrument provides that the trust will terminate upon the earlier of D's death or D's 21st birthday. The terms of the trust satisfy all of the requirements to be a QSST except those of section 1361(d)(3)(A)(ii) (that corpus may be distributed during the current income beneficiary's life only to that beneficiary) and (iv) (that, upon termination of the trust during the life of the current income beneficiary, the corpus, must be distributed to that beneficiary). On February 10, 1996, M makes a gift of M's reversionary interest to D. Until M assigns M's reversion in the trust to D, M is deemed to own the entire trust under section 673(a) and the trust is a qualified subpart E trust. For purposes of section 1361(b)(1), 1366, 1367, and 1368, M is the shareholder of X. The trust ceases to be a qualified subpart E trust on February 10, 1996. Assuming that, by virtue of the assignment to D of M's reversionary interest, D (upon his 21st birthday) or D's estate (in the case of D's death before reaching age 21) is entitled under local law to receive the trust principal, the trust will be deemed as of February 10, 1996, to have satisfied the conditions of section 1361(d)(3)(A) (ii) and (iv) even though the terms of the trust do not explicitly so provide. D must make a QSST election by no later than April 25, 1996 (the end of the 16-day-and-2-month period that begins on February 10, 1996, the date on which the X stock is deemed transferred to the trust by M). See example (5) of § 1.1001-2(c) of the regulations.

*Example 8. QSST when the income beneficiary has the power to withdraw corpus.* On January 1, 1996, F transfers stock of an S corporation to an irrevocable trust whose income beneficiary is F's son, C. Under the terms of the trust, C is given the noncumulative power to withdraw from the corpus of the trust the greater of \$5,000 or 5 percent of the value of the corpus on a yearly basis. The terms of the trust meet the QSST requirements. Assuming the trust distributions are not in satisfaction of F's legal obligation to support C, the trust qualifies as a QSST. C (or if C is a minor, C's legal representative) must make the QSST election no later than March 16, 1996 (the end of the 16-day-and-2-month period that begins on the date the stock is transferred to the trust).

*Example 9. (i) Filing the QSST election.* On January 1, 1996, stock of Corporation T, a calendar year C corporation, is transferred to a trust that satisfies all of the requirements to be a QSST. On January 31, 1996, Corporation T files an election to be an S corporation that is to be effective for its taxable year beginning on January 1, 1996. In

order for the S election to be effective for the 1996 taxable year, the QSST election must be effective January 1, 1996, and must be filed within the period beginning on January 1, 1996, and ending March 16, 1996 (the 16-day-and-2-month period beginning on the first day of the first taxable year for which the election to be an S corporation is intended to be effective).

(ii) *QSST election when the S election is filed late.* Assume the same facts as in paragraph (i) of this *Example 9*, except that Corporation T's election to be an S corporation is filed on April 1, 1996 (after the 15th day of the 3rd month of the first taxable year for which it is to be effective but before the end of that taxable year). Because the election to be an S corporation is not timely filed for the 1996 taxable year, under section 1362(b)(3), the S election is treated as made for the taxable year beginning on January 1, 1997. The QSST election must be filed within the 16-day-and-2-month period beginning on April 1, 1996, the date the S election was made, and ending on June 16, 1996.

*Example 10. (i) Transfers to QTIP trust.* On June 1, 1996, A transferred S corporation stock to a trust for the benefit of A's spouse B, the terms of which satisfy the requirements of section 2523(f)(2) as qualified terminable interest property. Under the terms of the trust, B is the sole income beneficiary for life. In addition, corpus may be distributed to B, at the trustee's discretion, during B's lifetime. However, under section 677(a), A is treated as the owner of the trust. Accordingly, the trust is a permitted shareholder of the S corporation under section 1361(c)(2)(A)(i), and A is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *Transfers to QTIP trust where husband and wife divorce.* Assume the same facts as in paragraph (i) of this *Example 10*, except that A and B divorce on May 2, 1997. Under section 682, A ceases to be treated as the owner of the trust under section 677(a) because A and B are no longer husband and wife. Under section 682, after the divorce, B is the income beneficiary of the trust and corpus of the trust may only be distributed to B. Accordingly, assuming the trust otherwise meets the requirements of section 1361(d)(3), B must make the QSST election within 2 months and 15 days after the date of the divorce.

(iii) *Transfers to QTIP trust where no corpus distribution is permitted.* Assume the same facts as in paragraph (i) of this *Example 10*, except that the terms of the trust do not permit corpus to be distributed to B and require its retention by the trust for distribution to A and B's surviving children after the death of B. Under section 677, A is treated as the owner of the ordinary income portion of the trust, but the trust will be subject to tax on

gross income allocable to corpus. Accordingly, the trust does not qualify as an eligible shareholder of the S corporation because it is neither a qualified subpart E trust nor a QSST.

(2) *Effective date*—(i) *In general.* Paragraph (a) of this section, and paragraphs (c) through (k) of this section (as contained in the 26 CFR edition revised April 1, 2003) apply to taxable years of a corporation beginning after July 21, 1995. For taxable years beginning on or before July 21, 1995, to which paragraph (a) of this section and paragraphs (c) through (k) of this section (as contained in the 26 CFR edition revised April 1, 2003) do not apply, see § 18.1361-1 of this chapter (as contained in the 26 CFR edition revised April 1, 1995). However, paragraphs (h)(1)(vi), (h)(3)(i)(F), (h)(3)(ii), and (j)(12) of this section (as contained in the 26 CFR edition revised April 1, 2003) are applicable for taxable years beginning on and after May 14, 2002. Otherwise, paragraphs (b)(1)(ii), (f), (h)(1)(ii), (h)(1)(iv), (h)(3)(i)(B), (h)(3)(i)(D), (h)(3)(ii)(A), (h)(3)(ii)(B), (j)(6)(iii)(C), (j)(6)(iii)(D), (j)(7)(ii), and (k)(1) *Example 2*(ii) fourth and last sentences, *Example 3*, and *Example 4*(iii) of this section apply on and after July 17, 2003. Paragraphs (b)(1)(i), (e)(1), (e)(3), (h)(1)(vii), (h)(3)(i)(G), and the fifth sentence of paragraph (j)(8) are effective on *August 14, 2008*.

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

(iii) *Exception.* 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 for the QSST and the income beneficiary but on or before July 21, 1995, the QSST and the income beneficiary may both treat the transaction as if the beneficiary was the owner of

the stock sold or disposed of, and thus recognize any gain or loss, or as if the QSST was the owner of the stock sold or disposed of as described in paragraph (j)(8) of this section. This exception applies only if the QSST and the income beneficiary take consistent reporting positions. The QSST and the income beneficiary must disclose by a statement on their respective returns (or amended returns), that they are taking consistent reporting positions.

(1) *Classes of stock*—(1) *General rule.* A corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in paragraph (1)(4) of this section (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

(2) *Determination of whether stock confers identical rights to distribution and liquidation proceeds*—(i) *In general.* The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and

this paragraph (1). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

(ii) *State law requirements for payment and withholding of income tax.* State laws may require a corporation to pay or withhold state income taxes on behalf of some or all of the corporation's shareholders. Such laws are disregarded in determining whether all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds, within the meaning of paragraph (1)(1) of this section, provided that, when the constructive distributions resulting from the payment or withholding of taxes by the corporation are taken into account, the outstanding shares confer identical rights to distribution and liquidation proceeds. A difference in timing between the constructive distributions and the actual distributions to the other shareholders does not cause the corporation to be treated as having more than one class of stock.

(iii) *Buy-sell and redemption agreements—(A) In general.* Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless—

(1) A principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (1), and

(2) The agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.

Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock and, thus,

are disregarded in determining whether the outstanding shares of stock confer identical rights. For purposes of this paragraph (1)(2)(iii)(A), a good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence. Although an agreement may be disregarded in determining whether shares of stock confer identical distribution and liquidation rights, payments pursuant to the agreement may have income or transfer tax consequences.

(B) *Exception for certain agreements.* Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights. In addition, if stock that is substantially nonvested (within the meaning of § 1.83-3(b)) is treated as outstanding under these regulations, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded. Furthermore, the Commissioner may provide by Revenue Ruling or other published guidance that other types of bona fide agreements to redeem or purchase stock are disregarded.

(C) *Safe harbors for determinations of book value.* A determination of book value will be respected if—

(1) The book value is determined in accordance with Generally Accepted Accounting Principles (including permitted optional adjustments); or

(2) The book value is used for any substantial nontax purpose.

(iv) *Distributions that take into account varying interests in stock during a taxable year.* A governing provision does not, within the meaning of paragraph (1)(2)(i) of this section, alter the rights to liquidation and distribution proceeds conferred by an S corporation's stock merely because the governing provision provides that, as a result of a change in stock ownership, distributions in a taxable year are to be made on the basis of the shareholders' varying interests in the S corporation's income in the current or immediately preceding taxable year. If distributions

pursuant to the provision are not made within a reasonable time after the close of the taxable year in which the varying interests occur, the distributions may be recharacterized depending on the facts and circumstances, but will not result in a second class of stock.

(v) *Special rule for section 338(h)(10) elections.* If the shareholders of an S corporation sell their stock in a transaction for which an election is made under section 338(h)(10) and § 1.338(h)(10)-1, the receipt of varying amounts per share by the shareholders will not cause the S corporation to have more than one class of stock, provided that the varying amounts are determined in arm's length negotiations with the purchaser.

(vi) *Examples.* The application of paragraph (1)(2) of this section may be illustrated by the following examples. In each of the examples, the S corporation requirements of section 1361 are satisfied except as otherwise stated, the corporation has in effect an S election under section 1362, and the corporation has only the shareholders described.

*Example 1. Determination of whether stock confers identical rights to distribution and liquidation proceeds.* (i) The law of State A requires that permission be obtained from the State Commissioner of Corporations before stock may be issued by a corporation. The Commissioner grants permission to S, a corporation, to issue its stock subject to the restriction that any person who is issued stock in exchange for property, and not cash, must waive all rights to receive distributions until the shareholders who contributed cash for stock have received distributions in the amount of their cash contributions.

(ii) The condition imposed by the Commissioner pursuant to state law alters the rights to distribution and liquidation proceeds conferred by the outstanding stock of S so that those rights are not identical. Accordingly, under paragraph (1)(2)(i) of this section, S is treated as having more than one class of stock and does not qualify as a small business corporation.

*Example 2. Distributions that differ in timing.* (i) S, a corporation, has two equal shareholders, A and B. Under S's bylaws, A and B are entitled to equal distributions. S distributes \$50,000 to A in the current year, but does not distribute \$50,000 to B until one year later. The circumstances indicate that the difference in timing did not occur by reason

of a binding agreement relating to distribution or liquidation proceeds.

(ii) Under paragraph (1)(2)(i) of this section, the difference in timing of the distributions to A and B does not cause S to be treated as having more than one class of stock. However, section 7872 or other recharacterization principles may apply to determine the appropriate tax consequences.

*Example 3. Treatment of excessive compensation.* (i) S, a corporation, has two equal shareholders, C and D, who are each employed by S and have binding employment agreements with S. The compensation paid by S to C under C's employment agreement is reasonable. The compensation paid by S to D under D's employment agreement, however, is found to be excessive. The facts and circumstances do not reflect that a principal purpose to D's employment agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (1).

(ii) Under paragraph (1)(2)(i) of this section, the employment agreements are not governing provisions. Accordingly, S is not treated as having more than one class of stock by reason of the employment agreements, even though S is not allowed a deduction for the excessive compensation paid to D.

*Example 4. Agreement to pay fringe benefits.* (i) S, a corporation, is required under binding agreements to pay accident and health insurance premiums on behalf of certain of its employees who are also shareholders. Different premium amounts are paid by S for each employee-shareholder. The facts and circumstances do not reflect that a principal purpose of the agreements is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (1).

(ii) Under paragraph (1)(2)(i) of this section, the agreements are not governing provisions. Accordingly, S is not treated as having more than one class of stock by reason of the agreements. In addition, S is not treated as having more than one class of stock by reason of the payment of fringe benefits.

*Example 5. Below-market corporation-shareholder loan.* (i) E is a shareholder of S, a corporation. S makes a below-market loan to E that is a corporation-shareholder loan to which section 7872 applies. Under section 7872, E is deemed to receive a distribution with respect to S stock by reason of the loan. The facts and circumstances do not reflect that a principal purpose of the loan is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (1).

(ii) Under paragraph (1)(2)(i) of this section, the loan agreement is not a governing provision. Accordingly, S is not treated as having more than one class of stock by reason of the below-market loan to E.

*Example 6. Agreement to adjust distributions for state tax burdens.* (i) S, a corporation, executes a binding agreement with its shareholders to modify its normal distribution policy by making upward adjustments of its distributions to those shareholders who bear heavier state tax burdens. The adjustments are based on a formula that will give the shareholders equal after-tax distributions.

(ii) The binding agreement relates to distribution or liquidation proceeds. The agreement is thus a governing provision that alters the rights conferred by the outstanding stock of S to distribution proceeds so that those rights are not identical. Therefore, under paragraph (1)(2)(i) of this section, S is treated as having more than one class of stock.

*Example 7. State law requirements for payment and withholding of income tax.* (i) The law of State X requires corporations to pay state income taxes on behalf of nonresident shareholders. The law of State X does not require corporations to pay state income taxes on behalf of resident shareholders. S is incorporated in State X. S's resident shareholders have the right (for example, under the law of State X or pursuant to S's bylaws or a binding agreement) to distributions that take into account the payments S makes on behalf of its nonresident shareholders.

(ii) The payment by S of state income taxes on behalf of its nonresident shareholders are generally treated as constructive distributions to those shareholders. Because S's resident shareholders have the right to equal distributions, taking into account the constructive distributions to the nonresident shareholders, S's shares confer identical rights to distribution proceeds. Accordingly, under paragraph (1)(2)(ii) of this section, the state law requiring S to pay state income taxes on behalf of its nonresident shareholders is disregarded in determining whether S has more than one class of stock.

(iii) The same result would follow if the payments of state income taxes on behalf of nonresident shareholders are instead treated as advances to those shareholders and the governing provisions require the advances to be repaid or offset by reductions in distributions to those shareholders.

*Example 8. Redemption agreements.* (i) F, G, and H are shareholders of S, a corporation. F is also an employee of S. By agreement, S is to redeem F's shares on the termination of F's employment.

(ii) On these facts, under paragraph (1)(2)(iii)(B) of this section, the agreement is disregarded in determining whether all outstanding shares of S's stock confer identical rights to distribution and liquidation proceeds.

*Example 9. Analysis of redemption agreements.* (i) J, K, and L are shareholders of S, a corporation. L is also an employee of S. L's shares were not issued to L in connection

with the performance of services. By agreement, S is to redeem L's shares for an amount significantly below their fair market value on the termination of L's employment or if S's sales fall below certain levels.

(ii) Under paragraph (1)(2)(iii)(B) of this section, the portion of the agreement providing for redemption of L's stock on termination of employment is disregarded. Under paragraph (1)(2)(iii)(A), the portion of the agreement providing for redemption of L's stock if S's sales fall below certain levels is disregarded unless a principal purpose of that portion of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (1).

(3) *Stock taken into account.* Except as provided in paragraphs (b) (3), (4), and (5) of this section (relating to restricted stock, deferred compensation plans, and straight debt), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account. For example, substantially nonvested stock with respect to which an election under section 83(b) has been made is taken into account in determining whether a corporation has a second class of stock, and such stock is not treated as a second class of stock if the stock confers rights to distribution and liquidation proceeds that are identical, within the meaning of paragraph (1)(1) of this section, to the rights conferred by the other outstanding shares of stock.

(4) *Other instruments, obligations, or arrangements treated as a second class of stock—(i) In general.* Instruments, obligations, or arrangements are not treated as a second class of stock for purposes of this paragraph (1) unless they are described in paragraph (1)(5) (ii) or (iii) of this section. However, in no event are instruments, obligations, or arrangements described in paragraph (b)(4) of this section (relating to deferred compensation plans), paragraphs (1)(4)(iii) (B) and (C) of this section (relating to the exceptions and safe harbor for options), paragraph (1)(4)(ii)(B) of this section (relating to the safe harbors for certain short-term unwritten advances and proportionally-held debt), or paragraph (1)(5) of this section (relating to the safe harbor for straight debt), treated as a second class of stock for purposes of this paragraph (1).

(ii) *Instruments, obligations, or arrangements treated as equity under general principles*—(A) *In general.* Except as provided in paragraph (1)(4)(i) of this section, any instrument, obligation, or arrangement issued by a corporation (other than outstanding shares of stock described in paragraph (1)(3) of this section), regardless of whether designated as debt, is treated as a second class of stock of the corporation—

(1) If the instrument, obligation, or arrangement constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law; and

(2) A principal purpose of issuing or entering into the instrument, obligation, or arrangement is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders contained in paragraph (b)(1) of this section.

(B) *Safe harbor for certain short-term unwritten advances and proportionately held obligations*—(1) *Short-term unwritten advances.* Unwritten advances from a shareholder that do not exceed \$10,000 in the aggregate at any time during the taxable year of the corporation, are treated as debt by the parties, and are expected to be repaid within a reasonable time are not treated as a second class of stock for that taxable year, even if the advances are considered equity under general principles of Federal tax law. The failure of an unwritten advance to meet this safe harbor will not result in a second class of stock unless the advance is considered equity under paragraph (1)(4)(ii)(A)(1) of this section and a principal purpose of the advance is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders under paragraph (1)(4)(ii)(A)(2) of this section.

(2) *Proportionately-held obligations.* Obligations of the same class that are considered equity under general principles of Federal tax law, but are owned solely by the owners of, and in the same proportion as, the outstanding stock of the corporation, are not treated as a second class of stock. Furthermore, an obligation or obliga-

tions owned by the sole shareholder of a corporation are always held proportionately to the corporation's outstanding stock. The obligations that are considered equity that do not meet this safe harbor will not result in a second class of stock unless a principal purpose of the obligations is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders under paragraph (1)(4)(ii)(A)(2) of this section.

(iii) *Certain call options, warrants or similar instruments*—(A) *In general.* Except as otherwise provided in this paragraph (1)(4)(iii), a call option, warrant, or similar instrument (collectively, call option) issued by a corporation is treated as a second class of stock of the corporation if, taking into account all the facts and circumstances, the call option is substantially certain to be exercised (by the holder or a potential transferee) and has a strike price substantially below the fair market value of the underlying stock on the date that the call option is issued, transferred by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section, or materially modified. For purposes of this paragraph (1)(4)(iii), if an option is issued in connection with a loan and the time period in which the option can be exercised is extended in connection with (and consistent with) a modification of the terms of the loan, the extension of the time period in which the option may be exercised is not considered a material modification. In addition, a call option does not have a strike price substantially below fair market value if the price at the time of exercise cannot, pursuant to the terms of the instrument, be substantially below the fair market value of the underlying stock at the time of exercise.

(B) *Certain exceptions.* (1) A call option is not treated as a second class of stock for purposes of this paragraph (1) if it is issued to a person that is actively and regularly engaged in the business of lending and issued in connection with a commercially reasonable loan to the corporation. This paragraph (1)(4)(iii)(B)(1) continues to apply if the call option is transferred with

the loan (or if a portion of the call option is transferred with a corresponding portion of the loan). However, if the call option is transferred without a corresponding portion of the loan, this paragraph (1)(4)(iii)(B)(1) ceases to apply. Upon that transfer, the call option is tested under paragraph (1)(4)(iii)(A) (notwithstanding anything in that paragraph to the contrary) if, but for this paragraph, the call option would have been treated as a second class of stock on the date it was issued.

(2) A call option that is issued to an individual who is either an employee or an independent contractor in connection with the performance of services for the corporation or a related corporation (and that is not excessive by reference to the services performed) is not treated as a second class of stock for purposes of this paragraph (1) if—

(i) The call option is nontransferable within the meaning of § 1.83-3(d); and

(ii) The call option does not have a readily ascertainable fair market value as defined in § 1.83-7(b) at the time the option is issued.

If the call option becomes transferable, this paragraph (1)(4)(iii)(B)(2) ceases to apply. Solely for purposes of this paragraph (1)(4)(iii)(B)(2), a corporation is related to the issuing corporation if more than 50 percent of the total voting power and total value of its stock is owned by the issuing corporation.

(3) The Commissioner may provide other exceptions by Revenue Ruling or other published guidance.

(C) *Safe harbor for certain options.* A call option is not treated as a second class of stock if, on the date the call option is issued, transferred by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section, or materially modified, the strike price of the call option is at least 90 percent of the fair market value of the underlying stock on that date. For purposes of this paragraph (1)(4)(iii)(C), a good faith determination of fair market value by the corporation will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence to obtain a fair value.

Failure of an option to meet this safe harbor will not necessarily result in the option being treated as a second class of stock.

(iv) *Convertible debt.* A convertible debt instrument is considered a second class of stock if—

(A) It would be treated as a second class of stock under paragraph (1)(4)(ii) of this section (relating to instruments, obligations, or arrangements treated as equity under general principles); or

(B) It embodies rights equivalent to those of a call option that would be treated as a second class of stock under paragraph (1)(4)(iii) of this section (relating to certain call options, warrants, and similar instruments).

(v) *Examples.* The application of this paragraph (1)(4) may be illustrated by the following examples. In each of the examples, the S corporation requirements of section 1361 are satisfied except as otherwise stated, the corporation has in effect an S election under section 1362, and the corporation has only the shareholders described.

*Example 1. Transfer of call option by eligible shareholder to ineligible shareholder.* (i) S, a corporation, has 10 shareholders. S issues call options to A, B, and C, individuals who are U.S. residents. A, B, and C are not shareholders, employees, or independent contractors of S. The options have a strike price of \$40 and are issued on a date when the fair market value of S stock is also \$40. A year later, P, a partnership, purchases A's option. On the date of transfer, the fair market value of S stock is \$80.

(ii) On the date the call option is issued, its strike price is not substantially below the fair market value of the S stock. Under paragraph (1)(4)(iii)(A) of this section, whether a call option is a second class of stock must be redetermined if the call option is transferred by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section. In this case, A is an eligible shareholder of S under paragraph (b)(1) of this section, but P is not. Accordingly, the option is retested on the date it is transferred to D.

(iii) Because on the date the call option is transferred to P its strike price is 50% of the fair market value, the strike price is substantially below the fair market value of the S stock. Accordingly, the call option is treated as a second class of stock as of the date it is transferred to P if, at that time, it

is determined that the option is substantially certain to be exercised. The determination of whether the option is substantially certain to be exercised is made on the basis of all the facts and circumstances.

*Example 2. Call option issued in connection with the performance of services.* (i) E is a bona fide employee of S, a corporation. S issues to E a call option in connection with E's performance of services. At the time the call option is issued, it is not transferable and does not have a readily ascertainable fair market value. However, the call option becomes transferable before it is exercised by E.

(ii) While the option is not transferable, under paragraph (1)(4)(iii)(B)(2) of this section, it is not treated as a second class of stock, regardless of its strike price. When the option becomes transferable, that paragraph ceases to apply, and the general rule of paragraph (1)(4)(iii)(A) of this section applies. Accordingly, if the option is materially modified or is transferred to a person who is not an eligible shareholder under paragraph (b)(1) of this section, and on the date of such modification or transfer, the option is substantially certain to be exercised and has a strike price substantially below the fair market value of the underlying stock, the option is treated as a second class of stock.

(iii) If E left S's employment before the option became transferable, the exception provided by paragraph (1)(4)(iii)(B)(2) would continue to apply until the option became transferable.

(5) *Straight debt safe harbor—(i) In general.* Notwithstanding paragraph (1)(4) of this section, straight debt is not treated as a second class of stock. For purposes of section 1361(c)(5) and this section, the term straight debt means a written unconditional obligation, regardless of whether embodied in a formal note, to pay a sum certain on demand, or on a specified due date, which—

(A) Does not provide for an interest rate or payment dates that are contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock, or similar factors;

(B) Is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation; and

(C) Is held by an individual (other than a nonresident alien), an estate, or a trust described in section 1361(c)(2).

(ii) *Subordination.* The fact that an obligation is subordinated to other debt of the corporation does not prevent the obligation from qualifying as straight debt.

(iii) *Modification or transfer.* An obligation that originally qualifies as straight debt ceases to so qualify if the obligation—

(A) Is materially modified so that it no longer satisfies the definition of straight debt; or

(B) Is transferred to a third party who is not an eligible shareholder under paragraph (b)(1) of this section.

(iv) *Treatment of straight debt for other purposes.* An obligation of an S corporation that satisfies the definition of straight debt in paragraph (1)(5)(i) of this section is not treated as a second class of stock even if it is considered equity under general principles of Federal tax law. Such an obligation is generally treated as debt and when so treated is subject to the applicable rules governing indebtedness for other purposes of the Code. Accordingly, interest paid or accrued with respect to a straight debt obligation is generally treated as interest by the corporation and the recipient and does not constitute a distribution to which section 1368 applies. However, if a straight debt obligation bears a rate of interest that is unreasonably high, an appropriate portion of the interest may be recharacterized and treated as a payment that is not interest. Such a recharacterization does not result in a second class of stock.

(v) *Treatment of C corporation debt upon conversion to S status.* If a C corporation has outstanding an obligation that satisfies the definition of straight debt in paragraph (1)(5)(i) of this section, but that is considered equity under general principles of Federal tax law, the obligation is not treated as a second class of stock for purposes of this section if the C corporation converts to S status. In addition, the conversion from C corporation status to S corporation status is not treated as an exchange of debt for stock with respect to such an instrument.

(6) *Inadvertent terminations.* See section 1362(f) and the regulations thereunder for rules relating to inadvertent terminations in cases where the one class of stock requirement has been inadvertently breached.

(7) *Effective date.* Section 1.1361-1(1) generally applies to taxable years of a corporation beginning on or after May

28, 1992. However, § 1.1361-1(1) does not apply to: an instrument, obligation, or arrangement issued or entered into before May 28, 1992, and not materially modified after that date; a buy-sell agreement, redemption agreement, or agreement restricting transferability entered into before May 28, 1992, and not materially modified after that date; or a call option or similar instrument issued before May 28, 1992, and not materially modified after that date. In addition, a corporation and its shareholders may apply this § 1.1361-1(1) to prior taxable years.

(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 non-

resident 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 holds stock. If the trust includes a power described in paragraph (m)(4)(vi)(B) of this section, then the election statement must include a statement that such a power is included in the instrument, but does not need to include the name, address, or taxpayer identification number of any particular charity or any other information regarding the power.

(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 the stock which it holds in an S corporation, then, with respect to that corporation, any person who first met the definition of a potential current beneficiary during the 1-year 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 and other powers*—(A) *Powers of appointment.* A person to whom a distribution may be made during any period pursuant to a power of appointment (as described for transfer tax purposes in section 2041 and § 20.2041-1(b) of this chapter and section 2514 and § 25.2514-1(b) of this chapter) is not a potential current beneficiary unless the power is exercised in favor of that person during the period. It is immaterial for purposes of this paragraph

(m)(4)(vi)(A) whether such power of appointment is a “general power of appointment” for transfer tax purposes as described in §§ 20.2041-1(c) and 25.2514-1(c) of this chapter. The mere existence of one or more powers of appointment during the lifetime of a power holder that would permit current distributions from the trust to be made to more than the number of persons described in section 1361(b)(1)(A) or to a person described in section 1361(b)(1)(B) or (C) will not cause the S corporation election to terminate unless one or more of such powers are exercised, collectively, in favor of an excessive number of persons or in favor of a person who is ineligible to be an S corporation shareholder. For purposes of this paragraph (m)(4)(vi)(A), a “power of appointment” includes a power, regardless of by whom held, to add a beneficiary or class of beneficiaries to the class of potential current beneficiaries, but generally does not include a power held by a fiduciary who is not also a beneficiary of the trust to spray or sprinkle trust distributions among beneficiaries. Nothing in this paragraph (m)(4)(vi)(A) alters the definition of “power of appointment” for purposes of any provision of the Internal Revenue Code or the regulations.

(B) *Powers to distribute to certain organizations not pursuant to powers of appointment.* If a trustee or other fiduciary has a power (that does not constitute a power of appointment for transfer tax purposes as described in §§ 20.2041-1(b) and 25.2514-1(b) of this chapter) to make distributions from the trust to one or more members of a class of organizations described in section 1361(c)(6), such organizations will be counted collectively as only one potential current beneficiary for purposes of this paragraph (m), except that each organization receiving a distribution also will be counted as a potential current beneficiary. This paragraph (m)(4)(vi)(B) shall not apply to a power to currently distribute to one or more particular charitable organizations described in section 1361(c)(6). Each of such organizations is a potential current beneficiary 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 "ATTENTION ENTITY CONTROL—CONVERSION OF AN ESBT TO A QSST PURSUANT TO SECTION 1.1361-1(m)" and include all information otherwise required for a QSST election under §1.1361-1(j)(6). A separate 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, 2005, Trust makes a valid ESBT election. On January 1, 2006, *A*, a nonresident alien, becomes a potential current beneficiary of Trust. Trust does not dispose of all of its S corporation stock within one year after January 1, 2006. As of January 1, 2006, *A* is the 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, 2006. 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 one year after January 1, 2006, 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 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 from which *A* has a right to all net income and funds it with S corporation stock. *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 for any period will be *A* and each person who receives a distribution from Trust pursuant to *A*'s exercise of *A*'s power of appointment during that period.

*Example 8. Power to distribute to an unlimited class of charitable organizations not pursuant to a power of appointment.* *M* creates Trust from which *A* has a right to all net income and funds it with S corporation stock. In addition, the trustee of Trust, who is not *A* or a descendant of *M*, has the power to make

discretionary distributions of principal to the living descendants of *M* and to any organizations described in section 1361(c)(6). The potential current beneficiaries of Trust for any period will be *A*, each then-living descendant of *M*, and each exempt organization described in section 1361(c)(6) that receives a distribution during that period. In addition, the class of exempt organizations will be counted as one potential current beneficiary.

*Example 9. Power to distribute to a class of named charitable organizations not pursuant to a power of appointment.* *M* creates Trust from which *A* has a right to all net income and funds it with S corporation stock. In addition, the trustee of Trust, who is not *A* or a descendant of *M*, has the power to make discretionary distributions of principal to the living descendants of *M* and to *X*, *Y*, and *Z*, each of which is an organization described in section 1361(c)(6). The potential current beneficiaries of Trust for any period will be *A*, *X*, *Y*, *Z*, and each living descendant of *M*.

(9) *Effective date.* This paragraph (m) is applicable for taxable years of ESBTs beginning on and after May 14, 2002. Paragraphs (m)(2)(ii)(A), (m)(4)(iii) and (vi), and (m)(8), *Example 2, Example 5, Example 7, Example 8, and Example 9* of this section are effective on August 14, 2008.

[T.D. 8419, 57 FR 22649, May 29, 1992; 57 FR 28613, June 26, 1992, as amended by T.D. 8600, 60 FR 37581, July 21, 1995; 60 FR 49976, Sept. 27, 1995; 60 FR 58234, Nov. 27, 1995; 61 FR 2869, Jan. 29, 1996; T.D. 8869, 65 FR 3849, Jan. 25, 2000; T.D. 8940, 66 FR 9929, 9957, Feb. 13, 2001; T.D. 8994, 67 FR 34397, May 14, 2002; T.D. 9078, 68 FR 42252, July 17, 2003; T.D. 9422, 73 FR 47527, Aug. 14, 2008]

### § 1.1361-2 Definitions relating to S corporation subsidiaries.

(a) *In general.* The term *qualified subsidiary* (QSub) means any domestic corporation that is not an ineligible corporation (as defined in section 1361(b)(2) and the regulations thereunder), if—

(1) 100 percent of the stock of such corporation is held by an S corporation; and

(2) The S corporation properly elects to treat the subsidiary as a QSub under § 1.1361-3.

(b) *Stock treated as held by S corporation.* For purposes of satisfying the 100 percent stock ownership requirement in section 1361(b)(3)(B)(i) and paragraph (a)(1) of this section—

(1) Stock of a corporation is treated as held by an S corporation if the S

corporation is the owner of that stock for Federal income tax purposes; and

(2) Any outstanding instruments, obligations, or arrangements of the corporation which would not be considered stock for purposes of section 1361(b)(1)(D) if the corporation were an S corporation are not treated as outstanding stock of the QSub.

(c) *Straight debt safe harbor.* Section 1.1361-1(1)(5)(iv) and (v) apply to an obligation of a corporation for which a QSub election is made if that obligation would satisfy the definition of straight debt in § 1.1361-1(1)(5) if issued by the S corporation.

(d) *Examples.* The following examples illustrate the application of this section:

*Example 1.* *X*, an S corporation, owns 100 percent of *Y*, a corporation for which a valid QSub election is in effect for the taxable year. *Y* owns 100 percent of *Z*, a corporation otherwise eligible for QSub status. *X* may elect to treat *Z* as a QSub under section 1361(b)(3)(B)(ii).

*Example 2.* Assume the same facts as in *Example 1*, except that *Y* is a business entity that is disregarded as an entity separate from its owner under § 301.7701-2(c)(2) of this chapter. *X* may elect to treat *Z* as a QSub.

*Example 3.* Assume the same facts as in *Example 1*, except that *Y* owns 50 percent of *Z*, and *X* owns the other 50 percent. *X* may elect to treat *Z* as a QSub.

*Example 4.* Assume the same facts as in *Example 1*, except that *Y* is a C corporation. Although *Y* is a domestic corporation that is otherwise eligible to be a QSub, no QSub election has been made for *Y*. Thus, *X* is not treated as holding the stock of *Z*. Consequently, *X* may not elect to treat *Z* as a QSub.

*Example 5.* Individuals *A* and *B* own 100 percent of the stock of corporation *X*, an S corporation, and, except for *C*'s interest (described below), *X* owns 100 percent of corporation *Y*, a C corporation. Individual *C* holds an instrument issued by *Y* that is considered to be equity under general principles of tax law but would satisfy the definition of straight debt under § 1.1361-1(1)(5) if *Y* were an S corporation. In determining whether *X* owns 100 percent of *Y* for purposes of making the QSub election, the instrument held by *C* is not considered outstanding stock. In addition, under § 1.1361-1(1)(5)(v), the QSub election is not treated as an exchange of debt for stock with respect to such instrument, and § 1.1361-1(1)(5)(iv) applies to determine the tax treatment of payments on the instrument while *Y*'s QSub election is in effect.

[T.D. 8869, 65 FR 3849, Jan. 25, 2000]