Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **201327009**
Release Date: 7/5/2013

CC:PSI:02:AMikolashek
PRESP-153734-12

UILC: 1361.03-02, 1366.00-00

date: May 01, 2013

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from:
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subject: Interest Deduction by QSST Beneficiaries

This Chief Counsel Advice responds to a request for assistance dated December 14, 2012. This advice may not be used or cited as precedent.

ISSUE

A QSST purchased S corporation stock from a third party (not the beneficiary) in exchange for a note and the QSST made timely payments under the note, including interest payments. The only asset owned by the QSST is the S corporation stock. Section 1361(d) provides that where a beneficiary makes a QSST election that portion of the trust that consists of the S corporation stock is treated as a grantor trust for federal income tax purposes. Is the interest expense associated with the debt incurred by the QSST to acquire the S corporation stock allocated to the grantor trust portion of the QSST thereby allowing the beneficiary to report the interest expense as a deduction on his personal income tax return?

LAW

Section 1361(d)(1) provides, in relevant part, that in the case of a qualified subchapter S trust with respect to which a beneficiary makes an election under § 1361(d)(2) such trust shall be treated as a wholly-owned grantor trust, and for purposes of § 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election is made.

Section 1.1361-1(j)(7)(i) of the Income Tax Regulations provides that the income beneficiary is treated (for purposes of § 678(a)) as the owner of that portion of the trust that consists of the S corporation stock and the beneficiary is treated as the shareholder for purposes of §§ 1361(b)(1), 1366, 1367, and 1368.

Section 1366 provides, in part, that in determining an S corporation shareholder's federal income tax liability, the shareholder shall take into account the shareholder's pro rata share of the corporation's – (A) items of income (including, tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and (B) nonseparately computed income or loss.

Section 671 provides, in part, that where the grantor is treated as the owner of any portion of a trust, there shall be included in computing the taxable income and credits of the grantor those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 1.671-3(a)(2) provides that if the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion. Items directly related to trust property not included in the portion treated as owned by the grantor or other person are governed by the provisions of subparts A through D, part I, subchapter J, chapter 1 of the Code. Items that relate both to the portion treated as owned by the grantor and to the balance of the trust must be apportioned in a manner that is reasonable in the light of all the circumstances of each case, including the terms of the governing instrument, local law, and the practice of the trustee if it is reasonable and consistent.

Section 1.652(b)-3(a) provides that "all deductible items directly attributable to one class of income … are allocated thereto. For example, repairs to, taxes on, and other expenses directly attributable to the maintenance of rental property or the collection of rental income are allocated to rental income. Similarly, all expenditures directly attributable to a business carried on by a trust are allocated to the income from such business. … "

Section 1.652(b)-3(b) provides that "the deductions which are not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing distributable net income, but a portion must be allocated to nontaxable income pursuant to § 265 and the regulations thereunder."

Section 1.652(b)-3(c) provides examples of expenses not considered directly attributable to a specific class of income, such as trustee's commissions, safe deposit boxes rentals, and State income and personal property taxes.

Section 1.163-8T(a)(3) provides the general rule of 'interest tracing' is that "interest expense on a debt is allocated in the same manner as the debt to which such interest expense relates is allocated." Section 1.163-8T(a)(4)(A)-(B) provides that interest expenses are allocated to trade or business expenditures or passive activities (as defined in § 1.163-8T(b)).

Notice 89-35, 1989-1 C.B. 675, addresses the allocation of interest expenses in connection with the acquisition of an interest in a passthrough entity. The notice provides, in relevant part, that where debt proceeds are allocated under § 1.163-8T to the purchase of an interest in a passthrough entity (other than by way of a contribution to the capital of the entity), the debt proceeds and associated interest expense shall be allocated among all the assets of the passthrough entity using any reasonable method. One reasonable method referenced in the notice is a pro-rata allocation based on the fair market value, book value, or adjusted basis of the assets, reduced by any debt of the passthrough entity or the owner allocated to such assets. Individuals should report allowable interest expense paid or incurred on either Schedule E or Schedule A of Form 1040, depending on the type of expenditure to which the interest expense is allocated.

Notice 88-37, 1988-1 C.B. 522, addresses how to report interest expenses related to debt-financed acquisitions. Interest expenses allocated to trade or business expenditures (within the meaning of § 1.168-8T(b)(7)) are deductible without limitation. The deductible amount of interest expenses allocated to a passive activity expenditure must be determined under § 1.469-1T(f)(2).

ANALYSIS

Section 1366 provides that the beneficiary, as the S corporation shareholder, must report those items of income and deduction that flow through to shareholders. The interest payment made by the QSST on acquisition indebtedness incurred to purchase the S corporation stock is not an expense that flows through from the S corporation under § 1366. This office has not previously addressed the allocation of interest expense to a QSST in the same fashion as was done with Electing Small Business Trusts (ESBTs)[1].

When a QSST beneficiary makes an election under § 1361(d)(2), § 1361(d)(1)(B) creates two portions within the QSST – one consisting of income, deductions, and credits related to the S corporation (the S portion) and one portion consisting of all other income, deductions, and credits (the non-S portion). The S portion is treated as a

[1] Section 641(c) addresses the tax implications of an ESBT. Prior to the Small Business and Work Opportunity Tax Act of 2007, Pub. L. 110-28, which amended § 641(c), the regulations under § 641(c) provided that interest paid by an ESBT on money borrowed by the trust to purchase stock in an S corporation be allocated to the S portion but the expense was not a deductible administrative expense for purposes of determining the taxable income of the S portion. The preamble to the regulations stated that Treasury did not believe that "administrative expenses" included expenses incurred to acquire additional assets. Section 641(c)(2)(C)(iv) now provides that such interest expenses are deductible.

grantor trust of the beneficiary and the beneficiary is treated as the S corporation shareholder for all purposes of §§ 1361(b)(1), 1366, 1367, and 1368. § 1.1361-1(j)(7). Section 1.1361-1(j)(8) reiterates that the grantor is deemed to own the portion of the QSST consisting of the S corporation stock, but creates an exception when the QSST is determining and attributing the federal income tax consequences of a disposition of the S corporation stock. However, even within this exception there is an exception that again emphasizes the beneficiary's ownership interest. When the QSST disposes of the S corporation stock, the beneficiary is treated as personally disposing of the S corporation stock for purposes of applying §§ 465 and 469 to the beneficiary.

Applying the rules in § 1361(d), the S corporation stock is treated as though it is held in a grantor trust (the S portion). We should, therefore, look to the rules of subchapter J to determine which portion of the QSST receives the interest expense allocation. Under § 671 and the regulations thereunder, all items of income and deduction directly related to the grantor trust are attributed to the grantor. The rules for determining the items of income, deduction, and credit against tax that are attributable to or included in the grantor portion of the trust are set forth in § 1.671-3. Section 1.671-3(a)(2) provides that if the grantor portion consists of specific trust property and its income, then all items directly related to that property are attributed to the grantor portion. Where items directly relate to trust property are not included in the grantor portion, these items are governed by subparts A through D. Where the item relates to both portions, the items are apportioned between the grantor and non-grantor portion in a reasonable manner.

The regulations under § 652(b) provide guidance for determining what deductions are allocable to different classes of income held by a trust. Section 1.652(b)-3(a) provides that all deductible items that are directly attributable to one class of income are allocated to that class. By way of example the regulations explain that all expenditures directly distributable to a business carried on by a trust are allocated to the income from such business. Similarly, under § 1.652(b)-3(b) where deductions are not directly attributable to a specific class of income, the regulations provide that these deductions may be allocated to any item of income. Examples of such expenses include trustee's commissions, safe deposit boxes rentals, and State income and personal property taxes.

The rules under § 163 provide guidance to determine to which class of income the interest expense incurred by the trust is allocated. The interest tracing rules (§ 1.163-8T) provide guidance in allocating interest expense for purposes of applying §§ 469 and 163(d) and (h). Section 163(d) limits the deduction for investment interest and § 163(h) allows a deduction for all but personal interest. The interest tracing rules provide that interest on a debt is allocated in the same manner as the debt to which the interest expense relates is allocated. To trace the interest you must follow the debt proceeds. Interest allocated to a trade or business expenditure is fully deductible under § 163. Notice 89-35 directs taxpayers that where debt is used to purchase an interest in a passthrough entity, the debt proceeds and associated interest are allocated among the

assets of the passthrough entity. Notice 88-37 provides that interest that is traced under §1.163-8T to a trade or business expenditure are deductible.

The debt incurred by the QSST was used to acquire the S corporation stock and the interest is fully traceable to that purchase under § 1.163-8T and Notice 89-35. Because the interest expense is traced to the income from the S corporation business, the rules under § 1.652(b)-3(a) would cause that expense to be directly appointed to the portion representing the S corporation income. Therefore, § 1.671-3(a)(2) would seem to require that based on § 1.652(b)-3 the interest expense deduction should be attributable to the S portion of the QSST and, thus, deductible by the beneficiary.

CONCLUSION

According to the facts provided, the cash from the S corporation was the sole source of the payment of interest and the QSST held no other significant income producing assets. Absent the interest payment, the beneficiary would have received a larger distribution and has instead suffered an economic detriment. Based on the rules applicable to trusts in subchapter J of the Code, the interest expense is allocated to the S portion and is an allowable deduction by the beneficiary against his federal income tax liability. We do not address the situation where a QSST has significant income producing assets other than S corporation stock and co-mingles the S corporation distributions with the other income before payment as the answer may depend on the particular facts of the case. Nor do we address the treatment of debt and associated interest under either §§ 465 or 469.

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Please call if you have any further questions.