

deductions, and credits of the person or persons succeeding to the property of the estate or trust.

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[T.D. 8994, 67 FR 34394, May 14, 2002]

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

(a) *In general.* An electing small business trust (ESBT) within the meaning of section 1361(e) is treated as two separate trusts for purposes of chapter 1 of the Internal Revenue Code. The portion of an ESBT that consists of stock in one or more S corporations is treated as one trust. The portion of an ESBT that consists of all the other assets in the trust is treated as a separate trust. The grantor or another person may be treated as the owner of all or a portion of either or both such trusts under subpart E, part I, subchapter J, chapter 1

of the Internal Revenue Code. The ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return. *See* § 1.1361-1(m).

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

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

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

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

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

(2) *Section 1366 amounts*—(i) *In general.* The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Rules otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. *See* § 1.1361-1(m)(3)(iv) for allocation of those items in the taxable year of the S corporation in which the trust is an ESBT for part of the year and an eligible shareholder under section 1361(a)(2)(A)(i) through (iv) for the rest of the year.

(ii) *Special rule for charitable contributions.* If a deduction described in paragraph (d)(2)(i) of this section is attributable to an amount of the S corporation's gross income that is paid by the S corporation for a charitable purpose specified in section 170(c) (without regard to section 170(c)(2)(A)), the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1). The limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion.

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

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

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

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

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

(ii) *Special rule for certain interest.* Interest paid by the trust on money bor-

rowed by the trust to purchase stock in an S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion.

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

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

(f) *Adjustments to basis of stock in the S portion under section 1367.* The basis of S corporation stock in the S portion must be adjusted in accordance with section 1367 and the regulations thereunder. If the ESBT owns stock in more than one S corporation, the adjustments to the basis in the S corporation stock of each S corporation must be determined separately with respect to each S corporation. Accordingly, items of income, loss, deduction, or credit of an S corporation that are taken into account by the ESBT under section 1366 can only result in an adjustment to the basis of the stock of that S corporation and cannot affect the basis in the stock of the other S corporations held by the ESBT.

(g) *Taxation of non-S portion—(1) In general.* The taxable income of the non-S portion is determined by taking into account all items of income, deduction, and credit to the extent not taken into account by either the grantor portion or the S portion. The items attributable to the non-S portion are taxed under subparts A through D of part I, subchapter J, chapter 1 of the Internal Revenue Code. The non-S portion may consist of more than one share pursuant to section 663(c).

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

(3) *Interest on installment obligations.* If income from the sale or disposition of stock in an S corporation is reported

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

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

(h) *Allocation of state and local income taxes and administration expenses.* Whenever state and local income taxes or administration expenses relate to more than one portion of an ESBT, they must be allocated between or among the portions to which they relate. These items may be allocated in any manner that is reasonable in light of all the circumstances, including the terms of the governing instrument, applicable local law, and the practice of the trustee with respect to the trust if it is reasonable and consistent. The taxes and expenses apportioned to each portion of the ESBT are taken into account by that portion.

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

(j) *Termination or revocation of ESBT election.* If the ESBT election of the trust terminates pursuant to § 1.1361-1(m)(5) or the ESBT election is revoked pursuant to § 1.1361-1(m)(6), the rules contained in this section are thereafter

not applicable to the trust. If, upon termination or revocation, the S portion has a net operating loss under section 172; a capital loss carryover under section 1212; or deductions in excess of gross income; then any such loss, carryover, or excess deductions shall be allowed as a deduction, in accordance with the regulations under section 642(h), to the trust, or to the beneficiaries succeeding to the property of the trust if the entire trust terminates.

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

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

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

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

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

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

B must take into account the items of income attributable to the grantor portion, that is, 10% of each item, as follows:

Ordinary income from <i>X</i>	\$500
Dividend income from <i>Y</i>	\$90

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Dividend income from X	\$10
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Total grantor portion income	\$600
The total income of the S portion is \$4,500, determined as follows:	
Ordinary income from X	\$5,000
Less: Grantor portion	(\$500)
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Total S portion income	\$4,500

The total income of the non-S portion is \$900 determined as follows:

Dividend income from Y (less grantor portion)	\$810
Dividend income from X (less grantor portion)	\$90
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Total non-S portion income	\$900

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

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

Charitable contributions from X	\$30
Trustee fees	\$20
State and local income taxes	\$10

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

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

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

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

Example 2. Sale of S stock. Trust has a valid ESBT election in effect and owns stock in X, an S corporation. No person is treated as the owner of any portion of Trust under subpart E. In 2003, Trust sells all of its stock in X to a person who is unrelated to Trust and its beneficiaries and realizes a capital gain of \$5,000. This gain is taken into account by the S portion and is taxed using the appropriate capital gain rate found in section 1(h).

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

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

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

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

Example 5. ESBT distributions. (i) As of January 1, 2002, Trust owns stock in X, a C corporation. No portion of Trust is treated as owned by the grantor or another person under subpart E. X elects to be an S corporation effective January 1, 2003, and Trust elects to be an ESBT effective January 1, 2003. On February 1, 2003, X makes an \$8,000 distribution to Trust, of which \$3,000 is treated as a dividend from accumulated earnings and profits under section 1368(c)(2) and the remainder is applied against Trust's basis in the X stock under section 1368(b). The trustee of Trust makes a distribution of \$4,000 to Beneficiary during 2003. For 2003, Trust's share of X's section 1366 items is \$5,000 of ordinary income. For the year, Trust has no other income and no expenses or state or local taxes.

(ii) For 2003, Trust has \$5,000 of taxable income in the S portion. This income is taxed to Trust at the maximum rate provided in section 1(e). Trust also has \$3,000 of distributable net income (DNI) in the non-S portion. The non-S portion of Trust receives a distribution deduction under section 661(a) of

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

[T.D. 8994, 67 FR 34395, May 14, 2002]

§ 1.642(a)(1)-1 Partially tax-exempt interest.

An estate or trust is allowed the credit against tax for partially tax-exempt interest provided by section 35 only to the extent that the credit does not relate to interest properly allocable to a beneficiary under section 652 or 662 and the regulations thereunder. A beneficiary of an estate or trust is allowed the credit against tax for partially tax-exempt interest provided by section 35 only to the extent that the credit relates to interest properly allocable to him under section 652 or 662 and the regulations thereunder. If an estate or trust holds partially tax-exempt bonds and elects under section 171 to treat the premium on the bonds as amortizable, the credit allowable under section 35, with respect to the bond interest (whether allowable to the estate or trust or to the beneficiary), is reduced under section 171(a)(3) by reducing the shares of the interest allocable, respectively, to the estate or trust and its beneficiary by the portion of the amortization deduction attributable to the shares.

§ 1.642(a)(2)-1 Foreign taxes.

An estate or trust is allowed the credit against tax for taxes imposed by foreign countries and possessions of the United States to the extent allowed by section 901 only for so much of those taxes as are not properly allocable under that section to the beneficiaries. See section 901(b)(4). For purposes of section 901(b)(4), the term *beneficiaries* includes charitable beneficiaries.

§ 1.642(a)(3)-1 Dividends received by an estate or trust.

An estate or trust is allowed a credit against the tax for dividends received on or before December 31, 1964 (see section 34), only for so much of the dividends as are not properly allocable to any beneficiary under section 652 or 662. Section 642(a)(3), and this section

do not apply to amounts received as dividends after December 31, 1964. For treatment of the credit in the hands of the beneficiary see § 1.652(b)-1.

[T.D. 6777, 29 FR 17808, Dec. 16, 1964]

§ 1.642(a)(3)-2 Time of receipt of dividends by beneficiary.

In general, dividends are deemed received by a beneficiary in the taxable year in which they are includible in his gross income under section 652 or 662. For example, a simple trust, reporting on the basis of a fiscal year ending October 30, receives quarterly dividends on November 3, 1954, and February 3, May 3, and August 3, 1955. These dividends are all allocable to beneficiary A, reporting on a calendar year basis, under section 652 and are deemed received by A in 1955. See section 652(c). Accordingly, A may take all these dividends into account in determining his credit for dividends received under section 34 and his dividends exclusion under section 116. However, solely for purposes of determining whether dividends deemed received by individuals from trusts or estates qualify under the time limitations of section 34(a) or section 116(a), section 642(a)(3) provides that the time of receipt of the dividends by the trust or estate is also considered the time of receipt by the beneficiary. For example, a simple trust reporting on the basis of a fiscal year ending October 30 receives quarterly dividends on December 3, 1953, and March 3, June 3, and September 3, 1954. These dividends are all allocable to beneficiary A, reporting on the calendar year basis, under section 652 and are includible in his income for 1954. However, for purposes of section 34(a) or section 116(a), these dividends are deemed received by A on the same dates that the trust received them. Accordingly, A may take into account in determining the credit under section 34 only those dividends received by the trust on September 3, 1954, since the dividend received credit is not allowed under section 34 for dividends received before August 1, 1954 (or after December 31, 1964). Section 642(a)(3) and this section do not apply to amounts received by an estate or trust as dividends after December 31, 1964. However, the rules in this section relating to