August 13, 2018

The Honorable David J. Kautter
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Mr. William M. Paul
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

Ms. Holly Porter
Associate Chief Counsel
Passthroughs & Special Industries
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

RE: Request for Immediate Guidance Regarding S Corporation Items Included in Pub. L. No. 115-97

Dear Messrs. Kautter and Paul and Ms. Porter:

The American Institute of CPAs (AICPA) respectfully requests immediate guidance on various S corporation items included in Pub. L. No. 115-97 (commonly referred to as the *Tax Cuts and Jobs Act* (TCJA)). Taxpayers and practitioners need clarity on S corporation issues in order to comply with their 2018 tax obligations and to make informed decisions regarding cash-flow, entity structure, and tax planning issues.

We have identified certain items affecting S corporations that we recommend the government address in the coming months.[1] We urge the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) to focus their attention on these areas in need of priority guidance. Our letter includes both the AICPA priority issues and the recommendations to resolve these issues.

Specifically, we recommend that Treasury and IRS provide the following items:

1. Guidance on the application of the new laws on loss carryforwards.

[1] Certain issues discussed in this comment letter impact entities beyond S corporations. Guidance and clarity in these areas may also aid individual taxpayers and partnerships in compliance with the TCJA.

a. Clarify how to coordinate various loss and deduction limitations with section 199A[2] qualified business income (QBI) carryover losses by applying the order as follows: section 163(j), 1366(d), section 465, section 469, section 461(l), and section 199A.
b. Clarify that the carryforward rule under section 163(j)(2) applies to S corporations despite section 1371(b)(2).
c. Clarify the definition of real property trades or businesses beyond section 469(c)(7)(C) for purposes of the disallowed business interest deduction under section 163(j).
d. Clarify the application of the section 461(l) limitation on net operating losses (NOLs).

2. Guidance on certain provisions relating to the post-termination transition period (PTTP) and the eligible terminated S corporation period ("ETSC Period") under section 1371(f).

   a. Clarify how a corporation computes its accumulated adjustments account (AAA) upon re-electing S corporation status if the corporation was an ETSC and if the corporation was not an ETSC.
   b. Clarify how the ETSC Period rules of section 1371(f) apply when a corporation has more than one PTTP.
   c. Identify the shareholders eligible to receive distributions from a corporation's AAA during the ETSC Period.
   d. Clarify how distributions are allocated between the AAA and accumulated earnings and profits (AE&P) under section 1371(f).
   e. Clarify how AAA is adjusted during the PTTP and the ETSC Period.

3. Guidance on the treatment of deferred foreign income upon transition to participation exemption system of taxation (section 965) for S corporation trust shareholders[3] and what trust transactions are section 965 triggering events and how a transferee of S corporation stock held in trust might assume the liability for the section 965 transition tax.

   a. Clarify that transition tax on deferred foreign income is not triggered by transfer to an irrevocable grantor trust or a revocable grantor trust.
   b. Provide clarity regarding the assumption of the section 965 transition tax liability on the death of the grantor of a grantor type irrevocable trust that holds S corporation stock, as well as on the death of the grantor of a revocable trust making the section 645 election.
   c. Provide clarity regarding a qualified subchapter S trust (QSST) and whether the trust or the beneficiary assumes the liability for the section 965 transition tax.
   d. Provide clarity on whether a QSST conversion to an electing small business trust (ESBT) conversion, or an ESBT to QSST conversion, is a triggering event for purposes of the section 965 transition tax.
   e. Provide clarity on whether the severance or division of a trust into separate shares is a triggering event for purposes of the section 965 transition tax.
   f. Provide clarity on the material modifications in trusts or trust beneficiaries that Treasury and the IRS would treat as a triggering event for purposes of section 965(i)(2)(A)(iii).

---

[2] All section references in this letter are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder, unless otherwise specified.
[3] The AICPA will address non-trust related section 965 items regarding S Corporations in a separate comment letter on section 965 proposed regulations.

Our comments were developed by the AICPA S Corporation Taxation and Trust, Estate, and Gift Taxation Technical Resource Panels and approved by the Tax Executive Committee.

* * * * *

The AICPA is the world's largest member association representing the CPA profession, with more than 431,000 members in 137 countries and territories, and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of these comments. If you would like to discuss these issues further, please feel free to contact Laura MacDonough, Chair, AICPA S Corporation Taxation Technical Resource Panel, at (202) 327-8060 or Laura.Macdonough@ey.com; or Amy Wang, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9264 or Amy.Wang@aicpa-cima.com; or me at (408) 924-3508 or Annette.Nellen@sjsu.edu.

Sincerely,

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

cc: The Honorable David J. Kautter, Acting Commissioner, Internal Revenue Service
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation

AMERICAN INSTITUTE OF CPAs

**Request for Immediate Guidance Regarding
S Corporation Items Included in Pub. L. No. 115-97**

1. Guidance on the application of the new laws on loss carryforwards.

a. Clarify how to coordinate various loss and deduction limitations with section 199A qualified business income (QBI) carryover losses by applying the order as follows: section 163(j), 1366(d), section 465, section 469, section 461(l), and section 199A.

Overview

Section 199A was enacted to provide a reduction in the effective U.S. federal income tax rate applicable to QBI. Since tax rates apply to taxable income as finally determined, a noncorporate taxpayer should first compute allowable deductions under sections 163(j), 469, and 461(l) before applying the loss limitation rules of section 199A. Section 199A(e)(1) adopts this view by providing that, for purposes of section 199A, taxable income is computed without regard to the section 199A deduction; no other deductions are excluded from consideration.

Recommendation

Treasury and IRS should provide guidance prescribing the ordering of the loss limitation rules as follows (first to last): section 163(j), 1366(d), section 465, section 469, section 461(l), and section 199A.

Analysis

The new section 163(j) provides a limitation on the amount that is currently deductible for business income. The section 163(j) limitation applies at the corporate-level[4] and therefore must apply before the basis (section 1366(d)), at-risk (section 465), and passive activity loss limitations (section 469), which apply at the shareholder level.

In addition, new section 461(l) provides a limitation on excess business losses of noncorporate taxpayers. Section 461(l)(6) provides that section 469 applies before section 461(l). A major component in determining the section 199A deduction is QBI, which is defined generally as the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business.[5] However, an item cannot qualify for the section 199A deduction unless it is

[4] See section 163(j)(4)(D).
[5] See section 199A(c)(1).

included in income or allowed as a deduction or loss.[6] The section 199A deduction is claimed at the shareholder, and not the S corporation, level. Thus, to determine if an item is allowed as a deduction or loss, the section 163(j) interest limitation and the section 469 and section 461(l) loss limitations must first apply.

Accordingly, the proper order for determining the application of the above deduction and loss limitations is as follows: section 163(j), section 469, section 461(l) and section 199A.

b. Clarify that the carryforward rule under section 163(j)(2) applies to S corporations despite section 1371(b)(2).

Overview

Section 163(j)(1) limits the deduction for business interest for any taxable year beginning after December 31, 2017 to the sum of the taxpayer's business interest income and 30 percent of a taxpayer's adjusted taxable income, plus the taxpayer's floor plan financing interest. The limitation does not apply to taxpayers with average gross receipts of $25 million or less over the prior three-year period (other than a tax shelter as defined under section 448).

Pursuant to section 163(j)(4)(D), the deduction limitation applies at the S corporation level and is taken into account in determining the S corporation's nonseparately stated taxable income or loss.

Section 163(j)(2) provides that any business interest not allowed as a deduction by reason of the section 163(j)(1) limitation is treated as interest paid or accrued in the succeeding taxable year.

Recommendation

Treasury and IRS should provide guidance to clarify that the carryforward rule of section 163(j)(2) applies to S corporations despite section 1371(b)(2).

Analysis

Section 163(j)(2) provides that any business interest not allowed as a deduction by reason of the section 163(j)(1) limitation is treated as interest paid or accrued in the succeeding taxable year. Thus, if an S corporation's deduction for business interest is limited under section 163(j)(2), the disallowed interest would presumably carry over to the S corporation's succeeding taxable year and treated as paid or accrued by the S corporation in that year. However, section 1371(b)(2) provides that "[n]o carryforward, and no carryback," shall arise at the corporate level for a taxable year for which a corporation is an S corporation. While the caption to this Internal Revenue Code (IRC) subsection is "No carryover between C and S year," the statutory language

[6] See section 199A(c)(3)(A)(ii).

contained in section 1371(b)(2) does not limit its application to carryovers from a C year. Guidance is needed to resolve the apparent disconnect by explicitly adopting a carryforward at the S corporation level. This guidance should provide that a carryforward is allowed from an S corporation year to either an S corporation year or a C corporation year. Absent this allowance, a permanent loss of a business deduction for a true economic outlay could result. Section 163(j)(4)(D) is a more specific provision and should therefore override section 1371(b)(2), permitting an interest deduction disallowed under section 163(j) to carry forward from an S corporation year to another S corporation year, or to a C corporation year.

c. Clarify the definition of real property trades or businesses beyond section 469(c)(7)(C) for purposes of the disallowed business interest deduction under section 163(j).

Overview

Guidance should clarify the definition of real property trades or businesses for purposes of the section 163(j) interest disallowance.

Recommendation

Treasury and IRS should provide guidance to clarify the definition of real property trades or businesses beyond section 469(c)(7)(C).

Analysis

Section 163(j)(7)(B) indicates that real property trade or business means any trade or business described in section 469(c)(7)(C). However, there are no regulations under section 469(c)(7)(C) that expound upon the statutory language of section 469(c)(7)(C). Treasury and the IRS should provide regulations for section 163(j)(7)(B) and 469(c)(7)(C) that define the terms used at section 469(c)(7)(C).

d. Clarify the application of the section 461(l) limitation on net operating losses (NOLs).

Overview

Under the TCJA, new section 461(l) provides that an "excess business loss" of a taxpayer other than a corporation is not allowed for the tax year. Any disallowed excess business loss of the taxpayer is treated as the taxpayer's NOL and carried forward for utilization in a subsequent tax year (subject to certain taxable income limitations).

Recommendation

Guidance should provide that an NOL, created upon the occurrence of the loss limitation provisions of section 461(l), is not again subject to the loss limitation provisions of section 461(l) in a subsequent year.

Analysis

For taxable years beginning after December 31, 2017 and before January 1, 2026, excess business losses of a taxpayer other than a corporation are not allowed for the taxable year. These losses are carried forward and treated as an NOL carryforward.

An excess business loss for the taxable year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer (determined without regard to the limitation of the provision), over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount.[7] The threshold amount for a taxable year is $250,000 (or $500,000 in the case of a joint return). The threshold amount is indexed for inflation.

Once the NOL has been established, there is a question as to whether an "aggregate deduction" of the taxpayer's trade or business in a subsequent tax year should include the NOL. Treating the NOL in this manner would potentially subject the original NOL to an additional loss limitation deferral under section 461(l). We believe that subjecting the NOL to a loss limitation in a subsequent year is a misinterpretation of the statute.

The new statute explicitly states that the disallowed loss becomes an NOL and there is no mention that this amount is retested under section 461(l) in a subsequent tax year. Furthermore, the new provision does not parallel pre-2018 section 461(j), which involved subsidized farming losses. The pre-2018 section 461(j) explicitly provided that disallowed subsidized farm losses retained their character in a subsequent tax year. New section 461(l) does not contain a similar character-retention rule. Accordingly, it would appear that the NOL generated under section 461(l) is no longer subject to other loss limitation provisions (but nevertheless remains subject to taxable income limitations).

Treasury and IRS should provide guidance that an NOL that is created upon the occurrence of the loss limitation provisions of section 461(l) is not included in the definition of aggregate deductions of the taxpayer, and therefore is not subject to the loss limitation provisions of section 461(l) in a subsequent year.

[7] See section 461(l)(3)(A).

2. Guidance on certain provisions relating to the post-termination transition period (PTTP) and the eligible terminated S corporation (ETSC) period under section 1371(f).

The TCJA significantly increased the difference between the U.S. federal income tax rate applicable to C corporations and the U.S. federal income tax rates applicable to other taxpayers. As a result of this change, many corporations (with the consent of their shareholders) have elected to terminate S corporation status and other S corporations are considering S corporation status termination.

Having a clear understanding of how a corporation's distributions are sourced following the termination of its S election is important to properly plan for a status termination. A clear understanding of this process is also needed to properly determine a shareholder's liability for tax post-termination.

Under section 1371(e), any distribution of money by a corporation with respect to its stock during a PTTP is applied against and reduces the adjusted basis of stock to the extent that the amount of the distribution does not exceed the accumulated adjustments account (AAA).

Under section 1371(e), a PTTP arises regardless of the event causing the termination. Thus, if a corporation's S election is terminated by revocation, by intentionally or unintentionally violating an eligibility requirement, or as a result of excess passive investment income, a PTTP will result. Under section 1377(b)(1), a PTTP includes:

1. The period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of the day which is one year after such last day, or the due date for filing the return for the last taxable year as an S corporation (including extensions);

2. The 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the corporation's S election and that adjusts a subchapter S item of income, loss, or deduction of the corporation arising in the S period; and

3. The 120-day period beginning on the date of a determination that the corporation's S election had terminated for a previous taxable year.

The TCJA added section 1371(f), which provides that in the case of a distribution of money by an ETSC after the PTTP (the "ETSC Period"), the AAA is allocated to the distribution, and the distribution is chargeable to accumulated earnings and profits (AE&P) "in the same ratio of such accumulated adjustments account bears to the amount of such accumulated earnings and profits."[8]

[8] See section 1371(f).

An ETSC is defined in section 481(d) as any C corporation that was an S corporation on December 21, 2017, and during the two-year period beginning on December 22, 2017, revoked its S corporation election, and the owners of the stock of which, determined on the date the revocation is made, are the same owners (and in identical proportions) as on December 22, 2017.

Treasury and the IRS should provide guidance addressing the following issues relating to the PTTP and the ETSC Period:

a. Clarify how a corporation computes its AAA upon re-electing S corporation status if the corporation was not an ETSC and if the corporation was an ETSC.

Overview

Section 1368(e)(1)(A) provides that the term "accumulated adjustments account" means an account of the S corporation which is adjusted for the S period in a manner similar to the adjustments under section 1367…." The "S period" is defined in section 1368(e)(2) as the most recent continuous period during which the corporation has been an S corporation.

In Chief Counsel Advice (CCA) 201446021,[9] the IRS concluded that a corporation's AAA disappears at the end of the corporation's PTTP. Accordingly, the AAA of a corporation re-electing S status is zero as of the beginning of its first S year resulting from the re-election.

Recommendation

Treasury and the IRS should provide guidance clarifying how a corporation computes its AAA upon re-electing S corporation status if the corporation is an ETSC and if the corporation is not an ETSC. The AICPA recommends that regardless of the status of the corporation as an ETSC, guidance should indicate that the AAA of a corporation upon re-electing S status is its AAA at the time that its S election terminated, adjusted for distributions from its AAA during its PTTP and, if applicable, the ETSC Period, and for applicable corporate transactions *(e.g.,* as redemptions and reorganizations).

Analysis

The enactment of section 1371(f) suggests that the AAA of a corporation does not disappear at the end of the corporation's PTTP as it provides for potentially indefinite distributions from the AAA following the corporation's PTTP. Further, sections 1368(e)(1) and (2) together support this interpretation to mean that the AAA is generally not adjusted during the period that the corporation is not an S corporation. In this regard, we note that no provision in section 1368 precludes the making of appropriate adjustments to the AAA during the period in which the corporation is not an S corporation (*e.g.*, for distributions from the AAA during an earlier PTTP

[9] See CCA 201446021.

when computing AAA available for distribution during a later PTTP, or for a redemption or reorganization transaction).

b. Clarify how the ETSC Period rules of section 1371(f) apply when a corporation has more than one PTTP.

<u>Overview</u>

A corporation whose S election has terminated may have more than one PTTP. The ETSC Period provisions of section 1371(f) apply after the PTTP. The language of section 1371(f) appears to contemplate only a single PTTP.

<u>Recommendation</u>

Treasury and the IRS should provide guidance explaining how section 1371(e) and section 1371(f) interact when a corporation has more than one PTTP. This guidance should provide that the rules of section 1371(e) apply during any PTTP of the corporation and that the rules of section 1371(f) apply during any period of an ETSC after the ETSC's first PTTP, except during any subsequent PTTP.

<u>Analysis</u>

As noted above, a PTTP includes (i) the period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of the day which is one year after such last day, or the due date for filing the return for the last taxable year as an S corporation (including extensions); (ii) the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the corporation's S election and that adjusts a subchapter S item of income, loss, or deduction of the corporation arising in the S period; and (iii) the 120-day period beginning on the date of a determination that the corporation's S election had terminated for a previous taxable year. Accordingly, a corporation may have more than one PTTP. The rules of section 1371(e) should apply during any PTTP and the rules of section 1371(f) should apply during any period of an ETSC after the ETSC's first PTTP, except during any subsequent PTTP. Section 1371(f) was enacted to provide an ETSC with an enhanced ability to distribute its AAA. Thus, an ETSC should not have a disadvantage relative to other corporations whose S elections have terminated with respect to its ability to make distributions to its shareholders from its AAA.

c. Provide guidance identifying the shareholders eligible to receive distributions from a corporation's AAA during the ETSC Period.

Overview

Treasury Reg. § 1.1377-2(b) provides that the special treatment under section 1371(e)(1) for distributions of money by a corporation with respect to its stock during the PTTP is available only to those shareholders who were shareholders in the S corporation at the time of termination. Section 1371(f) does not provide any special rules as to whom the special treatment of distributions under this section may apply.

Recommendation

Treasury and the IRS should provide guidance identifying the persons to whom the special treatment of distributions under section 1371(f) applies. This guidance should specify that the special treatment of distributions under section 1371(f) applies to any shareholder receiving a distribution during the ETSC Period. We recognize that this treatment is contrary to the position expressed in Treas. Reg. § 1.1377-2(b) regarding who is eligible for the special treatment of distributions made during the PTTP. However, there is no statutory provision limiting the persons eligible to receive distributions during the ETSC Period (or a PTTP) to persons owning stock as of the effective date of the revocation of an ETSC's S election.

This guidance should also address whether the special treatment under sections 1371(e)(1) and 1371(f) is available to any trust (including a qualified subchapter S trust (QSST) and electing small business trust (ESBT)) that was a shareholder on the last day of S corporation status and whose status changed as a result of termination of S status (*e.g.*, from a deemed grantor to a complex trust in the case of a QSST). All trusts that were shareholders at the time of the termination should have the special treatment under 1371(e) and 1371(f) available.

Finally, the guidance should address how the AAA is adjusted when distributions are made to persons who are not eligible for the special treatment under section 1371(e)(1) (and under section 1371(f) if the recommendation above is not adopted). Guidance should provide that the AAA is only reduced by the amount of distributions treated as coming from the AAA by the corporation's shareholders.

d. Provide guidance on how distributions are allocated between the AAA and AE&P under section 1371(f).

Overview

Section 1371(f) provides that in the "case of a distribution of money… the accumulated adjustments account shall be allocated to such distribution, and the distribution shall be chargeable to accumulated earnings and profits, in the same ratio as the amount of such accumulated adjustments account bears to the amount of such accumulated earnings and profits." Therefore, to determine the source of distributions made during the ETSC Period by an ETSC, it is necessary to know the AAA and the AE&P of the ETSC.

Recommendation

Treasury and the IRS should provide guidance addressing the point in time when the AAA and AE&P are determined for purposes of determining the ratio of the AAA to AE&P in applying section 1371(f). This guidance should also clarify the source of the distribution that is not treated as coming from the AAA (*i.e.*, whether the distribution is first sourced to current or AE&P). The guidance should provide that for purposes of section 1371(f), the ratio of the AAA to AE&P is determined at the beginning of the taxable year of the corporation in which the distributions are made and this ratio applies to all distributions made during the year. The guidance should also provide that any eligible distributions made during the ETSC Period not treated as coming from the AAA are first sourced to AE&P.

Analysis

Treasury and the IRS should provide that for purposes of section 1371(f), the ratio of the AAA and AE&P is determined at the beginning of the taxable year of the corporation in which the distributions are made and that this ratio applies to all distributions made during the year. Although midyear determinations of AE&P are necessary for some purposes (*e.g.*, Rev. Rul. 74-164, 1974-1 CB 74 [Earnings & profit (E&P) application to distributions when there is a loss in the current year] and Rev. Rul. 74-338, 1974-2 CB 101 [E&P adjustment for a section 302(a) redemption]), there is no reason for this level of complexity for section 1371(f) purposes.

This guidance should also provide that the portion of any eligible distribution made during the ETSC Period that is not treated as coming from the AAA is sourced first to AE&P, notwithstanding the general rule of section 316, which provides that except as otherwise provided in this subtitle, every distribution is made out of E&P to the extent, and from the most recently accumulated earnings and profits. The language in section 1371(f) is an exception to section 316, specifically providing that "the distribution shall be chargeable to *accumulated* earnings and profits…." [Emphasis added.]

3. **Guidance on the treatment of deferred foreign income upon transition to participation exemption system of taxation (section 965) for S corporation trust shareholders[10] and what trust transactions are section 965 triggering events and how a transferee of S corporation stock held in trust might assume the liability for the section 965 transition tax.**

[10] The AICPA will address non-trust related section 965 items regarding S Corporations in a separate comment letter on section 965 proposed regulations.

Overview

Under section 965, there are a number of S corporation trust transactions that can raise questions about whether a triggering event has occurred. These trust transactions generally fall into the following categories: (i) a legal transfer that is considered a transfer for transfer tax purposes, but not for income tax purposes (*e.g.*, a transfer to an irrevocable grantor trust); (ii) a legal transfer that is not considered a transfer for either transfer tax or income tax purposes (*e.g.*, a decanting, family settlement agreement, or disclaimer); (iii) a non-transfer, but a change in taxpayer for income tax reporting purposes (*e.g.*, a conversion of a grantor trust to a non-grantor trust, election of QSST status, election of ESBT status, a merger of two or more trusts, or a severance (division) of trusts into separate shares); and (iv) a material modification of a trust (*e.g.*, a termination of trust, a sale of the S corporation interest held by the trust, or a change in the beneficiaries of the trust outside of a familial relationship).

Recommendation

The AICPA recommends:

1. A transfer that does not result in a change of taxpayer for income tax purposes is not a triggering event under section 965(i)(2)(A)(iii);

2. A transfer that results in a change in shareholder for income tax reporting purposes is a triggering event (eligible for continued deferral via the assumption of deferred tax liability); and

3. A material modification in a trust or a trust's beneficiaries when there is not a change in income tax owner is not a triggering event (i.e., only a change in income tax ownership is a triggering event).

Below we outline a few transactions that frequently occur with regards to S corporation trusts. This is not an all-inclusive discussion of potential transactions, but a recommended starting point for future Treasury and IRS guidance.

a. Clarify that transition tax on deferred foreign income is not triggered by transfer to an irrevocable grantor trust or a revocable grantor trust.

Overview

The TCJA Conference Committee Report[11] states that "the third type of triggering event is a transfer of shares of stock in the S corporation by the electing taxpayer, whether by sale, death or

[11] See "Conference Report to Accompany H.R. 1," page 612.

otherwise, unless the transferee of the stock agrees with the Secretary to have liability for the net tax liability in the same manner as the transferor."

Recommendation

Treasury and the IRS should provide guidance to clarify the term "transfer" as this term relates to various trusts that receive or hold S corporation shares of stock. The guidance should take the position that transfers that are disregarded for income tax purposes (*e.g.*, transfers to grantor trusts) are not triggering events under section 965(i)(2)(A). Therefore, no agreement to assume the deferred tax liability is required in these instances.

Analysis

S corporation ownership is limited to certain trusts described in section 1361(c)(2), which include trusts "treated as owned by an individual," commonly referred to as grantor trusts under sections 671-678. The underlying grantor is considered the shareholder (section 1361(c)(2)(B)(i)) and thus the transfer of S corporation stock, either to or from the trust, is also disregarded for income tax purposes.

Based on the definition of an S corporation stock transfer triggering event under section 965(i)(2)(A)(iii) and the exception under section 965(i)(2)(C) for an agreement (where the net tax liability is considered the same for the transferee as it were for the transferor) the transfer of S corporation stock either to or from individuals to their grantor type trust (as defined under sections 671-678) would not meet the definition of a triggering event as intended by Congress- as there is no change in income tax ownership. Treasury and the IRS should provide guidance to clarify this issue.

b. Provide guidance regarding the assumption of the section 965 transition tax liability on the death of the grantor of a grantor type irrevocable trust that holds S corporation stock, as well as on the death of the grantor of a revocable trust making the section 645 election.

Overview

The TCJA Conference Committee Report[12] states that "the third type of triggering event is a transfer of shares of stock in the S corporation by the electing taxpayer, whether by sale, death or otherwise, unless the transferee of the stock agrees with the Secretary to have liability for the net tax liability in the same manner as the transferor."

[12] See "Conference Report to Accompany H.R. 1," page 612.

Recommendation

Treasury and IRS should provide guidance on whether a trust's conversion from grantor status to nongrantor status (due to the death of the grantor), regardless if the trust is treated as part of a decedent's estate under section 645, is a triggering event under section 965(i)(2)(A)(iii). If this event qualifies as a trigger, guidance is needed as to how the trustee (or the trustee and executor in the case of a trust making an election under section 645) would enter into an agreement described in section 965(i)(2)(C).

Analysis

S corporation ownership is limited to certain trusts described in section 1361(c)(2), which include trusts "treated as owned by an individual," commonly referred to as grantor trusts under sections 671-678.

Grantor trusts become nongrantor trusts upon the death of the grantor. Nongrantor trusts are generally not permitted as S corporation shareholders unless they elect classification as either QSSTs or ESBTs. In addition, if the executor of a decedent's estate and the trustee of the decedent's revocable grantor trust so elect under section 645, the trust is treated as part of the decedent's estate for a period of time after the decedent's death. Estates are eligible S corporation shareholders under section 1361(b)(1)(B). Therefore, a trust subject to a section 645 election is an eligible S corporation shareholder for the period the section 645 election is in effect.

Upon a trust's conversion from grantor to nongrantor status, or from grantor status to inclusion as part of a decedent's estate under section 645, the trust becomes a new taxpayer as it is no longer treated as owned by the grantor. Treasury and the IRS should provide guidance to include this conversion of status as a triggering event under section 965(i)(2)(A)(iii) and treat it as eligible for the transfer of liability treatment described in section 965(i)(2)(C).

c. Provide guidance regarding a QSST and whether the trust or the beneficiary assumes the liability for the section 965 transition tax.

Overview

QSSTs are one of a few types of trusts that are eligible to hold S corporation stock provided it meets the requirements of section 1361(d). Under section 1361(d)(1)(B), the QSST income beneficiary is "treated as the owner of that portion of the trust which consists of stock in an S corporation." As a result, the current income tax beneficiary assumes the income tax liability for the taxable income generated by the QSST's S corporation stock.

Recommendation

For purposes of the section 965 transition tax, Treasury and the IRS should clarify whether the QSST beneficiary, or the trust, can assume the tax liability under section 965(i)(2)(C) if a triggering event occurs.

Analysis

The current income beneficiary of a QSST assumes the liability for taxable income generated by S corporation stock held by the QSST. Treasury Reg. §1.1361-1(j)(7) extends this treatment, stating that the current income beneficiary (and not the trust) is treated as the shareholder of the S corporation stock held by the QSST.

Section 965 imposes a transition tax by mandating the inclusion of certain accumulated foreign earnings of controlled foreign corporations (CFCs) and other specified foreign corporations (SFCs) in a U.S. taxpayer's gross income. The IRS released guidance on March 13, 2018[13] clarifying that the amount included in an individual taxpayer's gross income under section 965 is reported as other income on Line 21 of Form 1040.

In the case of S corporations with U.S. shareholders, the shareholders may elect to defer the payment of their transition tax liability until a year in which a triggering event occurs.

Taxpayers need guidance as to whether it is the income beneficiary (as the income tax owner) or the trust that needs to assume the liability in order to avoid a triggering event upon a transfer of S corporation stock.

d. Provide guidance on whether a QSST conversion to an ESBT conversion, or an ESBT to QSST conversion, is a triggering event for purposes of the section 965 transition tax.

Overview

Only certain types of trusts are permitted to hold S corporation stock. QSSTs and ESBTs are two of the eligible trusts. It is possible to convert a QSST to an ESBT provided the trust satisfies the ESBT requirements of section 1361(e). Similarly, it is possible to convert an ESBT to a QSST provided the trust meets the QSST requirements of section 1361(d). Under Treas. Reg. § 1.1361-1(m)(4)(vii), the underlying beneficiaries of both QSSTs and ESBTs are treated as S corporation shareholders. Electing QSST or ESBT status does not change the beneficiaries of the trust, but it could change the shareholder for income tax purposes.

[13] See "Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns."

In general terms, the triggering events listed under section 965(i)(2) include:

1. The termination of a corporation's status as an S corporation;

2. The cessation of an S corporation's business, existence, or the sale or liquidation of substantially all of its assets; and

3. The transfer of any share of stock in such S corporation by the taxpayer.

Recommendation

Treasury and the IRS should clarify the circumstances, if any, under which the conversion of a QSST to an ESBT, or an ESBT to a QSST, might qualify as a triggering event for purposes of the section 965 transition tax.

Analysis

QSSTs may convert to ESBTs, or vice versa ("QSST/ESBT conversion"), provided they satisfy the specific requirements for ESBTs or QSSTs. Electing QSST or ESBT status does not change any of the beneficial owners of the trust, but it does change the shareholder (or taxpayer) for income tax purposes.

Under section 1361(d)(1)(B), the QSST income beneficiary is "treated as the owner of that portion of the trust which consists of stock in an S corporation." As a result, the current income tax beneficiary assumes the income tax liability for the taxable income generated by the QSST's S corporation stock. Under section 641(c), the portion of any ESBT that consists of stock in one or more S corporations is treated as a separate trust and the income of that separate trust is taxed at the trust level. The ESBT may also qualify as a partially or wholly owned grantor trust.

In both conversion transactions, the beneficiaries of the trust do not change. If a QSST/ESBT conversion transaction does not cause an income tax ownership change, it is inappropriate to treat the conversion as a triggering event for section 965 purposes. However, if Treasury and the IRS determine that a conversion from QSST to ESBT, or from ESBT to QSST, is a triggering event (due to a change in the income tax owner or otherwise) under section 965(i)(2)(A)(iii), guidance is needed on how the transferee trustee would enter into an agreement described in section 965(i)(2)(C) to assume the section 965 tax liability.

e. Provide guidance on whether the severance or division of a trust into separate shares is a triggering event for purposes of the section 965 transition tax.

Overview

Trusts operating under section 645 and ESBTs frequently hold assets for the benefit of multiple beneficiaries. The provisions of these trust agreements often provide for the trustee to create separate shares funded in the ordinary course of administration or as milestones (*e.g.*, ages of beneficiaries) are reached. The mere division of a trust into separate shares does not alter the respective beneficiaries, but it does create new income tax filing obligations with new tax identification numbers for each separate share or successor in interest.

Recommendation

Treasury and the IRS should clarify whether trust divisions are triggering events described in section 965(i)(2)(A)(iii). If the divisions qualify as triggering events, guidance is needed on how the successor entities should enter into a section 965(i)(2)(C) agreement, if eligible.

Analysis

Section 965 imposes a transition tax by mandating the inclusion of certain accumulated foreign earnings of CFCs and other SFCs in a U.S. taxpayer's gross income. In the case of S corporations with U.S. shareholders, the shareholders may elect to defer the payment of their transition tax liability until a year in which a triggering event occurs.

The severance or division of a trust creates additional successor entities, each of which may have separate income tax filing obligations. For tax administrative purposes, the assumption of tax liability should stay with the person or entity that will ultimately owe the tax obligation.

If Treasury and the IRS determine that a severance or division of a trust is a triggering event under section 965(i)(2)(A)(iii), guidance is needed on how the deemed transferee (*i.e.*, the resulting fiduciaries, entities, or beneficiaries) would enter into an agreement described in section 965(i)(2)(C) to assume the section 965 tax liability.

f. Provide guidance on the material modifications in trusts or trust beneficiaries that Treasury and the IRS would treat as a triggering event for purposes of section 965(i)(2)(A)(iii).

Overview

Trusts may have material modifications through decanting, judicial reformation or otherwise. These modifications may result in the termination of the trust, the distribution of assets outside of the trust, the sale of assets held by the trust, or a change in the beneficiaries of the trust outside of a familial relationship. It is uncertain whether Treasury and the IRS would treat these modifications as triggering events for purposes of section 965(i)(2)(A)(iii). It is also uncertain whether the successors in interest are then eligible for the transfer of liability treatment described in section 965(i)(2)(C).

Recommendation

Treasury and the IRS should clarify whether trust modifications qualify as triggering events described in section 965(i)(2)(A)(iii). If the modifications do qualify as triggering events, guidance is needed on whether Treasury and the IRS would treat the successors in interest as eligible for the transfer of liability treatment described in section 965(i)(2)(C).

Analysis

Section 965 imposes a transition tax by mandating the inclusion of certain accumulated foreign earnings of CFC and other SFCs in a U.S. taxpayer's gross income. In the case of S corporations with U.S. shareholders, the shareholders may elect to defer the payment of their transition tax liability until a year in which a triggering event occurs.

Treasury and the IRS should clarify whether a circumstance may exist where a material modification could arise (whether through amendment, decanting, judicial modification, severance, division, distribution, termination, or otherwise) which would give rise to a triggering event under section 965(i)(2)(A)(iii). Furthermore, guidance should also clarify whether Treasury and the IRS would allow the holder or transferee (*i.e.*, the resulting fiduciaries, entities, beneficiaries, distribute, or owner) the eligibility to enter into an agreement described in section 965(i)(2)(C) to assume the section 965 tax liability.