

Thus, according to the commentator, the final regulations should clarify that testamentary trusts include trusts to which S corporation stock is transferred pursuant to the terms of the electing trust during the section 645 election period as well as new trusts to which S corporation stock is deemed to be distributed at the end of the section 645 election period. The commentator noted that the purpose of section 645 is to create parity between electing trusts and wills. In furtherance of this purpose, the commentator reasoned that if an electing trust transfers or is deemed to distribute S corporation stock to a new trust, the new trust should be a permitted shareholder for the 2-year period beginning on the day the stock is transferred or deemed distributed to the new trust. The final regulations adopt the commentator's suggestion to clarify that a testamentary trust also includes a trust that receives S corporation stock from an electing trust.

The IRS is considering issuing guidance on whether a trust that has a QSST or an ESBT election in effect may make an election under section 645.

Effective Date

Except where otherwise specifically provided, these final regulations are applicable on and after July 17, 2003. In addition, the IRS will not challenge the treatment of certain testamentary trusts that receive S corporation stock from an electing trust under section 645 as permitted shareholders of the 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 the trust.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 533(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Deane M. Burke, Office of the Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

■ Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

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

■ **Par. 2.** Section 1.1361-1 is amended as follows:

■ 1. 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)(7)(ii), the fourth and last sentences of paragraph (k)(1) *Example 2*(ii), (k)(1) *Examples 3* and *4*(iii), and (k)(2)(i) are revised.

■ 2. The undesignated paragraph following paragraph (h)(3)(i)(B) is removed.

■ 3. Paragraph (j)(6)(iii)(D) is redesignated as paragraph (j)(6)(iii)(E).

■ 4. New paragraph (j)(6)(iii)(D) is added.

■ 5. Paragraph (k)(2)(ii) is redesignated as paragraph (k)(2)(iii).

■ 6. New paragraph (k)(2)(ii) is added.

The revisions and additions read as follows:

§ 1.1361-1 S corporation defined.

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(b)* * * (1)* * *

(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;

* * * * *

(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.

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

(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.

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(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.

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

(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