

**ESTATE PLANNING AND ADMINISTRATION FOR S CORPORATIONS**

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# ESTATE PLANNING AND ADMINISTRATION FOR S CORPORATIONS

## I. INTRODUCTION

S corporations present a host of unique challenges for the fiduciary during an estate or trust administration. Many of these challenges arise because S corporations are a hybrid between partnerships and C corporations. They are flow-through entities like partnerships, but they generally follow C corporation rules for distributions, redemptions, and sales of stock. S corporations typically operate active businesses rather than simply owning a passive investment portfolio. Unlike partnerships, only certain persons are eligible to own S corporation or else the S election will be terminated. S corporations need to consider certain tax elections that are either unique or especially appropriate for them. Unlike partnerships, S corporations cannot elect to adjust the inside basis of their assets upon the death of a shareholder. And finally, they present all the normal problems during administration such as gain or loss on funding bequests and income in respect of a decedent (IRD). This outline covers these critical issues and compares the different treatment for partnerships where helpful.

## II. ALLOCATION OF INCOME IN THE YEAR OF DEATH

### A. S Corporations

When an S corporation shareholder dies, the corporate income is prorated between the decedent and the successor shareholder on a daily basis before and after death. Income allocated to the period before death is included on the decedent's final income tax return.<sup>1</sup> Income allocated to the period after death is included on the successor's income tax return.

Alternatively, the S corporation may elect the interim closing of the books method. This divides the corporation's taxable year into two separate years, the first of which ends at the close of the day the shareholder died.<sup>2</sup> This election is only available if a shareholder terminates his entire interest in the S corporation, all the "affected shareholders" agree, and the corporation attaches the election to its tax return for the year.<sup>3</sup> Affected shareholders are those whose interest is terminated and those to whom shares are transferred during the year.<sup>4</sup> It can make a big difference which method the S corporation chooses if income is not earned evenly throughout the year.

### EXAMPLE

Mary died on June 30 and left her 40% interest in S Corp. to her son, Jack. Her daughter is the residuary beneficiary of Mary's estate. The S Corp incurred a \$1 million capital gain on August 1 and has no other income or expense that year. Under a daily proration, Mary's final income tax return and Jack each report a \$200,000 capital gain. [40% X 6/12 X \$1,000,000]. But under an interim closing, Mary's final return reports nothing

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<sup>1</sup> IRC § 1377(a)(1); Reg. § 1.1377-1(a).

<sup>2</sup> IRC § 1377(a)(2); Reg. § 1.1377-1(b)(1).

<sup>3</sup> Reg. § 1.1377-1(b)(5).

<sup>4</sup> Reg. § 1.1377-1(b)(2).

and Jack reports \$400,000 [40% X \$1,000,000].<sup>5</sup>

	Mary's Final Return	Jack's Return	Total
Daily Proration	\$ 200,000	200,000	\$ 400,000
Interim Closing	-0-	400,000	\$ 400,000

Jack may not agree to an interim closing of the books because it causes him to report more income than the daily proration method. Because Jack is an affected shareholder, he can force the corporation to use the daily proration method.

## B. Partnerships

Partnerships also use two basic methods to allocate income and deductions when a partner terminates his interest during the year.<sup>6</sup> But with a partnership, the default method is the interim closing of the books. An interim closing separates the partnership into two or more segments during the year. Items occurring in each segment are allocated to those who were partners during that segment. Alternatively, the partners may agree to the proration method, which allocates to each partner a fraction of partnership income for the entire year, regardless of when the partnership incurred the items. Any reasonable proration method may be used.<sup>7</sup> Contrast this flexibility with the S corporation rules, which require a per share-per day allocation. Because of the potentially significant difference between the two methods, the executor should work with the partnership to determine which one produces the better result for his clients.

Regardless of whether the proration or interim closing method is used, cash basis partnerships must use the accrual basis to allocate interest, taxes, payments for services or the use of property (other than guaranteed payments subject to Section 83), and any other items specified in the regulations.<sup>8</sup> The partnership must assign a portion of these items to each day in the period to which it is attributable. The daily portion is then assigned to the partners in proportion to their partnership interest at the close of each day. This prevents partners from deliberately misstating income among the partners by timing the payment of large cash basis expenses. The most common cash basis items likely to affect family limited partnerships under this rule are real estate taxes and payments for services.

### EXAMPLE

Don is a 50 percent partner in DS Partnership. He died on September 30. DS incurred a capital gain of \$1,000,000 on June 1, just before Don died, and has no other income or expenses during the year. Under an interim closing of the books, Don reports \$500,000

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<sup>5</sup> Reg. § 1.1361-1(j)(7).

<sup>6</sup> Reg. § 1.706-1(c)(2)(ii); *Richardson v. Comm'r.*, 693 F.2d 1189 (5<sup>th</sup> Cir. 1982).

<sup>7</sup> Reg. § 1.706-1(c)(2)(ii).

<sup>8</sup> IRC § 706(d)(2); Prop. Reg. § 1.706-3(a) (2005); *See Cantrell, Partnership Interests for Services Regs. Offer Estate Planners a "Bona Fide" Solution*, *The Tax Adviser*, October 2005, at 636 (taxation of partnership interests granted for services rendered).

[50% of \$1,000,000] of capital gain on his final 1040 resulting in a tax liability of \$75,000. His estate may deduct this income tax liability as a debt on his federal estate tax return Form 706.<sup>9</sup> The estate reports no income or loss.

The proration method is illustrated in the following example:

### **EXAMPLE**

Using the same facts as the previous example, Don, a 50 percent partner in DS Partnership, died on September 30. DS incurred a capital gain of \$1,000,000 on June 1, just before Don died, and has no other income or expenses during the year. Under a proration method, Don reports \$375,000 [9/12 50% X \$1,000,000] of capital gain on his final 1040 and the resulting tax liability is deductible as a debt on his federal estate tax return.<sup>10</sup> The estate reports \$125,000 of capital gain [3/12 X 50% X \$1,000,000].

Depending on the particular income and estate tax rates and other relevant facts, one method may be clearly superior to the other. Executors should work with the partnership to selecting the best method for both the outgoing and incoming partners, if possible. If the partners can't agree, the partnership must use the interim closing of the books method.<sup>11</sup>

### **III. SHAREHOLDER ELIGIBILITY**

An S corporation can only have certain types of owners in order to maintain its S status.<sup>12</sup> These include U.S. citizens, resident individuals, estates, certain trusts, and certain tax exempt organizations. If the estate transfers S stock to an ineligible owner, the corporation's S status will terminate. In some cases, this produces no harm other than the nuisance of converting the entity from an S corporation to a C corporation. But in many cases, it can work a grave harm to the S corporation and its other shareholders.

A corporation whose S status is terminated is not eligible to make another S election until the 5<sup>th</sup> taxable year following the first taxable year in which the termination occurred. Therefore, the fiduciary who inherits an interest in an S corporation should take steps to preserve the S status of the corporation.

#### **A. Estate as an Eligible Shareholder**

An estate is an eligible shareholder of S stock under IRC § 1361(b)(1)(B) as long as is reasonably necessary to administer the estate. Thus, the death of an S shareholder will not terminate the corporation's S status where the estate becomes the new shareholder. There is no statutory length of time an estate may be left open. It may remain open for federal income tax purposes for the period required by the administrator or executor to perform the ordinary duties of administration, whether that period is longer or shorter than specified under local law for the settlement of estates.<sup>13</sup> During that time the estate will report the items of income and deduction

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<sup>9</sup> Reg. § 20.2053-6(f).

<sup>10</sup> Reg. § 20.2053-6(f).

<sup>11</sup> Reg. § 1.706-1(c)(2)(ii)

<sup>12</sup> IRC § 1361(b)(1).

<sup>13</sup> Reg. § 1.641(b)-3(a).

reflected on Schedule K-1 issued to it by the S corporation. In addition, if the estate elects a fiscal year other than the calendar year, it can achieve up to an 11 month deferral of income tax.

### EXAMPLE

Assume an estate that owns S corporation stock selects a November 30 tax year. The S corporation, which is on a calendar year, issues a Schedule K-1 to the estate showing \$200,000 of taxable income. The estate will report that \$200,000 on its tax return for the year ending November 30, 2009. Thus it will have an 11 month deferral of tax on that amount, at least for the first two years during which it is not required to pay estimated taxes.<sup>14</sup>

However, if the estate remains open for an unduly prolonged period, it may cause the estate to be taxed as a trust for federal income tax purposes.<sup>15</sup> If that happens, the S election will be terminated unless the deemed trust becomes a qualified Subchapter S Trust (QSST) or an electing small business trust (ESBT) within 2 years of the deemed conversion date.

Keeping an estate open long enough to hold stock during the period for which IRC § 6166 allows the deferral of estate taxes will not cause the estate to become an ineligible shareholder.<sup>16</sup> The same applies to permit a grantor trust to hold S stock after the death of a grantor for the § 6166 deferral period.<sup>17</sup> Thus that deferral may last up to 15 years.<sup>18</sup> However, there is no automatic rule that allows estates to remain open for an unduly prolonged period for other reasons, such as for completing the federal estate tax audit.<sup>19</sup> Although that would certainly seem to be a valid reason to keep the estate open. Therefore, estates must justify the reasons for an unduly prolonged administration based on facts and circumstances in order to avoid becoming a deemed trust that could potentially disqualify the S corporation's status.

#### B. Trusts as Qualified S Corporation Shareholders

Only certain trusts are permitted to own S corporation stock. In all cases, the trust must be a domestic trust. Estate planners must be very careful to identify eligible trusts in drafting, funding, and anticipating who might become an S corporation shareholder. The types of permissible and impermissible trusts are described below.

##### 1. Grantor Trust

A trust all of which is treated under Sections 671-679 as owned by an individual who is a citizen or resident of the United States (a wholly owned grantor trust) is a permitted shareholder during the life of a domestic grantor.<sup>20</sup> Where only a portion of a trust is treated as owned by the

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<sup>14</sup> IRC § 6654(l)(2).

<sup>15</sup> *Id.*; Old Va. Brick Co., 44 T.C. 724 (1965), *aff'd*, 367 F.2d 276 (4<sup>th</sup> Cir. 1966).

<sup>16</sup> Rev. Rul. 76-23, 1976-1 C.B. 264

<sup>17</sup> Ltr. Rul. 200226031 (Mar. 26, 2002); "Trust Funded with S Corporation Stock is a Permissible S Corporation Shareholder Upon Death of Grantor During § 6166 Deferral Period," Tax Mgmt. Mem. 43-19, at 397 (Sept. 23, 2002).

<sup>18</sup> IRC § 6166(a).

<sup>19</sup> Ltr. Rul. 7951131 (Sept. 24, 1979).

<sup>20</sup> IRC § 1361(c)(2)(A)(i).

grantor under § 677, the trust is not an eligible shareholder.<sup>21</sup> Several private letter rulings have held that a grantor retained annuity trust (GRAT) qualifies as an S corporation shareholder because income distributable to the grantor during the annuity period is sufficient to cause the grantor to be treated as the owner of the entire trust.<sup>22</sup> However, all the GRAT remainder beneficiaries should be permitted S corporation shareholders or else the corporation will need to take corrective action within 2 years after the grantor's death to avoid terminating the S election. Such action might include redeeming the ineligible shareholder(s) or transferring the stock to an eligible shareholder.

A self-funded special needs trust qualifies as an S corporation shareholder because it is a grantor trust for tax purposes. Although a self-funded special needs trust can own S stock without terminating the S election, keep in mind that some or all of the stock might eventually be needed to repay the state for Medicaid benefits.<sup>23</sup> Therefore, the S corporation should be prepared to redeem the trust on the death of the disabled individual.

If the grantor dies, the trust is permitted to hold the S stock for up to two years from the grantor's death without terminating the S corporation's status.<sup>24</sup> During this period, the estate is treated as the shareholder for eligibility purposes.<sup>25</sup> However, the income of the S corporation passes through to the trust, not the estate. At anytime during this period, the trust can elect to become a qualified subchapter S trust (QSST) or an electing small business trust (ESBT) if it qualifies under the applicable rules and the election is made properly.

One should be very careful with a single member LLC owning S corporation stock. In Letter Ruling 200841007 an individual owned S corporation stock through his single member LLC, a disregarded entity for tax purposes. He transferred LLC units to 5 revocable living trusts, which were wholly owned grantor trusts, also ignored for income tax purposes. However, when he died, the LLC became a partnership because it had multiple owners. Because a partnership is not eligible to own S corporation stock, the S election terminated immediately. The LLC was immediately liquidated and the S stock was transferred to the 5 trusts. But the trusts were not allowed the 2-year grace period for eligibility following the death of a grantor under IRC § 1361(c)(2)(ii) because they were not the shareholders on the date of death. Rather the partnership was the S shareholder. The ruling concluded that the "springing partnership" was inadvertent and allowed the S election to continue as long as the trusts and individuals filed amended returns consistent with the trusts being treated as owners of the S corporation stock.

## 2. Voting Trust

Voting trusts, which are created primarily to exercise the voting power of the

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<sup>21</sup> Ltr. Rul. 200226006 (S stock transferred to a trust created for him by his father made him a grantor of that portion of the trust under Sec. 677. However, because he was not the owner of *all* of the trust, the trust was ineligible to hold S stock under Sec. 1361(c)(2)(A)(i).)

<sup>22</sup> Ltr. Rul. 9248016 (GRAT with a power to substitute assets under § 675(4) was a wholly owned grantor trust eligible to own S corporation stock); Ltr. Rul. 199942017 (GRAT with a power to borrow under § 675(3) was a wholly owned grantor trust eligible to own S corporation stock); Ltr. Rul. 9451056, 9449012 (grantor of a GRAT is treated as the owner of the entire trust.)

<sup>23</sup> 42 U.S.C. 1396p(d)(4)(A).

<sup>24</sup> IRC § 1361(c)(2)(A)(ii).

<sup>25</sup> Reg. § 1.1361-1(h)(3)(i)(B).

S corporation stock, are permitted shareholders.<sup>26</sup> The beneficial owners of the trust are treated as the owners of their portion of the trust. The beneficial owners must be citizens or residents of the United States. In addition, a written trust agreement entered into by the shareholders must delegate the right to vote to one or more trustees, require all distributions with respect to the stock of the corporation held by the trust to be paid to, or on behalf of, the beneficial owners of the stock, require title and possession of the stock to be delivered to the beneficial owners upon termination of the trust, and terminate, under its terms or by state law, on or before a specific date or event.<sup>27</sup>

The question has arisen whether the statute requires the voting trust to independently qualify under the grantor trust rules of Subpart E, or merely to be *treated* like one, like the QSST rules under § 1361(d)(1)(A). The regulations state “To qualify as a voting trust for purposes of this section (a qualified voting trust), the beneficial owners must be treated as the owners of their respective portions of the trust under subpart E....”<sup>28</sup> While the distinction between qualifying as a grantor trust and merely being treated like one is not so important for the grantor of the voting trust, it becomes important for successive beneficiaries. That is, how can the successor beneficiary qualify as the grantor of a voting trust? Does the voting trust need to contain special terms that qualify the successive beneficiaries as grantors under Subpart E? The answer is probably no. One author notes “Under the regulations, as long as title and possession of the voting trust’s stock go to the beneficial owners upon the trust’s termination, the beneficiaries can transfer their interests in the trust during its existence. To interpret the rules otherwise would foreclose the transfer of any stock once held in a voting trust.”<sup>29</sup>

### 3. Testamentary Trust

If the estate transfers S stock to a trust pursuant to a will, the testamentary trust remains a qualified S shareholder for an additional 2-year period beginning on the date of the transfer.<sup>30</sup> During that time the trust reports the items of S corporation income and deduction reflected on Schedule K-1 of the S corporation. Thus, between the period of estate administration (assuming it is not unduly prolonged) and the two-year period for testamentary trusts, the trust should have ample time to qualify as a permitted QSST or ESBT shareholder, or dispose of its interest.

### 4. Qualified Subchapter S Trust (QSST)

In order for a trust to be an eligible S shareholder after the two-year period allowed for a decedent’s grantor trust or a testamentary trust discussed above, the trust must either be a qualified subchapter S trust (QSST) or an electing small business trust (ESBT).<sup>31</sup> In order to be a QSST, the trust terms must provide that:

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<sup>26</sup> 1361(c)(2)(A)(iv).

<sup>27</sup> Reg. § 1.1361-1(h)(1)(v).

<sup>28</sup> Reg. § 1.1361-1(h)(1)(v).

<sup>29</sup> Samuel P. Starr, “S Corporations: Formation and Termination”, BNA Portfolio 730 T.M., I.I.E.1.d.

<sup>30</sup> IRC § 1361(c)(2)(A)(iii).

<sup>31</sup> IRC § 1361(c)(2)(A)(v); IRC § 1361(d).

- During the life of the current income beneficiary, there is only one income beneficiary of the trust. However, a QSST may have multiple income beneficiaries if they have separate shares under IRC § 663(c);<sup>32</sup>
- Any corpus distributed during the life of the current income beneficiary must be distributed only to that beneficiary;
- The income interest of the current beneficiary in the trust must terminate on the earlier of such beneficiary's death or the termination of the trust;
- Upon termination of the trust during the life of the current income beneficiary, the trust must distribute all of its assets to that beneficiary;

In addition, the trust income must be distributed each year directly to the beneficiary, or to a custodial account for the benefit of a minor beneficiary, who is a resident or citizen of the United States.<sup>33</sup> Distributions within the first 65 days after the trust's year end for which the trustee makes a 65-day election to treat them as made on the last day of the preceding year are considered distributions of the prior year income for purposes of the QSST requirements.<sup>34</sup>

A QTIP marital trust will automatically meet the income distribution requirements of a QSST. However, a special needs trust will generally not qualify as a QSST because it will usually limit distributions to the disabled beneficiary in order to maintain their eligibility for government benefits. But, in several private letter rulings, the IRS has created an exception for special disability trusts. The rulings allow a special needs trust to be a beneficiary of a QSST, where the QSST distributes all its income to the special needs trust, but the special needs trust makes only limited distributions to or for the benefit of the disabled beneficiary.<sup>35</sup>

*a. Making the QSST Election.* The beneficiary of the trust must affirmatively elect to be taxed as a QSST.<sup>36</sup> The beneficiary does so by signing and filing a statement with the service center where the S corporation files its income tax return within 2 months and 15 days after the election is to be effective.<sup>37</sup> The trustee is not required to consent to this election. The QSST election is revocable only with the Commissioner's consent.<sup>38</sup>

The failure to meet any of these requirements will disqualify the trust as an eligible S shareholder as of the date it ceases to meet the requirements.<sup>39</sup> However, the Service has been extremely generous in granting relief for failure to distribute QSST income or make a timely QSST election as long as the failure is "inadvertent" and not an attempt at retroactive tax planning.<sup>40</sup> The IRS has even allowed trustees to amend the trust agreement to satisfy the QSST

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<sup>32</sup> IRC § 1361(d)(3).

<sup>33</sup> Reg. § 1.1361-1(e)(1); IRC § 1361(d)(3)(B).

<sup>34</sup> Ltr. Rul. 8717024 (Jan. 17, 1987).

<sup>35</sup> Ltr. Ruls. 9444059, 9444024, 9444022, 9442036.

<sup>36</sup> IRC § 1361(d)(2)(A); *see* Exhibit A for a sample QSST election.

<sup>37</sup> IRC § 1361(d)(2)(D); Reg. § 1.1361-1(j)(6).

<sup>38</sup> Reg. § 1.1361-1(j)(11).

<sup>39</sup> IRC § 1361(d)(4).

<sup>40</sup> IRC § 1362(f); Rev. Proc. 2003-43, 2003-1 C.B. 998 (procedures for automatic relief without a letter ruling for failure of an S corporation Q-Sub, QSST, or ESBT to make a proper election); Ltr. Rul. 200932031, 200932022, 200932001, 200931036, 200905014, 200839008, 200726029 (relief from disqualification for failure to distribute income); Ltr. Ruls. 200929002, 200909024, 200906037, 200906027, 200903066, 200901024, 200843006,

requirements after the time when the S election would have terminated. In a couple of recent private letter rulings the trustee of a trust that qualified as an ESBT, but did not wish to make an ESBT election, was allowed to amend the trust document to create separate subtrusts that were eligible and did make a late QSST election.<sup>41</sup>

*b. Reporting Requirements.* A QSST beneficiary is treated as if he or she is the direct owner of the portion of the QSST that owns the S corporation stock under Section 678(a).<sup>42</sup> As such, the beneficiary is taxed on the entire amount shown on the trust's Schedule K-1 received from the S corporation. But when the QSST disposes of the stock, the trust rather than the beneficiary of the QSST recognizes gain or loss.<sup>43</sup>

A QSST must file a Form 1041 regardless of whether its only asset is the S corporation stock or not.<sup>44</sup> If the QSST only owns the S stock, the QSST files a Form 1041 with a plain paper statement reflecting the separately stated S items, which it furnishes to the income beneficiary to report on his or her own Form 1040. If the QSST owns other assets in addition to the S stock, the QSST's other income and deductions are reflected on page 1 of the Form 1041 and taxed according to the general rules of Subchapter J.<sup>45</sup>

*c. Death of the Income Beneficiary.* If the income beneficiary dies and the trust continues to hold S corporation stock, but does not qualify as a QSST, grantor trust, or ESBT, then for two years after the income beneficiary's death, the estate is treated as the S shareholder for eligibility purposes.<sup>46</sup> Within that two year period the trust must dispose of the stock or make an ESBT election or else the S election will be terminated. While the estate is treated as the shareholder for eligibility purposes, the trust is treated as the shareholder for purposes of reporting income and deductions, basis, and distributions.<sup>47</sup> If, after the 2-year period, the trust continues to hold S corporation stock and does not otherwise qualify as a permitted shareholder, the S election will terminate. If the termination is inadvertent, the corporation may request relief under § 1362(f).

If there are multiple successive income beneficiaries after the death of the income beneficiary, each successor beneficiary must have a separate share under the trust in order for the trust to continue to be a qualified QSST. Although the trust could probably make an ESBT election instead, that may not be desirable because it causes the trust's share of the S corporation income to be taxed at the highest marginal tax rates applicable to such income. Alternatively, the trust document could provide that the QSST divides into multiple trusts upon the death of the income beneficiary. In that case, each new trust must make a separate QSST election.<sup>48</sup>

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200843007, 200841030, 200840029, 200840027, 200840026, 200820014, 200807004, 200806005, 200805004, 200804009, 200801004, 200742001, 200726027, 200716011, 200705021, 200705020, 200705018, 200704025, 200703032, 200702020 (relief from S corporation termination and disqualification of the QSST for inadvertent failure of the beneficiary to make a timely QSST election).

<sup>41</sup> Ltr. Rul. 200934007, 200932031.

<sup>42</sup> IRC § 1361(d)(1)(B).

<sup>43</sup> Reg. § 1.1361-1(j)(8); Ltr. Rul. 9721020.

<sup>44</sup> Reg. § 1.671-4(b)(6)(iii).

<sup>45</sup> Reg. § 1.1361-1(j)(8).

<sup>46</sup> Reg. § 1.1361-1(j)(7)(ii).

<sup>47</sup> *Id.*

<sup>48</sup> Reg. § 1.1361-1(j)(9).

*d. Refusal to Consent to the QSST Election.* If the trust continues to meet the QSST requirements after the income beneficiary's death, then the QSST election continues in place without any further action required by the trust or the beneficiaries.<sup>49</sup> However, a successor income beneficiary may affirmatively refuse to consent to the QSST election within the 2-month-and-15-day period after becoming the successor income beneficiary. If the affirmative refusal is filed, the trust generally becomes an ineligible shareholder.<sup>50</sup> The beneficiary may refuse to consent to the S election because, for example, the corporation is passing through income but not making distributions, and he or she does not want to pay tax currently on the trust's share of the corporation's income. A sample refusal form is included at Exhibit D.

### EXAMPLE

Diane is the income beneficiary of a QSST. She dies on August 15, 2009 and the trust names her granddaughter, Annie as the successor income beneficiary. For the 2 ½ month period after Diane's death, Annie (or her parent acting on her behalf, if she is still a minor) can file an affirmative refusal to consent to the QSST election. Annie's refusal to consent is due October 30, 2009 and becomes effective on August 15, 2009, the day Annie became a beneficiary of the QSST. The trust is now an ineligible shareholder and must dispose of its stock or make an ESBT election within two years from August 15, 2009.

The ability of a new beneficiary to terminate the S election is in sharp contrast with the general procedure for terminating an S election, which requires more than 50 percent of the shareholders' consent.<sup>51</sup>

*e. Crummey Withdrawal Rights.* The terms of a QSST must require that any corpus distributed during the life of the current income beneficiary be distributed only to that beneficiary.<sup>52</sup> This would preclude granting Crummey withdrawal rights to any beneficiary other than the current income beneficiary. Therefore, attorneys drafting trusts intended to qualify as eligible S corporation shareholders should realize that adding Crummey withdrawal rights for multiple beneficiaries will preclude the trust from qualifying for QSST status. The trust could, however, make an ESBT election because the ESBT rules do not preclude Crummey withdrawal rights. However, beneficiaries with such rights must be individuals, estates, and certain charitable organizations.<sup>53</sup> Nonetheless, ESBT status may not be desirable because the ESBT's share of taxable income from the S corporation is taxed at the maximum tax rate for individuals.

## 5. Electing Small Business Trust (ESBT)

The Small Business Job Protection Act of 1996 introduced a new, more flexible form of trust eligible to hold S stock called an "electing small business trust," or ESBT. This is ideal for trusts that do not qualify as QSSTs because they have more than one current beneficiary or wish

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<sup>49</sup> Reg. § 1.1361-1(j)(9)(i).

<sup>50</sup> Reg. 1.1361-1(j)(9) and (10).

<sup>51</sup> IRC § 1361(d)(1)(B).

<sup>52</sup> IRC § 1361(d)(3)(A)(ii).

<sup>53</sup> IRC § 1361(e)(1)(A).

to accumulate their income.<sup>54</sup> For example, a special needs trust (disability trust) is an ideal candidate for an ESBT. It cannot distribute all its income annually because to do so would probably disqualify the beneficiary for government benefits. Trusts with Crummy powers for multiple beneficiaries who may not be current income beneficiaries are also ideal candidates for an ESBT. They are not eligible to make a QSST election because a QSST requires that any corpus distributed during the life of the current beneficiary may be distributed only to the current income beneficiary.<sup>55</sup>

An ESBT must meet all of the following criteria:

- All beneficiaries of the trust must be individuals, estates, charitable organizations described in IRC §§ 170(c)(2)-(5), or a government organization described in § 170(c)(1) that holds a contingent interest in the trust.<sup>56</sup> A government organization may not be a potential current beneficiary (PCB). PCBs are described in more detail below. A beneficiary generally includes any person who has a present, remainder, or reversionary interest in the trust. However, it does not include a person whose interest is so remote as to be negligible. Nor does it include a person in whose favor a power of appointment can be exercised until the power is actually exercised in favor of that person.<sup>57</sup> Charitable remainder annuity and unitrusts (CRATS and CRUTS) defined in IRC § 664(d) are statutorily excluded from eligibility as ESBT shareholders.<sup>58</sup> However, a charitable lead annuity trust (CLAT) may be an S shareholder.<sup>59</sup> Nonresident aliens may be ESBT beneficiaries as long as they are not potential current beneficiaries.<sup>60</sup> The rules regarding eligible beneficiaries of an ESBT apply to the entire trust even if only a portion of the trust is treated as an ESBT.
- No interest in the trust can be acquired by purchase.<sup>61</sup> Thus, an interest in the trust must generally be acquired by gift, bequest, or transfer in trust. If any portion of the basis in the acquired interest in the trust is determined under § 1012, such interest has been acquired by purchase.<sup>62</sup> For example, if a donee pays the gift tax on the net gift of a beneficial interest in the trust, the donee is deemed to have purchased an interest in the trust.<sup>63</sup> Purchasing an interest in the trust should not be confused with the trust itself purchasing S corporation shares to hold in the trust, which is perfectly permissible without disqualifying the ESBT.<sup>64</sup>

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<sup>54</sup> IRC §§ 1361(c)(2)(A)(v); 1361(e):

<sup>55</sup> IRC § 1361(d)(3)(A)(ii).

<sup>56</sup> IRC § 1361(e)(1)(A)(i).

<sup>57</sup> Reg. § 1.1361-1(m)(1)(ii)(C).

<sup>58</sup> IRC § 1361(e)(1)(B)(iii); Ltr. Rul. 200703023 (Jan. 19, 2007) (S status terminated on transfer of stock to a CRUT. But the IRS held that the S corporation's election could remain valid because the termination was inadvertent. The shareholders were required to transfer the stock back to the original owners and treat them as if they had continued to own the stock for federal income tax purposes.).

<sup>59</sup> Reg § 1.641(c)-1(l), Ex. 4.

<sup>60</sup> Reg. § 1.1361-1(m)(1)(ii)(D).

<sup>61</sup> IRC § 1361(e)(1)(A)(ii).

<sup>62</sup> Reg. § 1.1361-1(m)(1)(iii).

<sup>63</sup> *Id.*

<sup>64</sup> Reg. § 1.1361-1(m)(1)(iii).

- The trustee, not the beneficiary, makes an ESBT election.<sup>65</sup> He does this by signing and filing, with the service center where the S corporation files its income tax return, a statement that contains the name, address, and taxpayer identification number of the trust, the potential current beneficiaries, and the S corporations in which the trust currently holds stock.<sup>66</sup> If the trust includes a power of appointment, the election must disclose the existence of the power, but need not include any detailed information about it. The election must also identify the election as an ESBT election made under § 1361(e)(3), indicate the first date on which the trust owned the S stock, the date the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed), and represent that the trust meets the statutory requirements of an ESBT.<sup>67</sup>

The election can be revoked only with IRS's consent.<sup>68</sup> Rev. Proc. 2004-43 provides automatic relief for failure to make a timely ESBT election.<sup>69</sup> In addition, the IRS has granted relief from S corporation termination in private letter rulings where the termination was inadvertent and the trustee makes a late retroactive ESBT election.<sup>70</sup> In Letter Ruling 200927012, the IRS allowed the trust to make a late ESBT election even though the S corporation was dissolved by the time of the election.

In some cases, a trust may satisfy the requirements for an ESBT, but would rather be taxed as a QSST. In that case, the trustee might consider creating a separate subtrust that meets the QSST requirements. In Letter Ruling 200932031 the trustee of a trust that qualified as an ESBT, but did not wish to make an ESBT election, was allowed to amend the trust document to create a separate subtrust that was eligible and did make a late QSST election.<sup>71</sup>

An ESBT can meet all of these qualifications and still cause the S election to terminate if it has a "potential current beneficiary" (PCB) that is an ineligible shareholder or causes the number of shareholders to exceed 100.<sup>72</sup> In that case, the trust has one year from the admission of the ineligible beneficiary to dispose of its interest in the S corporation before causing the corporation to lose its S status.<sup>73</sup>

A potential current beneficiary is any beneficiary who is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust.<sup>74</sup> It does not include a person who only holds a future interest in the trust.<sup>75</sup> Nor does it include a person who is only entitled to receive a distribution after a specified time or when a specified event occurs (such as the death of a holder of a power of appointment), until the time arrives or event

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<sup>65</sup> IRC § 1361(e)(3).

<sup>66</sup> See Exhibit B for sample ESBT election form.

<sup>67</sup> Reg. § 1.1361-1(m)(2).

<sup>68</sup> IRC § 1361(d)(2)(C).

<sup>69</sup> Rev. Proc. 2003-43, 2001-1 C.B. 998.

<sup>70</sup> Ltr. Rul. 200934003, 200927012.

<sup>71</sup> Ltr. Rul. 200932031 (August 7, 2009).

<sup>72</sup> IRC §§ 1361(b)(1)(A) (100 shareholder limit), 1361(c)(2)(B)(v) (who counts as a shareholder with an ESBT); Reg. § 1.1361-1(m)(4)(i) (each potential current beneficiary counts as a shareholder).

<sup>73</sup> IRC § 1361(e)(2); Reg. §§ 1.1361-1(m)(4)(iii); (m)(8), Ex. 2.

<sup>74</sup> IRC § 1361(e)(2) (potential current beneficiary defined).

<sup>75</sup> IRC § 1361(e)(2); Reg. § 1.1361-1(m)(4)(i).

occurs.<sup>76</sup> For tax years after December 31, 2004, it does not include a person in whose favor an unexercised power of appointment can be exercised.<sup>77</sup>

The price paid for an ESBT's flexibility in distributing or accumulating income for multiple beneficiaries is that the trust (not the beneficiaries) is taxed on income related to the S corporation stock at the highest individual rate (35% for 2009), except for long-term capital gains which are taxed at the capital gain rate that applies.<sup>78</sup> The taxable income of an ESBT consisting solely of stock in one or more S corporations includes:<sup>79</sup>

1. The S corporation items of income, loss, or deduction allocated to it (i.e., passed through on Schedule K-1 of Form 1120S) as an S corporation shareholder.
2. Gain or loss from the sale of the S corporation stock, but not the interest income on an installment sale of the S stock.<sup>80</sup>
3. State and local income taxes and administrative costs directly related to the S portion.<sup>81</sup>
4. Interest expense on indebtedness incurred to acquire S corporation stock.<sup>82</sup>
5. Capital losses to the extent of capital gains.
6. The ESBT is not entitled to an income distribution deduction or the personal exemption normally allowed for trusts unless it has other taxable income not attributable to the S corporation.<sup>83</sup>
7. The ESBT is not entitled to an alternative minimum tax exemption.<sup>84</sup>

The tax on these items of income, deduction, gains or losses is calculated separately on a plain paper schedule attached to the Form 1041 and entered on line 7 of Form 1041, Schedule G. The ESBT is also required to make estimated tax payment under the same rules as individuals.<sup>85</sup> When an ESBT holds other property in addition to S corporation stock, the trust consists of two portions, the "S" portion and the "Other" (non-S) portion.<sup>86</sup> The S portion items are disregarded when figuring the tax liability of the "Other" portion, which is taxed under the normal trust taxation rules. Distributions from the "Other" portion and the "S" portion are deductible (limited to the DNI of the "Other" portion) in computing the taxable income of the "Other" portion.

## 6. IRAs and Qualified Plans

An IRA is not an eligible S corporation shareholder.<sup>87</sup> Therefore, if S stock is transferred to an IRA, the S status terminates immediately. However, in PLR 200817013 the IRS provided

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<sup>76</sup> Reg. § 1.1361-1(m)(4)(v).

<sup>77</sup> IRC § 1361(e)(2); Reg. § 1.1361-1(m)(4)(vi) (Sept. 28, 2007).

<sup>78</sup> IRC § 641(c)(2)(A).

<sup>79</sup> IRC § 641(c)(2).

<sup>80</sup> Reg. § 1.1361-1(j)(8).

<sup>81</sup> Reg. § 1.641-1(d)(4); Reg. § 1.641(c)-1(l), Example 1.

<sup>82</sup> IRC § 641(c)(2)(C)(iv) (added by the Small Business and Work Opportunity Tax Act of 2007 effective for taxable years beginning after December 31, 2006).

<sup>83</sup> *Id.*

<sup>84</sup> IRC § 641(c)(2)(B).

<sup>85</sup> IRC § 6654(l).

<sup>86</sup> IRC § 641(c)(1).

<sup>87</sup> Rev. Rul. 92-73, 1992-2 CB 224.

relief from termination to an S corporation where five of its shareholders transferred their stock to their self-directed IRAs.<sup>88</sup> The IRS required the shareholders to report their share of the S corporation income during the time that their IRAs owned the stock. No mention was made in the ruling about whether the transfer was a prohibited contribution of property since only cash contributions are permitted, except for rollover contributions, or whether the transfer was a prohibited transaction under IRC § 4975, potentially disqualifying the IRA altogether.

However, as of October 22, 2004, an IRA that is a bank as defined in IRC § 581 or a depository institution holding company can be an S corporation shareholder.<sup>89</sup> In that case, the individual for whose benefit the IRA was created is treated as the shareholder.<sup>90</sup> However, if an S corporation other than a bank or depository institution holding company issues shares to an IRA, the S election will be immediately terminated.<sup>91</sup>

Qualified retirement plan trusts are eligible to hold S corporation stock.<sup>92</sup> For purposes of the 100-shareholder limit, a qualified retirement plan counts as one shareholder.<sup>93</sup> However, the trust's share of the S corporation's pass-through income as well as any gain or loss on disposing of the S stock is taxed as unrelated business taxable income (UBTI).<sup>94</sup> Employee stock ownership plans (ESOPs) that own S stock, however, are exempt from the UBTI rules.<sup>95</sup>

### C. 100 Shareholder Limit

In planning and funding the various bequests under the will or trust, the executor needs to keep in mind that only certain individuals and entities are permitted shareholders of an S corporation or else the election will be immediately terminated. An S corporation may not have:

- More than 100 shareholders. A husband and wife are counted as one shareholder. Also members of a “six-generation” family are counted as one shareholder. This includes a common ancestor, any lineal descendant of the common ancestor, and any spouse or former spouse of the common ancestor or any such lineal descendant. A common ancestor is one who is not more than six generations removed from the youngest generation of shareholders who would be members of the family of that common ancestor. Legally adopted children and foster children are treated as a child by blood.<sup>96</sup>
- A nonresident alien shareholder
- More than one class of stock

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<sup>88</sup> Ltr. Rul. 200817013.

<sup>89</sup> IRC § 1361(c)(2)(A)(vi); Reg. § 1.1361-1(h)(1)(vii).

<sup>90</sup> Reg. § 1.1361-1(h)(3)(i)(G).

<sup>91</sup> Reg. § 1.1361-1(h)(1)(vii); Ltr. Rul. 200802008.

<sup>92</sup> IRC § 1361(c)(6).

<sup>93</sup> S. Rep. No. 281, 104th Congress, 2nd Sess., p. 63–64.

<sup>94</sup> IRC § 512(e)(1).

<sup>95</sup> IRC § 512(e)(3).

<sup>96</sup> IRC § 1361(c)(1); Reg. § 1.1361-1(e).

#### D. Charitable Organizations as S Shareholders

Commencing January 1, 1998 qualified plans and charities described in §§ 401(a) or 501(c)(3) and exempt from taxation under § 501(a) may be S corporation shareholders.<sup>97</sup> Therefore, an individual could contribute S stock to a charity and claim a charitable contribution deduction for the value of the shares. A charitable contribution of S stock is treated in the same manner as a charitable contribution of a partnership interest. That is, the amount of the charitable contribution is reduced by the ordinary income that would be recognized on a sale of the stock if § 751(a) applied to S stock.<sup>98</sup>

S stock is usually not an attractive gift to the charity, however, because the S corporation income allocable to charity would generally be unrelated business taxable income, which is subject to regular corporate or trust income tax rates.<sup>99</sup> Moreover, private foundations are usually prohibited from owning stock in a closely held S corporation because there is a 10 percent excise tax on “excess business holdings” if the private foundation and all disqualified persons own more than 20 percent of the voting stock of an incorporated business enterprise.<sup>100</sup> A business enterprise includes a trade or business with more than 5 percent of its gross income from passive sources.<sup>101</sup> And unless disposed of by year end, the holding is subject to a 200 percent excise tax. “Disqualified persons” includes the foundation’s founder and descendants, its managers, and substantial contributors.<sup>102</sup>

And finally, if disqualified persons own more than 35 percent of the voting power of the S corporation, the S corporation would be a disqualified person with respect to the foundation. Thus any redemption of the S corporation by the foundation would be self-dealing subject to the tax under IRC § 4941. However, there are certain exceptions that could apply at the time the private foundation’s interest in the corporation is redeemed.

### IV. INCOME IN RESPECT OF A DECEDENT

The stock of an S corporation acquires a new basis on the date of a shareholder’s death equal to its fair market value on the date of death under IRC § 1014. It also acquires a long-term holding period for purposes of determining gain or loss on disposition of the stock.<sup>103</sup> However, this does not apply to income in respect of a decedent (IRD) under IRC § 691 owned by the S corporation. The rules for S corporations and partnerships differ on IRD.

#### A. S Corporations

The basis of S stock under § 1014 is reduced by the value of income in respect of a decedent.<sup>104</sup> If any person acquires stock in an S corporation by reason of the death of a decedent or by bequest, devise, or inheritance, § 691 is applied with respect to any item of income of the S

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<sup>97</sup> IRC §§ 1361(c)(6), 1361(b)(1)(B).

<sup>98</sup> IRC § 179(e)(1).

<sup>99</sup> IRC §§ 511(a), 511(b).

<sup>100</sup> IRC § 4943(c)(2).

<sup>101</sup> IRC § 4943(d)(3)(B).

<sup>102</sup> IRC § 4946(a).

<sup>103</sup> IRC § 1223(11).

<sup>104</sup> IRC § 1367(b)(4)(B).

corporation in the same manner as if the decedent had held directly his prorata share of the item.<sup>105</sup> In other words, there is complete parity between IRD owned outright by a decedent and the IRD inside an S corporation. This is not true with respect to a deceased partner.

## B. Partnerships

There are differences between IRD attributable to a partnership interest and that attributable to an S corporation. However, neither receives an adjusted basis under § 1014(c) for the portion of the entity that is attributable to income in respect of a decedent under IRC § 691.<sup>106</sup> In other words, the estate receives no step-up in basis for IRD inside the partnership or the S corporation.<sup>107</sup> This is true even when the partnership makes a § 754 election.<sup>108</sup> Therefore, when a partner dies, the estate needs to examine the balance sheets of any partnership it owns and any subsidiary partnerships they own.

### 1. Statutory IRD

The references to IRD of a deceased partner in the Internal Revenue Code are skimpy. Section 691(e) cross references § 753, which simply provides that § 736(a) payments are IRD. Section 736(a) payments are those made by a partnership in liquidation of a retired or deceased partner's interest in excess of those made under § 736(b), which are payments for a partner's interest in partnership property. Thus, § 736(a) payments are for *income* and § 736(b) payments are for *property*. In classifying payments between § 736(a) and (b), the Code specifically provides that payments for unrealized receivables and unstated goodwill made to a general partner of a service partnership are considered § 736(a) payments. But goodwill is property if the partnership agreement expressly provides for a payment of goodwill.<sup>109</sup>

Note that § 736 applies only when an ongoing partnership pays the deceased partner's estate or successor. It does not apply when other partners purchase the interest. Even though the economic consequences may be the same to the retired or deceased partner in both cases, the tax consequences may vary.<sup>110</sup>

Because § 753 refers exclusively to § 736(a) payments, which are payments for unrealized receivables and unstated goodwill of a general partner in a service partnership and all other payments except those for partnership property, it can be argued that nothing else from the partnership should constitute IRD. That is, we are not required to "look through" the partnership for other forms of income that would constitute IRD if owned outright by the decedent, such as accrued dividends and interest, etc.

Contrast the rule for S corporations under which § 1367(b)(4) clearly provides that "If any person acquires stock in an S corporation by reason of the death of a decedent or by bequest,

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<sup>105</sup> IRC § 1367(b)(4)(A).

<sup>106</sup> IRC § 1367(b)(4)(B); Reg. § 1.742-1.

<sup>107</sup> Quick Trust v. Comm'r, 54 T.C. 1336, *aff'd* 444 F.2d 90 (8<sup>th</sup> Cir. 1971); Woodhall v. Comm'r, 28 T.C.M. 1438, *aff'd* 454 F.2d 226 (9<sup>th</sup> Cir. 1972); Rev. Rul. 66-325, 1966-2 C.B. 249.

<sup>108</sup> Reg. § 1.755-1(b)(4)(ii), Example (as amended Dec. 14, 1999 by T.D. 8847).

<sup>109</sup> IRC § 736(b)(2)(B).

<sup>110</sup> Reg. § 1.736-1(a)(1)(i).

devise, or inheritance, section 691 shall be applied with respect to any item of the S corporation in the same manner as if the decedent had held directly his pro rata share of such item.”<sup>111</sup>

## 2. Judicially Created IRD

However, the IRS, the Tax Court, and two Circuit Courts of Appeal have held that IRD of a deceased partner is not so limited.<sup>112</sup> In *Quick v. Commissioner*, the Eight Circuit affirmed the Tax Court’s position that payments received by a deceased partner in liquidation of a two-man service partnership representing his share of zero-basis accounts receivable were IRD. The Tax Court held that the specific cross-reference in § 691(e) to § 753 “has no legal effect.”<sup>113</sup> And even if it did, it was not limited to payments described in § 753. It “merely states that certain distributions in liquidation under section 736(a) shall be treated as income in respect of a decedent. It does not state that no other amounts can be so treated.”

Further, the Tax Court found that the legislative history indicates that Congress did not view a partnership interest as a “unitary res, incapable of further analysis,” but “as a bundle of rights.” Both the House and Senate committee reports to § 751 specifically state that income rights relating to unrealized receivables or fees are regarded “as severable from the partnership interest and as subject to the same tax consequences which would be accorded an individual entrepreneur.”<sup>114</sup> The Senate committee report adds:

The House bill provides that a decedent partner’s share of unrealized receivables are [sic] to be treated as income in respect of a decedent. Such rights to income are to be taxed to the estate or heirs when collected, with an appropriate adjustment for estate taxes. \*\*\* Your committee’s bill agrees substantially with the House in the treatment described above but also provides that other income apart from unrealized receivables is to be treated as income in respect of a decedent. [S. Rept. No. 1622, 83d Cong., 2d Sess., p. 99 (1954)]<sup>115</sup>

Less than seven months after *Quick* was decided, the Ninth Circuit also upheld the Tax Court in a case with facts nearly identical to those in *Quick*. In *Woodhall v. Commissioner*, the Ninth Circuit held that payments received by the estate of a general partner in a two-man partnership pursuant to a written buy-sell agreement providing that the partnership shall terminate upon the death of either partner and the survivor shall purchase the decedent’s interest in the partnership were IRD.<sup>116</sup> Like *Quick*, it relied on the legislative history of §§ 741, 743, and 751 wherein the House Report specifically states that “A decedent partner’s share of unrealized receivables and fees will be treated as income in respect of a decedent.”<sup>117</sup>

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<sup>111</sup> Reg. § 1.1367-1(j).

<sup>112</sup> PLR 9715008; *Quick Trust v. Comm’r*, 54 T.C. 1336, *aff’d* 444 F.2d 90 (8<sup>th</sup> Cir. 1971); *Woodhall v. Comm’r*, 28 T.C.M. 1438, *aff’d* 454 F.2d 226 (9<sup>th</sup> Cir. 1972); Rev. Rul. 66-325, 1966-2 C.B. 249.

<sup>113</sup> § 7806(a) provides that cross references in the Internal Revenue Code are made only for convenience, and shall be given no legal effect.

<sup>114</sup> See H. Rept. No. 1337, 83d Cong., 2d Sess., p. 71 (1954); S. Rept. No. 1622, 83d Cong., 2d Sess., p. 99 (1954).

<sup>115</sup> *Quick Trust v. Comm’r*, 54 T.C. 1336, 1345, *aff’d* 444 F.2d 90 (8<sup>th</sup> Cir. 1971).

<sup>116</sup> *Woodhall v. Comm’r*, 28 T.C.M. 1438, *aff’d* 454 F.2d 226 (9<sup>th</sup> Cir. 1972).

<sup>117</sup> H.R. 1337, to accompany H.R. 8300 (P.L. 591), 83rd Cong., 2d Sess., pp. 70-71 (1954).

Whether the courts will expand the scope of *Quick* and *Woodhall* to include more categories of IRD from a partnership than unrealized accounts receivable is unclear. These cases have neither been followed nor criticized by other Circuit Courts of Appeal. But they have generated considerable disagreement among commentators.<sup>118</sup> In the meantime, it is not entirely clear which payments, if any, other than those under § 736(a) constitute IRD of a deceased partner. The regulations do not mention anything other than § 736(a) payments as IRD.<sup>119</sup> But the Preamble to Reg. § 1.755-1(b)(4) suggests that Treasury and the IRS adopt the *Quick* and *Woodhall* holdings. Taxpayers may challenge these holdings in another court someday.

### C. Reporting Requirements for IRD

The estate is responsible for reporting IRD and the related estate tax deduction and allocating it between the estate and beneficiary based on the amount it retains or distributes.<sup>120</sup> The instructions to Form 1041, U.S. Income Tax Return for Estates and Trusts, require the fiduciary to attach a schedule showing how the IRD deduction was calculated. However neither the § 691(c) regulations nor the instructions to Form 1065 or 1120S require the partnership or S corporation to report items of IRD on its books to the estate of a deceased partner or shareholder.

## V. BASIS ADJUSTMENTS AT DEATH

Although the stock of an S corporation acquires a new basis on the date of a shareholder's death equal to its market value under § 1014 (less items of IRD), this does not apply to the inside basis of the assets owned by the S corporation. There is no provision to adjust the inside basis of corporate assets on a shareholder's death. Contrast this with the ability of a partnership to make a § 754 election to adjust the inside basis of partnership assets with respect to a deceased partner. Therefore, if an S corporation sells an appreciated asset shortly after the deceased shareholder's death, the decedent's successor in interest will report a full prorata share of gain or loss just like all the other shareholders regardless of § 1014 step-up on the outside stock basis.

### EXAMPLE

Mary is a 10 percent shareholder in the S Corporation. She died on May 1, 2009 and her estate is the successor shareholder. Her stock is valued at \$100,000. On February 1, 2009 the S Corporation had sold some property generating a \$500,000 capital gain and \$200,000 of ordinary income depreciation recapture. The S corporation has no other income or loss that year. Under a daily proration, Mary's final Form 1040 reports \$20,833 of capital gain and \$8,333 of ordinary income. [10% X 5/12 X \$500,000 and 10% X 5/12 X \$200,000]. The estate's Form 1041 reports \$29,167 of capital gain and \$11,667 of ordinary income. [10% X 7/12 X \$500,000 and 10% X 7/12 X \$200,000].

Thus the estate obtains no immediate benefit from the step-up in outside stock basis it received upon Mary's death. Moreover, it must report a share of gain that arose before it acquired its interest.<sup>121</sup> However, the income it reports increases its basis in the stock and will reduce any

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<sup>118</sup> McKee, Nelson, & Whitmire ¶ 23.02[2][b] (4<sup>th</sup> ed. 2007).

<sup>119</sup> Reg. § 1.753-1.

<sup>120</sup> Reg. § 1.691(c)-2.

<sup>121</sup> IRC § 1377(a)(1); Reg. § 1.1377-1(a); see also discussion in Section II of this outline.

gain or increase any loss when it disposes of its stock in a taxable transaction later on. The estate should request that the corporation elect the “interim closing of the books” method of allocating income. If so, the corporation would close its books on May 1 and allocate 10 percent of the gain entirely to Mary for reporting on her final Form 1040 and the estate would report nothing. Although the combined tax liability of Mary and the estate may be the same under either method, the individuals who ultimately bear that liability may differ depending on the terms Mary’s will.

## VI. TAXATION OF DISTRIBUTIONS

It is important to distinguish between a distribution and a redemption by an S corporation. A distribution generally involves a nonliquidating distribution that is made to all shareholders in proportion to their stock ownership. On the other hand, a redemption contemplates a full or partial reduction of the shareholder’s interest in the corporation. The tax treatment of distributions and redemptions of an S shareholder is quite different. This section discusses distributions, whereas Section X.B. discusses redemptions.

### A. Corporations Without Earnings and Profits

Distributions of cash from an S corporation are generally tax-free to the extent they do not exceed the shareholder’s adjusted stock basis and the S corporation has no accumulated earnings and profits from its history as a C corporation.<sup>122</sup> The distribution reduces the shareholder’s basis in his or her stock.<sup>123</sup> Distributions in excess of basis result in a taxable gain on the sale of an asset.<sup>124</sup> Stock basis is determined as of the end of the corporation’s tax year.

The taxation of property distributions differs sharply between an S corporation and a partnership. S corporations are treated like C corporations for property distributions.<sup>125</sup> Thus, a distribution of *appreciated* property from an S corporation is a deemed sale of the asset at its market value.<sup>126</sup> The corporation recognizes gain as if it had sold the asset and the gain passes through to the shareholders.<sup>127</sup> A corporate level tax known as a “built-in gain tax” may also apply if the corporation was formerly a C corporation and made its S election less than 10 years ago with appreciated property.<sup>128</sup> This “built-in gains tax” can be avoided by waiting 10 years from the date of the S election to dispose of appreciated property owned at the time of the S election.

### EXAMPLE

The Smith Estate owns 100 percent of an S corporation and has a stock basis of \$100,000. The S corporation owns a building with a basis of \$10,000 and a value of \$100,000. It has no C corporation earnings and profits. In 2009 the corporation distributes the building to the estate. The corporation recognizes a \$90,000 gain on the

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<sup>122</sup> IRC § 1368(b)(1).

<sup>123</sup> IRC § 1367(a)(2)(A).

<sup>124</sup> IRC § 1368(b)(2).

<sup>125</sup> IRC § 1371(a).

<sup>126</sup> IRC §§ 1368(a), 1371(a), 301(b)(1).

<sup>127</sup> IRC §§ 311(b), 1366.

<sup>128</sup> IRC § 1374.

distribution, which passes through to the estate. The \$90,000 gain increases the estate's stock basis to \$190,000 [\$100,000 initial basis + \$90,000 capital gain]. The \$100,000 distribution is tax-free because it does not exceed the estate's stock basis.

The tax treatment of distributing *depreciated* property differs greatly from that of distributing appreciated property. When a corporation distributes property valued at less than its tax basis, the corporation does not recognize a loss.<sup>129</sup> It reduces its accumulated adjustments account (AAA) by the market value of the property and the market value becomes the shareholder's new basis in the property.<sup>130</sup> In essence, the disallowed loss is left in the corporation in the form of AAA against which future distributions can be made tax-free. A better tax result occurs if the corporation sells the property and distributes the cash. But if the property is sold to a person who owns more than 50 percent of the stock, the corporation cannot deduct the loss.<sup>131</sup> The loss is suspended until the shareholder disposes of the property to an unrelated party.<sup>132</sup>

## B. Corporations With Earnings and Profits

If an S corporation has earnings and profits (E&P) from its history as a C corporation, the distribution rules change dramatically. In that case, the corporation's accumulated adjustments account (AAA) comes out first.<sup>133</sup> It is tax-free to the extent of the shareholder's basis in the S corporation stock. Any excess AAA over the shareholder's basis is taxed as capital gain. Distributions in excess of that are taxed as a dividend to the extent of the corporation's E&P. Any remaining distribution is tax-free to the extent of any remaining stock basis. Any remaining distributions are capital gain. More precisely, distributions are taxed in the following order: (1) tax-free to the extent of AAA, not to exceed the shareholder's stock basis,<sup>134</sup> (2) capital gain to the extent of AAA in excess of the shareholder's stock basis, (3) ordinary dividend income to the extent of C corporation E&P,<sup>135</sup> (4) tax-free to the extent of any remaining basis,<sup>136</sup> and (5) capital gain to the extent of any excess.<sup>137</sup>

### EXAMPLE A

An estate owns all the stock of an S corporation. Its basis in the stock is \$100,000. The S corporation has AAA of \$50,000 and former C corporation E&P of \$25,000. In 2009, the S corporation redeems the estate for \$200,000. The first \$50,000 is a tax-free distribution of AAA and reduces the estate's basis in its stock. The next \$25,000 is a taxable dividend. The next \$50,000 is a tax-free recovery of remaining stock basis and the last \$75,000 is capital gain as follows:

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<sup>129</sup> IRC § 311(a).

<sup>130</sup> Reg. § 1.1368-2(c)(2).

<sup>131</sup> IRC § 267(a)(1).

<sup>132</sup> IRC § 267(d).

<sup>133</sup> IRC § 1368(c)(1).

<sup>134</sup> IRC § 1367(a)(2)(A).

<sup>135</sup> *Id.*

<sup>136</sup> IRC §§ 1368(c)(3), 1368(b).

<sup>137</sup> *Id.*

Total Distribution	Tax-Free AAA (limited to stock basis)	Dividend Income	Tax-Free Recovery of Remaining Basis	Capital Gain
\$200,000	\$50,000	\$25,000	\$50,000	\$75,000

### EXAMPLE B

Assume the same facts as the example above, except that the S corporation had AAA of \$150,000. In that case, the first \$100,000 would be a tax-free distribution of AAA, limited to the shareholder's stock basis. The next \$50,000 of AAA is taxed as capital gain, the next \$25,000 is a taxable dividend, and the last \$25,000 is capital gain:

Total Distribution	Tax-Free AAA (limited to stock basis)	Capital Gain on AAA in Excess of Basis	Dividend Income	Capital Gain
\$200,000	\$100,000	\$50,000	\$25,000	\$25,000

Note that in both examples, the \$200,000 distribution resulted in a tax-free recovery of \$100,000 (the shareholder's basis), dividends of \$25,000, and capital gains of \$75,000. However, if the distribution had been only \$100,000, the estate in Example A would receive \$50,000 tax-free and \$50,000 of capital gains, whereas the estate in Example B would receive the entire \$100,000 tax-free. Note, however, that the estate in Example A would have \$50,000 of remaining stock basis, whereas the estate in Example B would have none.

**Earnings and Profits:** A corporation's earnings and profits (E&P) is a theoretical measure of its income that can be distributed to its shareholders without impairing capital. E&P is determined by starting with each year's taxable income during the time the corporation was a C corporation and adjusting for tax-free income, nondeductible expenses, and a laundry list of other items, a few of which are listed below.<sup>138</sup> No adjustments are made to E&P when an S election is in effect.<sup>139</sup> Therefore, there are no reductions of E&P due to reversals of the items listed below after the S election takes effect. This can create a trap because these items are usually timing differences only. E&P can be reduced, however, for dividends, but only after the corporation exhausts its accumulated adjustments account (AAA).<sup>140</sup>

- using straight-line instead of accelerated depreciation

<sup>138</sup> Robert W. Jamison, 'S Corporation Taxation' (CCH 2009 ed.), ¶ 305.

<sup>139</sup> IRC § 1371(c)(1).

<sup>140</sup> See IRS Form 5472 for the calculation of E&P.

- eliminating bonus and § 179 depreciation
- capitalizing intangible drilling costs (IDC), mineral exploration, and development costs
- converting LIFO (last-in first-out) to FIFO (first-in first-out) for inventory
- recognizing all installment sale gains
- using percentage-of-completion instead of completed-contract on long-term contracts

## VII. FUNDING WITH S CORPORATION STOCK

The executor who plans to transfer S corporation stock to a beneficiary must consider many things. These include how the S corporation income will be allocated between the estate and the beneficiary in the distribution year, the possible recognition of gain or loss on funding with S stock, and the possible recognition of income in respect of a decedent (IRD) on funding. The executor must also make sure that the beneficiary is an eligible S corporation shareholder in order to avoid terminating the S election.

### A. Funding Events That Close the Books

S corporations pass through items of income or loss to the shareholders on a per-share, per-day basis.<sup>141</sup> Thus income for the entire year is assigned 1/365<sup>th</sup> to each day and allocated based on the shareholder's percentage ownership times the number of days they were shareholders. However, if a shareholder terminates his entire interest in the corporation and all the affected shareholders agree, the corporation may use an interim closing of the books method.<sup>142</sup> This method allocates income before and after the transfer as if the corporation had two separate tax years – one before and one after the transfer. The interim closing method can produce starkly different results than a daily proration. Regardless of which method is used, when an estate distributes S corporation stock to a beneficiary, the estate reports its share of S corporation income and deductions up to the date of the transfer and the beneficiary reports its share of the income and deductions afterward.<sup>143</sup>

Specific bequests of S corporation stock are treated as a transfer directly from the decedent to the beneficiary as if there was no period of administration. Therefore, they close the entity's books on the death of the shareholder, not when the shares are transferred to the beneficiary.<sup>144</sup> The legatee's basis is adjusted under § 1014 and the estate recognizes no gain or loss on the transfer.<sup>145</sup> The decedent reports income up to the date of his death and the legatee reports income thereafter. Distributions in satisfaction of a pecuniary bequest, however, close the S corporation's taxable year with respect to the estate on the distribution date because the distribution is a deemed sale or exchange of the asset.<sup>146</sup> Distributions in satisfaction of a residuary bequest also close the S corporation's books on the date of the distribution.<sup>147</sup>

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<sup>141</sup> Reg. § 1.1377-1(a).

<sup>142</sup> IRC § 1377(a)(1); Reg. § 1.1377-1(a).

<sup>143</sup> *Id.*

<sup>144</sup> IRC § 663(a)(1); Reg. § 1.663(a)-1.

<sup>145</sup> Reg. § 1.661(a)-2(f).

<sup>146</sup> *Id.*

<sup>147</sup> Reg. § 1.1377-1(b)(4).

## B. Gain or Loss on Funding with S Stock

The fiduciary should exercise care when distributing assets that have appreciated or depreciated significantly since the decedent's death, or that constitute income in respect of a decedent (IRD) under § 691. Depending on the formula in the will or trust agreement, the simple act of transferring S stock to satisfy a pecuniary bequest may cause the estate or trust to recognize gain or loss on any post-death change in value of the stock. It may also trigger recognition of any IRD inherent in the S corporation.

Distributions by the estate to fund specific bequests are not treated as taxable sales or exchanges by the estate.<sup>148</sup> Nor are residuary bequests, by negative implication in the regulations.<sup>149</sup> On the other hand, if the executor uses S corporation stock to satisfy a gift of a specific dollar amount (i.e. a pecuniary bequest) or to satisfy a gift of specific property other than the stock, then the estate or trust recognizes gain or loss based on the difference between the fair market value of the stock on the date of the distribution and its date of death basis.<sup>150</sup> This applies whether the gift is a fixed dollar amount or a formula fixed dollar amount.<sup>151</sup>

If the S stock has declined in value since the decedent's date of death, estates may deduct the loss under § 267(b)(13) for taxable years beginning after August 5, 1997. However, living trusts acting as will substitutes may not recognize losses incurred in funding pecuniary bequests. In either case, unused losses in the estate or trust's final year may carry over to the beneficiaries.<sup>152</sup>

## C. IRD Recognition on Funding with S Stock

Similarly, if an estate satisfies a pecuniary bequest with property, including S stock, any part of which constitutes IRD, the estate recognizes income on the transfer.<sup>153</sup> On the other hand, if the estate transfers IRD assets to specific or residuary legatees, only the legatee recognizes income when received.<sup>154</sup> Therefore, the fiduciary must be careful to determine whether there is IRD in an S corporation, which he plans to use to fund a pecuniary bequest.<sup>155</sup>

## D. Carrying Out DNI When Funding with S Stock

An estate or trust is entitled to deduct cash or other amounts distributed in-kind to beneficiaries.<sup>156</sup> Further, it recognizes no gain or loss on the distribution of in-kind property unless it is in satisfaction of a right to receive a specific dollar amount or property other than the property distributed.<sup>157</sup> In determining the estate or trust's deduction, property distributions are taken into account at the lesser of their fair market value or basis in the hands of the estate or

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<sup>148</sup> IRC § 663(a)(1); Reg. § 1.663(a)-1.

<sup>149</sup> Reg. § 1.661(a)-2(f).

<sup>150</sup> *Id.*

<sup>151</sup> Rev. Rul. 60-87, 1960-1 CB 286.

<sup>152</sup> IRC § 642(h).

<sup>153</sup> Reg. § 1.691(a)-4(b)(2); Ltr. Ruls. 9123036, 9315016, 9507008; *see* discussion of IRD at section IV of this outline.

<sup>154</sup> *Id.*

<sup>155</sup> *See* discussion at Section IV of this outline.

<sup>156</sup> IRC §§ 651(a), 661(a).

<sup>157</sup> Reg. § 1.661(a)-2(f).

trust on the date of distribution.<sup>158</sup> The deduction, however, cannot exceed the fiduciary's DNI.<sup>159</sup>

The estate's deduction carries out income to the beneficiaries, limited to their share of the fiduciary's DNI.<sup>160</sup> Thus, DNI acts as a limit on both the fiduciary's deduction and the beneficiaries' reportable income. In the case of multiple beneficiaries, DNI is allocated among them based on actual distributions received by each and is deemed to include a pro rata share of each class of income included in DNI.<sup>161</sup> Almost every distribution of cash or property carries out all or a part of the fiduciary's DNI to the recipient except for the following:

- specific bequests<sup>162</sup>
- bequests to charitable beneficiaries which are governed by IRC § 642(c),<sup>163</sup> and
- distributions to a "separate share" that is not entitled to the fiduciary's net income under the terms of the governing instrument or local law (except for its share of estate IRD)<sup>164</sup>

## 1. The Separate Share Rule

The separate share rule requires the fiduciary to maintain separate accountings of DNI within a single estate or trust where the entity has separate and independent shares for separate beneficiaries or groups of beneficiaries.<sup>165</sup> The effect of the rule is to limit the DNI carryout to those shares based on their share of the fiduciary's accounting income.<sup>166</sup> As such, distributions to one beneficiary (or group of beneficiaries) only carry out that beneficiary's share of the DNI and not that of the other beneficiaries. Without the separate share rule, DNI would be carried out based on relative distributions received by the beneficiaries during the tax year.<sup>167</sup>

A separate share exists if the economic interests of the beneficiary or class of beneficiaries neither affect nor are affected by the economic interests accruing to another beneficiary or class of beneficiaries. For example, a formula pecuniary bequest and a residuary bequest are separate shares.<sup>168</sup> A qualified revocable trust for which an election is made under § 645 is always a separate share of the estate and may itself contain two or more separate shares. Conversely, a bequest of a specific sum of money or of property is specifically excluded from separate share treatment.<sup>169</sup> The regulations contain 11 examples of when separate shares exist.<sup>170</sup>

## 2. Pecuniary Bequests and DNI Carryout

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<sup>158</sup> IRC § 643(e)(1) and (2).

<sup>159</sup> IRC §§ 651(b), 661(a).

<sup>160</sup> IRC §§ 652(a), 662(a).

<sup>161</sup> Reg. §§ 1.652(b)-2(a) and 1.662(b)-1.

<sup>162</sup> IRC § 663(a).

<sup>163</sup> *Id.*

<sup>164</sup> Reg. § 1.663(c)-2(b)(2).

<sup>165</sup> Reg. § 1.663(c)-4(a).

<sup>166</sup> Reg. §§ 1.663(c)-4(a), 1.663(c)-2(b)(2).

<sup>167</sup> Reg. § 1.662(a)-2(b).

<sup>168</sup> Reg. § 1.663(c)-5, Example 4.

<sup>169</sup> Reg. § 1.663(c)-4(a).

<sup>170</sup> Reg. § 1.663(c)-5, T.D. 8849, Dec. 27, 1999.

Distributions to satisfy a pecuniary bequest that is not entitled to a share of fiduciary accounting income under the terms of the governing instrument or local law do not carry out DNI.<sup>171</sup> The regulations provide the following example:

#### **EXAMPLE**

Testator's will contains a pecuniary formula bequest to a child's trust and a residuary bequest to his surviving spouse. The will provides that the child's trust is not entitled to any estate income, appreciation, or depreciation in estate assets. During the estate's first tax year, it receives \$50,000 in dividends. The executor partially funds the child's trust with a partnership interest with an adjusted basis to the estate of \$350,000 and a market value of \$380,000 on the distribution date. As a result of this distribution, the estate realizes a \$30,000 long-term capital gain.<sup>172</sup> It is not entitled to a deduction when it funds the child's trust.

In the example above, the estate has two separate shares - the formula pecuniary bequest to the child's trust and the residuary bequest to the surviving spouse. Because the will provides that no income is allocated to the child's trust, the trust's share of the estate's DNI is zero. Therefore, the estate may not deduct the \$380,000 distribution to the child's trust and the trust reports no income under § 662. Because no distributions were made to the spouse, there is no need to compute the DNI allocable to the marital share.

### **3. Income from Pass-Through Entities**

The pro rata share of an S corporation or partnership's tax items is allocated to separate shares in the same proportion that fiduciary accounting income from that entity would be apportioned to them under the governing instrument or local law.<sup>173</sup>

#### **EXAMPLE**

Assume the same facts as the previous example, except that the partnership issues a K-1 to the estate showing \$100,000 of interest income. Because the will provides that no income is allocated to the child's trust, no DNI is allocated to it. Therefore, the estate may not deduct the \$380,000 distribution to the child's trust and the trust includes no amount in income.<sup>174</sup> The estate reports the full amount of the K-1 income from the partnership. However, the partnership should have prorated the income between the estate and the child's trust before and after the funding date.<sup>175</sup>

### **4. Special Rule for IRD Included in DNI**

There is a special rule for allocating an estate's IRD among separate shares. The regulations provide that IRD reported by the estate is allocated among its separate shares based on the relative value of each share that could potentially be funded with it. This is an exception to the

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<sup>171</sup> Reg. § 1.663(c)-2(b)(2).

<sup>172</sup> Reg. § 1.663(c)-5, at Example 4.

<sup>173</sup> Reg. § 1.663(c)-2(b)(4).

<sup>174</sup> Reg. § 1.663(c)-5, Example 5.

<sup>175</sup> See discussion at Section VII.A. of this outline.

general rule that DNI is only allocated to shares that are entitled to receive income under the terms of the governing instrument or applicable local law.<sup>176</sup>

### EXAMPLE

Assume the same facts as the previous example except that the estate funds the child's trust with S stock. During the estate's first tax year, the S corporation collected \$100,000 of cash basis accounts receivable, which is IRD. Because the S stock is corpus under local law, both separate shares may potentially be funded with it. Therefore, the estate must allocate the IRD between the two shares based upon their relative values using a reasonable and equitable method. Although the estate may not claim a deduction when it funds the child's trust because it is a pecuniary bequest, it may deduct the trust's ratable portion of IRD. Correspondingly, the trust must include this amount in income under § 662.<sup>177</sup>

Thus, DNI can be allocated to the pecuniary share despite that it is not entitled to any fiduciary income under state law.<sup>178</sup>

## VIII. HOLDING S CORPORATION STOCK IN TRUST

### A. Determining "Trust Income" from an S Corporation

The trustee must determine whether distributions from an entity in which it holds an interest are income or principal. Most wills and trust agreements default to the state law rules for determining income and principal. And because most states have adopted the Uniform Principal and Income Act (1997), money distributions from entities are treated as income and property distributions are treated as principal.<sup>179</sup> Entities include C and S corporations, partnerships, limited liability companies, regulated investment companies, real estate investment trusts, common trust funds, and any other entity in which a trustee has an interest (except a trust or estate, a business activity, or an asset-backed security to which other sections of the Act apply.)

However, any money distributed in complete or partial liquidation of the entity is principal. A partial liquidation is one that the entity "indicates" as a partial liquidating distribution regardless of the size of the distribution.<sup>180</sup> The trustee may rely on a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors or other person or group authorized to exercise powers similar to a board of directors.<sup>181</sup>

If the entity is silent about whether the distribution is a partial liquidating distribution, the Act considers it a partial liquidating distribution if it (or a series of related distributions) exceeds

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<sup>176</sup> Reg. § 1.663(c)-2(b)(3).

<sup>177</sup> Reg. § 1.663(c)-5, Example 6.

<sup>178</sup> Reg. § 1.663(c)-2(b)(2).

<sup>179</sup> UNIF. PRINCIPAL & INCOME ACT §§ 401(b), (c).

<sup>180</sup> *Id.* at § 401(d)(1).

<sup>181</sup> *Id.* at § 401(f).

20 percent of the entity's gross assets.<sup>182</sup> However, the portion of the distribution that equals the income tax due on the entity's taxable income is ignored in calculating the 20 percent.<sup>183</sup>

## 1. QTIP Trusts That Own S Corporation Stock

Trustees of marital trusts should be especially careful that the surviving spouse is entitled to all the "income" from the entity so that the trust qualifies for the estate tax marital deduction under IRC § 2056(b)(7). The IRS has shown willingness to accept reasonable allocations between income and principal where a marital trust owns a partnership interest.<sup>184</sup>

Most recently, Revenue Ruling 2006-26 held that a QTIP trust qualifies for the marital deduction where its income is determined under a state law unitrust of 3 to 5 percent or based on traditional income, with or without an exercise of the power to adjust by the trustee.<sup>185</sup> In addition, the spouse must be able to compel the trustee to make the property productive.<sup>186</sup> Although this Revenue Ruling deals strictly with income from IRAs paid to a QTIP trust, its reasoning can apply to income from a partnership interest.

Thus, where a QTIP trust owns S corporation stock that is not paying the trust a reasonable return on its investment, say 3 to 5 percent of the value of the corporation's assets or its book income, the IRS might find that the QTIP trust does not qualify for the estate tax marital deduction under § 2056(b)(7). QTIP trusts owning S corporations and partnerships should be concerned if the entity does not routinely distribute some of its earnings.

On the other hand, the IRS may take a different view of S corporations that do not distribute all their earnings than they do investment partnerships. This is because most S corporations operate businesses that have complex working capital needs. As long as the S corporation pays a reasonable dividend to the QTIP trust, which the trust then makes available to the surviving spouse, the IRS would probably agree that the spouse has a qualifying income interest for life in the QTIP and thus qualifies for the marital deduction under IRC § 2056.

## 2. Deemed Dividends of a QSST and "Trust Income"

The terms of a QSST must require it to distribute all of its trust income to the beneficiary.<sup>187</sup> Cash distributions from an S corporation are trust income unless they exceed 20 percent of the S corporation's gross assets or the corporation indicates that it is a liquidating distribution.<sup>188</sup> However, an S corporation can also make a "deemed" dividend without actually making one.<sup>189</sup> This allows the corporation to deem out its Subchapter C earnings and profits (E&P) ahead of its

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<sup>182</sup> *Id.* at § (d)(2).

<sup>183</sup> *Id.* at § (e).

<sup>184</sup> FSA 199920016 (contribution of assets of a QTIP trust to a family limited partnership didn't result in a gift because the beneficiary still received the same amount of income that she received from the QTIP trust before); (P.L.R. 9739017 (IRS allows a will formula allocating a portion of partnership liquidation payments to marital trust income to meet the marital deduction requirements).

<sup>185</sup> Rev. Rul. 2006-26, 2006-22 I.R.B. 939.

<sup>186</sup> Reg. §§ 20.2056(b)-5(f)(4) and (5).

<sup>187</sup> IRC § 1368(d)(3); Reg. § 1.1361-1(j)(1)(i).

<sup>188</sup> P.L.R. 200451021 (Dec. 17, 2004).

<sup>189</sup> Reg. § 1.1368-1(f)(3).

AAA out of the normal order.<sup>190</sup> The corporation is deemed to have made the distribution and the shareholders are deemed to have immediately contributed it back to the corporation. Deemed dividends are popular because they are taxed at the favorable 15 percent dividend rate and they allow the corporation to strip out its E&P without borrowing the money. But the question arises whether deemed dividends are trust income. A recent private letter ruling held that a Subchapter S corporation's deemed dividend of E&P was not trust accounting income.<sup>191</sup> Therefore, the trust was not required to distribute it to its beneficiary, but received the favorable tax treatment.

### 3. The 20-Percent Rule

Trustees and practitioners are beginning to see many problems with the rule under UPIA § 401(d)(2) that classifies distributions in excess of 20 percent of an entity's gross assets as principal. In determining whether a distribution exceeds 20 percent of the entity's gross assets, the trustee must have the entity's financial statements for the year ended immediately before the distribution (or first distribution of a series). The entity may prepare its financial statements on GAAP, market value, tax basis, or any other method it deems appropriate. For example, in 2004 Microsoft declared a dividend that exceeded 30 percent of its book value, based on Microsoft's December 31, 2003 audited financial statements included in its Form 10-K filing with the SEC.

If the entity prepares its financial statements using historical cost and its assets have appreciated substantially, the 20-percent rule favors the principal beneficiary because distributions are more likely to exceed 20 percent of gross assets and be treated as principal. Note also the control that the entity has over the trust's income or principal. The entity can specify that a distribution is either a partial liquidating distribution or not by merely stating so. In addition, the entity can simply pay more than 20 percent of its gross assets if it wants to create a principal distribution for the trust beneficiaries.

The trustee can also manipulate income and principal under the 20-percent rule. For example, if the trustee transfers trust assets to an entity that makes no distributions or that distributes more than 20 percent of its gross assets, the trust has no income from that entity. Alternatively, if the entity distributes less than 20 percent of its gross assets, the trust can have a steady stream of income even if the entity is selling off corpus to support the distributions. Of course these maneuvers are tempered by the fiduciary's duty of loyalty to all the beneficiaries under the Uniform Prudent Investor Act.

Although most trustees do not usually manipulate trust income in violation of their fiduciary duties, some trustees and beneficiaries may take novel approaches in interpreting the statute or the entity's financial statements. For example, in *Thomas v. Elder*, the beneficiary argued that a trust's \$1.2 million distribution from an S corporation was income because it was less than 20 percent of the S corporation's gross assets of \$14,470,169, despite that the trust only owned a 16 percent interest in the S corporation.<sup>192</sup> He interpreted the statute to say that distributions are income where a single owner receives less than 20 percent of the entity's gross assets, regardless of the owner's percentage interest. The California Court of Appeal accepted that reasoning and held in the beneficiary's favor. In another case, *Hasso v. Hasso*, the trustee claimed that a series of distributions from an S corporation to a trust was principal because it exceeded 20 percent of

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<sup>190</sup> See discussion at Section VI of this outline.

<sup>191</sup> P.L.R. 200446007 (Nov. 12, 2004).

<sup>192</sup> *Thomas v. Elder*, 21 Cal. Rptr. 3d 741 (Dec. 2, 2004)

\$133 million of “special purpose” gross assets rather than the corporation’s \$630 million of total assets as referenced in a footnote to the financial statements.<sup>193</sup> However, the court declined that argument and held that the distribution must be based on total assets referenced in the footnote.

A final problem with the 20-percent rule is its rigidity. If a distribution exceeds 20 percent of the entity’s gross assets, it is per se principal despite that the distribution may actually represent many years of accumulated income. This was probably the case with Microsoft when it declared a dividend of its surplus cash in 2004. Some trustees treated it as income and others as principal.

#### 4. NCCUSL Considers Changes to UPIA § 401

Because of various problems with UPIA § 401, members of the American Bar Association, ACTEC, and the AICPA have recommended that the National Conference of Commissioners on Uniform State Laws (NCCUSL) amend it. Most notably they recommend eliminating the 20-percent rule in UPIA § 401(d)(2) altogether. Instead they have suggested that a trustee be given discretion to consider a number of factors in determining whether to classify large distributions as income or principal. However, because these changes are significant and substantive, it may be awhile before NCCUSL adopts them, if at all. Therefore, attorneys may want to consider drafting any desired changes to the 20-percent rule in new wills or trust instruments.

#### B. Carrying Out Capital Gains of an S Corporation

Both S corporations and partnerships pass through capital gains to their owners. In a QSST, the beneficiary reports the capital gains directly as if he or she were the S corporation shareholder. In an ESBT, the trust pays a trust level capital gains tax with no distribution deduction allowed. Estates and trusts that are temporarily eligible to own S corporation stock include capital gains from passthrough entities directly in their taxable income and may be able to carry it out to the beneficiaries when they make distributions.<sup>194</sup>

The § 643 regulations do not directly address how or whether an estate or trust can carry out capital gains from passthrough entities to their beneficiaries. They address only certain situations in which the estate or trust can include capital gains in distributable net income and carry it out to the beneficiary. These include situations where:

- the trustee has either the power to adjust or the discretion to distribute principal, and has discretion under local law or the governing instrument to deem all or part of such items as capital gains;
- the trustee is operating under a state unitrust statute that either provides an ordering rule or leaves it to the trustee’s discretion whether to distribute capital gains;
- the trustee distributes trust property or sale proceeds thereof in full or partial termination of a beneficiary’s interest; or
- the trust uses the sales proceeds of specific assets to determine the amount required to be distributed to a beneficiary.

In states that have adopted the power to adjust or a unitrust, trustees may include capital gains in DNI only to the extent that either state law or the governing instrument gives the trustee

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<sup>193</sup> Hasso v. Hasso, 55 Cal. Rptr. 3d 667 (Mar. 6, 2007), pet. for review denied, No. S1511873 (May 16, 2007).

<sup>194</sup> Reg. § 1.643(a)-3.

the authority to allocate capital gains to income. Texas is the only state so far to add capital gain authority in its power to adjust statute.<sup>195</sup> Trustees in other states wishing to include capital gains in DNI under a power to adjust or unitrust may only do so if their state law or the trust instrument specifically grants that authority.<sup>196</sup>

Where the estate or trust has capital gains from a passthrough entity, the regulations provide no guidance on how those gains are included in DNI. Indeed, they avoid the question by stating:

“One commentator [the AICPA<sup>197</sup>] requested examples of the effect on DNI of capital gains from a passthrough entity and income from a passthrough entity that is more or less than the trust accounting income from that entity. These issues are beyond the scope of this project.”<sup>198</sup>

Perhaps the IRS avoided the question because it realized that IRC § 643(a)(3) governs only capital gains and losses of the trust and not those incurred by a separate legal entity. Section 643(a)(3) excludes from DNI “gains from the sale or exchange of capital assets...allocated to corpus” that are not paid to a beneficiary or permanently set aside for charity. Partnership capital gains are not “gains from the sale or exchange of capital assets...allocated to corpus.” They are gains from the sale of partnership assets over which the trustee has no authority or control. Therefore, the trustee cannot allocate them to corpus.<sup>199</sup>

The United States Court of Federal Claims addressed this issue in *Crisp v. United States*.<sup>200</sup> In *Crisp*, the Hunt Trust invested \$5 million in ZH Associates, a Texas limited partnership, which generated significant capital gains from arbitrage and hedging activities. The trustee, Don Crisp, included the partnership capital gains in DNI and carried them out to the income beneficiary, Caroline Hunt. The IRS challenged the inclusion of the partnership’s capital gains in the trust’s DNI as contrary to the Texas Trust Code, the trust instrument, and IRC § 643(a).

The IRS argued that partnerships are not separate taxpayers under IRC §§ 701 and 702, but mere conduits through which tax items flow to their partners. Therefore, its capital gains are corpus and should not be included in DNI. However, the Court noted that §§ 701 and 702 do not control the allocation between income and principal. The IRS also analogized capital gains of a partnership to those of a mutual fund, which the Texas Trust Code allocates to corpus even though the trust does not own the underlying securities. However, the Court was not persuaded by this argument because ZH was not a mutual fund. Third, the IRS urged that partnership capital gains fit squarely the definition of capital gains in the tax code and therefore should be excluded from DNI under § 643(a)(3). However, the Court pointed out that the Code affects only the rate of tax on capital gains, but does not control their classification as income or principal.

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<sup>195</sup> TEX. PROP. CODE § 116.005 (the power to adjust includes the power to allocate all or a part of a capital gain to trust income).

<sup>196</sup> Reg. § 1.643(a)-3(b); Jerry A. Kasner, *Capital Gains: A New Definition for Income and Principal?*, TAX NOTES TODAY, Mar. 5, 2001 (commenting on the drafting implications of the new proposed regulations under § 643).

<sup>197</sup> Tax Notes Today, 2001 TNT 97-26 (May 17, 2001) (Comments by the AICPA to Treasury regarding the proposed regulations to revise the definition of trust income under Section 643(b)).

<sup>198</sup> T.D. 9102.

<sup>199</sup> See also E. James Gamble, Trust Accounting and Income Taxes, AICPA Conference (June 2005).

<sup>200</sup> *Crisp v. United States*, 34 Fed. Cl. 112 (1995).

Finally, the IRS argued that the trustee was unreasonably using the partnership form to convert corpus into DNI. But the Court pointed out that trustees can do this merely by the way they invest for income or growth. Further, the trust instrument gave the trustee broad discretion to choose among various business forms and the most advantageous to it was a partnership.

The Court further noted that profits credited to a trust by a partnership are not corpus as defined in either the trust agreement or under state law because the trust did not acquire the securities. Rather, ZH, a distinct legal entity acquired them.<sup>201</sup> He also gave great weight to the fact that the trustee hired a national accounting firm to audit the trust and it determined that the ZH profits were income. He notes that the \$5 million was only 1 percent of the total value of the trust and thus allocating its profits to income did not jeopardize the interests of the remaindermen. And even if the trustee's allocation to income tipped the scales in favor of Caroline Hunt, the facts show that she was the settlors' primary concern. Therefore, the capital gains of the partnership paid to the trust constituted income to the trust.

Even though *Crisp* was decided before the final § 643(a)-3 regulations and the widespread adoption of the 1997 UPIA, its holding is still sound. Partnership and S corporation capital gains are not "gains from the sale or exchange of capital assets...allocated to corpus" which must be excluded from DNI under IRC § 643(a). Rather they are capital gains of a separate legal entity over which the trustee has no authority. The trustee has authority to allocate only distributions from the entity and those rules are contained in UPIA § 401. Therefore, it is reasonable to conclude that capital gains from an S corporation or partnership owned by an estate or trust are not corpus of the estate or trust and may be included in DNI carried out to the beneficiary.

### C. Who Pays Income Taxes on S Corporation K-1 Income?

Most S corporations do not distribute all their taxable income. This causes the trustee numerous problems because he must determine who is obligated to pay the income taxes on the undistributed S corporation income. The rules differ depending on what type of trust owns the S stock. In the case of estates and trusts that can temporarily own S corporation stock, the estate or trust pays the tax on the S corporation taxable income and claims a deduction for distributions to the beneficiaries. The trust's tax must then be prorated between the income and principal beneficiaries. In the case of a QSST, the beneficiary is liable for the tax on the trust's share of S corporation income. And in the case of an ESBT, the S corporation pays the tax and may not pass any of the taxable income to the beneficiary.

#### 1. QSSTs

In the case of a QSST, the current income beneficiary pays the tax on income of an S corporation owned by the QSST as if he or she owned it directly.<sup>202</sup> Because that can work harshly on the income beneficiary if the S corporation makes no distributions, UPIA § 506 allows, but does not require, a fiduciary to adjust "between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from...the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includible in the taxable income of the

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<sup>201</sup> Crisp at 118-120.

<sup>202</sup> IRC § 1361(d)(1)(B).

estate, trust, or beneficiary.” For example, where a QSST beneficiary reports the trust’s share of S corporation income, it seems equitable for the trustee to reimburse the beneficiary for any taxes paid on undistributed S corporation income that inure to the benefit of the trust corpus.<sup>203</sup>

## 2. ESBTs

An ESBT pays a separate entity level tax on its share of the S corporation taxable income and receives no deduction for payments to the beneficiaries.<sup>204</sup> In that case, UPIA § 505 provides that taxes must be allocated to income to the extent that receipts from the entity are income and to principal to the extent that receipts from the entity are principal.<sup>205</sup> If income receipts are zero because the S corporation makes no distributions to the ESBT, the ESBT must find a way to pay the tax. In essence, the remainder beneficiary bears the tax.

## 3. Testamentary and Other Trusts

An estate or trust may qualify as an eligible S corporation shareholder even if it is not a QSST or ESBT. For example, a revocable living trust after the death of the grantor is an eligible S shareholder for two years from the date of death. The estate of an S corporation shareholder is a qualified S shareholder during the entire administration. Testamentary trusts are eligible to hold S stock for two years after funding with S corporation stock. And finally, a QSST is still eligible to own S stock for two years after the current income beneficiary dies. In all these cases, the estate or trust reports its share of the S corporation income and deductions and pays the tax.

The UPIA requires the fiduciary to allocate this tax between income and principal according to § 505(c) and (d). These mandatory provisions can produce some curious results.

### a. S Corporation Makes No Distributions

If the S corporation has taxable income, but makes no distributions, a trustee allocates the tax on its share of the entity’s taxable income to principal under the default rule, which charges undesignated disbursements to principal.<sup>206</sup> Hopefully, the trustee has a source of cash to pay the tax. In addition, if the trustee makes no distribution to its beneficiaries, the K-1 income of the entity is “trapped” inside the trust and taxed at the highest marginal tax rates. If the entity later distributes this income in a distribution constituting trust income, say in Year 2, the income beneficiary receives the distribution free of tax. The trustee should then decide whether to reduce the income beneficiary’s Year 2 distribution to repay the principal for the income taxes it paid in Year 1. However, this offsetting adjustment is entirely discretionary with the trustee.<sup>207</sup>

Another problem arises if the trust has income from other sources payable to the beneficiary in the same year it receives a K-1 with undistributed income from the entity. Distributing that other trust income may also sweep out part of the K-1 taxable income. Under the DNI carryout scheme, distributions are treated as consisting of the same proportion of each class of items

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<sup>203</sup> UNIF. PRINCIPAL & INCOME ACT § 506, cmt.

<sup>204</sup> IRC §§ 641(c)(1)(A); 641(c)(2)(C).

<sup>205</sup> UNIF. PRINCIPAL & INCOME ACT § 505 (1997).

<sup>206</sup> UPIA § 103(a)(4).

<sup>207</sup> UPIA § 506(a)(3).

entering into the trust's DNI, unless the trust instrument specifically allocates different classes of income to different beneficiaries (which they rarely do).<sup>208</sup>

### EXAMPLE

ABC Trust receives a K-1 from S Corp reflecting \$100,000 of dividend income, but makes no distributions. The Trust also receives \$100,000 of tax-exempt interest from municipal bonds it owns. The Trust distributes the \$100,000 of trust income to the beneficiary who expects to receive it tax-free. However, the IRC requires the distribution to be treated as \$50,000 of dividends and \$50,000 of tax-exempt interest.

Should the trustee make another distribution to the income beneficiary to compensate him for the tax? But then it carries out more taxable income, requiring another reimbursement, and so forth. These types of adjustments are allowed, but not mandatory under UPIA § 506.

#### b. S Corporation Designates a Payment for Taxes

Another common situation arises where the entity makes a payment to the trust and specifically designates it to pay the trust's taxes on the entity's taxable income. In that case, the entity has effectively designated the payment as corpus.<sup>209</sup> The trustee may rely on the entity's statement made at or near the time of the distribution to allocate the payment. In addition, recent private letter rulings have held that where an entity designated a payment for taxes, the payment was principal because the trustee had the authority to adjust between income and principal "to offset the shifting economic interests...that arise from...the ownership by a...trust of an interest in an entity."<sup>210</sup>

### EXAMPLE

ABC Trust receives a K-1 from S Corp reflecting taxable income of \$1 million. S Corp distributes \$350,000 to the trust specifically to pay its tax.

In the above example, the S corporation designated the payment as corpus by designating it for trust taxes. Therefore, the trustee pays its \$350,000 tax and the beneficiary receives nothing.

#### c. S Corporation Distributes Less Than its Taxable Income

When the trustee receives payments from the entity that are allocated to income, UPIA § 505(c) requires the trustee to calculate the tax on the entity's taxable income and subtract it from income receipts before paying the income beneficiary.<sup>211</sup> If the entity distributes less than enough to pay the full tax on that entity's K-1 income, then the trustee must reduce income

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<sup>208</sup> IRC §§ 652(b), 662(b); Reg. §§ 1.652(b)-1, 1.662(b)-1.

<sup>209</sup> UPIA § 401(f).

<sup>210</sup> Ltr. Ruls. 200531008, 200531009, and 200532021 (Aug. 2005) (payment made by an LLC to a trust where the LLC designated the payment for taxes on its undistributed taxable income was allocated to corpus).

<sup>211</sup> UPIA § 505(c) (as revised in 2008).

receipts dollar for dollar up to the entire tax liability attributable to those receipts.<sup>212</sup>

### EXAMPLE

ABC Trust receives a K-1 from S Corp reflecting taxable income of \$1 million. S Corp distributes \$100,000 to the trust, which is trust income. The trust is in the 35 percent tax bracket.

The tax on \$1,000,000 is \$350,000, which is more than the trust received from the S corporation. Thus, the trustee must use the entire \$100,000 from the S corporation to pay its tax and the income beneficiary gets nothing. In fact, anytime the entity distributes less than enough to pay the tax on its taxable income, the income beneficiary receives nothing.

Assume, however, that the entity distributes more than enough to pay taxes on its K-1 income. The trustee should have income receipts left over to pay the beneficiary. The only question is how much? The amount due the income beneficiary is figured after deducting the trustee's tax on the entity's taxable income. But, the trustee's tax on that income is figured after deducting payments to the beneficiary.<sup>213</sup> As long as payments to the beneficiary reduce the trustee's tax, calculating the amount due the beneficiary becomes a circular calculation, either solved by trial and error, or by the following algebraic equation:

$$D = (C - R * K) / (1 - R)$$

D = Distribution to income beneficiary

C = Cash paid by the entity to the trust

R = tax rate on income

K = entity's K-1 taxable income

### EXAMPLE

ABC Trust receives a K-1 from S Corp reflecting taxable income of \$1 million. S Corp distributes \$500,000 to the trust. S Corp represents that the distribution is income and so the trustee initially allocates the entire \$500,000 to income. The trust is in the 35 percent tax bracket.

In the above example, the \$500,000 S corporation distribution exceeds the trust's \$350,000 tax on the K-1 income by \$150,000. The trustee is required to distribute the \$150,000 as income and receives a distribution deduction for it. But the deduction reduces the trust's tax, which increases the beneficiary's income, and so on. Using the algebraic equation, the trustee determines that he must pay the income beneficiary \$230,769. After deducting the payment, the trust has exactly enough to pay its own tax on the remaining taxable income from the entity.

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<sup>212</sup> *Id.*

<sup>213</sup> UPIA § 505(d) (as revised in 2008).

Taxable Income per K-1	1,000,000
Payment to beneficiary	<u>230,769<sup>214</sup></u>
Trust Taxable Income	\$ 769,231
35 percent tax	269,231

Distribution from the Entity	\$ 500,000
Fiduciary's Tax Liability	<u>(269,231)</u>
Payable to the Beneficiary	\$ <u>230,769</u>

It should be noted that this circular calculation occurs only when the entity distributes an amount greater than enough to pay the tax on its taxable income, but less than its total taxable income. When the entity distributes an amount greater than or equal to its taxable income, the trust's tax liability attributable to that entity's taxable income is zero, because payments the trustee makes to the income beneficiary are fully deductible from the trustee's taxable income.

Usually the trustee's share of an entity's income and the resulting tax liability are not known until well after the year has ended for both the entity and the trust. If the trustee distributes too much or too little income to the beneficiary during the year, the trustee must correct for it the next year. Amounts paid to the beneficiary within 65 days after the trust's year end can be treated as paid the previous year.<sup>215</sup> However, if the amount of the correction is not known until after the 65 day grace period, the trustee may want to accrue the amount ultimately determined to be due.

d. Pre-Amendment UPIA Section 505

Only about a dozen states have enacted the revised version of UPIA Section 505 as of August 2009.<sup>216</sup> Those that have not are still operating under the pre-amendment version, which is subject to differing interpretations.<sup>217</sup> Some read it to require that in allocating taxes between income and principal, the trustee should ignore receipts that would be deductible by the trustee when paid to the beneficiary. In that case, the \$500,000 received from the entity would be ignored and no taxes would be allocated to it before distributions to the beneficiary. Thus the trustee pays the income beneficiary the full \$500,000 it received from the entity. The trustee bears the tax on the undistributed entity income of \$500,000. When a dispute arises over the interpretation in these states, it is likely to be resolved in favor of NCCUSL's 2008 revision.

Proponents of this interpretation believe it is fair because the income and principal beneficiary each pay tax on the amount they receive or retain. The income beneficiary pays its share of the tax on the \$500,000 that he receives and the trust bears its share of the tax on the \$500,000 that was retained in the S corporation. However, problems can arise if the entity later distributes the \$500,000 of undistributed taxable income. In that case, the trustee should consider

<sup>214</sup>  $D = (C - R * K) / (1 - R) = (500,000 - 350,000) / (1 - .35) = \$230,769$ . (D is the amount payable to the income beneficiary, K is the entity's K-1 taxable income, R is the trust tax rate, and C is the cash distributed by the entity).

<sup>215</sup> IRC § 663(b).

<sup>216</sup> See Legislative Facts for the Uniform Principal and Income Act (2008), available at [www.nccusl.org](http://www.nccusl.org).

<sup>217</sup> See David Keene, "Partnerships Held by Trusts and Estates: Discovering the Rules and Optimizing the Opportunities," TAXES – THE TAX MAGAZINE (Oct. 2007) at 53.

whether to reimburse the principal for the tax it initially bore on the undistributed income.<sup>218</sup>

However, critics of this interpretation fault it because it may leave the trustee with no source of cash to pay its tax on the undistributed K-1 income. If taxes on undistributed income of a flow-through entity create liquidity problems, the trustee should seriously consider whether the pass-through entity is a suitable investment for it.

#### D. Administrative Expenses and the 2-Percent Floor

Trusts incur a variety of administrative costs each year. Some of these costs are incurred directly and some are incurred indirectly through passthrough entities such as partnerships and S corporations. Most of the expenses incurred by estates and trusts, whether directly or indirectly, are classified as miscellaneous itemized deductions under IRC § 67(b). Individuals who incur such costs must reduce them by 2 percent of their adjusted gross income under § 67(a). The 2-percent reduction also applies to costs incurred indirectly through ownership in a passthrough entity.<sup>219</sup> This 2-percent reduction is popularly referred to as the “floor.”

The application of the 2-percent floor to individuals is relatively straightforward. But there has always been a great deal of uncertainty about how it applies to estates and trusts. Section 67(e) provides an exception from the floor for estates and trusts for administrative costs “which would not have been incurred if the property were not held in such trust or estate...” The meaning of that phrase has been the subject of nine judicial battles, including the Supreme Court’s interpretation in *Knight v. Commissioner*.<sup>220</sup>

##### 1. The Supreme Court’s Interpretation in *Knight*

On January 16, 2008 in *Knight v. Commissioner*, the U.S. Supreme Court attempted to resolve the dispute and held that the statute allows estates and trusts a full deduction only for costs that individuals do not “commonly” incur.<sup>221</sup> While the *Knight* opinion narrowly applied to investment advisory fees paid by the Rudkin Trust, its interpretation of § 67(e)(1) broadly applies to every type of fiduciary administrative cost except those specifically exempted from the floor under § 67(b), such as taxes, interest, casualty losses, and a handful of other deductions. Although there is not room for a complete laundry list of the possible administrative costs of estates and trusts affected here, a few of the costs in question are:

- Trustee fees
- Accounting fees
- Legal fees
- Bank charges
- Safe deposit box
- Insurance
- Appraisal fees
- Family office expenses (rent, salaries, supplies, telephones, etc.)

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<sup>218</sup> UPIA § 506.

<sup>219</sup> IRC § 67(c).

<sup>220</sup> *Knight v. CIR*, 552 U.S. 181 (2008); opinion and a transcript of the oral argument available at [www.supremecourtus.gov](http://www.supremecourtus.gov).

<sup>221</sup> *Knight v. Comm’r*, 552 U.S. 181 (2008).

- Tax advice and preparation
- Property maintenance
- Costs from passthrough entities

The Supreme Court held that in order to determine whether the trust's administrative costs are fully deductible, the trustee must predict whether a hypothetical individual with the same property would commonly incur the same cost. If they would, then the cost is subject to the floor. If they would not, the cost is fully deductible.

Based on this, it seems that lawyers and accountants should provide their trust clients detailed statements, itemizing which costs are "commonly incurred" by individuals and which are not. They might also describe in their engagement letters how their services to the estate or trust are distinct from those provided to individuals. They might also use special billing codes to code time that is unique to estates and trusts. However, this can be quite a challenge. In short, the Supreme Court created an administrative nightmare for both the IRS and the taxpayer, who must now determine whether each expenses incurred by the trust would have been "commonly" incurred by an individual holding the same property as the trust.<sup>222</sup>

## 2. Proposed Regulation § 1.67-4

Before the Supreme Court's decision in *Knight*, the IRS had issued proposed regulations under § 67(e) requiring that costs be "unique" to an estate or trust in order to be exempt from the 2-percent floor. Unique means that "an individual could not have incurred that cost in connection with property not held in an estate or trust." They also required the trustee to unbundle his or her trustee fee, allocating their fee among the various services they performed for the trust during the year, and deducting only those costs which are unique. But because these proposed regulations are contrary to the Supreme Court's holding in *Knight*, they have been rendered obsolete.

## 3. Notices 2008-32 and 2008-116

Since the *Knight* decision, the Service has issued two notices that waive the unbundling requirement for trustee fees for 2007 and 2008 tax returns.<sup>223</sup> Notice 2008-32 also stated that proposed regulation § 1.67-4 would be modified and may include safe harbors for unbundling trustee fees. It requested comments on whether safe harbors would be helpful, how they may be formulated, and what might be reasonable percentage(s) of administrative costs subject to the 2-percent floor. It also requested input on whether safe harbors should reflect the nature or value of the trust assets and/or the number of beneficiaries. This indicates that the IRS may be considering a safe harbor to exempt small trusts or those with multiple beneficiaries. The Notice did not, however, ask for comments on the meaning of "commonly." This indicates that the Service may either draw some bright lines or leave that open as a facts and circumstances test.

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<sup>222</sup> Lindsay Roshkind, "Interpreting I.R.C. Section 67(e): The Supreme Court's Attempt to Nail Investment Advisory Fees to the Floor," 60 Fla. L. Rev. 961, 970-972 (2008) ("By adopting the Fourth and Federal Circuits' interpretation of the second condition of Section 67(e)(1), the Court has added to the confusion surrounding the exception, rather than clarifying its application. By focusing the inquiry on what expenses are "uncommon (or unusual, or unlikely) for . . . a hypothetical individual to incur," it is unclear which expenses will qualify for the exception and which expenses will not.").

<sup>223</sup> Notice 2008-32, 2008-11 I.R.B. (Feb. 27, 2008); Notice 2008-116, 2008-52 I.R.B 1372 (Dec. 11, 2008).

The AICPA and dozens of other individuals and groups wrote comments in response to Notice 2008-32 and the proposed regulations. Not surprisingly, nearly all of the comments opposed unbundling of trustee fees because of the difficulty and because there is no basis for it in the statute's legislative history. Many commentators, including the AICPA, offered alternative safe harbors if the Service insists on unbundling. These include an exemption for small trusts (i.e. those under the applicable exclusion amount for estate tax purposes), noncorporate trustees, executors, legal, accounting, tax preparation, and appraisal fees, and de minimis fees below a certain dollar amount. Many commentators also asked the IRS to reissue the regulations in proposed form rather than final form and allow another round of comments. Final regulations are not expected before the end of 2009 according to Catherine Hughes, attorney adviser to Treasury.

#### 4. Administrative Expenses From Passthrough Entities

Neither the court decisions nor the IRS guidance discuss the treatment of miscellaneous itemized deductions from passthrough entities owned by an estate or trust. But presumably, based on *Knight*, they are subject to the 2-percent floor if they would have been commonly incurred by individuals. This requires the trustee to apply the "commonly" test to each miscellaneous itemized deduction on the K-1 it receives from a passthrough entity. Temporary Regulation § 1.67-2T issued in 1988 provides an example of how a passthrough entity should report miscellaneous itemized deductions (i.e. *affected* expenses) to a trust owner.<sup>224</sup> But it stops short of explaining how the trust should treat those expenses under § 67(e).

#### EXAMPLE

During 1987, a common trust fund (CTF) had the following items: (i) \$50,000 of short-term capital gains; (ii) \$150,000 of long-term capital gains; (iii) \$1,000,000 of dividend income; (iv) \$10,000 of deductions that are not affected expenses; and (v) \$60,000 of affected expenses. Trust T owned a 1-percent interest in the CTF. Therefore, T reports: (A) \$500 of short-term capital gains (1-percent of \$50,000); (B) \$1,500 of long-term capital gains (1-percent of \$150,000); (C) \$9,900 of ordinary taxable income (1-percent of \$1,000,000 of CTF's gross income excluding capital gains and losses over \$10,000 of CTF's deductions that are not affected expenses); (D) \$600 of affected expenses (1-percent of \$60,000).<sup>225</sup>

#### 5. Legislative Change Underway

Regardless of how carefully the regulations are drafted or what kind of safe harbors are adopted, they are bound to be hopelessly complex and inadministrable. Any partitioning of a trustee's fee based on time spent will be entirely arbitrary because trustee fees are based on the value of assets under management, not time spent. And if the final regulations provide a different rule for fees paid to trustees than those paid to outside advisers, they will be arbitrary and unfair. Unskilled trustees will lose deductions merely because they properly delegate the investment function to comply with their fiduciary duties. Thus, all signs point to a legislative fix.

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<sup>224</sup> Temp. Reg. § 1.67-2T(i) (affected expenses are defined as those that would be deductible as miscellaneous itemized deductions if paid or incurred by an individual.)

<sup>225</sup> Temp. Reg. § 1.67-2T(d)(2), Example.

The AICPA has made Section 67(e) reform a top legislative priority. It drafted a letter to Congress in September 2008 indicating its support for allowing estates and trusts a full deduction for all of their ordinary and necessary administrative costs. However, because the revenue cost of such a measure is too high, the AICPA has indicated its support for exempting only estates and small trusts from the floor. Small trusts are those with gross income under \$150,000. The proposal is still in the works and needs a legislative sponsor.

#### E. Passive Losses of S Corporations

Estates and trusts often find themselves owning an interest in a family business, ranch, rental property, or similar trade or business. They may own these interests either directly or indirectly through a passthrough entity such as an S corporation or partnership. Special rules apply to limit deductions for losses incurred by trade or business activities if the owner does not materially participate in the business.<sup>226</sup> Individuals must meet one of the seven tests for material participation described in Reg. § 1.469-5T in order to deduct passive losses.<sup>227</sup> However, Reg. § 1.469-8, which describes how these rules apply to estates and trusts, has not yet been written.<sup>228</sup>

Therefore, a host of questions arises when the business is producing losses. For example, should material participation be determined by the actions of the trustee, the beneficiaries, the agents or employees of the trust, or all three? Can the estate or trust “dispose” of the activity” and free up the suspended losses if it passes it to a related party? Do unused suspended passive losses of the estate carry out to the beneficiaries? If so, do they pass out on termination of the estate or when the activity is transferred to a beneficiary?

##### 1. Material Participation

In 2003, the District Court for the Northern District of Texas addressed material participation by a trust for the first time in *Carter v. United States*.<sup>229</sup> The Carter Trust was a testamentary trust that owned a 15,000 acre working cattle ranch with minerals. The trustee had extensive business, managerial and financial experience and maintained regular office hours related to trust business. However, he delegated certain aspects of the ranch operations to a full-time ranch manager and several employees who performed all of the ranch activities. The trust claimed losses in connection with the ranch operations, which the IRS disallowed as passive losses under § 469. The IRS maintained that “material participation” of a trust is determined by evaluating only the trustee’s activities. Because the trustee delegated much of his responsibility, the IRS argued that he did not personally participate materially. The Carter Trust, however, argued that because the trust (not the trustee) is the taxpayer, “material participation” should be determined by assessing the collective activities of its fiduciaries, employees, and agents.

Agreeing with the Carter Trust, the district court held that the material participation in the ranch operations should be determined by reference to all the persons who conducted the business of the ranch on Carter Trust’s behalf, including the trustee. The evidence was clear that the collective activities of those persons with relation to the ranch operations during relevant times were regular, continuous, and substantial so as to constitute material participation.

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<sup>226</sup> IRC § 469(h)(1).

<sup>227</sup> Temp. Reg. § 1.469-5T, T.D. 8175 (Feb. 19, 1988).

<sup>228</sup> Reg. § 1.469-8 [Reserved], T.D. 8417 (May 12, 1992).

<sup>229</sup> *Carter v. United States*, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

Notwithstanding the decision in *Carter v. United States*, the IRS issued TAM 200733023, which held that the sole means for a trust to establish material participation in a trade or business activity is for the fiduciary to be involved in the operations of the activity on a regular, continuous, and substantial basis.<sup>230</sup> It maintains that focusing on the trustee's activities for purposes of material participation accords with the general rationale for individuals that an individual business owner may not look to the activities of the his employees to satisfy the material participation requirement.<sup>231</sup> Because a trade or business generally involves employees or agents, if an owner can satisfy the material participation test by looking to the activities of his employees, it would gut the material participation test altogether.

However, TAM 200733023 may provide a roadmap for trustees wishing to establish material participation. In the TAM, the trust appointed "Special Trustees" to run the business. However their powers were so limited as to preclude their classification as fiduciaries for purposes of the material participation test. They could not legally bind or commit the trust to any course of action and had no discretionary powers. In addition, their duties of negotiating tax matters, handling the entry of new partners, and reviewing operating budgets had a questionable nexus to the conduct of the business. The legislative history suggests that active participation in the operations of the business is required. Therefore trusts should require special trustees to participate on a regular, continuous, and substantial basis in the operations of the business activity and vest in those trustees the discretionary power to bind the trust.

## 2. Disposition of the Asset

All current and suspended passive losses may be fully deducted, however, in the year that a person completely disposes of his or her interest in the passive activity. To qualify as a complete disposition, a person (or trust) must dispose of their entire interest in the passive activity to an unrelated party in a "fully taxable transaction."<sup>232</sup> A fully taxable liquidation, sale, or exchange qualifies as a complete disposition.

A disposition for purposes of the passive activity rules may not involve a related party until the related party sells to a person unrelated to the owner.<sup>233</sup> A related party is defined under IRC § 267(b) and includes a fiduciary and its beneficiaries.<sup>234</sup> It also includes family members of the trustee and the beneficiaries under constructive ownership rules, which attribute stock owned by the trust to the beneficiaries. Thus a sale of the activity to a family member of the trustee or any of the beneficiaries is not a disposition that frees up passive losses.<sup>235</sup> Family member includes a person's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.<sup>236</sup> Nor is a distribution of a passive activity to a beneficiary a disposition under the passive loss rules.<sup>237</sup>

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<sup>230</sup> TAM 2007 33023 (Aug. 17, 2007).

<sup>231</sup> Tax Reform Act of 1986, Sen. Rep. No. 99-313, at 735 ("the activities of [employees]... are not attributed to the taxpayer.")

<sup>232</sup> IRC § 469(g)(1).

<sup>233</sup> IRC § 469(g)(1)(B).

<sup>234</sup> IRC § 267(b)(6)

<sup>235</sup> IRC § 267(c)(1).

<sup>236</sup> IRC § 267(c)(1).

<sup>237</sup> IRC § 469(j)(12).

In this case, the unused passive loss adds to the basis of the activity in the hands of the beneficiary and the unused losses are not deductible for any taxable year.<sup>238</sup>

Therefore, selling or transferring a passive activity to a beneficiary is not a disposition that frees up the estate or trust's passive losses. It appears that the only type of disposition that would free up suspended passive losses of an estate or trust is a sale or exchange to a party who is unrelated to the trustee or any of the beneficiaries.

However, in *Bilthouse v. United States* the Seventh Circuit recently held that the owners of an S corporation disposed of their entire interest in an activity for passive loss purposes in the year the company became insolvent and the stock became worthless.<sup>239</sup> The Court relied on IRC § 165(g), which provides that if any security that is a capital asset becomes worthless during the taxable year, the loss resulting therefrom is treated as a loss from the *sale or exchange* of a capital asset. The parties agreed on this point, but could not agree on which year the stock became worthless. Thus, an estate or trust wishing to deduct losses of a passive entity should show that the stock is worthless. Keep in mind that the taxpayer has the burden to prove its worthlessness and the year in which it became worthless.

#### F. Charitable Contributions of S Corporations

A trust may claim a charitable deduction under § 642(c) for amounts of gross income that it contributes for charitable purposes as long as the trust instrument authorizes the trustee to make charitable contributions. Payments to charity are deductible only to the extent paid from the trust's gross income.<sup>240</sup> Revenue Ruling 2004-5 also allows a trust to deduct its share of contributions made by a partnership from the partnership's gross income even though the trust's governing instrument does not authorize the trustee to make charitable contributions.<sup>241</sup> Presumably the same rules would apply to allow a deduction for the trust's share of contributions made by an S corporation from the corporation's gross income. It is not clear whether a trust can deduct its share of contributions made by the entity in excess of the entity's gross income.

The regulations specifically address an ESBT's share of charitable contributions made by an S corporation in which it is a shareholder.<sup>242</sup> The contributions are deemed to be paid by the S portion of the ESBT pursuant to the terms of the trust's governing instrument within the meaning of § 642(c)(1). The deduction is limited to the gross income of the S portion. Any contributions made directly by the ESBT are limited to the gross income of the non-S portion of the trust.<sup>243</sup>

### IX. SALE OF S CORPORATION ASSETS AFTER DEATH

Purchasers of businesses usually prefer to buy assets rather than stock because it avoids acquiring unknown liabilities and allows them to depreciate the assets. But a sale of assets rather than stock can be disastrous for the shareholders of an S corporation unless it is planned carefully. While the S corporation stock owned by a decedent attains a stepped-up basis on his

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<sup>238</sup> *Id.*

<sup>239</sup> *Bilthouse v. United States*, 103 AFTR 2d 2009-429 (7<sup>th</sup> Cir 2009).

<sup>240</sup> IRC § 642(c)(1).

<sup>241</sup> Rev. Rul. 2004-5, 2004-3 I.R.B. 295; FSA 200140080.

<sup>242</sup> Reg. § 1.641(c)-1(d)(2)(ii).

<sup>243</sup> Reg. § 1.641(c)-1(g)(4).

death, there is no corresponding adjustment to the basis of the corporate assets themselves.<sup>244</sup> In other words, there is no equivalent of the § 754 election that partnerships enjoy and which allows them to step up the decedent's share of assets inside the entity.

#### A. Ten-Year Built-in Gains Tax

If an S corporation sells its assets shortly after the shareholder dies there could be a significant gain on that sale because the corporation's assets do not receive a step-up in basis under § 1014. Only the decedent's stock in the S corporation is adjusted at the date of death. In addition, if the corporation was formerly a C corporation that owned appreciated assets at the time of the time of the S election, a sale of those assets within ten years after the S election will give rise to a separate corporate level tax on the "net recognized built-in gain." The tax is computed at the highest rate for corporations, currently 35 percent.<sup>245</sup> The net recognized built-in gain is the lesser of the net built-in gain or loss recognized during the year or the S corporation's taxable income, not to exceed the total unrecognized built-in gain on the date of the S election.<sup>246</sup> This is known as the built-in gains tax and is common among S corporations that were formerly C corporations. The gain is also passed through to the shareholder, net of the built-in gain tax.<sup>247</sup>

The American Recovery and Reinvestment Act of 2009 changed the recognition period for built-in gain from ten to seven years for 2009 and 2010 only.<sup>248</sup> It provides that in 2009 and 2010 there is no built-in gain tax on an S corporation where the S election occurred more than seven years ago. Thus for 2009 there is no built-in gain tax if the S election was made in 2002 or earlier. And for 2010 there is no built-in gain tax if the S election was made in 2003 or earlier. However, in 2011 the recognition period reverts back to ten years. This provision is estimated to have cost the federal government \$415 million in lost revenue over a ten year period.<sup>249</sup>

One way to avoid the built-in gains tax is to reduce taxable income to zero by paying it out in salary. However, the salary will probably be taxed at the maximum individual rate plus employment taxes and may be hard to justify under the circumstances. Surprisingly, not all appreciated assets on hand at the date of the corporation's S election give rise to the built-in gain tax. In PLR 200821022, a sale of minerals that were mined and processed within ten years of the S election did not give rise to a built-in gain tax because on the date of the S election, the corporation only held a working interest in the oil and gas property and not the oil itself, which had not yet been extracted from the ground.<sup>250</sup>

An S corporation may also avoid the built-in gains tax by transferring its assets to a charitable remainder trust (CRT). The IRS has ruled that an S corporation did not recognize built-on gains tax on contribution of its appreciated real estate to a CRUT where the CRUT sold the real estate shortly thereafter.<sup>251</sup> The S corporation only recognized built-in gain to the extent

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<sup>244</sup> IRC § 1014.

<sup>245</sup> IRC § 1374.

<sup>246</sup> IRC § 1374(d)(2)(A).

<sup>247</sup> IRC § 1366(f)(2).

<sup>248</sup> IRC § 1374(d)(7)(B).

<sup>249</sup> Joint Committee on Taxation, Estimated Budget effects of the Revenue Provisions Contained in the Conference Agreement for H.R. 1, the "American Recovery and Reinvestment Act of 2009", JCX-19-09 (February 12, 2009).

<sup>250</sup> Ltr. Rul. 200821022 (Dec. 21, 2007).

<sup>251</sup> Ltr. Rul. 200644013 (Nov. 3, 2006).

that the unitrust payments it received during the ten-year recognition period were capital gain under IRC § 664(b).

Note that an installment sale does not avoid the built-in gain tax. If a corporation sells an asset before or during the 10-year recognition period and reports the income under the installment method during or after the recognition period, that income is subject to tax under § 1374.<sup>252</sup> The regulations provide details on how the taxable income limitation will be applied.

An S corporation may be able to avoid the built-in gain tax by leasing the property rather than selling it during the 10-year recognition period. However, if the S corporation has accumulated E&P from its C corporation years, the rental income may jeopardize its S election if it results in excess passive income as discussed in Section D below.

## B. Timing the Sale of S Corporation Assets With Liquidation

If a QSST sells its S stock, the QSST election terminates and the trust (not the income beneficiary) recognizes gain (or loss) on the sale.<sup>253</sup> On the other hand, if the S corporation sells its assets, the beneficiary reports the flow-through gain. The trust, however, gets to increase its stock basis equal to the amount of gain reported by the QSST beneficiary.<sup>254</sup> But the trust may report a capital loss on liquidation if its stock basis, now stepped up under both IRC §§ 1014 and 1367, exceeds the liquidation proceeds. Consequently, the beneficiary cannot offset the gain it reported on sale of the assets with a loss on liquidation of the S corporation.

Fortunately, the Service has ruled that if the S corporation adopts a plan of liquidation and sells its assets pursuant to that plan, the gain on sale of assets will be treated as gain from sale of the stock and allocated to the trust, which will offset the trust's loss on liquidation.<sup>255</sup> In general, though, unless the corporation has other capital losses to offset the gains from the S corporation, it should plan to liquidate the S corporation in the same year as the assets are sold in order to net the gains and losses attributable to the S corporation.

## C. Delaying the QSST or ESBT Election

In many instances it pays to delay the QSST or ESBT election. For example, if it appears that the S corporation will sell its assets and liquidate, a trust with S stock should wait until the sale occurs and the corporation is liquidated before making a QSST election. This way, the gain on the asset sale and the loss on liquidation are both reported by the trust. But if the trust makes a QSST election before the asset sale occurs, the gain flows through to the QSST beneficiary, but the trust gets the resulting basis increase and reports a loss on liquidation. However, the IRS has ruled that where the S corporation sells its assets pursuant to a plan of liquidation the trust should report the gain on sale of assets.<sup>256</sup> As a precaution, however, the fiduciary should delay a QSST election whenever possible. Alternatively, the QSST could sell its stock, before the assets are sold. In that way, the trust instead of the beneficiary reports the gain on sale of the stock.

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<sup>252</sup> Reg. § 1.1374-4(h).

<sup>253</sup> Reg. § 1.1361-1(j)(8).

<sup>254</sup> IRC § 1367(a)(1).

<sup>255</sup> Ltr. Rul. 199905011 (Feb. 15, 1999).

<sup>256</sup> *Id.*

Another situation when the trust should delay the QSST or ESBT election is when the S corporation is expected to incur a net operating loss during estate administration. In CCA 200734019, the IRS held that a testamentary trust could not deduct an unused NOL carryover passed to it on funding by the estate against the ESBT portion of the trust income.<sup>257</sup> The trust made an ESBT election on the same day it was funded. But because the NOL was not one of the handful of items that can be taken into account in computing the separate ESBT tax under § 641(c)(2)(C), the NOL could not offset the taxable income of the ESBT. If the trust had simply waited until the following year to make the ESBT election, it could have offset the NOL against its share of S corporation income in computing its tax under the regular rules for trusts.

#### D. Excess Passive Income of S Corporations with E&P

Another trap for S corporations after the death of the key employee is the excess passive investment income rules under IRC § 1375 and 1362(d)(3). These rules provide that if an S corporation with former C corporation earnings and profits (E&P) has gross receipts more than 25 percent of which are passive investment income, then there is a tax at the highest corporate rate (currently 35%) applied on the excess net passive income, limited to the corporation's taxable income.<sup>258</sup> This tax reduces the net taxable income passed through to the shareholder.<sup>259</sup> If the S corporation establishes to the satisfaction of the IRS that it determined in good faith that it had no E&P at the end of the taxable year and within a reasonable period of time after it determined that it did have E&P, it distributed the E&P, the 35 percent tax can be waived.<sup>260</sup> However, a waiver of the tax is not a relief from termination of the S election for having excess passive income for 3 consecutive years as discussed below.<sup>261</sup>

In addition, if more than 25 percent of the corporation's gross receipts are from passive investment income for 3 consecutive years, the S election will terminate.<sup>262</sup> This trap often catches S corporations with former C corporation E&P that sell their business and invest the proceeds, producing passive investment income (dividends, interest, rents, and annuities). S corporations with prior C corporation E&P can avoid excess passive income by distributing their C corporation E&P. The IRS has granted relief from S termination where a corporation with excess passive investment income for 3 years paid the tax and took corrective action to either avoid excess passive investment income in the future or distribute their accumulated E&P.<sup>263</sup>

The Small Business and Work Opportunity Tax Act of 2007 softened the rules a little by excluding gains on the sale of stock and securities from passive investment income for this purpose. Effective for tax years beginning after May 25, 2007, passive investment income includes only gross receipts derived from royalties, rents, dividends, interest (including tax-exempt interest)<sup>264</sup>, and annuities.<sup>265</sup> The Act also removed gross proceeds from the sale of

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<sup>257</sup> CCA 200734019 (Aug. 24, 2007).

<sup>258</sup> IRC § 1375(a) and IRC § 1375(b)(1).

<sup>259</sup> IRC § 1366(f)(3).

<sup>260</sup> IRC § 1375(d).

<sup>261</sup> Emailed Chief Counsel Advice (ECC) 200937029.

<sup>262</sup> IRC § 1362(d)(3).

<sup>263</sup> Ltr. Rul. 200934019, 200930027, 200927028.

<sup>264</sup> Reg. § 1.1375-1(f)(E)(2); Reg. § 1.1362-2(c)(5)(ii)(D)(1).

<sup>265</sup> IRC § 1362(d)(3)(C)(i) as amended by 2007 Small Business Act § 8231(a).

stock and securities from the definition of gross receipts and substituted only the gains therefrom<sup>266</sup>.

Excess net passive income is a fraction of the net passive income equal to the passive gross receipts in excess of 25 percent of gross receipts divided by total gross receipts for the year.<sup>267</sup> The excess net passive income may not exceed the corporation's taxable income for the year.<sup>268</sup>

### EXAMPLE

An S corporation with accumulated earnings and profits from a prior C corporation history has the following income and expense items for the year:

Rental Income	\$25,000
Taxable Interest Income	10,000
Tax-Exempt Interest Income	<u>7,000</u>
Total Gross Receipts	\$42,000
Rental Expenses	<u>13,000</u>
Total Net Passive Income	\$29,000

The S corporation has excess net passive income of \$21,750 as follows:

$$\frac{\$42,000 - (25\% \times \$42,000)}{\$42,000} \times \$29,000 = \$21,750$$

The S Corporation's tax on that income is \$7,610 (\$21,750 × 35%), notwithstanding that some of it is tax-exempt.<sup>269</sup>

Not all rental income is passive for purposes of § 1375. Rents derived in the active trade or business of renting property are not passive income for this purpose.<sup>270</sup> Whether a rental activity is an active trade or business is based on all the facts and circumstances. An active trade or business is more likely to be present when the corporation provides significant services, employs a large number of people, or incurs substantial costs in the rental business. Generally, this does not occur with net leases.

In several recent private letter rulings the IRS held that an S corporation's rental income from property management was not passive under § 1375 where the corporation provided significant services including maintaining and repairing the buildings, utilities and communications services, electrical, plumbing, roof and structural maintenance, trash and snow removal, sidewalk and fencing, landscaping, window washing, security services, extermination, recruiting and approving new tenants, negotiating leases, renewals and other agreements,

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<sup>266</sup> IRC § 1362(d)(3)(B) as amended by 2007 Small Business Act § 8231(a).

<sup>267</sup> IRC § 1375(b)(1)(A).

<sup>268</sup> IRC § 1375(b)(1)(B).

<sup>269</sup> Reg. § 1.1375-1(f), Ex. 2.

<sup>270</sup> Reg. § 1.1362-2(c)(5)(ii)(B)(2).

marketing the units for rent, communicating with tenants on issues relating to management and operation of the properties, supervising development and construction pertaining to the properties, and handling legal and accounting matters.<sup>271</sup> However, the IRS noted that the passive income rules under § 1362 are completely independent of the passive activity rules under § 469 and therefore the activities remained passive for purposes of § 469.

The easiest way to avoid excess passive income is to remove any C corporation E&P from the S corporation. This can be done by electing to treat distributions as coming first from E&P rather than from AAA.<sup>272</sup> All the affected shareholders must consent to this election. Corporations can also make a “deemed” distribution of E&P.<sup>273</sup> The deemed distribution is treated as if it were distributed to the shareholders in proportion to their stock ownership and immediately contributed back on the last day of the corporation’s taxable year.

## **X. OTHER PLANNING OPPORTUNITIES WITH S STOCK**

### **A. Shareholder Agreements and the One Class of Stock Rule**

S corporations can have only one class of stock.<sup>274</sup> This means that all shares must confer identical rights to distribution and liquidation proceeds.<sup>275</sup> In order to have a second class of stock, there must be two “equity” interests with different legal rights to distributions and liquidation proceeds.<sup>276</sup> In a recent private letter ruling, a corporation potentially terminated its S election by formalizing in a Shareholder Agreement its practice of filing a composite state income tax return and paying tax for its shareholders. However, the payment of state income taxes resulted in disproportionate distributions among the shareholders. The IRS allowed the corporation to cure the disproportional distributions by making remedial distributions to correct the disproportionality.<sup>277</sup>

However, there are a surprisingly large number of acceptable differences in stock that do not create a second class of stock. For example, differences in voting rights are disregarded in determining whether a corporation has more than one class of stock.<sup>278</sup> Likewise, buy-sell agreements among shareholders and restrictions on the transfer of stock are disregarded unless a principal purpose of the agreement is to circumvent the one class of stock requirement and the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly above or below fair market value.<sup>279</sup> An agreement to purchase or redeem a shareholder’s stock at book value, or a price between book value and fair market, does not create

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<sup>271</sup> Ltr. Ruls. 200937004, 200937002, 200932011, 200932010, 200923007, 200830011, 200825024, 200833003, 200825023.

<sup>272</sup> IRC § 1368(e)(3).

<sup>273</sup> Reg. § 1.368-1(f)(3).

<sup>274</sup> IRC § 1361(b)(1)(D).

<sup>275</sup> Reg. § 1.1361-1(l)(1).

<sup>276</sup> Ltr. Rul. 9112017.

<sup>277</sup> Ltr. Rul. 200934021.

<sup>278</sup> Reg. § 1.1361-1(l)(1).

<sup>279</sup> Reg. § 1.1361-1(l)(2)(iii).

a second class of stock.<sup>280</sup> Nor do agreements that create different redemption rights for the older and younger shareholders on the occurrence of certain terminating events.<sup>281</sup>

In addition, commercial contractual arrangements such as leases, employment agreements, or loan agreements are disregarded.<sup>282</sup> For example, an agreement to make monthly distributions to a shareholder's father was not a binding agreement creating a second class of stock.<sup>283</sup> Therefore, nonvoting stock and shareholder agreements can create valuable planning opportunities for S corporations and their shareholders.

## B. Redeeming a Shareholder

The S corporation may wish to redeem the estate, or a trust, after a shareholder dies. Distributions in redemption of stock are taxed as capital gains to the extent that the proceeds exceed the shareholder's basis in the stock. Generally a redemption shortly after death is tax-free to the deceased shareholder or his successor because the decedent's stock basis is adjusted to its fair market value on the date of death under § 1014. For S corporations with no former C corporation E&P, it makes no difference whether the distribution qualifies as a redemption or a regular current distribution. Regardless, distributions up to the shareholder's basis are tax-free and any excess distribution is capital gain.<sup>284</sup>

### 1. Redemptions Treated as Distributions

However, S corporations with former C corporation E&P have a special problem. If the distribution fails to qualify as a redemption, the portion of the distribution that exceeds the corporation's AAA is a distribution of E&P,<sup>285</sup> taxed as an ordinary dividend.<sup>286</sup> This could be a disaster depending on the amount of AAA and E&P. Therefore, it is usually advantageous for distributions from S corporations with former C corporation E&P to qualify as a redemption. In order to be treated as a redemption, the distribution must meet one of four requirements in IRC § 302(b) - it must 1) not be essentially equivalent to a dividend,<sup>287</sup> 2) be substantially disproportionate with respect to the shareholder,<sup>288</sup> 3) be in complete termination of the shareholder's interest, or 4) be in partial liquidation of the distributing corporation.

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<sup>280</sup> Reg. § 1.1361-1(1)(2)(iii).

<sup>281</sup> Ltr. Rul. 200329011 (The IRS did not find a second class of stock where a personal injury law firm that was an S corporation had a different buy out for the younger shareholders than the senior shareholders. The younger shareholders redemption price was determined under a formula designed to reward long-term employment. Whereas the older members' shares were redeemed at book value upon the terminating event.)

<sup>282</sup> Reg. § 1.1361-1(1)(2).

<sup>283</sup> Minton v. Comm'r, T.C. Memo 2007-372 (Dec. 26, 2007), *aff'd* No. 08-60284 (5th Cir. 2009).

<sup>284</sup> IRC § 1368(b); *see also* discussion at Section VI. of this outline.

<sup>285</sup> IRC § 1368(c)(1); Rev. Rul. 95-14, 1995-1 C.B. 169 (The AAA is a corporate level account and is not apportioned among the shareholders in a distribution that does not qualify as a sale or exchange.)

<sup>286</sup> IRC § 1368(c)(2).

<sup>287</sup> IRC § 302(b)(1); Reg. § 1.302-2(b)(1) (Whether a redemption is substantially equivalent to a dividend depends upon the facts and circumstances of each case. All distributions in pro rata redemptions of a part of the stock of the corporation will generally be treated as dividends rather than redemptions.)

<sup>288</sup> IRC § 302(b)(2) (A redemption is substantially disproportionate if immediately after the redemption, the shareholder owns less than 50% of the total combined voting power of all classes of stock entitled to vote and owns less than 80% of the common and voting stock owned immediately before the redemption.)

It can be nearly impossible for a shareholder in a closely held corporation to meet these tests because of the family attribution rules under IRC § 318.<sup>289</sup> If a redemption of an S corporation shareholder fails to qualify as a sale or exchange under § 302(a), it is treated as a distribution under § 1368. However, it will necessarily be non pro rata because it was intended as a redemption. In that case it carries out all of the corporation's accumulated adjustments account (AAA) and earnings and profits (E&P) to the extent of the distribution rather than the shareholder's pro rata share.<sup>290</sup>

## 2. Family Attribution Rules

The family attribution rules treat stock owned by certain related parties as owned by the redeeming shareholder. These attribution rules are very important because ownership under the attribution rules is used to determine the four tests of when a redemption qualifies as a sale or exchange rather than a distribution as discussed above. Under the attribution rules, an individual is considered to own any stock owned by a spouse, child, grandchild, or parent.<sup>291</sup> Stock owned by brothers and sisters, however, is not attributed. Entities also have attribution rules. Stock owned by an estate is considered to be owned proportionately by its beneficiaries.<sup>292</sup> And stock owned by the estate beneficiaries is considered to be owned by the estate.<sup>293</sup> Similarly stock owned by a partnership, trust, or corporation is constructively owned by its partners, beneficiaries, and 50 percent shareholders according to their ownership interest and vice versa.<sup>294</sup> The ownership of a trust beneficiary is determined actuarially according to factors and methods prescribed in Reg. § 20.2031-7.<sup>295</sup>

### EXAMPLE

Paul owns 20 percent of S Corporation and his son John owns the other 80 percent. The S Corporation is worth \$10 million, has \$5 million in E&P, and \$1 million of AAA. Paul dies and leaves everything equally to his children, John and Mary. Mary has no interest in the corporation. The corporation redeems the estate for \$2 million (20% X \$10 million). However, the estate cannot completely terminate, or even reduce its interest in the corporation because it constructively owns all of John's stock both before and after the redemption because he is a beneficiary. If the \$2 million distribution qualifies as a redemption, it is tax-free because the estate's basis is \$2 million. But if it fails to qualify as a redemption, only \$1,000,000 of the distribution is tax-free because it comes out of the corporation's AAA. The remaining \$1 million is taxed as an ordinary dividend from the corporation's E&P.

Under certain circumstances, individuals and entities can waive the attribution rules. A waiver requires that the distributee completely terminate his or her interest in the corporation,

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<sup>289</sup> IRC §§ 302(c)(1), 318.

<sup>290</sup> Rev. Rul. 95-14, 1995-1 C.B. 169; See also discussion at Section VI.B. of this outline for ordering rules applicable to pro rata distributions under § 1368(c) for corporations with E&P.

<sup>291</sup> IRC § 318(a)(1).

<sup>292</sup> IRC § 318(a)(2)(A).

<sup>293</sup> IRC § 318(a)(3)(A); Reg. § 1.318-3(a).

<sup>294</sup> IRC § 318(a)(2), (3); Reg. §§ 1.318-2, 318-3(b).

<sup>295</sup> Reg. § 1.318-3(b).

including that as an officer, director, or employee.<sup>296</sup> Further, the distributee must not acquire any interest in the corporation for 10 years after the distribution, other than by bequest or inheritance.<sup>297</sup> And the distributee may not have acquired any portion of the stock redeemed from a related person or have transferred any portion of the stock to a related person within the 10-year period ending on the date of the distribution.<sup>298</sup> The shareholder must also attach a statement to their tax return in the year of termination agreeing to notify the IRS if they acquire an interest in the corporation and to keep the necessary records.<sup>299</sup> In the example above, if the redemption occurred before Paul died, Paul could waive the attribution of John's stock to Paul *if* Paul was not an officer, director or employee of the corporation, does not acquire any interest in the corporation within 10 years of the distribution, and attaches the required statement agreeing to notify the IRS if he does so.<sup>300</sup>

Entities can also waive the family attribution rules.<sup>301</sup> For example, an estate can waive the attribution of shares of a beneficiary's family member to him. This prevents the reattribution of those shares to the estate by virtue of the beneficiary's constructive ownership. But an entity cannot waive the attribution of shares between itself and its owners, partners, or beneficiaries. In the above example, the estate cannot waive the attribution of John's stock to it and vice versa. But, it can waive "sideways attribution." That is, attribution of shares owned by a member of John's family to John, which would then be reattributed to the estate by virtue of John's constructive ownership. However, in the example, John has no family members who own stock. Nonetheless, the estate in the example above cannot terminate its interest because it constructively owns all of John's stock. Thus the redemption will be treated as a dividend.

The solution to this problem is for the estate to distribution the shares to Mary and John and close the estate. Then have the S corporation redeem Mary. Once the estate is closed, there are no estate attribution rules to contend with. In addition, John's stock is not attributed to Mary because brother and sister are not family members for purposes of § 318. Thus, the S corporation can redeem Mary's stock and she can avoid dividend treatment because she has completely terminated her interest. The example illustrates how important it is to carefully plan redemptions when an S corporation has E&P.

### C. Alternate Valuation

If an estate elects to value its assets on the alternate valuation date (AVD) under IRC § 2032, the regulations provide that ordinary dividends paid out of corporate earnings and profits (whether in cash, shares, or other property) declared after the decedent's death are not included in the alternate valuation of the stock.<sup>302</sup> Therefore, if the estate will elect the alternate valuation date and the stock is valued using a method affected by its net asset value, the corporation should distribute any post-death earnings before the AVD. Otherwise they will increase the value of the

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<sup>296</sup> IRC § 302(c)(2)(A)(i).

<sup>297</sup> IRC § 302(c)(2)(A)(ii);

<sup>298</sup> IRC § 302(c)(2)(B).

<sup>299</sup> IRC § 302(c)(2)(A)(iii).

<sup>300</sup> IRC § 302(c)(2).

<sup>301</sup> IRC § 302(c)(2)(C).

<sup>302</sup> Reg. § 20.2032-1(d)(4).

corporation on the alternate valuation date. Amounts earned, but not distributed by the corporation within 6 months of the decedent's death are include in the alternate valuation.<sup>303</sup>

If, however, a corporation makes a distribution in partial liquidation to stockholders of record during the alternate valuation period that is not accompanied by a surrender of a stock certificate for cancellation, the amount of the distribution is included on the alternate valuation date, except to the extent it was paid out of earnings and profits since the date of the decedent's death.<sup>304</sup> Similarly, if a corporation, with accumulated earnings and profits equal to its paid-in capital distributed all of its accumulated earnings and profits as a cash dividend during the alternate valuation period, the dividends will be included in the gross estate under the alternate valuation method.<sup>305</sup>

Although the regulations appear to address only C corporations, the same rule on post death distributions should apply to S corporations and partnerships. Therefore, if there is a chance that the executor will elect the alternate valuation date (AVD), the S corporation or the partnership should distribute any post-death earnings within 6 months of the shareholder's death. On the other hand, proposed regulations issued in April 2008 provide that any post-death distributions of cash or property made by the entity to the estate will be ignored in determining the alternate value.<sup>306</sup> Entity includes a corporation, partnership, or limited liability company. Thus, the proposed regulations appear to require that post-death distributions be included in the value of the entity on the AVD. But this provision is inconsistent with the current regulations, which provide that distributions of post-death earnings are not included in the AVD.<sup>307</sup> If the proposed regulations are adopted in their current form, they will create an internal inconsistency in the regulations, with § 20.2032-1(d)(4) being in conflict with § 20.2032-1(f)(i).

## **XI. CONCLUSION**

The executor or trustee with S corporation stock or a partnership interest must have a working knowledge of the income tax rules for trusts, S corporations, and partnerships. This is a tall order. The job demands active communication with the S corporation or partnership's managers and precise evaluation and timing of elections, distributions, sale of assets, and disposition of the entity itself. Successes in these areas often go unnoticed, but the trustee's errors are frequently magnified.

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<sup>303</sup> Ltr. Rul. 200343002.

<sup>304</sup> Reg. § 20.2032-1(d)(4).

<sup>305</sup> *Id.*

<sup>306</sup> Prop. Reg. § 20.2032-1(f)(3)(i).

<sup>307</sup> Reg. § 20.2032-1(d)(4).

## SAMPLE QSST ELECTION

Internal Revenue Service Center

RE: QUALIFIED SUBCHAPTER S TRUST ELECTION

The current income beneficiary of the \_\_\_\_\_ Trust hereby elects under IRC § 1361(d)(2) to treat the trust as a qualified Subchapter S trust pursuant to IRC § 1361(c)(2)(A)(i). The following information is provided:

	<u>Current Income Beneficiary</u>	<u>Trust</u>	<u>S Corporation</u>
Name:			
Address:			
Taxpayer ID No.:	xxx-xx-xxxx	xx-xxxxxxx	xx-xxxxxxx

This election is made under IRC § 1361(d)(2) to be effective as of [date] \_\_\_\_\_. On [date] \_\_\_\_\_ the stock of \_\_\_\_\_ was transferred to the \_\_\_\_\_ Trust, which meets all the requirements of Reg. § 1.1361-1(j)(6)(ii)(E)(1), (2), and (3) as follows:

- a. All trust income will be or is required to be distributed currently to one individual beneficiary who is a citizen or resident of the U.S.
- b. During the life of the current income beneficiary, there is only one income beneficiary of the trust.
- c. Any corpus distributed during the life of the current income beneficiary may be distributed only to that income beneficiary.
- d. The current income beneficiary's income interest in the trust terminates on the earlier of that beneficiary's death or the termination of the trust.
- e. If the trust terminates during the life of the current income beneficiary, the trust will distribute all of its assets to that income beneficiary.
- f. No distribution by the trust (income or corpus) will be in satisfaction of the grantor's legal obligation to support the income beneficiary.

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Name of beneficiary

Date

### EXHIBIT A

## SAMPLE ESBT ELECTION

Internal Revenue Service Center

RE: ELECTING SMALL BUSINESS TRUST (ESBT) ELECTION

The trustee of the \_\_\_\_\_ Trust hereby elects under IRC § 1361(e)(3) to treat the trust as an electing small business trust that is qualified to hold S corporation stock pursuant to IRC § 1361(c)(2)(A)(v). The following information is also provided:

Corporation Name, Address, ID #:

Trust Name, Address, ID #:

Beneficiaries' Name, Address, ID #:	Bob	Sally	Sue
	XXX-XX-XXXX	XXX-XX-XXXX	XXX-XX-XXXX

This election is made under IRC § 1361(e)(3). The date (or dates) on which the stock of the corporation was transferred to the trust is \_\_\_\_\_. The date on which the election is to be effective is \_\_\_\_\_.

The trustee meets the definitional requirements of IRC § 1361(e)(1) and all potential current beneficiaries of the trust meet the shareholder requirements of IRC § 1361(b)(1).

Signed:

Trustee

Date

## EXHIBIT B

**SAMPLE ELECTION AND CONSENT FORM  
TO USE THE INTERIM CLOSING OF THE BOOKS METHOD**

During this tax year ended [date] \_\_\_\_\_, a shareholder's entire interest in the corporation was terminated. [Name of S Corporation] elects under IRC § 1377(a)(2) and Reg. § 1.1377-1(b) to have the rules provided in IRC § 1377(a)(1) applied as if the tax year consisted of two separate tax years. The corporation and each affected shareholder whose signature appears below consent to this election, which is made with respect to the termination of the entire interest of [Name of Shareholder], as follows:

Manner of Shareholder's Termination: [death, sale, etc.] \_\_\_\_\_

Date of Termination: \_\_\_\_\_

**SHAREHOLDER CONSENT**

[Name of Shareholder], a shareholder of [Name of Corporation], TIN [number], hereby consent to the corporation's election under IRC § 1377(a)(2) and Reg. § 1.1377-1(b) to have the rules provided in IRC § 1377(a)(1) applied as if the tax year consisted of two separate tax years:

		Taxpayer Identification Number	
Date	Shareholder Signature		Address
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

**EXHIBIT C**

## SAMPLE REFUSAL TO CONSENT TO QSST ELECTION

Internal Revenue Service Center

RE: REFUSAL TO CONSENT TO QUALIFIED SUBCHAPTER S TRUST ELECTION

Dear Sir or Madame:

The current income beneficiary of the \_\_\_\_\_ Trust hereby makes this affirmative refusal to consent to a Qualified Subchapter S Trust election under IRC § 1361(d)(2). I became the current income beneficiary on \_\_\_\_\_ (date). As required by Reg. § 1.1361-1(j)(10), the following information is provided:

	<u>Current Income Beneficiary</u>	<u>Trust</u>	<u>S Corporation</u>
Name:			
Address:			
Taxpayer ID No.:	xxx-xx-xxxx	xx-xxxxxxxx	xx-xxxxxxxx

I am entitled to make this affirmative refusal to consent because I am the successor beneficiary of the \_\_\_\_\_ Trust created on \_\_\_\_\_ by \_\_\_\_\_.

Signed: \_\_\_\_\_  
Name of current income beneficiary Date

## EXHIBIT D