ESTATE PLANNING AND ADMINISTRATION FOR S CORPORATIONS

By

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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. ALLOCATING INCOME IN THE YEAR OF DEATH

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.[1] 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.[2] This election is available only if a shareholder terminates his entire interest in the S corporation, all the "affected shareholders" agree, and the corporation properly attaches the election to its tax return for the year.[3] Affected shareholders include those shareholders whose interest is terminated and those to whom shares are transferred during the year.[4] 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 and Jack reports $400,000 [40% X $1,000,000].[5]

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[1] IRC § 1377(a)(1); Reg. § 1.1377-1(a).
[2] IRC § 1377(a)(2); Reg. § 1.1377-1(b)(1).
[3] Reg. § 1.1377-1(b)(5); *See* Exhibit C.
[4] Reg. § 1.1377-1(b)(2).
[5] Reg. § 1.1361-1(j)(7).

	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.

III. SHAREHOLDER ELIGIBILITY

Only certain types of owners are permitted S corporation shareholders.[6] These include U.S. citizens, resident individuals, estates, certain trusts, and certain tax exempt organizations. A single member LLC that is disregarded for tax purposes is a permitted S corporation shareholder as long as the owner is a permitted shareholder.[7] If the owner dies and 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 from an S 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 forfeits flow through tax treatment and may be subject to a double tax on C corporation distributions. Any suspended losses that the shareholder has under the passive activity or the basis limitation rules remain suspended until the stock is disposed of or the corporation makes another S election. The corporation is not eligible to make another S election until the 5th taxable year following the first taxable year in which the termination occurred.[8] And the corporation's 5 or 10-year recognition period for purposes of the built-in gain tax starts all over again when it re-elects S status.[9] While the corporation can request relief from an inadvertent termination, such relief is not automatic.[10] In addition there is a $10,000 user fee ($2,000 and $4,000 for small taxpayers with AGI under $250,000 and $1 million respectively) plus the practitioner's time to prepare the request.[11] Therefore, fiduciaries with S corporations should make an effort to preserve the S election.

A. Estates

An estate is an eligible shareholder of a Subchapter S corporation during the period of estate administration.[12] Thus if a corporation owned by an estate makes an S election, the executor must sign the Form 2553, Election by Small Business Corporation.[13] "Estate" has the same

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[6] IRC § 1361(b)(1).
[7] Reg. § 301.7701-3(a); Ltr. Ruls. 200303032, 9745017.
[8] IRC § 1362(g).
[9] Reg. § 1.1374-10(c).
[10] Rev. Proc. 2003-43, 2003-1 C.B. 998; Rev. Proc. 2004-48, 2004-32 I.R.B. 172; Rev. Proc. 2007-62, 2007-41 I.R.B. 786.
[11] Rev. Proc. 2013-1, 2013-1 I.R.B. 1 (Dec. 31, 2012).
[12] IRC § 1361(b)(1)(B).
[13] Ltr. Rul. 201030021 and 201030002 (July 30, 2010).

meaning as in IRC § 641, which provides that the period of estate administration is the period actually required by the administrator or executor to perform the ordinary duties of administration. This includes collecting the assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than that specified under local law.[14] Although Form 1041 requires an explanation for estates that remain open for more than two years, there is no express statutory or regulatory length of time that an estate may remain open.[15] It depends entirely on facts and circumstances of each case.

For example, keeping an estate open long enough to hold stock during the 15 year period of estate tax deferral under IRC § 6166 will not terminate the S election.[16] Keeping the estate open long enough to seek qualification of a charitable beneficiary will not jeopardize the S election.[17] But, estates must justify the reasons for a prolonged administration in order to avoid the IRS taking the position that the estate has terminated and is considered owned by the persons succeeding to the property of the estate.[18] The IRS may also treat a prolonged estate as a de facto testamentary trust.[19] 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.

During the time an estate owns S corporation stock, it will report its share of the S corporation's income and deductions reflected on Schedule K-1. If the estate elects a non-calendar fiscal year end, it can defer reporting up to 11 months of corporate income.

EXAMPLE

> An estate with a November 30 tax year owns S corporation stock. The S corporation, which is on a calendar year, issues a 2009 Schedule K-1 to the estate with $200,000 of taxable income. The estate will report $200,000 on its return for the year ending November 30, 2010. Thus it will have an 11 month tax deferral on that income, at least for the first two years when it is not required to pay estimated taxes.[20]

B. Certain Trusts

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.

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[14] Treas. Reg. § 1.641(b)-3(a); Old Virginia Brick Co., 44 T.C. 724 (1965), *aff'd*, 367 F2d 276 (4th Cir. 1966).
[15] *Id.*
[16] Rev. Rul. 76-23, 1976-1 C.B. 264; 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).
[17] Ltr. Rul. 7951131 (Sept. 24, 1979).
[18] Treas. Reg. § 1.641(b)-3(d).
[19] Old Virginia Brick Co., 44 T.C. 724 (1965), *aff'd*, 367 F2d 276 (4th Cir. 1966).
[20] IRC § 6654(l)(2).

1. Grantor Trust

A trust all of which is treated under §§ 671-679 as owned by an individual who is a citizen or resident of the United States (i.e. a wholly owned grantor trust) is a permitted shareholder during the life of the grantor.[21] Where only a portion of a trust is treated as owned by the grantor under § 677, the trust is not an eligible shareholder.[22]

A grantor trust can have multiple income beneficiaries and still qualify as a wholly owned grantor trust for purposes of owning S corporation stock. In Letter Ruling 201039010 the IRS held that a trust created by B was a wholly owned grantor trust with respect to A, even though A was not the only beneficiary. [23] A was, however, the only beneficiary with Crummey powers. The IRS held that as long as no gifts were made to the trust in excess of the amount subject to A's Crummey powers, the trust was a grantor trust with respect to A under § 678.

The IRS has also approved combining Crummey powers with administrative powers under IRC § 675 to treat a beneficiary as the owner of the entire trust under IRC § 678(a). In Ltr. Rul. 201216034, the grantor transferred S corporation stock to a trust for a beneficiary with hanging Crummey powers.[24] The ruling found that the beneficiary was treated as the owner of the entire trust. He was treated as the owner of the portion over which he had a power to withdraw. And he was treated as the owner of the portion over which he had failed to exercise his withdrawal powers while retaining the power to substitute assets as long as the power was held in a nonfiduciary capacity.

A grantor 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.[25] During this period, the estate is treated as the shareholder for eligibility purposes.[26] However, the S corporation income items pass 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 multiple grantor trusts owning an S corporation through a disregarded LLC. During the grantor's life the grantor is the only shareholder because all of the intervening entities are disregarded for tax purposes.[27] But when the grantor dies and the trusts become nongrantor trusts, the LLC converts to a partnership, which is not an eligible S corporation shareholder. In Letter Ruling 200841007, five grantor trusts owned shares in an LLC that was disregarded during the grantor's life. But when the grantor died, the IRS held that the LLC became a partnership. And because a partnership is not a permitted S corporation shareholder, the S election terminated. The two-year grace period for grantor trusts owning S stock under § 1361(c)(2)(ii) did not apply because the partnership rather than the trusts owned the stock on the grantor's death.

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[21] IRC § 1361(c)(2)(A)(i).

[22] 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).)

[23] Ltr. Rul. 201039010 (Oct. 1, 2010).

[24] Ltr. Rul. 201216034 (Apr. 20, 2012).

[25] IRC § 1361(c)(2)(A)(ii).

[26] Reg. § 1.1361-1(h)(3)(i)(B).

[27] IRC 671; Ltr. Rul. 200303032; Ltr. Rul. 9745017.

a. Grantor Retained Annuity Trusts (GRATs)

A grantor retained annuity trust (GRAT) under § 2702 is commonly used to hold S corporation stock. A GRAT qualifies as an S corporation shareholder because the annuity payable to the grantor is sufficient to cause the grantor to be treated as owning the entire trust.[28] However, it is recommended that all the GRAT remainder beneficiaries 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.

GRATs are popular for estate planning because the grantor can gift S corporation stock to the trust with no income tax consequences and little or no gift tax consequences.[29] The GRAT pays the grantor an annuity for a certain term of years. The assets remaining in the GRAT at the end of the term are transferred to the remainder beneficiaries. Grantors can zero out the GRAT by setting the assumed value of the annuity under actuarial tables to equal the entire value of the property transferred to the trust. This produces a zero value on the remainder interest and thus a zero value for gift tax purposes. If the assets in the trust achieve a rate of return substantially in excess of the § 7520 rate assumed in valuing the annuity, substantial value can pass to the remainder beneficiaries with no further tax consequences.

If the grantor dies before the end of the GRAT term, the assets in the trust needed to produce the retained annuity for the rest of the term are included in the grantor's taxable estate.[30] Therefore, the goal is for the grantor to outlive the GRAT term. Thus, a popular term for GRATs is two years, which was approved in *Walton v. Commissioner*.[31] Using a two-year GRAT limits the risk of estate tax inclusion while availing the grantor an opportunity to make tax-free gifts of appreciating property. If the grantor survives the term of the GRAT, no part of the GRAT property is included in the grantor's estate regardless of how much it has appreciated.

Both Congress and the President have proposed a minimum term of ten years for GRATs.[32] Under their proposals, the GRAT in the example above would pay the grantor $117,231 over 10 years. The grantor could still nearly zero out the gift tax value, but would have to live ten years before the asset is completely excluded from his or her estate. Those who are interested in GRATs should act quickly before the window closes to create a 2-year GRAT.

However, all is not lost with a 10, 20, or even 100-year GRAT. Long-term GRATs can shift more wealth to the remainder beneficiaries than short-term GRATs by locking in today's low interest rates for a longer period of time. Long-term GRATs also allow the grantor to pay the income tax on trust income that much longer with no gift tax consequences to the grantor.[33] The Table below shows that long-term GRATs outperform short-term GRATs if the grantor survives the term, because they allow the grantor to accumulate less in his taxable estate. Each of the

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[28] 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.)

[29] IRC § 2702

[30] Reg. § 20.2036-1(c)(2)(i); Prop. Reg. § 20.2036-1(c)(3).

[31] Walton v. Comm'r, 115 T.C. 589, *acq.* Notice 2003-72, 2003-44 IRB 964.

[32] General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, p. 80.

[33] Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

GRATs below were created with $1 million when the § 7520 rate was 3 percent and the grantor invested the annuities at 5 percent after tax.

GRAT Term	GRAT Annuity	Future Value of Annuities at 5% in 20 Years
2 years	522,602	$2,707,208
10 years	117,231	$2,521,928
20 years	67,215	$2,333,655

If the grantor dies before the GRAT term ends, the amount included in the grantor's estate is the lesser of the amount in the GRAT or the amount needed to pay the annuity for the rest of the GRAT term without reducing the principal.[34]

> **Example.** D transferred $100,000 to a GRAT when the § 7520 rate was 3 percent. The GRAT pays a qualified annuity of $11,723 a year for 10 years. D died before the end of the GRAT term when the § 7520 rate was 6 percent. Assume the GRAT property was worth $300,000 when D died. The amount includible in D's estate is $185,533, which is the lesser of the value of the GRAT property ($300,000) or the principal necessary to pay an $11,723 annuity at 6 percent. [$11,723/.06=$195,433][35]

Thus, if interest rates rise and the GRAT property appreciates, the value includible in the grantor's estate with a 10-year GRAT could be less than what would have been included if no GRAT had been created.

If the grantor of a GRAT dies during the term of the GRAT, the trust ceases to be a grantor trust and becomes a nongrantor trust separate and apart from the grantor.[36] In the conversion, the grantor is deemed to have transferred his or her property to the trust. If there is consideration in the exchange, such as money, debt relief, or annuity payments, the transfer is taxable to the grantor to the extent that the consideration exceeds the grantor's basis in the property.[37] However, because GRAT property is included in the grantor's estate when he dies during the term of the GRAT, as discussed above, the property receives a stepped-up basis. Thus it is unlikely that the value of the remaining annuity payments paid to the estate will exceed the grantor's stepped-up basis and create an income tax for the grantor or his estate.

b. Intentionally Defective Grantor Trusts (IDGTs)

Another type of grantor trust that is popular for holding S corporation stock is an irrevocable intentionally defective grantor trust (IDGT). The S corporation owner typically sells his S stock to an IDGT for an installment note. He can generally sell it at a discount, lock in a

[34] Reg. § 20.2036-1(c)(2)(i); Prop. Reg. § 20.2036-1(c)(3).

[35] Example based on Reg. § 20.2036-1(c)(2)(iii), Ex. 2.

[36] Treas. Regs. § 1.1001-2(c), Example 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222; Technical Advice Memoranda 200011005; General Counsel Memoranda 37228.

[37] *Id.*

low interest rate, and avoid income and gift taxes on the transfer. The sale is ignored for federal income tax purposes because transactions between a grantor and a trust all of which is deemed owned by the grantor are not recognized for income tax purposes.[38] But the transfer is recognized for estate and gift tax purposes. Therefore, all future appreciation in the asset belongs to the trust and is excluded from the grantor's estate. However, because it is a sale, there is no gift tax.

But if the grantor dies before the note is paid, a host of income tax questions arise. The first question is whether gain is recognized on the unpaid portion of the note. If so, is it recognized by the grantor or by his estate? And if the transaction is taxable, does the note qualify for installment sale reporting under IRC § 453 or otherwise constitute income in respect of a decedent (IRD) under § 691 to the extent of any unrecognized gain? And finally, what is the basis of the note in the hands of the decedent (or his successor) and what is the basis of the property in the hands of the trust?

No single authority answers all these questions. Many commentators maintain that the termination of grantor trust status upon the grantor's death is a recognition event, based on the authorities that address lifetime conversions of grantor to nongrantor status.[39] At the moment of death, the grantor is deemed to have transferred his property to the trust in return for a promissory note. The grantor realizes gain to the extent the note balance exceeds his basis in the property on his date of death. His basis is not adjusted under § 1014 because the property was not included in his taxable estate.[40] However, because the note qualifies for installment sale treatment, the estate recognizes the gain as the note payments are received. The trust, a nongrantor trust, acquires a basis equal to the greater of the note balance on the date of death or the decedent's basis in the property.[41]

Other commentators maintain that there is no income tax upon the conversion to a nongrantor trust while the note is outstanding primarily because testamentary and lifetime gifts are generally not taxable events.[42] While they concede that the IRS and the courts have taxed lifetime conversions of grantor to nongrantor status where there is consideration transferred to the grantor, they point out that no authority taxes such conversions on account of death.[43]

However, the IRS consistently maintains that termination of grantor trust status during the grantor's life is a *deemed transfer* of property to the trust that may have income tax consequences to the extent of any consideration received.[44] Moreover, Revenue Ruling 77-402 holds that the result would be the same if the trust ceases to be a grantor trust by reason of renunciation, expiration, or lapse of the grantor's powers. If we extend the authorities to the death of the grantor, the grantor is deemed to have transferred property in a part gift part sale

[38] Rev. Rul. 85-13, 1985-1 CB 184.

[39] Carol A. Cantrell, "Gain is Realized at Death," Trusts & Estates (February 2010), p. 20; Deborah V. Dunn & David A. Handler, "Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates," J. Tax'n. (July 2001), p. 49.

[40] CCA 200937028.

[41] Reg. § 1.1015-4(a)(1).

[42] Jonathan G. Blattmachr and Mitchell M. Gans, "No Gain at Death," Trusts & Estates (February 2010), p. 34; Jonathan G. Blattmachr, Mitchell M. Gans, & Hugh H. Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," J. Tax'n. (Sept. 2002).

[43] *Id.*

[44] Reg. § 1.1001-2(c), Ex. 5; Madorin v. Comm'r, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222, TAM 200011005; GCM 37228; Diedrich v. Comm'r, 457 U.S. 191 (1982).

transaction for consideration equal to the unpaid note when grantor status ends. Thus the IRS would likely maintain that gain is realized by the decedent to the extent the note balance exceeds the grantor's adjusted basis in the property transferred.[45] It would be recognized as the installment payments are received by the estate.

c. Self-Funded Special Needs Trusts (SNTs)

A self-funded special needs trust also qualifies as an S corporation shareholder because it is a grantor trust for tax purposes. Although a self-funded special needs trust is eligible to own S stock without terminating the S election, some or all of the stock might eventually need to be sold to reimburse the state for Medicaid benefits.[46] Therefore, the S corporation should be prepared to redeem the trust on the death of the disabled beneficiary.

2. Qualified Revocable Trusts with a § 645 Election

A qualified revocable trust (QRT) that elects to be treated as part of the estate by making a § 645 election may be able to own S corporation stock longer than two years after the decedent's death. To qualify as a QRT, the grantor must have had the power to revest title to property in himself or herself.[47] A QRT qualifies to own S corporation stock for only two years if no estate tax return is required.[48] Estate tax return means the "return of tax imposed by Chapter 11" (the estate tax). Thus if no estate tax return is required because the gross estate is less than the exclusion amount or the grantor died in 2010 and opted out of the estate tax, the § 645 election does not allow any additional time to hold the S corporation stock beyond two years from the date of death.

However, if the estate is required to file an estate tax return, the qualification period ends six months after the determination of the final estate tax liability, which is the earliest of:

(a) The date that is 6 months after the issuance by the Internal Revenue Service of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within 12 months after the issuance of a letter;

(b) The date of a final disposition of the claim for refund, as defined in Reg. § 1.645-1(f)(2)(iii), that resolves the liability for the estate tax, unless suit is instituted within 6 months after a final disposition of the claim;

(c) The date of execution of the settlement agreement with the Internal Revenue Service that determines the liability for the estate tax;

(d) The date of issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for the estate tax unless a notice of appeal or petition for a certiorari is filed within 90 days after the issuance of a decision, judgment, decree, or other order of court; or

(e) The date of expiration of the period of limitations for assessment of the estate tax

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[45] *Id.*

[46] 42 U.S.C. 1396p(d)(4)(A).

[47] IRC §§ 645(b)(1) and 676(a).

[48] IRC § 645(b)(2)(A).

provided in § 6501.[49]

If the executor is filing a Form 706 solely to make the portability election under IRC 2010(c)(5), the IRS temporary regulations hold that an estate tax return is required to be filed.[50] And thus a trust that makes the § 645 election to be taxed as part of an estate that is filing a Form 706 solely for portability, is qualified to hold the S stock until six months after the determination of the final estate tax liability.

In addition to extending the normal two-year period of time that a QRT may own S corporation stock, other potential benefits of the § 645 election are:

(a) A non-calendar fiscal year is allowed, unlike a trust, which must use a calendar year end. A fiscal year allows the fiduciary and the beneficiaries to defer income taxes.[51]

(b) The tax items of one fiduciary, such as passive activity losses, net operating losses, capital losses or investment interest, which may otherwise be nondeductible, may be offset by the other entity's passive income, taxable regular income, capital gains or investment income.

(c) The fiduciary is exempt from making estimated tax payments for its first two years.[52]

(d) Losses may be recognized on the satisfaction of a pecuniary bequest with assets that have fair market value less than basis pursuant to § 267(b)(13).

(e) The availability of the charitable set aside deduction under § 642(c).

(f) The special $25,000 deduction for passive losses from rental real estate activities under § 469(i)(4).[53]

The election is made on Form 8855 – Election to Treat a Qualified Revocable Trust as Part of an Estate. It must be filed not later than the due date (including extensions) of the Form 1041 for the first taxable year of the estate.[54] The executor would file a timely Form 1041 for the combined estate and QRT for each taxable year during the election period. The trustee of the QRT must timely provide the executor of the estate with all the trust information necessary to file the Form 1041.[55] The trustee need not file a Form 1041 for the short taxable year of the QRT beginning with the decedent's death and ending December 31 of that year.[56]

A possible detriment of making the § 645 election is the uncertainty about how to allocate the tax benefits from using the combined entity between the estate and the QRT. It may be a good idea to prepare a tax allocation agreement between the fiduciaries. Neither the preamble nor the final regulations provide any rules for allocating the tax liability between the

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[49] Reg. § 1.645-1(f)(2).
[50] T.D. 9593, I.R.B. 2012-28 (July 9, 2012).
[51] Reg. § 1.441-1(c)(1).
[52] IRC § 6654(l)(2).
[53] Reg. § 1.645-1(e)(2).
[54] Reg. §1.645-1(c)(1)(i).
[55] Reg. §1.645-1(c)(1)(ii).
[56] Reg. §1.645-1(d)(2).

QRT(s) and the estate. However, the trustee(s) and the executor should allocate the tax liability in a manner that reasonably reflects the tax obligations of each entity. The failure to do so may result in unintended income or estate tax consequences.

Upon termination of the § 645 election period, the assets in the combined entity are deemed to be distributed to the estate and the trust. A distribution deduction under § 661 is allowed and the distributee trust includes the amount in its gross income under § 662. Net capital gains are also carried out with DNI as they would be in a liquidating distribution.[57] If the estate continues past the end of the § 645 election period, it maintains the same federal ID number, but the QRT must obtain a new ID number.[58]

3. Voting Trust

Voting trusts, which are created primarily to exercise the voting power of the S corporation stock, are permitted shareholders.[59] 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 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.[60]

The question arises whether a voting trust must independently qualify under the grantor trust rules of Subpart E, or is merely treated like a grantor trust, similar to 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…."[61] While the distinction between qualifying as a grantor trust and merely being treated like one is not important for the grantor of the voting trust, it becomes important for successive beneficiaries because they are not the grantor. It is uncertain whether the voting trust should contain special terms that qualify the successive beneficiaries as grantors under Subpart E. The answer is probably not. One author notes "To interpret the rules otherwise would foreclose the transfer of any stock once held in a voting trust."[62]

4. 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.[63] 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.

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[57] Reg. § 1.645-1(h)(1).
[58] Reg. § 1.645-1(h)(3).
[59] IRC § 1361(c)(2)(A)(iv).
[60] Reg. § 1.1361-1(h)(1)(v).
[61] Reg. § 1.1361-1(h)(1)(v).
[62] Samuel P. Starr, "S Corporations: Formation and Termination", BNA Portfolio 730 T.M., II.E.1.d.
[63] IRC § 1361(c)(2)(A)(iii).

5. 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).[64] In order to be a QSST, the trust terms must provide that:

- During the life of the current income beneficiary, there is only one income beneficiary of the trust who is a U.S. citizen or resident. However, a QSST may have multiple income beneficiaries if they have separate shares under IRC § 663(c);[65]

- 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;

- if the trust terminates before the current income beneficiary dies, 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.[66] 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.[67]

A QTIP trust will automatically meet the requirements of a QSST. A minor's trust under IRC § 2503(c) will qualify as long as it has only one current income beneficiary and distributes all its income each year. However, a GRAT will not qualify as a QSST because it distributes its assets to the remainder beneficiary upon termination during the grantor's life rather than to the grantor, who is the current income beneficiary.[68] Nonetheless, a GRAT is still eligible to own S corporation stock because it is a wholly owned grantor trust. Nor will a special needs trust qualify as a QSST because it usually withholds rather than distributes income to the beneficiary in order to maintain their eligibility for government aid. 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 trust makes only limited distributions to or for the benefit of the beneficiary.[69]

a. Making the QSST Election. The beneficiary of the trust (or separate share) must affirmatively elect to be taxed as a QSST.[70] If a trust has multiple shares, the election is made on a share by share basis. Not all shares need to make the election. Moreover some shares may elect QSST and other shares may elect ESBT.[71] The beneficiary does so by signing and filing a

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[64] IRC § 1361(c)(2)(A)(v); IRC § 1361(d).
[65] IRC §1361(d)(3); Ltr. Rul. 201119005, 201122003.
[66] Reg. § 1.1361-1(e)(1); IRC § 1361(d)(3)(B).
[67] Ltr. Rul. 8717024 (Jan. 17, 1987).
[68] Note however, that a GRAT will qualify to hold S stock because it is a wholly owned grantor trust.
[69] Ltr. Ruls. 9444059, 9444024, 9444022, 9442036.
[70] IRC § 1361(d)(2)(A); *see* Exhibit A for a sample QSST election.
[71] Ltr. Rul. 201122003.

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.[72] The trustee is not required to consent to this election. The QSST election is revocable only with the Commissioner's consent.[73]

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.[74] However, the Service has been extremely generous in granting relief for failure to distribute QSST income[75] or make a timely QSST election as long as the failure is "inadvertent" and not an attempt at retroactive tax planning.[76] The IRS has even allowed trustees to amend the trust agreement to satisfy the QSST 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.[77] The IRS receives so many requests for relief from inadvertent failure to properly elect S status each year, that it has included guidance under § 1362 and § 9100 on its 2012-2013 Priority Guidance Plan.[78]

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).[79] 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.[80]

A QSST must file a Form 1041 regardless of whether its only asset is the S corporation stock or not.[81] 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.[82]

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[72] IRC § 1361(d)(2)(D); Reg. § 1.1361-1(j)(6).

[73] Reg. § 1.1361-1(j)(11).

[74] IRC § 1361(d)(4).

[75] Ltr. Rul. 201228009, 201047018, 200932031, 200932022, 200932001, 200931036, 200905014, 200839008, 200726029 (failure to distribute QSST income).

[76] IRC § 1362(f); Rev. Proc. 2003-43, 2003-1 C.B. 998 (procedures for relief without a user fee for failure of an S corporation Q-Sub, QSST, or ESBT to make a proper election); Ltr. Ruls. 201306015-16, 201302004-6, 201301004, 201246002, 201245014, 201242009, 201208023, 201206009, 201203011, 201201005, 201151004, 201147016, 201146002, 201146001, 201117008, 201123023, 201117016, 201114002, 201128021, 201127005, 201106002, 201102034, 201103028, 201050019, 201050021, 201048020, 201047018, 201045016, 201042022, 201041025-28, 201037001; 201036005; 201034016; 201032020; 201029005; 201020007; 201017041; 201017020; 201016046; 201016016; 201016015; 200929002, 200917024, 200909024, 200906037, 200906027, 200903066, 200901024, 200843006, 200843007, 200841030, 200840029, 200840027, 200840026, 200820014, 200807004, 200806005, 200805004, 200804009, 200801004.

[77] Ltr. Rul. 200934007, 200932031.

[78] Department of the Treasury 2012-2013 Priority Guidance Plan, updated Feb. 5, 2013, *available at* http://www.irs.gov/pub/irs-utl/2012-2013_pgp_2nd_quarter_update.pdf.

[79] IRC § 1361(d)(1)(B).

[80] Reg. § 1.1361-1(j)(8); Ltr. Rul. 9721020.

[81] Reg. § 1.671-4(b)(6)(iii).

[82] Reg. § 1.1361-1(j)(8).

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.[83] Within that two year period the trust must qualify as a permitted shareholder or dispose of the stock, or else the S election will be terminated. While the estate is treated as the shareholder for eligibility purposes, the trust is the shareholder for purposes of reporting income and deductions, basis, and distributions.[84] 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 beneficiaries after the death of the QSST beneficiary, each new beneficiary must own a separate share of the trust in order for the trust to continue to be a qualified QSST.[85] 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.[86]

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.[87] 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.[88] 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

> Sue is the income beneficiary of a QSST. She dies on August 15, 2012 and the trust names Annie as the successor income beneficiary. For the 2 ½ month period after Sue's death, Annie can file an affirmative refusal to consent to the QSST election. Annie's refusal to consent is due October 30, 2012 (2 ½ months after she becomes the current income beneficiary) and is effective as of August 15, 2012, the day Annie became a beneficiary. If Annie refuses to consent, the trust becomes an ineligible shareholder on August 15, 2012 and must dispose of its stock or make an ESBT election within two years of August 15, 2012.

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[83] Reg. § 1.1361-1(j)(7)(ii).

[84] *Id.*

[85] Ltr. Rul. 201119005 (QSST divided into separate shares after the death of the QSST income beneficiary continued to qualify as a QSST. The successive income beneficiaries were not required to make a new QSST election.)

[86] Reg. § 1.1361-1(j)(9).

[87] Reg. § 1.1361-1(j)(9)(i).

[88] Reg. 1.1361-1(j)(9) and (10).

A new beneficiary's ability to terminate the S election is in sharp contrast with the general procedure for terminating an S election, which requires the consent of more than 50 percent of the shareholders.[89]

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.[90] Crummey withdrawal rights are rights to withdraw corpus. Therefore, attorneys drafting trusts intended to qualify as a QSST should avoid multiple Crummey power holders. However, if multiple Crummey withdrawal rights are important to the planning objective, the trust could provide for separate shares. Alternatively, the trust could make an ESBT election because an ESBT allows multiple beneficiaries. However, ESBT beneficiaries who have withdrawal rights must be individuals, estates, or certain charitable organizations.[91] Even so, ESBT status may not be desirable because its share of the S corporation income is taxed at the maximum individual tax rate (39.6% in 2013 and after) and is also subject to the 3.8 percent Medicare surtax starting in 2013.

6. 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. An ESBT may have more than one current beneficiary and may accumulate its income.[92] For example, a special needs (disability) trust is an ideal candidate for an ESBT because it generally does not distribute its income to avoid disqualifying the beneficiary from government aid. Crummey trusts with power holders who are not current income beneficiaries are also ideal candidates for an ESBT. They are not eligible to make a QSST election because they may distribute corpus to someone other than a current income beneficiary.[93] Charitable remainder annuity and unitrusts (CRATS and CRUTs) defined in IRC § 664(d) are ineligible ESBT shareholders by statute.[94] But charitable lead annuity trusts (CLATs) may be S shareholders and elect ESBT treatment.[95]

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 (39.6% for 2013), except for long-term capital gains which are taxed at the capital gain rate that applies (20% in 2013).[96] The taxable income of an ESBT consisting solely of stock in one or more S corporations includes:[97]

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[89] IRC § 1361(d)(1)(B).

[90] IRC § 1361(d)(3)(A)(ii).

[91] IRC § 1361(e)(1)(A)

[92] IRC §§ 1361(c)(2)(A)(v); 1361(e):

[93] IRC § 1361(d)(3)(A)(ii).

[94] 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.).

[95] Reg § 1.641(c)-1(l), Ex. 4.

[96] IRC § 641(c)(2)(A).

[97] IRC § 641(c)(2).

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.[98]
3. State and local income taxes and administrative costs directly related to the S portion.[99]
4. Interest expense on indebtedness incurred to acquire S corporation stock.[100]
5. Capital losses, but only to the extent of capital gains.[101]
6. The ESBT is *not* entitled to an income distribution deduction or the $100/$300 personal exemption unless it has taxable income from sources other than the S corporation.[102]
7. The ESBT is *not* entitled to an alternative minimum tax exemption.[103]
8. The ESBT is subject to the 3.8 percent Medicare tax on its undistributed net investment income.[104] The S portion of the ESBT shares a single $11,950 Medicare exemption with the non-S portion of the trust.

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.[105] 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.[106] 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.

An ESBT must meet all of the following criteria:

- All beneficiaries 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.[107] A government organization may not be a potential current beneficiary (PCB), as described 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.[108] Nonresident aliens may be ESBT beneficiaries as long as they are not

[98] Reg. § 1.1361-1(j)(8).
[99] Reg. § 1.641-1(d)(4); Reg. § 1.641(c)-1(l), Example 1.
[100] 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).
[101] IRC § 641(c)(2)(D); IRC § 1211(b).
[102] *Id.*
[103] IRC § 641(c)(2)(B).
[104] Prop. Reg. § 1.1411-3(c)(1).
[105] IRC § 6654(l).
[106] IRC § 641(c)(1).
[107] IRC § 1361(e)(1)(A)(i).
[108] Reg. § 1.1361-1(m)(1)(ii)(C).

potential current beneficiaries.[109] 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.[110] The interest must 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.[111] 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.[112] 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.[113]

- The trustee, not the beneficiary, makes an ESBT election.[114] He does so by signing and filing with the Service Center where the S corporation files its income tax return, a statement containing the name, address, and taxpayer ID number of the trust, the potential current beneficiaries, and the S corporations in which the trust currently holds stock.[115] It must also disclose any powers of appointment, but need not provide any detailed information about it. The election must be identified 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.[116]

The ESBT election can be revoked only with IRS's consent.[117] Rev. Proc. 2003-43 provides relief from failure to make a timely ESBT election.[118] Although the relief is not automatic, no user fees apply. The IRS has granted relief from S corporation termination where the trust's failure to make the ESBT election was inadvertent and the trustee makes a late retroactive ESBT election.[119] 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 it made the election. In Letter Ruling 201209005, the IRS allowed the trustee to correct a deficient ESBT election. The ruling doesn't say, but the trustee probably sent the election to the wrong IRS Service Center.

In some cases, a trust may satisfy the requirements for an ESBT, but would rather be a QSST. In that case, the trustee might consider creating a separate subtrust that meets the QSST requirements. In Letter Ruling 200932031 the trustee that did not wish to make an ESBT

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[109] Reg. § 1.1361-1(m)(1)(ii)(D).
[110] IRC § 1361(e)(1)(A)(ii).
[111] Reg. § 1.1361-1(m)(1)(iii).
[112] *Id.*
[113] Reg. § 1.1361-1(m)(1)(iii).
[114] IRC § 1361(e)(3).
[115] *See* Exhibit B for sample ESBT election form.
[116] Reg. § 1.1361-1(m)(2).
[117] IRC § 1361(d)(2)(C); Ltr. Rul. 201114002.
[118] Rev. Proc. 2003-43, 2001-1 C.B. 998.
[119] Ltr. Rul. 201308022, 201252007, 201247008, 201244002, 201243009, 201205006, 201201006, 201147012, 201144018, 201129001, 201140010, 201128023, 201117004, 201118008, 201117016, 201114002, 201103015, 201108028, 201108012, 201106002, 201051010, 201042002, 201041025-28, 201035009; 201034003; 201032030; 201032020; 201032018; 201015013; 201015001; 201011005; 201010008; 201010007; 201006010, 200941002, 200934003, 200927012.

election, was allowed to amend the trust document to create a separate subtrust that was eligible to and did make a late QSST election.[120] Each subtrust beneficiary must affirmatively elect to be a QSST where the trust is converting from an ESBT to a QSST. Similarly, in Letter Ruling 201122003, an ESBT divided into separate shares under IRC § 663(c), allowing each income beneficiary of a separate share to revoke the ESBT election as to his or her separate share and treat it as a QSST.[121] That is, each separate share of an ESBT can make a QSST election with no effect on the ESBT election for the nonelecting shares.

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 the number of shareholders exceeds 100.[122] In that case, the trust has one year from the terminating event to dispose of its interest in the S corporation to avoid loss of its S status.[123]

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.[124] It does not include a person who only holds a future interest in the trust.[125] 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 occurs.[126] For tax years after December 31, 2004, it does not include a person in whose favor an unexercised power of appointment can be exercised.[127]

7. IRAs and Qualified Plans

An IRA is not an eligible S corporation shareholder.[128] Therefore, if S stock is transferred to an IRA, the S status terminates immediately. In PLR 200940013 the IRS provided relied from termination of an S corporation that had been transferred to an IRA because the termination was inadvertent. However, as a condition of the ruling, during any period that the IRA owned the S corporation stock and the corporation produced net losses, the IRA would be treated as the shareholder.[129] And for any period that the IRA owned the S corporation stock and the corporation produced net gains, the individuals would be treated as the shareholder.

In another recent private letter ruling, PLR 200817013, the IRS provided relief from termination to an S corporation where five of its shareholders transferred their stock to their self-directed IRAs.[130] 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

[120] Ltr. Rul. 201119005, 200932031.
[121] Ltr. Rul. 201122003.
[122] 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).
[123] IRC § 1361(e)(2); Reg. §§ 1.1361-1(m)(4)(iii); (m)(8), Ex. 2.
[124] IRC § 1361(e)(2) (potential current beneficiary defined).
[125] IRC § 1361(e)(2); Reg. § 1.1361-1(m)(4)(i).
[126] Reg. § 1.1361-1(m)(4)(v).
[127] IRC § 1361(e)(2); Reg. § 1.1361-1(m)(4)(vi) (Sept. 28, 2007).
[128] Taproot v. Comm'r, 133 T.C. No. 9, Docket No. 15396-07 (Sept. 29, 2009), *affd*. No. 10-70892 (9th Cir 2012); Rev. Rul. 92-73, 1992-2 CB 224.
[129] Ltr. Rul. 200940013 (Oct. 2, 2009).
[130] Ltr. Rul. 200817013.

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.

Beginning October 22, 2004, an IRA can hold stock in an S corporation that is a bank as defined in IRC § 581 or a depository institution holding company.[131] In that case, the individual for whose benefit the IRA was created is treated as the shareholder.[132] 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.[133]

Qualified retirement plan trusts are eligible to hold S corporation stock.[134] For purposes of the 100-shareholder limit, a qualified retirement plan counts as one shareholder.[135] 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).[136] Employee stock ownership plans (ESOPs) that own S stock, however, are exempt from the UBTI rules.[137]

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.[138]
- A nonresident alien shareholder
- More than one class of stock

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.[139] Therefore, an employee stock ownership plan (ESOP) is eligible to own S corporation stock. And an individual can contribute S stock to a charity and claim a charitable contribution

[131] IRC § 1361(c)(2)(A)(vi); Reg. § 1.1361-1(h)(1)(vii).
[132] Reg. § 1.1361-1(h)(3)(i)(G).
[133] Reg. § 1.1361-1(h)(1)(vii); Ltr. Rul. 200802008.
[134] IRC § 1361(c)(6).
[135] S. Rep. No. 281, 104th Congress, 2nd Sess., p. 63–64.
[136] IRC § 512(e)(1).
[137] IRC § 512(e)(3).
[138] IRC § 1361(c)(1); Reg. § 1.1361-1(e).
[139] IRC §§ 1361(c)(6), 1361(b)(1)(B).

deduction for the fair market value of the stock less the amount of ordinary income that would be recognized on a sale of the stock if § 751(a) applied to S stock.[140] But S stock cannot be contributed to a charitable remainder trust (CRT) because the IRS has held that the requirements of §§ 1361 and 664 are incompatible and a trust cannot meet both sets of requirements.[141] Note, however, that a charitable lead trust can own S stock and make an ESBT election.[142]

During the time that the S corporation stock is owned by the charity, its earnings are basically tax exempt, except for its unrelated business taxable income discussed below. Any AAA accumulated during the time that the stock is owned by the charity is available for tax free distribution even after the charity disposes of its stock. If the charity's ownership of the S corporation stock is a sham, the IRS can unwind the transaction.[143]

S stock is usually not attractive to a charity, however, because the S corporation's business income would be unrelated business taxable income (UBTI) and subject to regular corporate or trust income tax rates.[144] Moreover, private foundations are subject to a 10 percent excise tax on "excess business holdings" when they, together with disqualified persons, own more than 20 percent of the voting stock of an incorporated business enterprise.[145] If the foundation does not dispose of the stock by year end, it is subject to an additional 200 percent excise tax.[146]

"Disqualified persons" include the foundation's founder and descendants, managers, substantial contributors, and their spouses, ancestors, children, grandchildren, great-grandchildren, and spouses of the children, grandchildren, and great grandchildren.[147] A business enterprise is any trade or business, except one with 95 percent or more of its gross income from passive sources.[148] Therefore, a private foundation could own stock in an S corporation with only passive assets. But absent that, the foundation is subject to an excise tax.

And finally, if disqualified persons own more than 35 percent of the voting power of the S corporation, the corporation would be a disqualified person with respect to the foundation. Thus if the foundation redeems the stock, the transaction would be self-dealing under IRC § 4941.

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.[149] 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.

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[140] IRC § 170(e)(1).

[141] Rev. Rul. 92-48, 1992-1 C.B. 301; IRC § 1361(e)(1)(B)(iii).

[142] Reg. § 1.641(c)-1(l), Ex. 4.

[143] Santa Clara Valley Housing Group v. U.S., 108 AFTR 2d 2011-XXXX, (DC CA), 09/21/2011.

[144] IRC §§ 511(a), 511(b).

[145] IRC §§ 4943(a), (c)(2).

[146] IRC § 4943(b).

[147] IRC § 4943(d)(4); § 4946(a), (d).

[148] IRC § 4943(d)(3)(B) (dividends, interest, loan fees, annuities, royalties, rentals, gains, etc.)

[149] IRC § 1223(11).

A. Look-Through Rule for IRD

If any person acquires stock in an S corporation by reason of the death of a decedent or by bequest, devise, or inheritance, the basis of the stock under § 1014 is its fair market value reduced by the value of any income in respect of a decedent.[150] Income in respect of a decedent applies to any item of the S corporation in the same manner as if the decedent had held directly his prorata share of the item.[151] In other words, there is complete parity between IRD owned outright by a decedent and the decedent's share of IRD owned by an S corporation. This is not true with respect to a deceased partner. IRD of a deceased partner is determined under § 753, which includes only payments of income to a retiring partner under § 736(a).[152]

B. 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.[153] 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 1120S require the S corporation to report items of IRD on its books to the estate of a deceased shareholder. Therefore, it will be difficult for a beneficiary who inherits an interest in an S corporation to know how much IRD is included in the K-1 items reported to him or her. In most cases, these are small amounts. But they could be significant if they include unrecognized gain on installment obligations or similar items.

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, 2010 with the estate as her successor shareholder. In April 2009, the S Corporation incurred a $500,000 capital gain and $200,000 of ordinary income. It had 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].

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[150] IRC § 1367(b)(4)(B).

[151] IRC § 1367(b)(4)(A).

[152] IRC § 691(e).

[153] Reg. § 1.691(c)-2.

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.[154] However, the income it reports increases its basis in the stock and will reduce any 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.[155] The distribution reduces the shareholder's basis in his or her stock.[156] Distributions in excess of basis result in a taxable gain on the sale of an asset.[157] 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.[158] Thus, a distribution of *appreciated* property from an S corporation is a deemed sale of the asset at its market value.[159] The corporation recognizes gain as if it had sold the asset and the gain passes through to the shareholders.[160] A corporate level "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.[161] 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

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[154] IRC § 1377(a)(1); Reg. § 1.1377-1(a); *see* also discussion in Section II of this outline.
[155] IRC § 1368(b)(1).
[156] IRC § 1367(a)(2)(A).
[157] IRC § 1368(b)(2).
[158] IRC § 1371(a).
[159] IRC §§ 1368(a), 1371(a), 301(b)(1).
[160] IRC §§ 311(b), 1366.
[161] IRC § 1374.

of $100,000. It has no C corporation E&P. In 2009 the corporation distributes the building to the estate, recognizing a $90,000 gain, which passes through to the estate. The $90,000 gain increases the estate's stock basis to $190,000 [$100,000 + $90,000]. The $100,000 distribution is tax-free because it does not exceed the estate's stock basis.

The tax consequences of distributing *depreciated* property differs greatly from that of distributing appreciated property. When a corporation distributes depreciated property, it may not recognize a loss.[162] It reduces its accumulated adjustments account (AAA) by the value of the property and that value becomes the shareholder's new basis in the property.[163] In essence, the disallowed loss increases the corporation's 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 loss is not allowed under the related party rules.[164] It is suspended until the shareholder disposes of the property to an unrelated party.[165]

B. Corporations With Earnings and Profits

S corporations with earnings and profits (E&P) as a former C corporation follow different rules for taxing distributions. In that case, their accumulated adjustments account (AAA) comes out first tax-free to the extent of the shareholder's basis in the S corporation stock.[166] 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. Distributions in excess of that are tax-free to the extent of any remaining stock basis. Any remaining distributions are capital gain.

In other words, distributions are taxed in the following order: (1) tax-free to the extent of AAA, up to the shareholder's stock basis,[167] (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,[168] 4) tax-free to the extent of any remaining basis,[169] and 5) capital gain on the excess.[170]

EXAMPLE A

An estate owns all the stock of an S corporation, which has a basis of $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 with no reduction in basis. 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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[162] IRC § 311(a).
[163] Reg. § 1.1368-2(c)(2).
[164] IRC § 267(a)(1).
[165] IRC § 267(d).
[166] IRC § 1368(c)(1).
[167] IRC § 1367(a)(2)(A).
[168] *Id.*
[169] IRC §§ 1368(c)(3), 1368(b).
[170] *Id.*

	Character of Distributions	Stock Basis
Tax-free AAA limited to stock basis	$ 50,000	(50,000)
Dividend income from E&P	25,000	
Tax-free recovery of remaining basis	50,000	(50,000)
Capital gain on distributions in excess of basis	75,000	
Total	$200,000	$(100,000)

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 and reducing the shareholder's 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:

	Character of Distributions	Stock Basis
Tax-free AAA limited to stock basis	$ 100,000	(100,000)
Capital gain on AAA in excess of basis	50,000	
Dividend income from E&P	25,000	
Capital gain on distributions in excess of basis	25,000	
Total	$ 200,000	$(100,000)

Note that in both examples, the $200,000 distribution resulted in a tax-free recovery of $100,000 equal to 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.[171] No adjustments are made to E&P when an S election is in

[171] Robert W. Jamison, "S Corporation Taxation" (CCH 2009 ed.), ¶ 305.

effect.[172] 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).[173]

- using straight-line instead of accelerated depreciation
- 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 income or loss to the shareholders on a per-share, per-day basis.[174] Income for the entire year is assigned 1/365th 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.[175] 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 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.[176]

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.[177] The legatee's basis is adjusted under § 1014 and the estate recognizes no gain or loss on the

[172] IRC § 1371(c)(1).
[173] *See* IRS Form 5472 for the calculation of E&P.
[174] Reg. § 1.1377-1(a).
[175] IRC § 1377(a)(1); Reg. § 1.1377-1(a).
[176] *Id.*
[177] IRC § 663(a)(1); Reg. § 1.663(a)-1.

transfer.[178] 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.[179] Distributions in satisfaction of a residuary bequest also close the S corporation's books on the date of the distribution.[180]

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.[181] Nor are residuary bequests, by negative implication in the regulations.[182] 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.[183] This applies whether the gift is a fixed dollar amount or a formula fixed dollar amount.[184]

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.[185]

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.[186] On the other hand, if the estate transfers IRD assets to specific or residuary legatees, only the legatee recognizes income when received.[187] 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.[188]

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[178] Reg. § 1.661(a)-2(f).
[179] *Id.*
[180] Reg. § 1.1377-1(b)(4).
[181] IRC § 663(a)(1); Reg. § 1.663(a)-1.
[182] Reg. § 1.661(a)-2(f).
[183] *Id.*
[184] Rev. Rul. 60-87, 1960-1 CB 286.
[185] IRC § 642(h).
[186] Reg. § 1.691(a)-4(b)(2); Ltr. Ruls. 9123036, 9315016, 9507008; *see* discussion of IRD at section IV of this outline.
[187] *Id.*
[188] *See* discussion at Section IV of this outline.

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.[189] 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.[190] 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 trust on the date of distribution.[191] The deduction, however, cannot exceed the fiduciary's DNI.[192]

The estate's deduction carries out income to the beneficiaries, limited to their share of the fiduciary's DNI.[193] 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.[194] 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[195]
- bequests to charitable beneficiaries which are governed by IRC § 642(c),[196] 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)[197]

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.[198] The effect of the rule is to limit the DNI carryout to those shares based on their share of the fiduciary's accounting income.[199] 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.[200]

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.[201] 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

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[189] IRC §§ 651(a), 661(a).
[190] Reg. § 1.661(a)-2(f).
[191] IRC § 643(e)(1) and (2).
[192] IRC §§ 651(b), 661(a).
[193] IRC §§ 652(a), 662(a).
[194] Reg. §§ 1.652(b)-2(a) and 1.662(b)-1.
[195] IRC § 663(a).
[196] *Id.*
[197] Reg. § 1.663(c)-2(b)(2).
[198] Reg. § 1.663(c)-4(a).
[199] Reg. §§ 1.663(c)-4(a), 1.663(c)-2(b)(2).
[200] Reg. § 1.662(a)-2(b).
[201] Reg. § 1.663(c)-5, Example 4.

bequest of a specific sum of money or of property is specifically excluded from separate share treatment.[202] The regulations contain 11 examples of when separate shares exist.[203]

2. Pecuniary Bequests and DNI Carryout

Distributions to satisfy a pecuniary bequest that does not share in the estate's income under the governing instrument or local law, do not carry out DNI.[204] The regulations illustrate.[205]

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 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 S corporation stock with a basis of $350,000 and a market value of $380,000 on the distribution date. The estate realizes a $30,000 long-term capital gain on the distribution. The estate is not entitled to a distribution 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 the shares under the governing instrument or local law.[206]

EXAMPLE

> Assume the same facts as the previous example, except that the S corporation issues a K-1 to the estate showing $100,000 of income. Because the will provides that no income is allocated to the child's trust, none of the $100,000 is allocated to it.[207] The estate reports the $100,000 shown on the S corporation's K-1. Income earned by the S corporation after the funding date is reported by the child's trust.

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[202] Reg. § 1.663(c)-4(a).
[203] Reg. § 1.663(c)-5, T.D. 8849, Dec. 27, 1999.
[204] Reg. § 1.663(c)-2(b)(2).
[205] Reg. § 1.663(c)-5, at Example 4.
[206] Reg. § 1.663(c)-2(b)(4).
[207] Reg. § 1.663(c)-5, Example 5.

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 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.[208]

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. [209]

Thus, DNI can be allocated to the pecuniary share despite that it is not entitled to any fiduciary income under state law.[210]

VIII. HOLDING S CORPORATION STOCK IN TRUST

A. 3.8 Percent Medicare Tax

Beginning January 1, 2013, IRC § 1411 imposes a new surtax of 3.8 percent on the undistributed net investment income of estates, and trusts. The surtax is in addition to all other taxes imposed by Subtitle A (Income Taxes).[211] Some trusts are exempt from the Medicare tax, such as pension trusts, trusts solely devoted to charity, charitable remainder trusts, grantor trusts, foreign trusts, 529 plans, HSAs, education savings accounts, and other such trusts that are statutorily exempt from tax.[212] In the case of a QSST or a grantor trust, the Medicare tax applies to the grantor as if the grantor were the owner of the property.[213] In other words, the trust is ignored for purposes of the Medicare tax.

The Medicare tax is applied to the *lesser* of the estate or trust's a) adjusted gross income under § 67(e) in excess of the highest income tax bracket threshold ($11,950 in 2013) or b) undistributed net investment income.[214] Undistributed net investment income is the estate or trust's net investment income less distributions of that investment income. Thus, distributions are segregated between investment income and non-investment income in the same manner as

[208] Reg. § 1.663(c)-2(b)(3).
[209] Reg. § 1.663(c)-5, Example 6.
[210] Reg. § 1.663(c)-2(b)(2).
[211] IRC § 1411(a)(1).
[212] Prop. Reg. § 1.1411-3(b).
[213] Prop. Reg. § 1.1411-3(b)(5).
[214] IRC § 1411(a)(2).

current regulations prescribe for determining the character of amounts distributed under Reg. § 1.661(b)-1. The beneficiary is then subject to the Medicare tax on the net investment income distributed to him or her.

Net investment income includes gross income from interest, dividends, rents, royalties, annuities, gains from the disposition of property, passive activities, and trading activities less "properly allocable" expenses.[215] Several types of income are excluded from net investment income. The statute expressly excludes distributions from IRAs and qualified plans.[216] But tax exempt income and the inside build-up of annuities are also exempt because they are not included in gross income. Net investment income excludes nonpassive trade or business income.[217] However, because the IRS maintains that trustees must personally materially participate in a trade or business on a regular, continuous and substantial basis, a trust would rarely have nonpassive trade or business income.

It is very difficult for an ESBT to plan around the Medicare tax because it is not entitled to a distribution deduction. The regulations provide a detailed example of how the Medicare tax applies to an ESBT.[218] The S and non-S portions are treated separately for purposes of determining the undistributed net investment income and the AGI. Then the amounts are combined to determine the lesser of AGI in excess of the threshold or undistributed net investment income. The S and non-S portions share a single $11,950 threshold and net losses of one portion are not allowed to offset income of the other portion.

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.[219]

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

[215] IRC § 1411(c)(1).
[216] IRC § 1411(c)(5).
[217] IRC § 1411(c)(1)(A)(ii).
[218] Prop. Reg. § 1.1411-3(c)(1) and. § 1.1411-3 (f), Ex. 3.
[219] Reg. § 1.643(a)-3.

- 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 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.[220] 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.[221]

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[222]] 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."[223]

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.[224]

The United States Court of Federal Claims addressed this issue in *Crisp v. United States*.[225] 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

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220 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).

221 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).

222 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)).

223 T.D. 9102.

224 *See also* E. James Gamble, Trust Accounting and Income Taxes, AICPA Conference (June 2005).

225 Crisp v. United States, 34 Fed. Cl. 112 (1995).

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.

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.[226] 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.[227] Because that can work harshly on the income beneficiary if the S corporation makes no distributions, UPIA § 506

[226] Crisp at 118-120.
[227] IRC § 1361(d)(1)(B).

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 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.[228]

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.[229] 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.[230] 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 just like a regular trust. In addition, the trustee must allocate its tax on the S corporation income between principal and income according to the Uniform Principal and Income Act (UPIA) § 505(c) and (d), which can produce some unexpected 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.[231] 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.[232]

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[228] UNIF. PRINCIPAL & INCOME ACT § 506, cmt.
[229] IRC §§ 641(c)(1)(A); 641(c)(2)(C).
[230] UNIF. PRINCIPAL & INCOME ACT § 505.
[231] UPIA § 103(a)(4).
[232] UPIA § 506(a)(3).

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 entering into the trust's DNI, unless the trust instrument specifically allocates different classes of income to different beneficiaries (which they rarely do).[233]

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 when 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.[234] The trustee may rely on the entity's statement made at or near the time of the distribution to allocate the payment to trust taxes. In addition, recent private letter rulings have upheld an entity's designation of a payment for taxes based on the trustee's 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."[235]

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.[236] If the entity distributes less than

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[233] IRC §§ 652(b), 662(b); Reg. §§ 1.652(b)-1, 1.662(b)-1.
[234] UPIA § 401(f).
[235] 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).
[236] UPIA § 505(c) (as revised in 2008).

enough to pay the full tax on that entity's K-1 income, then the trustee must reduce income receipts dollar for dollar up to the entire tax liability attributable to those receipts.[237]

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 it represents to be income. The trust is in the 35 % 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.[238] 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 which it represents to be income. So the trustee initially allocates $500,000 to trust income. The trust is in the 35 % 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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[237] *Id.*
[238] UPIA § 505(d) (as revised in 2008).

Taxable Income per K-1		1,000,000
Payment to beneficiary		230,769[239]
Trust Taxable Income		$ 769,231
35 percent tax	269,231	
Distribution from the Entity		$ 500,000
Fiduciary's Tax Liability		(269,231)
Payable to the Beneficiary		$ 230,769

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.[240] 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.[241] Those that have not are still operating under the pre-amendment version, which is subject to differing interpretations.[242] 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 whether to reimburse the principal for the tax it initially bore on the undistributed income.[243]

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[239] 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).

[240] IRC § 663(b).

[241] *See* Legislative Facts for the Uniform Principal and Income Act (2008), available at www.nccusl.org.

[242] *See* David Keene, "Partnerships Held by Trusts and Estates: Discovering the Rules and Optimizing the Opportunities," TAXES – THE TAX MAGAZINE (Oct. 2007) at 53.

[243] UPIA § 506.

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. Passive Income and Losses of S Corporations

Estates and trusts often own an interest in a family business, ranch, or rental property. They may own these either directly or indirectly through an S corporation or a partnership. Income and losses from these entities are generally "passive" because the shareholders or the partners do not materially participate in the business. Material participation plays a major role in the taxation of income and losses from these entities. If the owner does not materially participate in the activity, its income will be subject to the new 3.8 percent surtax on unearned income for individuals, estates, and trusts starting in 2013.[244] And its losses are limited.[245] However, if the shareholder materially participates, the income is not subject to the 3.8 percent surtax and losses are fully deductible. Therefore material participation is the preferred status.

1. Material Participation for Individuals

Section 469(h)(1) provides that a taxpayer materially participates in a trade or business if the taxpayer is involved in the activity's operations on a regular, continuous, and substantial basis. Temporary regulations provide a list of seven tests for material participation by an individual as follows.[246]

1. The taxpayer participates in an activity for more than 500 hours during the tax year.

2. The taxpayer's participation in the activity for the current year constitutes substantially all the participation of all individuals in the activity, including nonowners.

3. The taxpayer participates in an activity for more than 100 hours during the tax year, and no other individual, including nonowners, participates more hours than the taxpayer.

4. The activity is a "significant participation activity," and the taxpayer's total participation in all significant participation activities exceeds 500 hours. A significant participation activity is one in which (a) the taxpayer cannot be treated as materially participating under any of the other six tests, and (b) the taxpayer participates in the activity for more than 100 but fewer than 500 hours.

5. The taxpayer materially participates in an activity for any five of the 10 immediately preceding tax years.

6. The taxpayer materially participates in a personal service activity for any three preceding tax years (whether or not consecutive). A personal service activity for these purposes is an activity in the field of health (including veterinarians), law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income producing factor.[247]

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[244] IRC § 1411.
[245] IRC § 469(h)(1).
[246] Temp. Reg. § 1.469-5T, T.D. 8175 (Feb. 19, 1988).
[247] Temp. Reg. § 1.469-5T(d); Rev. Rul. 91-30.

7. Based on all facts and circumstances, the individual materially participates on a regular, continuous, and substantial basis. This is a subjective test that evidently will be used if the shareholder does not fit into one of the other categories, but the individual's annual participation must be at least 100 hours and cannot include management activities unless no other person receives compensation for services rendered to that activity.[248]

2. Material Participation for Estates and Trusts

However, the seven tests do not apply to estates and trusts. Instead, Reg. § 1.469-8 has been reserved to describe how these rules apply to estates and trusts.[249] Unfortunately, it has not yet been written. New proposed regulations have been written to determine whether partners in limited partnerships and LLCs are active or passive.[250] But they apparently do not apply to estate and trust owners. Therefore, a host of questions arises when an estate or trust owns a passive activity. 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?

In 2003, a Texas District Court addressed material participation by a trust for the first time in *Carter v. United States*.[251] The Carter Trust 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 some of the ranch operations to a full-time ranch manager and several employees who performed all of the ranch activities. The trust claimed losses from 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 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.

Notwithstanding the decision in *Carter v. United States*, the IRS has issued a letter ruling and a TAM holding 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,

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[248] Temp. Reg. § 1.469-5T(b).

[249] Reg. § 1.469-8 [Reserved], T.D. 8417 (May 12, 1992).

[250] Prop. Reg. § 1.469-5(e), Notice of Proposed Rulemaking, Fed. Reg. Vol. 76, No. 228, p. 72875. 11/28/2011 (treating a partner in a limited partnership or an LLC as actively participating only if the individual does not have rights to manage the entity at all times during the entity's taxable year under the law governing the entity or under the entity's agreement. Rights to manage include the power to bind the entity).

[251] Carter v. United States, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

continuous, and substantial basis.[252] Both Letter Ruling 201029014 and TAM 200733023 hold that focusing on the trustee's activities for purposes of material participation follows 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.[253] 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.

Letter Ruling 201029014 held that the trustee could materially participate if it was involved in the operations of the business on a regular, continuous and substantial basis, but did not rule on the facts. However, TAM 200733023 found that the trustee failed to meet the material participation. But the TAM provided a roadmap for trustees wishing to establish material participation. The IRS held that the "Special Trustees" in the TAM who ran the business had only limited powers and could not be considered as fiduciaries for purposes of the material participation test. They could not legally bind the trust or commit it to any course of action, they had no discretionary powers, and many of their duties had a questionable nexus to the conduct of the business. Consequently, trusts wishing to establish material participation should require any special trustees to participate on a regular, continuous, and substantial basis in the operations of the business activity and vest in them the discretionary power to bind the trust.

It should be noted that material participation by the trustee does not subject the trust or its beneficiaries to the self-employment tax. In *Ding v. Commissioner* the Ninth Circuit affirmed the Tax Court's holding that "S corporation pass-through items are not included as self-employment income," even when the shareholders help to produce that income.[254] Unlike a partnership, the business of a corporation is not the business of its shareholders. Moreover, § 1366 "only permits use of S corporation pass-through items in calculating chapter 1 tax liability, not chapter 2 – in which the self-employment tax provision is located."[255] Therefore, the trustee can avoid both the self-employment tax and the 3.8 percent surtax that begins in 2013 by materially participating in the entity's activities.

3. Disposition of the Asset

All current and suspended passive losses may be fully deducted in the year a person completely disposes of his or her interest in the passive activity. To qualify as a complete disposition, a person must dispose of their entire interest in the passive activity to an unrelated party in a "fully taxable transaction."[256] A fully taxable liquidation, sale, or exchange qualifies as a complete disposition. The death of a shareholder is not a complete disposition in a taxable transaction because death itself is not a taxable transaction. However, special rules allow suspended passive losses to be deducted on the decedent's final income tax return to the extent the losses exceed the basis step up afforded on the death of the shareholder.[257] Any losses unable to be used under this rule expire.

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[252] TAM 2007 33023 (Aug. 17, 2007).

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

[254] Ding v. Comm'r, 200 F.3d 587 (9th Cir. 1999), *aff'g* T.C. Memo 1997-435; Rev. Rul. 59-221, 1959-1 C.B. 225.

[255] Ding at 589.

[256] IRC § 469(g)(1).

[257] IRC § 469(g)(2).

EXAMPLE

> Bob died on May 1, 2010 with $50,000 of suspended passive losses from an S corporation. On his date of death, Bob's estate received a $30,000 step-up in basis of the stock, which is the difference between the stock's value of $100,000 and its pre-death basis of $70,000. Therefore, Bob's executor may only deduct the remaining $20,000 of suspended passive losses on Bob's final Form 1040. [$50,000 – $30,000]. The $30,000 added to basis is not deductible.

A disposition to a related party is not a disposition for purposes of the passive activity rules.[258] A related party is defined under IRC § 267(b) and includes a fiduciary and its beneficiaries.[259] 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. Family member includes a person's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.[260] 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.[261]

Nor is the distribution of a passive activity by an estate or trust to a beneficiary a disposition that frees up passive losses.[262] Upon distribution to a beneficiary of an estate or trust, the unused passive losses are added to the basis of the activity in the hands of the beneficiary.[263] In this case, the beneficiary can only use them to reduce the gain or increase the loss upon disposition of the activity. This is similar but not identical to the rule for gifts. In the case of a gift, all of the donor's suspended passive losses are added to the basis of the activity in the hands of the donee.[264]

It appears that the only type of disposition that will free up suspended passive losses of an estate or trust is a sale or exchange in a fully taxable transaction. This may include a liquidation of the corporation, a redemption of a shareholder, or worthlessness of the S corporation stock. A liquidation of the corporation will probably qualify as a fully taxable disposition because it does not violate the related party rules. No related party is acquiring the shareholder's interest in the corporation.[265] However, it is not so clear that a complete redemption under § 302(b) will qualify as a fully taxable disposition under the passive activity rules.[266] If not, a redeemed shareholder may not be able to deduct his suspended passive losses on a redemption. The related party rules under § 469(g)(1)(B) may prevent the deduction if the shareholder, together with his family members (as defined in § 267(c)(4)), own more than 50 percent of the stock.[267] Regulations are

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[258] IRC § 469(g)(1)(B).
[259] IRC § 267(b)(6)
[260] IRC § 267(c)(1).
[261] IRC § 267(c)(1).
[262] IRC § 469(j)(12).
[263] *Id.*
[264] IRC § 469(j)(6).
[265] IRC § 469(g)(1)(B).
[266] *See* discussion at Section X.B. for when a redemption qualifies as a redemption under § 302 rather than a distribution under § 1368.
[267] IRC § 469(g)(1)(B).

reserved to address the "Treatment of losses upon certain dispositions."[268] But in the meantime, it is not clear that a redemption that qualifies under § 302(b) frees up suspended passive losses.

On the bright side, the seventh Circuit in *Bilthouse v. United States* found that worthlessness of stock qualifies as a fully taxable disposition. The Court held that the owners of an S corporation disposed of their entire interest in a passive activity in the year the company became insolvent and the stock became worthless.[269] 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 is treated as a *sale or exchange* of a capital asset. Thus it is vital to establish not only the worthlessness, but the year in which the stock becomes worthless.

E. Charitable Contributions Made By 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.[270] 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.[271] 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.[272] 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.[273]

F. 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.[274] 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

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[268] Reg. § 1.469-6.
[269] Bilthouse v. United States, 103 AFTR 2d 2009-429 (7th Cir 2009).
[270] IRC § 642(c)(1).
[271] Rev. Rul. 2004-5, 2004-3 I.R.B. 295; FSA 200140080.
[272] Reg. § 1.641(c)-1(d)(2)(ii).
[273] Reg. § 1.641(c)-1(g)(4).
[274] UNIF. PRINCIPAL & INCOME ACT §§ 401(b), (c).

regardless of the size of the distribution.[275] 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.[276]

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 20 percent of the entity's gross assets.[277] 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.[278]

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.[279]

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.[280] In addition, the spouse must be able to compel the trustee to make the property productive.[281] 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.

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[275] *Id.* at § 401(d)(1).
[276] *Id.* at § 401(f).
[277] *Id.* at § (d)(2).
[278] *Id.* at § (e).
[279] 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).
[280] Rev. Rul. 2006-26, 2006-22 I.R.B. 939.
[281] Reg. §§ 20.2056(b)-5(f)(4) and (5).

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.[282] 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.[283] However, an S corporation can also make a "deemed" dividend without actually making one.[284] This allows the corporation to deem out its Subchapter C earnings and profits (E&P) ahead of its AAA out of the normal order.[285] 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 or 20 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.[286] Therefore, the trust was not required to distribute the deemed dividend to its beneficiary, but still 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.

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. The 20-percent rule is rigid. If the distribution exceeds 20 percent of the entity's gross assets, it is per se principal despite that it may actually represent many years of accumulated income. This was probably the case with Microsoft when it declared a dividend in 2004 that exceeded 30 percent of its book value, based on audited financial statements in its SEC Form 10-K filing. Some trustees treated the dividend as income and some treated it 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

[282] IRC § 1368(e)(3); Reg. § 1.1361-1(j)(1)(i).

[283] P.L.R. 200451021 (Dec. 17, 2004).

[284] Reg. § 1.1368-1(f)(3).

[285] *See* discussion at Section VI of this outline.

[286] P.L.R. 200446007 (Nov. 12, 2004).

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.[287] 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 $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.[288] However, the court declined that argument and held that the distribution must be based on total assets referenced in the footnote.

The most recent case addressing the 20-percent rule is *Manson v. Shepherd*.[289] Here a California Appeal Court determined that a $3 million distribution to a trust from its primary asset, Wave Crest Development Corporation, was a distribution in partial liquidation of the company and therefore principal to the trust. The court found that the corporation's board had sufficiently "indicated" that the distribution was principal by stating in its minutes that the cash arose from selling its High Street property and was distributed to the trust shareholder because it had promised to repay its debt to the company. From those minutes, the court inferred that Wave Crest made it known, or "indicated," at the time of the board meeting that the $3 million distribution was a liquidating distribution under § 16350(d)(1)(A) of the Cal. Uniform Principal and Income Act properly allocated to principal.

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 death, there is no corresponding adjustment to the basis of the corporate assets themselves.[290] 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.

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[287] Thomas v. Elder, 21 Cal. Rptr. 3d 741 (Dec. 2, 2004)

[288] Hasso v. Hasso, 55 Cal. Rptr. 3d 667 (Mar. 6, 2007), pet. for review denied, No. S1511873 (May 16, 2007).

[289] Manson v. Shepherd, 188 Cal. App. 4th 1244 (Cal. App. 6th Dist. 2010).

[290] IRC § 1014.

A. Built-in Gains Tax

If an S corporation sells its assets after a shareholder dies, the decedent's estate could pay a significant amount of tax even though the S corporation stock receives a stepped-up basis under § 1014. This is because only the outside basis of the stock is adjusted at the date of death, not the inside basis of the corporation's assets. Compare this to a partnership, which can make a Section 754 election to step up the basis of the assets inside the partnership. There is no equivalent to a Section 754 election for an S corporation. The corporation's inside basis of its assets does not change on the death of a shareholder.

Moreover, if the S corporation was formerly a C corporation, a sale of its assets within ten years of the S election may cause a separate corporate level tax at the highest corporate tax rate (35%) on any net built-in gain at the time of the S election.[291] Net built-in gain is the difference between the market value and the basis of all the corporation's assets on the date of its S election. A tax is levied on the lesser of the net built-in gain recognized during the year or the S corporation's taxable income, not to exceed the total unrecognized net built-in gain on the date of the election.[292] The built-in gains (BIG) tax is deducted from the net built-in gain, which is then allocated proportionately among the shareholders and passed through to them on Schedule K-1 in the year of sale.[293]

Recent legislation has gradually reduced the ten-year recognition period from ten to five years. For sales of assets in 2011, 2012, and 2013, the recognition period is only five years after the S election.[294] So if the corporation made its S election in 2006 or earlier, it has no built-in gain tax for sales in 2011 or after. If the corporation made its S election in 2007 or earlier, it has no built-in gain tax for sales in 2012 or after. And if the corporation made its S election in 2009 or earlier, it has no built-in gain tax for sales in 2013. However, after 2013, the recognition period reverts to ten years for all S corporations, unless Congress decides to change it again.

The potential for built-in gain tax can have a significant impact on what a buyer will pay for the S corporation stock. In *Litchfield v. Commissioner* the Tax Court addressed the percentage discounts that should be used for built-in capital gains taxes, for lack of control, and for lack of marketability relating to the estate's minority interests in two closely held family S corporations.[295] As of the valuation date, one of the S corporations had built-in gain of $28,762,306, constituting 86.7 percent of its total net asset value, and the other one had $38,984,799 of built-in capital gains, constituting 73.8 percent of its total net asset value. Both sides' experts used the net asset valuation method to appraise the stock and applied discounts to reflect the substantial built-in gain taxes. Quoting *Eisenberg* and *Davis*, [296] the Tax Court in *Litchfield* noted:

> A hypothetical buyer would be willing to pay fair market value for the LRC and LSC stock, which would take into account and would reflect the millions of dollars in

[291] IRC § 1374.

[292] IRC § 1374(d)(2)(A).

[293] IRC § 1366(f)(2).

[294] IRC § 1374(d)(7)(C).

[295] Litchfield v. Comm'r, T.C. Memo 2009-21 (Jan. 29, 2009).

[296] Eisenberg v. Comm'r, 155 F.3d 50, 57 (2d Cir. 1998), *vacating and remanding* T.C. Memo 1997-483; Davis v. Comm'r, 110 T.C. 530, 537 (1998).

> untaxed appreciation over the years in the values of LRC's and LSC's underlying assets. Knowledgeable buyers, however, also would negotiate discounts in the price of the stock to estimate, on the basis of current tax laws, the corporate capital gain tax liabilities due on that very same appreciation when the assets are sold or otherwise disposed of by the corporation. In other words, if a valuation of or price for corporate stock in a hypothetical sale is significantly affected by the untaxed appreciated value of the underlying corporate assets, the stock valuation or hypothetical stock price also should reflect the corporate capital gains tax liabilities that the appreciated assets carry with them and that will be paid by the corporation upon sale or other disposition of the assets.

It is also critical that the S corporation establish the market value of the stock on the S election date where the stock is expected to be sold shortly thereafter. In *Ringgold Telephone Company v. Commissioner*, the taxpayer valued the stock at $2.98 million on the S election date.[297] But within 11 months of the S election, the stock was sold for $5.2 million. Upon examination, the IRS maintained that the stock should have been valued at $5.2 million on the S election date, given the sale shortly thereafter. However, the Tax Court held that the sale price was not determinative and that other factors should be taken into account. Most importantly, the purchase was a strategic acquisition and the buyer was willing to pay more than what the average hypothetical buyer would pay. In addition, the taxpayer's expert was more persuasive than the government's expert. Thus, the Tax Court largely accepted the taxpayer's expert, but adjusted the value to $3.7 million, roughly half way between the two valuations.

One way to avoid the built-in gains tax is to reduce the S corporation's 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. In addition, if the built-in gains in any year are limited by the amount of taxable income, any excess built-in gains carryforward and are treated as if they arose the following year.[298] Therefore, if built-in gains are to be avoided, it will be necessary to reduce taxable income to zero every year during the recognition period.

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.[299]

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.[300] The S corporation only recognized built-in gain to the extent that the unitrust payments it received during the ten-year recognition period were capital gain under IRC § 664(b).

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[297] Ringgold v. Comm'r, T.C. Memo 2010-103.
[298] Reg. § 1.1374-2(c).
[299] Ltr. Rul. 200821022 (Dec. 21, 2007).
[300] Ltr. Rul. 200644013 (Nov. 3, 2006).

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.[301] 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 QSST 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.[302] 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 by the amount of the gain.[303] If the corporation liquidates after selling its assets, it is possible that the trust will report a capital loss. This is because the liquidation proceeds received by the trust may be less than the trust's basis in the S corporation's stock, which has been stepped up under IRC §§ 1014 and by the gain it reported on sale of the assets. This creates a mismatch because the trust reports the capital loss, which cannot be passed through to the beneficiary who reported the gain on the sale of the assets.

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.[304] 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. And even this is not a perfect solution because some of the gain on sale of the assets may be subject to recapture as ordinary income under IRC §§ 1245 and 1250.

C. Delaying the QSST or ESBT Election

In many instances it pays to delay the QSST or EBST 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.[305] 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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[301] Reg. § 1.1374-4(h).
[302] Reg. § 1.1361-1(j)(8).
[303] IRC § 1367(a)(1).
[304] Ltr. Rul. 199905011 (Feb. 15, 1999).
[305] *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.[306] 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.

The reasoning in CCA 200734019 might also apply to passive and at risk loss carryovers that accrued before a trust makes the ESBT election. If so, such loss carryovers may not be able to offset income earned by the S corporation after the ESBT election. It is not clear whether these suspended losses can be added to the basis of the S corporation stock, whether they disappear, or whether they remain suspended until the ESBT terminates and the stock reverts back to the trust again. There is simply no guidance on this point.

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) at the end of a year has gross receipts of which more than 25 percent are passive investment income, the highest corporate tax rate (currently 35%) applies to the lesser of excess net passive income or taxable income.[307] Passive income means gross receipts from certain royalties, rents, dividends, interest and annuities.[308] Where an S corporation has invested in a partnership, the S corporation's gross receipts include its prorata share of the partnership's gross receipts.[309] The tax reduces the net taxable income passed through to the shareholder.[310]

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.[311] An S corporation can also be relieved from inadvertent termination of its S election from excess net passive income for three consecutive years if it applies for a letter ruling and distributes its E&P in an actual or deemed dividend within the time specified in the ruling.[312]

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.[313] In determining its share of passive income from a passthrough entity that it owns, the S corporation should include

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306 CCA 200734019 (Aug. 24, 2007).

307 IRC § 1375(a) and IRC § 1375(b)(1).

308 IRC §§ 1362(d)(3)(C); 1375(b)(3); Reg. § 1.1362-2(c)(5)(ii)(A).

309 IRC § 702(c); Ltr. Rul. 200309021, 9411024, 8852021,.

310 IRC § 1366(f)(3).

311 IRC § 1375(d).

312 Ltr. Rul. 201110001, 201042010; *but see* Chief Counsel Advice (ECC) 200937029.

313 IRC § 1362(d)(3).

its share of the entity's gross receipts rather than the entity's net income or loss.[314] The limitation on excess passive income often catches S corporations after they sell their business and invest the proceeds in investment assets. S corporations with E&P can avoid excess passive income by distributing their 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.[315]

Passive investment income includes gross receipts derived from royalties, rents, dividends, interest (including tax-exempt interest),[316] and annuities.[317] It does not include capital gains.[318] Excess net passive income is the excess of passive investment income over 25 percent of the corporation's gross receipts.[319] In the case of dispositions of capital assets, gross receipts are taken into account only to the extent of capital gains. The excess net passive income is limited to the corporation's taxable income for the year.[320]

EXAMPLE

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

Rental Income	$25,000
Taxable Interest Income	10,000
Tax-Exempt Interest Income	7,000
Total Gross Receipts	$42,000
Rental Expenses	(13,000)
Total Net Passive Income	$29,000

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

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

The S corporation's tax on $21,750 is $7,610 ($21,750 × 35%), notwithstanding that some of it is tax-exempt.[321] The S corporation will pay the lesser of $21,750 or 35 percent of its taxable income computed as if it were a C corporation.

Not all rental income is passive for purposes of § 1375. Rents derived in the active trade or business of renting property are not passive for this purpose.322 Whether a rental activity is an

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[314] Ltr. Rul. 200928024; Rev. Rul. 71-455, 1971-2 C.B. 318.
[315] Ltr. Rul. 201030018; 201025033; 200934019, 200930027, 200927028.
[316] Reg. § 1.1375-1(f)(E)(2); Reg. § 1.1362-2(c)(5)(ii)(D)(1).
[317] IRC § 1362(d)(3)(C)(i).
[318] *Id.*
[319] IRC § 1375(b)(1)(A).
[320] IRC § 1375(b)(1)(B).
[321] Reg. § 1.1375-1(f), Ex. 2.
[322] Reg. § 1.1362-2(c)(5)(ii)(B)(2).

active trade or business depends on the facts and circumstances. An active trade or business is more likely to exist when the corporation provides significant services, employs a large number of people, or incurs substantial costs in the rental business.

Several recent private letter rulings have 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, 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.[323] 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 were still 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.[324] All the affected shareholders must consent to this election. Corporations can also make a "deemed" distribution of E&P.[325] 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.[326] This means that all shares must have identical distribution and liquidation rights.[327] In order to have a second class of stock, there must be two "equity" interests with different legal rights to distributions and liquidation proceeds.[328] 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 state income 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.[329] Similarly, the IRS allowed an S corporation to make disproportionate distributions to correct on a cumulative basis prior disproportionate distributions since its inception as an S corporation.[330]

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[323] Ltr. Ruls. 201029015; 201027022; 201005025, 200937004, 200937002, 200932011, 200932010, 200923007, 200830011, 200825024, 200833003, 200825023.
[324] IRC § 1368(e)(3).
[325] Reg. § 1.1368-1(f)(3).
[326] IRC § 1361(b)(1)(D).
[327] Reg. § 1.1361-1(l)(1).
[328] Ltr. Rul. 9112017.
[329] Ltr. Rul. 200934021.
[330] Ltr. Rul. 201006026 (Nov. 17, 2009).

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.[331] 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.[332] 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 a second class of stock.[333] Nor do agreements that create different redemption rights for the older and younger shareholders on the occurrence of certain terminating events.[334]

In addition, commercial contractual arrangements such as leases, employment agreements, or loan agreements are disregarded.[335] For example, an agreement to make monthly distributions to a shareholder's father was not a binding agreement creating a second class of stock.[336] Therefore, nonvoting stock and shareholder agreements can create valuable planning opportunities for S corporations and their shareholders.

B. Sale or Redemption of Stock

After a shareholder dies, the estate may wish to sell its S corporation stock. Sale of the stock soon after death is generally tax-free, assuming the sale proceeds are approximately equal to the decedent's stepped-up basis under § 1014. On the other hand, distributions in redemption of stock are generally taxed to the extent that the proceeds exceed the shareholder's basis in the stock. A redemption shortly after death is generally tax-free 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 distribution because in both cases, distributions up to the shareholder's basis are tax-free and any excess distribution is capital gain.[337]

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,[338] taxed as an ordinary dividend.[339] This could be a

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[331] Reg. § 1.1361-1(l)(1).
[332] Reg. § 1.1361-1(l)(2)(iii).
[333] Reg. § 1.1361-1(l)(2)(iii).
[334] Ltr. Rul. 200329011 (No 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.); Ltr. Rul. 201309003 (No second class of stock where departing shareholders were promised additional sale proceeds if the settlement of a legal dispute exceeded a certain amount.)
[335] Reg. § 1.1361-1(l)(2).
[336] Minton v. Comm'r, T.C. Memo 2007-372 (Dec. 26, 2007), *aff'd* No. 08-60284 (5th Cir. 2009).
[337] IRC § 1368(b).
[338] 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.).

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, 2) be substantially disproportionate with respect to the shareholder,[340] 3) be in complete termination of the shareholder's interest, or 4) be in partial liquidation of the distributing corporation.

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.[341] 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 prorata because it was intended to be 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 only the shareholder's prorata share.[342]

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 they determine whether a redemption is treated as a sale or exchange, or rather as a distribution. Under the attribution rules, an individual is considered to own any stock owned by a spouse, child, grandchild, or parent.[343] 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.[344] And stock owned by the estate beneficiaries is considered to be owned by the estate.[345] 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 vise versa.[346] The ownership of a trust beneficiary is determined actuarially according to factors and methods prescribed in Reg. § 20.2031-7.[347]

EXAMPLE

Paul owns 20 percent of S Corp and his son John owns the other 80 percent. S Corp. is worth \$10 million, has \$5 million in E&P, and \$1 million of AAA. Paul dies leaving his estate 50-50 to John and Mary. Mary has no other interest in S Corp. S Corp. redeems the estate for \$2 million (20% X \$10 million). However, the estate cannot completely terminate or reduce its interest in S Corp. because it constructively owns all of John's stock both before and after the redemption

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[339] IRC § 1368(c)(2).

[340] 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 stock owned immediately before the redemption.)

[341] IRC §§ 302(c)(1), 318.

[342] IRC §§ 302(c)(1), 318.

[343] IRC § 318(a)(1).

[344] IRC § 318(a)(2)(A).

[345] IRC § 318(a)(3)(A); Reg. § 1.318-3(a).

[346] IRC § 318(a)(2), (3); Reg. §§ 1.318-2, 318-3(b).

[347] Reg. § 1.318-3(b).

> because John is a beneficiary. If the $2 million distribution qualifies as a redemption, it is tax-free because the estate's tax basis is $2 million. But if it fails to qualify as a redemption, only $1 million of the distribution is tax-free because it comes from the corporation's AAA. The other $1 million is a dividend from E&P.

Under certain circumstances, the attribution rules can be waived. A waiver requires the distributee to completely terminate his or her interest in the corporation, including that as an officer, director, or employee.[348] Further, the distributee must not acquire any interest in the corporation for 10 years after the distribution, other than by bequest or inheritance.[349] Nor may the distributee have acquired any portion of the stock being 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.[350] The shareholder must also attach a statement to their tax return in the termination year agreeing to notify the IRS if they acquire an interest in the corporation and to keep the necessary records.[351] 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 agrees to notify the IRS if he does so.[352]

Entities can also waive the family attribution rules.[353] 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 distribute the shares to Mary and John and close the estate. Then the S corporation can redeem Mary without worrying about the attribution rules because stock owned by siblings is not attributed under § 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. "Tax Effecting" S Corporation Earnings

In valuing an S corporation, many appraisers "tax effect" the S corporation's earnings.[354]

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[348] IRC § 302(c)(2)(A)(i).
[349] IRC § 302(c)(2)(A)(ii).
[350] IRC § 302(c)(2)(B).
[351] IRC § 302(c)(2)(A)(iii).
[352] IRC § 302(c)(2).
[353] IRC § 302(c)(2)(C).
[354] Daniel Tinkelman, P.V. Viswanath, and Glen M. Vogel, "Sub S Valuation: To Tax Effect or Not To Tax Effect Is Not Really The Question," Tax Lawyer, Vol. 65, No. 3, p. 555.

This means that they reduce the S corporation's discounted cash flow by the income taxes that are due on that income if it were a C corporation. They justify tax effecting for several reasons. First, it makes sense to reduce earnings by the income taxes regardless of who pays the taxes. Taxes reduce the value of the investment whether they are paid by the owner on flow through income or by the corporation at the corporate level. In both cases, taxes reduce the value of the investment. Second, many potential buyers are C corporations or would convert the S corporation to a C corporation. Such a buyer would consider the projected after tax earnings.

However, the IRS rejects tax effecting in valuing an S corporation because they believe it is improper to reduce S corporation earnings by a tax it does not pay and that S corporations have a clear tax advantage over C corporations because there is no double-tax. In addition, the IRS has won several victories where the Tax Court rejected tax effecting an S corporation's earnings.[355] However, these were shaky victories. In each case, either the taxpayer's appraiser did not offer sufficient evidence that tax effecting was appropriate or the appraiser ascribed *no* premium to the corporation's status as an S corporation.[356] The Tax Court clearly believes that *some* premium is warranted, especially considering the large difference between corporate and personal taxes that existed before 2001, giving the S corporation shareholder a decided advantage over the double tax of a C corporation.

But today's slim margin between corporate and personal tax rates give the S corporation shareholder a much smaller advantage over a C corporation. For example, assume a corporation has $1,000,000 of pre-tax earnings and would be subject to a 35 percent tax rate on its income as a C corporation. Its shareholder is subject to a 39.6 percent ordinary tax rate, a 20 percent capital gain rate, and a 3.8 percent Medicare tax. Assume the corporation distributes its net after tax earnings. The investor's total tax burden under both an S or a C corporation regime would be as follows:

	S Corporation	C Corporation
Pre-Tax Earnings	$100,000	$100,000
35% C Corporation Tax		(35,000)
43.4% Individual Tax[357]	(43,400)	
23.8% Tax on $65,000 Dividend Income		(15,470)
Net After-Tax Cash Flow	$ 56,600	$ 49,530

In the above example, the S corporation shareholder pockets $7,070 more cash that the C corporation shareholder. Therefore, many appraisers are tax effecting the S corporation earnings, but adding a slight premium to the result to reflect the S corporation advantage.[358] In the above

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[355] Gross v. Comm'r, 272 F.3d 333 (6th cir. 2001); Gallagher v. Comm'r, 101 TCN 1702 (2011); Wall v. Comm'r, TCM 2001-75. Adams v. Comm'r, TCM 2002-80; Dallas v. Comm'r, TCM 2006-212;

[356] Gallagher v. Comm'r, 101 TCN 1702 (2011); Wall v. Comm'r, TCM 2001-75.

[357] 39.6% plus 3.8% = 43.4%

[358] Daniel Tinkelman, P.V. Viswanath, and Glen M. Vogel, "Sub S Valuation: To Tax Effect or Not To Tax Effect Is Not Really The Question," Tax Lawyer, Vol. 65, No. 3, p. 555.

example, the appraiser might apply a 14% premium to the after-tax earnings of the S corporation. [$56,600/$49,530= 14%]

A balanced approach makes more sense than not tax effecting at all, which is the IRS's approach, or tax effecting with no recognition of the S corporation advantage, which many appraisers advocate. Many factors must be considered in deciding whether and how to tax effect (or not). For example, the appraiser should consider whether the corporation is distributing or retaining its earnings, whether the S corporation's Schedule K-1 includes phantom income such as AMT adjustments that would adversely affect an S corporation shareholder, whether the S corporation had built in gains under IRC § 1374, whether the corporation has pre-S election earnings and profits as a C corporation, what tax rates were in effect at the time of the valuation, whether there was a foreseeable rate change, whether the corporation has had any recent offers from a C corporation, whether the corporation has a history as a c corporation, and a host of other factors.

The Service will likely reject any attempt to tax effect the earnings of an S corporation based on its perceived Tax Court victories. However, the time is ripe for a challenge of the IRS's stance by a taxpayer with the right set of facts and a seasoned expert.

D. 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.[359] 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 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.[360]

If, however, a corporation makes a partially liquidating distribution to the shareholders during the alternate valuation period that is not accompanied by a surrender of stock, the distribution is included on the AVD, except to the extent it was paid out of earnings and profits since the decedent's death.[361] 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.[362] Although the regulations appear to address only C corporations, they should also apply to distributions from other entities such as S corporations and partnerships. Therefore, if there is a chance that the executor will elect the AVD, the entity should distribute any post-death earnings within 6 months of the shareholder's death.

On November 17, 2011, the IRS issued new proposed regulations that will significantly change these rules. On the same date, the IRS withdrew proposed regulations issued in April 2008, which provided that post-death distributions of cash or property made by the entity to the

[359] Reg. § 20.2032-1(d)(4).
[360] Ltr. Rul. 200343002.
[361] Reg. § 20.2032-1(d)(4).
[362] *Id.*

estate will be ignored in determining the alternate value.[363] Entity included a corporation, partnership, or limited liability company. Thus, the proposed regulations appeared to require that post-death distributions be included in the value of the entity on the AVD.

Similar to the 2008 proposed regulations, the 2011 proposed regulations require a post-death distribution from an entity to be valued separately from the entity. The distribution is valued on the distribution date and the entity is valued on the 6-month AVD as long as the sum of the distribution and the value of the entity after the distribution are equal to the value of the entity prior to the distribution. If not, the entire interest in the entity is valued on the distribution date. The proposed regulations provide this example:[364]

> **Example (6).** At D's death, D owned an interest in Partnership X that is includible in D's gross estate. During the alternate valuation period, X made a cash distribution to each of the partners. No part of the distribution constituted post-death earnings. On the date of the distribution, the fair market value of D's interest in X before the distribution equaled the sum of the distribution paid to D's estate and the fair market value of D's interest in X immediately after the distribution. The alternate valuation date of the property distributed is the date of the distribution, and the alternate valuation date of D's interest in X is the 6-month date.
>
> If, instead, the fair market value of D's interest in X before the distribution did not equal the sum of the distribution paid to D's estate and the fair market value of D's interest in X (not including any post-death earnings) immediately after the distribution, then the alternate valuation date of D's entire interest in X would be the date of the distribution.

Apparently the proposed regulations are attempting to prevent taxpayers gaining an AVD advantage by making distributions that cause a diminution of the value of the decedent's interest in the entity by more than the amount of the distribution. However, until these regulations are published in final form in the Federal Register, the existing regulations apply. If the executor plans to use the AVD, it is advisable to distribute post-death earnings within 6 months of death to remove those earnings from the AVD value.

XI. CONCLUSION

The executor or trustee with S corporation stock must have a working knowledge of the income tax rules for trusts and S corporations. This is a tall order. The job demands active communication with the S corporation'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.

[363] Prop. Reg. § 20.2032-1(f)(3)(i) (2008).
[364] Prop. Reg. § 20.2032-1(c)(5) (2011).

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:

	Current Income Beneficiary	Trust	S Corporation
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.

____

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:

Date	Shareholder Signature	Taxpayer Identification Number	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:

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

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