



September 13, 2018

The Honorable David J. Kautter
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RE: Request for Immediate Guidance Regarding Trusts and Estates Reporting of the Transition Tax Under Section 965

Dear Messrs. Kautter and Paul and Ms. Porter:

The American Institute of CPAs (AICPA) respectfully requests immediate guidance on the reporting for individuals, trusts and estates of the transition tax under section 965,¹ which was included in [Pub. L. No. 115-97](#) (commonly referred to as the *Tax Cuts and Jobs Act* (TCJA)). These taxpayers need clarity on section 965 reporting issues in order to comply with their 2017 tax obligations.

We identified various items affecting individuals, trusts and estates under section 965 that we recommend the government address immediately. 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 addresses both the AICPA priority issues and our recommendations to resolve these issues.

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

1. Automatic relief from penalties incurred by individuals, trusts or estates that have acted reasonably and made a good faith effort to properly report their section 965 tax liability on their 2017 tax returns.
2. Clarification that trusts and estates report the section 965 tax in the same manner as individuals.

¹ 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.

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3. Clarification that the person (including a trust or estate) that owes the section 965 tax is the person who can make the section 965(i) election or assume the liability.
4. Guidance on the treatment of deferred foreign income upon transition to participation exemption system of taxation (section 965) for S corporation trust shareholders,² 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.³

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

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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 Peggy Ugent, Chair, AICPA Trust, Estate, and Gift Tax Technical Resource Panel, at (512) 983-8285 or peggyugent@gsrjlaw.com; Eileen Sherr, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9256 or Eileen.Sherr@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
Ms. Catherine Hughes, Estate and Gift Tax Attorney Advisor, Office of Tax Policy,
Department of the Treasury

² The AICPA will address non-trust related section 965 items regarding S Corporations in a separate comment letter on section 965 proposed regulations.

³ On August 13, 2018, the AICPA submitted to the Treasury and IRS this recommendation a [comment letter](#) regarding S corporation issues and trusts.

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Ms. Melissa C. Liquerman, Branch Chief, Branch 4, Passthroughs and Special Industries, Internal Revenue Service

Ms. Marjorie A. Rollinson, Associate Chief Counsel (International), Internal Revenue Service

Ms. Kathryn Zuba, Associate Chief Counsel (Procedure and Administration), Internal Revenue Service

Mr. Clifford Warren, Special Counsel, Office of Associate Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service

AMERICAN INSTITUTE OF CPAs

Request for Immediate Guidance Regarding Individuals, Trusts and Estates Reporting of the Section 965 Transition Tax Included in [Pub. L. No. 115-97](#)

1. Guidance on Penalty Relief for Individuals, Trusts and Estates.

Overview

The Department of the Treasury (“Treasury”) and the Internal Revenue Service (IRS) have provided guidance related to the reporting requirements for section 965, including several notices,⁴ [Rev. Proc. 2018-17](#), [Publication 5292](#), [Frequently Asked Questions](#) (FAQs) with sample reporting statements and proposed regulations.⁵ However, individuals, trusts and estates need further guidance in order to comply with the reporting under section 965.

Recommendation

The AICPA urges the IRS to provide automatic relief from penalties incurred by individuals, trusts or estates that have acted reasonably and made a good faith effort to properly report their section 965 tax liability on their 2017 tax returns.

Analysis

a. Penalty Relief Where Individuals, Trusts and Estates Do Not Receive Complete Information From Pass-through Entities Regarding Section 965 Inclusions.

Many individuals, trusts and estates received Schedules K-1 that do not provide sufficient information for the pass-through owners to properly report their section 965 inclusions.

The FAQs require individuals, trusts and estates with section 965 inclusions to report with their 2017 income tax returns a significant amount of income regarding those inclusions. In particular, Q3 requires taxpayers to report the aggregate foreign cash position, if applicable, and Q8 requires U.S. shareholders of specified foreign corporations (SFCs) (i.e., taxpayers who directly, indirectly, or constructively own at least 10% of a SFC) to file Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, unless an exception applies. In addition, individuals, trusts and estates that have interests in SFCs through pass-through entities must know their percentage interests in those SFCs to determine whether they are U.S. shareholders, which may impact other calculations related to section 965.

⁴ [Notice 2018-07](#), [Notice 2018-13](#), [Notice 2018-26](#).

⁵ [Guidance Regarding the Transition Tax under Section 965 and Related Provisions](#).

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However, Q9 only requires pass-through entities to provide to their owners limited information relating to section 965. In particular, Q9 does not require pass-through entities to provide the owner's pro rata share of the aggregate cash position nor does it require the owner's percentage interest in the underlying SFCs. As a result, many of the Schedules K-1 that individuals, trusts and estates received do not include this information. While taxpayers can request the pass-through entities provide this information, such a process is burdensome during the already tight timeframe to file these tax returns, and in the case of multi-tiered pass-through entities, there is not sufficient time to gather this information to timely file a tax return.

The AICPA urges the IRS to provide automatic relief from penalties incurred by individuals, trusts or estates that have acted reasonably and made a good faith effort to properly report their section 965 tax liability and related forms on their 2017 tax returns.

b. Penalty Relief Where Trusts and Estates Relied on FAQs That Were Subsequently Updated.

Some practitioners and taxpayers were confused regarding the FAQs Appendix: Q&A2 language for trusts and estates reporting on [Form 1041](#), *U.S. Income Tax Return for Estates and Trusts*. IRS has updated the FAQs several times this year. When the IRS updated the FAQs on April 13, 2018, it updated the Form 1041 section of Appendix: Q&A2 adding the below bolded text, instructing trusts not distributing the section 965 amounts to beneficiaries to “Include in total on Page 2, Schedule G, Line 7 the net tax liability under section 965 **reduced by the amount of the net tax liability deferred under section 965(i), if applicable.**” This instruction provided sufficient guidance to taxpayers as to how to report the section 965(i) election on a Form 1041.

However, practitioners noticed from at least May 4, 2018 until when they checked again on August 20, 2018, that the Appendix: Q&A2 no longer contained the bolded text that was added on April 13, 2018, even though the webpage said that it was updated April 13, 2018. As of the date of this letter, the bolded text language is back on the webpage. From May until August, practitioners were confused whether the IRS viewed the amount deferred under section 965(i) as an amount eligible for payment in installments (which it is under section 965(i)(4)(A)), and therefore included in Form 1041, Page 1, Line 24a, even though it specifically provided separate instructions for individuals making the section 965(i) election that are similar to the instructions included in the April 13, 2018 update for trusts. Practitioners were uncertain as to whether the IRS inadvertently removed this language (as the page continued to display that it was updated on April 13, 2018), or if the IRS planned to revise it again. It is helpful that the Appendix: Q&A2 language is now the same as the language updated on April 13, 2018, as practitioners are no longer confused. However, some taxpayers may have already filed tax returns following the Appendix: Q&A2 language that was previously posted on the website from June through August, including the amounts deferred under section 965(i) in Form 1041, Page 1, Line 24a.

Significant uncertainty remains on how trusts and estates should properly disclose and report on Form 1041 certain information related to the calculation of their section 965 transition tax liability

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and the related installment payment schedule. The extended deadlines for filing 2017 tax returns are rapidly approaching. A timely filed tax return is required, and there are penalties for failure to file the return. Guidance is urgently needed on the factors that the IRS will consider in determining whether a trust or estate has substantially complied with its tax reporting obligations in relation to its section 965 transition tax liability.

In the absence of updated forms or instructions for the 2017 tax year or binding guidance, trusts and estates are unaware what information is required or how to properly report such information on Form 1041 to meet the “substantially complete” definition and thus avoid penalties. The AICPA recommends that the IRS provide automatic relief from these penalties for any trust or estate that has acted reasonably and made a good faith effort to provide any required information.

2. Clarification that Trusts and Estates Report the Section 965 Amounts in the Same Manner as Individuals.

Overview

Currently, many of the tax preparation software programs are not able to correctly process the section 965 reporting for trusts and estates distributing some, but not all, of the section 965 amount to beneficiaries. The current Treasury and IRS guidance provides that trusts and estates do not report in a similar manner to individuals, even though section 641(b) provides that trusts and estates are subject to tax in the same manner as individuals, with certain exceptions.

Appendix: Q&A2 instructs trusts distributing the net section 965 amount (section 965(a) inclusion minus the section 965(c) deduction) to beneficiaries to include the net section 965 amount, “to the extent distributed,” on Form 1041, Page 1, Line 8, Other Income. For trusts not distributing the net section 965 amount to beneficiaries, Appendix: Q&A2 instructs trusts to not report the net section 965 amount on the Form 1041 and instead only report it on the IRC 965 Transition Tax Statement, Line 1. The section 965 tax is calculated separately, and then added back on Form 1041 Page 2, Sch. G, Line 7.

Recommendation

For section 965 reporting purposes, Treasury and IRS should revise the FAQs to allow trusts and estates to report the section 965 amount in a manner similar to individuals (i.e., include the net section 965 amount on Form 1041, Page 1, Line 8, regardless of whether it is distributed).

Analysis

There are advantages if Treasury and the IRS would treat trusts and estates for section 965 reporting purposes as taxed similar to individuals rather than the current treatment as similar to corporations. The current required reporting for trusts and estates is not appropriate for various situations and, therefore, the software often does not allow the correct treatment. If trusts and

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estates are allowed to report in the same manner as individuals (i.e., by including the net section 965 amount on Form 1041, Page 1, Line 8, regardless of whether it is distributed), the software likely would work correctly for that reporting.

Currently, for trusts distributing the entire net 965 amount to beneficiaries, the Q&A2 reporting is appropriate. For trusts not making any distributions to beneficiaries, the reporting is awkward, but possible with some software overrides on Schedule G, Line 7. However, when a trust distributes some, but not all, of the net section 965 amount, the tax preparation software packages tested by several practitioners have not generated tax returns that comply with the reporting instructions in Appendix: Q&A2. In such situations, the software has not correctly computed the tax and reported Schedule K-1 items.

For these trusts, because only the portion of the net section 965 amount distributed to beneficiaries is reported on Line 8 of the tax return, the Schedules K-1 generated by the software are not allocating the Schedule K-1 income properly among the different categories of income, and the tax on the non-section 965 income is not properly computed.⁶

Further, because the regulations were just recently issued, most tax preparation software is not updated for the net investment income tax (NIIT) effect of section 965. The income of section 965(a) is subject to NIIT, but section 965(c) deductions are not permitted for NIIT.

⁶ For example, assume a trust has \$5,000 of qualified dividends, \$1,000 of net section 965 inclusion, and no expenses. It distributes \$3,000 to the beneficiary and its distributable net income (DNI) is \$6,000.

In this scenario, the beneficiary's Schedule K-1 would report \$2,500 of qualified dividends and \$500 of other income as the net section 965 inclusion. The Schedule K-1 would include a statement to the beneficiary with the section 965(a) and section 965(c) amounts attributable to the net section 965 inclusion, and the deemed paid foreign tax credit (FTC) information. This scenario is the "with" calculation when computing the net tax liability under section 965. In addition, the trust's entity-level tax is calculated by applying the qualified dividends rate to the \$2,500 of qualified dividends retained at the trust level, and applying ordinary income rates to the \$500 of other income retained at the trust level.

However, when the preparer updates the return to reflect the reporting instructions provided in Appendix: Q&A2, the beneficiary's Schedule K-1 (generated by the software) automatically changes. Under the guidance, \$5,000 of qualified dividends and only \$500 of the net section 965 inclusion (the portion of the net section 965 amount that is distributed to the beneficiary) is reported on the face of the return. The \$3,000 distribution is reported on Schedule B. As a result, the software-generated Schedule K-1 reflects \$2,727 of qualified dividends and \$272 of other income that is net section 965 inclusion. In addition, it subjects only \$2,273 of the trust's income to tax at qualified dividend rates.

While in a simple example such as the above, it is possible to override the amounts on the Schedule K-1 to reflect \$2,500 of qualified dividends and \$500 of other income, and override the qualified dividends retained at the trust level on page 1 of the Form 1041, it is difficult to override all of the numbers on more complicated returns with multiple categories of income and expense allocations. Another option is to replace several software-generated forms (Form 1041, Page 2 (to make Schedule G correct), Schedule I (to make the AMT calculation correct), Form 8960 (to make the NIIT calculation correct), and the Schedule K-1) with the versions of those forms from the "with" calculation. However, this process is cumbersome and prone to error.

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The IRS should update the FAQs to require all trusts report in the same manner as individuals (which is consistent with section 641(b)), and include the net section 965 amount on Form 1041, Line 8 as other income. This treatment would allow the software to properly compute the tax and Schedule K-1 and would eliminate the need for multiple manual adjustments.

Form 1041 is already drafted in a manner that properly allocates the income between the trust/estate and the beneficiary. Therefore, if trusts/estates report in a similar manner as individuals, all items will flow properly. The trust or estate will only need to list some information on the Schedule K-1 footnotes required by the FAQs.

3. Clarification That the Person (Including a Trust or Estate) That Owes the Section 965 Tax is the Person Who Can Make the Section 965(i) Election or Assume the Liability.

Overview

The definition of “pass-through entity” in section Prop. Reg. § 1.965-1(f)(28) is unclear with regard to trusts. Section 965 does not provide any restrictions on a trust or trust owner/beneficiary’s ability to make the section 965 election.

Recommendation

Treasury and the IRS should clarify in the proposed regulations for section 965 that the person, including a trust, estate, individual, or entity, that owes the section 965 tax is the person who can make the election under section 965(i) or assume the liability.

Analysis

The definition of “pass-through entity” in section Prop. Reg. § 1.965-1(f)(28) is unclear with regard to trusts. In particular, our members are uncertain whether Treasury and the IRS consider a grantor trust (and a qualified subchapter S trust “QSST”) as a pass-through entity under that definition. In addition, Prop. Reg. § 1.965-7(c) limits the election and assumption of liability to the shareholder (other than pass-through entities). Some practitioners are concerned that this interpretation means a grantor trust or QSST may not make an election to defer tax under section 965(i) or assume liability as an eligible transferee.

In addition, although section 1361 treats grantor trust owners and QSST beneficiaries as shareholders, such treatment is currently limited to purposes of section 1361(b)(1). Therefore, it is uncertain if the treatment of grantor trust owners and QSST beneficiaries as shareholders would extend to section 965, which would mean the grantor trust owner and QSST beneficiary could similarly make an election or assume liability under section 965(i).

Because section 965 did not provide any restrictions on a trust or trust owner/beneficiary’s ability to make the section 965(i) election, the corresponding regulations should allow the person who

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owes the section 965 tax (including a grantor trust owner, QSST beneficiary, a testamentary trust within the 2 year period, an estate, etc.) to make the section 965(i) election or assume the liability.

4. Guidance on the Treatment of Deferred Foreign Income Upon Transition to Participation Exemption System of Taxation (Section 965) for S Corporation Trust Shareholders,⁷ 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.

Overview

Under section 965, there are a number of S corporation trust transactions that 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 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 the income tax owner is not a triggering event (*i.e.*, only a change in income tax ownership is a triggering event).

⁷ The AICPA will address non-trust related section 965 items regarding S Corporations in a separate comment letter on section 965 proposed regulations.

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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 the 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 Report⁸ 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 be liable for the net tax liability in the same manner as the transferor.”

Recommendation

Treasury and the IRS should clarify the term “transfer” as the 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 to or from individuals to their grantor type trust would not meet the definition of a triggering event as intended by Congress since there is no change in income tax ownership.

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.

⁸ See “[Conference Report to Accompany H.R. 1](#),” page 612.

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Overview

The TCJA Conference Committee Report⁹ 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 be liable for the net tax liability in the same manner as the transferor.”

Recommendation

Treasury and IRS should provide guidance 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). 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).

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 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.

⁹ See “[Conference Report to Accompany H.R. 1](#),” page 612.

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c. Provide Guidance Regarding a QSST and Whether the Trust or the Beneficiary Assumes the Liability for the Section 965 Transition Tax.

Overview

A QSST is one of a few types of trusts that is 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 assumes 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, 2018¹⁰ 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 assumes the liability in order to avoid a triggering event upon a transfer of S corporation stock.

¹⁰ See [“Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns.”](#)

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. A QSST may convert to an ESBT provided the trust satisfies the ESBT requirements of section 1361(e). Similarly, an ESBT may convert 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.

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.

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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, Treasury and IRS should not 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 Trusts 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 trusts 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 trusts does not alter the respective beneficiaries, but it does create new income tax filing obligations with new tax identification numbers for each separate trust 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 remain 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.

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f. Provide Guidance that for Material Modifications in Trusts or Trust Beneficiaries That Result in a Different Income Taxpayer, Treasury and the IRS Would Treat Such Situations 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 that trust modifications that result in a different income taxpayer qualify as triggering events described in section 965(i)(2)(A)(iii). If the modifications qualify as triggering events, guidance is needed to 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 a material modification that results in a different income taxpayer (whether through amendment, decanting, judicial modification, severance, division, distribution, termination, or otherwise) would constitute a triggering event under section 965(i)(2)(A)(iii). Furthermore, guidance should allow the holder or transferee (*i.e.*, the resulting fiduciaries, entities, beneficiaries, distribute, or owner) to enter into an agreement described in section 965(i)(2)(C) to assume the section 965 tax liability.