S Corporation Stock in Trusts and Estates - Preserving the S Election and Other Practical Problems

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I. INTRODUCTION

A. The Importance of S Corporations.

1. Since the repeal of the General Utilities rule by the Tax Reform Act of 1986, the S corporation is frequently the entity of choice for avoiding double taxation on the sale of a business or selected assets or for getting the corporate earnings into the hands of the shareholders.

2. Current income tax savings can be realized because of the spread between the top corporate rate of 34 percent and the top individual rate of 31 percent.

3. Undistributed earnings increase the basis in the S stock.

4. S corporations are not subject to the alternative minimum tax, the accumulated earnings tax, or the personal holding company tax.

5. These advantages may be of greater importance to a trust or estate where the beneficiaries are not employees of the business.

B. Basic Choice of Entity Considerations.

1. Limited liability can make the S corporation more attractive than a partnership or sole proprietorship where an entity other than a C corporation is to be used.

2. An S corporation as a general partner in a limited partnership is attractive in many situations as a way to obtain both limited liability and pass-through treatment without subjecting the entire enterprise to the
disadvantages of S status (for example, the risk of an impermissible shareholder or gain on the in-kind distribution of an asset).

3. S corporation stock may be easier to administer in a trust or estate than a proprietorship or partnership interest.

4. The liquidation, split up, or reorganization of an S corporation can involve more tax cost than a partnership.

5. S corporations cannot have multiple classes of interests whereas partnerships can.

C. S Corporation Qualification Requirements.

1. The corporation must be a domestic corporation.

2. The corporation must have no more than 35 shareholders.

3. The corporation must not be part of an affiliated group (for example, it must not own 80 percent or more of the stock of any corporation).

4. Each shareholder must be an individual, an estate, a grantor trust, a qualified subchapter S trust (QSST), or a voting trust. Corporations, partnerships, nonresident aliens, and other types of trusts are not permitted shareholders.

5. The corporation can have only one class of outstanding shares. Voting and nonvoting common shares are allowed if the right to vote is the only distinction. Preferred shares are not permitted.

6. An election form signed by the corporation and all shareholders must be filed with the Internal Revenue Service no later than 2-1/2 months after the beginning of the first year of S status.

7. The corporation generally cannot have terminated or revoked an S election within the last five years.

D. OSST Requirements.

1. Qualification requirements. §1361(d)(3).
   a. There must be only one income beneficiary at a time.
b. The income beneficiary must be a U.S. citizen or resident.

c. All fiduciary accounting income must be distributed or required to be distributed currently to the income beneficiary. In PLR 9103015 the Internal Revenue Service held that the distribution of income "at least annually" was required for QSST purposes. Payments to or for a spouse or child of the beneficiary are permitted if in satisfaction of the beneficiary's legal obligation. PLR 8907010. The instrument may permit income to be accumulated at any time that the trust is not an S corporation shareholder. PLR 9014008. Income may not, however, be paid to the beneficiary's revocable or grantor trust. PLR 9014008 and PLR 9014008. Undistributed S corporation income is not "income" for QSST purposes and is not subject to the current distribution requirements. PLR 9025011.

d. Corpus must be distributable only to the income beneficiary during the income beneficiary's life. A trust is not a QSST if its terms provide that in the event the trust does not hold shares of an S corporation, the trust may terminate during the life of the current income beneficiary and distribute its corpus to persons other than the current income beneficiary. Rev. Rul. 89-55, 1989-1 C.B. 268. The trust cannot be a QSST where remaindermen as well as current income beneficiaries have Crummey powers of withdrawal. PLR 901687.

e. If the trust terminates during the income beneficiary's life, all the trust assets must be distributable to the income beneficiary.

f. The income beneficiary's income interest must continue until the income beneficiary's death or earlier termination of the trust.

2. The QSST election is made by the beneficiary, not the trustee. §1361(d)(2)(A).


4. The election continues as to each successive income beneficiary unless there is an affirmative refusal to consent to the election. §1361(d)(2)(B)(ii).
E. **Taxation of S Shareholders.**

1. Generally shareholders of an S corporation are taxed in a manner similar to partners in a partnership.

2. S shareholders separately take into account their pro rata shares of items of income, loss, deduction, or credit and their pro rata shares of nonseparately computed income or loss.

3. The character of an item is determined as if received directly from the source from which it was realized by the S corporation.

4. Items are taken into account by the S shareholder in his taxable year in which falls the last day of the S corporation's taxable year.

5. When there is a change in share ownership, items are allocated ratably on a per share, per day basis unless an election is made to close the books. Note that in a partnership the partnership's taxable year closes with respect to a partner who sells his entire interest.

6. A deceased S shareholder must include on his final return his share of items through his date of death. All items for the balance of the year are reported by his estate. Note that in a partnership all income (or loss) in year of death is reported on the fiduciary income tax return and none on the deceased partner's final return.

7. Distributions of the accumulated adjustments account (AAA) are tax free (generally up to one year after termination of S election), although such distributions produce taxable gain to the extent they exceed the shareholder's basis in his stock. Distributions in excess of AAA are taxable if the S corporation is a converted C corporation and has accumulated earnings and profits (AE&P). Beyond AAA and AE&P, distributions are treated as a return of basis, with any excess treated as capital gain. Note that in a partnership distributions of property (other than cash) in excess of basis are not taxed to the partner.

8. Basis of S stock is computed in a manner similar to that used for a partnership. Note that basis is not increased for corporate debt.
9. Losses of an S corporation may only be deducted to the extent of the basis of the S shareholder in his stock and debt.

10. The at-risk rules of section 465 apply to S corporations as well as partnerships.

11. The passive activity loss limitation rules of section 469 allow losses from passive activities to be used only to the extent of net income from passive activities. These rules apply to S shareholders and trusts and estates holding S stock. Material participation is determined by reference to the activity of the fiduciary, except for grantor trusts and QsSTs in which cases the material participation of the beneficiaries is relevant. General Explanation of the Tax Reform Act of 1986, at 242, n. 33.

12. If the S election is terminated on other than the first day of the taxable year and the S corporation is a partner in a partnership, it is considered to have sold its entire interest in the partnership on the last day of the S short year if the normalization election under section 1362(e)(3) is made or the 50 percent ownership change rule of section 1362(e)(6)(D) applies. Prop. Reg. §1.1362-4(c)(5).

II. PLANNING THE ESTATE OF THE S SHAREHOLDER

A. Asking the Right Questions.

1. Does the client own any S stock?

2. Will the S election be continued?

3. Does the S corporation have assets that may produce capital gains?

4. Is the S corporation a converted C corporation with AE&P?

5. Do the S corporation shareholders have buy-sell or other agreements?

6. Do the articles of incorporation or bylaws of the S corporation contain transfer restrictions or other provisions relating to the S status?

7. Has the board of directors of the S corporation adopted resolutions relating to the payment of dividends?
8. Are any of the client's intended beneficiaries nonresident aliens or likely to become bankrupt or wish to pledge their shares?

9. What repercussions will flow if the client disposes of his S stock in a manner that terminates the S election?

10. Will the beneficiaries be content with the S election? Should voting control be separated from beneficial ownership?

11. Does the client own shares in any C corporation that is likely to make an S election?

B. Deciding Whether to Leave the S Stock Outright or in Trust.

1. Outright -- the easy way out.

   a. Lets the beneficiaries step into the decedent's shoes upon distribution by the executor.

   b. Keeps the trustee from being put in an uncomfortable position.

   c. The S corporation may operate with more flexibility by not having a fiduciary as a shareholder.

   d. Permits the use of more stringent shareholder agreements.

2. Advantages of trusts.

   a. Protection and conservation of both the S stock and the S election.

   b. Tax planning opportunities can result from a QSST election through the operation of Subpart E.

   Example: If a bypass trust holds an interest in a partnership that has a capital gain, the gain is taxed to trust and reduces the value of the trust for the remaindermen. If the trust holds S stock and the beneficiary makes the QSST election, capital gains of the S corporation are taxed to the beneficiary (reducing the size of his estate) without reducing the
trust's value. On the other hand, obviously not every beneficiary would be happy with this result.

3. Limitations of trusts.

a. The use of sprinkling trusts and contingent income beneficiary provisions is prohibited.


C. Drafting for Testamentary Flexibility.

1. Assuming nontax considerations do not dictate who should get the stock, consider giving the executor broad discretion to take income tax effects into account in allocating and distributing assets.

a. If S stock is specifically bequeathed or distributions will not be pro rata, the executor should be authorized or directed to make equitable adjustments.

b. Conflicts of interest can arise where the executor is also a beneficiary, in which event directions as opposed to discretion may be more appropriate.

c. Authorize the fiduciary to sell to family members for notes that can be held in a sprinkling trust.

d. Authorize the trustee to divide a trust if needed or desirable in making a QSST election (but do not authorize the trusts to be recombined when S stock is no longer held).

2. A separate "pocket" trust designed to hold S stock may be the best alternative.

a. Allows other assets to be placed in a sprinkling trust.

b. Permits use of different trustees. For example, a corporate fiduciary may be reluctant to serve as trustee over a trust with S stock or may be reluctant to sign a shareholders agreement. It may also be
unacceptable to the family to give a corporate trustee effective control over S stock.

c. If there is a surviving spouse, the trust should be structured as a qualified terminable interest property (QTIP) trust. A QTIP trust by its very nature meets all of the QSST requirements (although the reverse is not true). This gives the flexibility to qualify the S stock for a marital deduction and use the unified credit to shelter other assets (for example, where the S corporation is not likely to appreciate because it is distributing all of its earnings to its shareholders).

d. Consider authorization for the trustee of a credit shelter or other nonmarital deduction QSST to purchase all or a portion of the S corporation stock that is allocated to a marital trust. This may be desirable for control purposes where because of values only a portion of the S stock could be allocated to the credit shelter trust. If the purchase is from a marital trust for a promissory note, estate-freezing opportunities exist in the surviving spouse's estate.

3. Trusts for the benefit of children (or grandchildren).

a. The typical "pot" trust for the collective benefit of the children until the youngest reaches a specified age will not meet the QSST requirements.

b. The safest approach is a separate simple trust for each beneficiary. Although a complex trust is permissible, the simple trust approach eliminates the potential for losing S status if the trustee fails to distribute all income (or misclassifies a receipt as principal instead of income). Note that the trust may permit income to be accumulated at any time that it is not an S shareholder. PLR 9014008.

c. A trust satisfying the separate share rule of section 663(c) can be used where it is desired to avoid the extra fiduciary fees that would result from the use of separate trusts. §1361(d)(3).
d. The will can provide that a non-QSST will convert into a QSST upon receiving S stock. For example, a sprinkling trust for a specific child and his or her issue can automatically convert into a simple trust for the child. However, the will cannot provide that the trust changes back to a sprinkling trust after it no longer holds S stock. See Rev. Rul. 89-55, 1989-1 C.B. 268.

4. Preparing for disclaimers.

a. Consider a special trust for S stock with dispositive provisions in the event of a disclaimer. For instance, a disclaimer of S stock from a marital trust to a credit shelter bypass trust will cause a loss of S status if the credit shelter trust is not in QSST form.

b. Maximum S election tax-planning benefits (for example, basis adjustments) will not be available for a single trust that has made a partial QTIP election.

c. A disclaimer from a marital trust to a credit shelter bypass trust should be effective even if it relates just to S stock.

D. Irrevocable Life Insurance Trust.

1. Although an insurance trust will initially have only cash upon the insured's death, it should be drafted with the expectation that the trustee will purchase illiquid assets, including S stock, from the probate estate.

a. The insurance provides liquidity for the payment of estate taxes and other administration expenses.

b. If the S stock is likely to increase substantially in value, it may be desirable to hold it in a trust designed to be exempt from further estate and generation-skipping transfer taxes.

c. Be sure to provide for the same flexibility as in a testamentary trust, that is, include provisions for separate trusts which qualify as QSSTs or provide appropriate fiduciary discretion.
2. Consider a split-dollar arrangement between the trust and the S Corporation.

a. Permits the equivalent of an interest-free loan from the corporation to the trust without being characterized as such. See Rev. Rul. 64-328, 1964-2 C.B. 11.

b. Reduces the trust's share of the premium payments to a relatively nominal amount, thereby facilitating the effective use of Crummey annual withdrawal powers to shelter the annual premium-related gifts.

c. Particularly effective in the case of second-to-die life insurance because of the low premiums and even lower P.S. 38 costs (the joint and survivor equivalent of P.S. 58).

d. There is a concern that the dividends or cash value buildup in the policy (to the extent in excess of the amounts to be repaid to the corporation) will be taxable to the insured or the trust. See Rev. Rul. 66-110, 1966-1 C.B. 12.

e. Where the insured's interest in a policy was forfeitable until a certain date, at which time the employer's interest in the policy was "rolled out" to the employee, the Internal Revenue Service has ruled that the net value of the policy at the time of the rollout was taxable to the employee under section 83(a). PLR 7916029 and PLR 8310027.

f. Even if the employee or the trust is subject to income tax on the constructive transfer of the cash value buildup, the net effect may be a wash because of the deductibility to the corporation.

g. Care must be taken that the rollout of the corporation's interest in the policy does not constitute a transfer for value to the trust under section 101(a)(2). Use of a collateral assignment split-dollar arrangement (rather than the endorsement method) will avoid the need for a transfer of the policy and thus lessen this potential exposure (and may also lessen the likelihood of taxation of the policy buildup as discussed above).

h. The Internal Revenue Service has approved a split-dollar arrangement between a
corporation and a shareholder (as shareholder), in which case the constructive benefits to the insured are treated as dividends rather than compensation (thereby avoiding the application of section 83). Rev. Rul. 79-50, 1979-1 C.B. 138. See also Johnson v. Commissioner, 74 T.C. 1316 (1980). Assuming the S corporation has sufficient AAA, this arrangement may have preferable income tax consequences, but beware of inadvertently creating a second class of stock where there is more than one shareholder.

E. Inter Vivos Transfers.

1. Many clients prefer the simplicity of simply making direct gifts of S stock to children or grandchildren.

   a. Gifts can be outright or in Uniform Transfers to Minors Act custodianships.

   b. A section 2503(c) trust will qualify as a QSST as long as all income is distributed. A trust for a single beneficiary, all the contributions to which are sheltered by a Crummey withdrawal power, will be treated as a section 678 trust by the Internal Revenue Service and thus as an eligible S shareholder.

   c. Standard principles of valuation apply, including potential minority and lack of marketability discounts.

   d. If the client is concerned about maintaining control, he can create and give away nonvoting shares without violating the one-class-of-stock rule of section 1361(b)(1)(D).

2. If a client's children (or grandchildren) are employed by an S corporation of which the client is the principal shareholder, the lower generation employees should receive maximum reasonable compensation, and the client should receive minimum reasonable compensation.

   a. Be aware of the general income tax rules on reasonable compensation, and of section 1366(e), permitting the Internal Revenue Service to adjust the S corporation income tax consequences within the family group.
b. This is an easy opportunity to derive modest transfer tax benefits, but should not be abused.

III. POSTMORTEM PLANNING WITH S CORPORATIONS

A. Advantages of Holding S Stock in the Estate Rather Than Distributing to a Trust.

1. An estate may hold S stock indefinitely, subject only to the prolonged administration rules of section 1.641(b)-3(a) of the regulations.

   a. An estate that is kept open to hold S stock during the period of estate tax deferral under section 6166 is a permissible shareholder. Rev. Rul. 76-23, 1976-1 C.B. 264.

   b. The IRS will not issue an advance ruling on whether the administration of an estate is unduly prolonged. Rev. Proc. 91-3, 1991-1 I.R.B. 52.

   c. If administration is unduly prolonged, status as an estate ceases. Brown v. United States, 890 F.2d 1329 (5th Cir. 1989); Old Virginia Brick Co. v. Commissioner, 367 F.2d 276 (4th Cir. 1966). If the entity is then treated as a trust, eligibility as an S shareholder may be lost.

2. An estate may "sprinkle" income to its beneficiaries.

   a. There is no requirement that the beneficiaries themselves be permitted shareholders.

   b. Trusts that would otherwise not be permitted shareholders can receive S income from an estate.

3. An estate can elect a fiscal year, thus permitting limited deferral of income. §441.

   a. This can be particularly advantageous if a sizeable distribution of AE&P is to be made in order to provide liquidity to the estate.

   b. Staggered fiscal years may create flexibility in matching passive activity income with passive activity losses.
4. An estate (or living trust that receives the residue of the estate) does not pay estimated taxes for any taxable year ending before the date that is two years after the decedent's death. §6654(1)(2).

B. Initial S Election by Estate as Sole Shareholder.

1. The executor should be alert to this opportunity.
   a. If the decedent dies within 2-1/2 months of the beginning of the C corporation's taxable year, a retroactive election apparently can be made.
   b. A retroactive election has the effect of causing the newly elected S corporation's income attributable to the predeath portion of the year to become taxable on the decedent's final return.

2. Significant deferral is available under certain circumstances.

   Example: Decedent dies March 1, 1991 owning a calendar year corporation. Decedent's will leaves Estate outright to Beneficiaries. By March 15, 1991, Executor files Form 2553 making an S election. Executor selects a fiscal year of March 31 for Estate. Income of S corporation for period from March 1, 1991 through December 31, 1991 goes on Estate's Form 1041 for year ended March 31, 1992. S corporation income received by Estate after April 1, 1991 and distributed to Beneficiaries will be reflected on their K-1s for Estate's March 31, 1992 fiscal year end and reported on their calendar 1992 returns. Result is that Beneficiaries receive income as early as April, 1991 but do not pay income taxes on it until April, 1993.

3. Ideal candidate is an estate that qualifies for section 6166 deferral and owns a C corporation with appreciated long-term assets.
   a. Making the S election begins the 10-year built-in gain period.
   b. Current earnings of the corporation can be withdrawn by the estate in order to pay
interest and principal under the section 6166 election.

c. Upon expiration of the deferral period (assuming at least 10 years had been elected), the corporation's assets can be sold and the corporation liquidated without double tax.

4. Under section 1361(c)(2)(A)(ii) a grantor trust holding stock has two years from the date of the grantor's death to participate in an S election, assuming the trust is fully includible in the grantor's gross estate.

a. Because the trust is the actual shareholder, it will exercise all voting rights in making the election from the standpoint of the corporation. However, the shareholder consent to the election must be made by the grantor's executor because the estate of the grantor is treated as the shareholder for eligibility purposes, §1361(c)(2)(B)(ii).

b. Although it is not clear who bears the income tax burden (the estate or the trust), the benefits (dividends) go to the trust's beneficiaries. Most commentators take the position that the trust receives the K-1 and bears the income tax burden and that the deemed owner rules only apply for eligibility purposes.

c. Apparently a QSST election cannot be made by the grantor trust during the two-year period the estate is treated as the shareholder even if the trust would otherwise qualify, Prop. Reg. §1.1361-1A(i)(e).

C. **Use of Disclaimers.**

1. If all trusts under the plan are impermissible shareholders, a disclaimer may enable the stock to pass to an eligible shareholder.

   Example: Stock goes to sprinkling trust lasting for life of Child, terminating at Child's death in favor of Grandchildren. If Child disclaims stock, it will pass directly to Grandchildren and S election continues.

2. If the S stock is left in trust with other assets and it is desired to disclaim only the S stock,
the stock must be "removed from the trust" in order to be a qualified disclaimer. Reg. §25.2518-3(a)(2). For this purpose it should be permissible for the S stock to pass by reason of the disclaimer to a separate trust, qualifying as a QSST for the disclaimant's child.

3. Disclaimers relate back to the date of death, and as a result a disclaimer may be used after the fact to shift the income tax burden of the S income.

4. See PLR 9025086 and PLR 9045060 as examples of the use of disclaimers to meet the QSST requirements. Reformations can also be used to satisfy the criteria. PLR 8907004, PLR 9032007, and PLR 9103015.

D. Subchapter J Issues Where Stock is an Asset of the Residuary Estate.

1. While S stock is held in the estate, the S corporation income allocable to the estate is includible by the estate on its Form 1041.

2. If distributions are made by the estate to its beneficiaries, distributable net income (DNI) is carried out to the beneficiaries even though there may be no fiduciary accounting income.

3. If no distributions are made by the estate, the estate must pay the income taxes attributable to the S income allocated to the estate even though the S corporation may not have paid any dividends. These income taxes are probably chargeable to the principal account under the law of most states.

4. Unless the S stock is to be distributed pro rata to the beneficiaries, inequities can arise.

   Example: Will gives Executor authority to allocate assets to the beneficiaries. Executor allocates S stock to A and marketable securities to B. Taxes on S corporation income allocable to portion of year preceding distribution to A are borne equally by A and B.

5. The fiduciary should consider the income tax effects in determining distribution date values and in timing the distribution of the S stock.
6. An equitable adjustment may be appropriate if the income tax effects were not taken into account in a nonfractional distribution of the S stock.

7. For S stock going into trust, equitable adjustments between the income beneficiary and the remainderman may be necessary depending upon the circumstances.

E. Subchapter J Issues Where Stock is Specifically Bequeathed.

1. Until the S stock is distributed to the legatee, the S corporation income allocable to the estate is includible on its Form 1041. Is the result different if under state law title to personal property is deemed to pass automatically to the legatee at the decedent's death?

2. Absent the ability of the executor to make an equitable adjustment of some type, the residuary beneficiaries will bear the full expense of the income taxes attributable to the S income that is retained by the S corporation, whereas the amount of such income will increase the basis of the S stock.

3. Even where the S corporation pays out its earnings, the residuary beneficiaries can suffer.

Example: Will leaves S stock to A, residue to B. S corporation has income of $100 which it distributes to Estate. Estate also has $100 of taxable dividends and $100 of tax-exempt interest. Estate distributes the $100 S dividend to A and the other $200 to B. A will have taxable income of only $66.66 \[ (300 - 100) \times \frac{1}{3} = 66.66 \]. B will have taxable income of $133.33 \[ (300 - 100) \times \frac{2}{3} = 133.33 \] instead of $100.

See, however, Ferguson, Freeland & Stephens, Federal Income Taxation of Estates and Beneficiaries, at pp. 572 – 573, which concludes in these circumstances that the S corporation dividend would be treated as specifically allocated to A within the meaning of Regulation section 1.661(b)-1 and section 1.662(b)-1, with the result that the S corporation distribution would be traced to A and fully taxable to A if the dividend is distributed in the year in which it is received by the estate.
4. Conversely, if the S corporation suffers a loss, the loss belongs to the estate as long as the S stock is still held by the executor.

a. Whether the loss can be used may depend upon the finding of material participation by the executor.

b. The loss may shelter current income that belongs to the residual beneficiary.

5. These mismatching problems can be avoided or minimized by having the executor distribute the S stock as quickly as possible.

a. The distribution of the S stock itself does not carry out DNI. §663(a).

b. Refunding bonds and other security devices can be used to protect the fiduciary (for example, a grantor trust created by the legatee may be used if there is a concern that a pledge agreement or escrow for the benefit of the estate would constitute an impermissible shareholder).

F. S Stock as an Asset of the Marital Trust.

1. If the estate plan divides into a "sprinkling" credit shelter trust and a marital trust, the marital trust is the only permissible shareholder of the two. If death taxes are payable from the credit shelter or other nonmarital trust and it is desired to use S stock in a section 303 redemption to fund such taxes, theoretically the trust would have to be the holder of the stock at least momentarily prior to the redemption, (see §303(b)(3)), but it is not a permissible shareholder.

2. A QTIP trust by its very nature has all the requirements of a QSST, but the surviving spouse must be amenable to the QSST election.

3. A testamentary general power of appointment trust likewise can qualify as a QSST.

4. A marital trust over which the spouse is given an unlimited power of withdrawal is a section 678 grantor-type trust but also meets the QSST requirements.
a. Because the trust is a permitted shareholder as a result of section 678, a QSST election cannot be made. Prop. Reg. §1.1361-1A(i)(3).

b. An advantage of making the QSST election is that the S election will automatically continue if there is a successive income beneficiary. Otherwise, the two-year rule of section 1361(c)(2)(A)(ii) applies. If the surviving spouse has a messy estate with tax problems, the trustee of the marital trust may not be willing to distribute within two years of the surviving spouse's death. A release of the power of withdrawal may be desirable to permit a QSST election.

5. Will the QSST election continue if the assets of the marital trust are added to another trust that has not itself made a QSST election but is eligible to do so? What if the marital trust simply divides into separate trusts for the children at the spouse's death? What if the marital trust continues in trust for a particular child? What if the marital trust is distributable outright, but there will be delays beyond the 60-day or two-year period (for example, while awaiting the estate tax closing letter)? The successive income beneficiary rules are not very clear. See Prop. Reg. §1.1361-1A(i)(5).

6. A general power of appointment trust over which the spouse is given a special lifetime power of appointment in favor of children, charity, or others would not appear to qualify for QSST treatment.

a. Section 1361(d)(3)(A)(ii) requires that any corpus distributed during the life of the income beneficiary may be distributed only to such beneficiary.

b. A disclaimer of the special power would not be a qualified disclaimer under section 2518 because of the retained general power (see Reg. §25.2518-3(d), Ex. (9)), but as long as it is effective under state law it should not matter because the retention of the testamentary general power prevents a completed gift for gift tax purposes, and by hypothesis the trust will be fully includible in the spouse's estate in any event.
7. An estate trust also qualifies for QSST treatment, but the trustee must be attentive to the requirement that all trust income be actually distributed to the spouse currently.

8. A surviving spouse may be reluctant to make the QSST election without assurance that the S corporation will make sufficient distributions of its earnings, particularly if capital gains are likely at the S corporation level.

   a. The potential problems are aggravated if the S corporation is a partner in partnerships that are generating taxable income but not distributing earnings.

   b. If extraordinary dividends are principal and the spouse is only entitled to income, the spouse may want a say in what capital assets the S corporation sells.

9. Because the S stock may generate little or no income, the spouse should be given the right to force conversion.

   a. This may present practical problems in maintaining the S election unless adequately dealt with in the shareholders agreement.

   b. If the spouse is not given this conversion right, the marital deduction may be jeopardized (for example, if the marital trust is a QTIP or a general power of appointment trust).

G. S Stock as an Asset of the Credit Shelter Trust.

1. If the estate plan divides into a QTIP marital and a credit shelter trust for the sole benefit of the spouse for life, which otherwise qualifies as a QSST, the executor has more flexibility to plan.

2. The spouse need not be given the right to force conversion of S stock in the credit shelter trust, but note the position of the Internal Revenue Service that failure of an income beneficiary to enforce a reasonable rate of return mandated by state law results in taxable gifts to the remaindermen. See PLR 8923007 and PLR 9015024. The instrument should specifically authorize the retention of the S stock even if it is nonincome producing.
3. A single trust over which a partial QTIP election can be made is not an appropriate planning technique where S stock is involved, as the credit shelter portion may be encumbered with marital deduction savings provisions that restrict the benefits of QSST planning. See, however, PLR 9023015, which sanctions the use of a provision requiring the conversion of nonincome-producing property which is applicable by its terms only to that portion of the trust for which a QTIP election is made.

4. A QSST election over a credit shelter trust holding stock in an S corporation that pays little or no dividends results in indirect transfers to the remaindermen without the payment of gift taxes by virtue of the income taxes paid by the surviving spouse on the S earnings that were retained by the S corporation. To what extent do Dickman-like theories apply if the spouse is in effective control of the S corporation's dividend policies?

5. Because of the interplay of the 65-day rule of section 663(b) and section 1361(d)(4)(B), the trustee of a QSST has the unilateral ability for 65 days to terminate retroactively the S election to the beginning of the current taxable year.

H. Principal and Income Issues.

1. Where the governing instrument is silent, state law (for example, Uniform Principal and Income Act) determines whether an S corporation distribution is income or principal for fiduciary accounting purposes and which account bears the expense of the income taxes attributable to the S corporation income (whether or not distributed).

2. All ordinary and extraordinary cash dividends and dividends in kind (other than the corporation's own shares) are generally deemed income.

3. When assets of a corporation are liquidated, amounts paid as cash dividends declared before such liquidation are generally deemed income, and all other amounts paid on disbursement of the corporate assets to the stockholders are generally deemed principal.

4. All disbursements of corporate assets to the stockholders, whenever made, which are designated by the corporation as a return of capital or
division of corporate property are generally deemed principal.

5. Expenses incurred as carrying charges on an unproductive estate are generally paid out of principal. An unproductive estate under the Uniform Principal and Income Act is one that for more than a year has not produced an average net income of at least one percent per annum of its value and the trustee is under a duty to change the form of investment.

6. Earnings accumulated by the S corporation over the years and then distributed in one large cash dividend would not be principal, although presumably the principal account would be entitled to reimbursement for any income taxes it had borne on such income as it was earned.

7. Does the fiduciary who may be in control of the S corporation have a duty to cause the corporation to make a designation concerning a return of capital?

8. Is the sale of a division and a subsequent distribution of part but not all of the proceeds within the liquidation rules of the Uniform Principal and Income Act? If not, what if all the proceeds were distributed? What if none of the proceeds were distributed but regular dividends were paid -- who bears the income taxes on the sale, the income beneficiary or the remainderman?

9. What is the effect of including provisions in the governing instrument granting the fiduciary the right to determine what is income and principal?

10. Rule of thumb suggested by John B. Huffaker:

   One fairly logical rule to follow ... would be to allocate the tax burden to the income distribution if an amount is distributed and to principal if it is not. Then when there is an income distribution in excess of current income, principal could be reimbursed. This assumes the executor has discretion.

11. The difficulty in determining what is income and what is principal can place the fiduciary in a difficult spot, particularly in the QSST setting.

a. To maintain QSST status all of the income (within the meaning of section 643(b)) must be distributed or required to be distributed currently. §1361(d)(3)(B).

b. Income means income determined under the terms of the governing instrument and applicable local law. Reg. §1.643(b)-1.

c. Presumably a simple trust satisfies the test because of its governing instrument requirement and eliminates the possibility that QSST status could be accidentally lost.

d. With a complex trust as a QSST the trustee should probably lean toward classifying a receipt as income and not principal. The S corporation should consider having the trustee sign an agreement at the time of the S election agreeing to certify each year that the required distributions have been made.

e. If not all income is distributed by the QSST, an inadvertent termination ruling may be requested under section 1362(f).

IV. INADVERTENT TERMINATIONS

A. Typical Terminating Events Involving Trusts.


2. Failure to make the QSST election upon transfer of shares to an otherwise eligible trust. PLR 9139010.

3. Failure of QSST to distribute all income. PLR 9042010.

4. Retention of S stock beyond the 60-day or two-year period. PLR 9111044 and PLR 9119034.

5. Failure of secondary beneficiaries to make QSST elections after the death of the primary QSST beneficiary.
B. **Procedure to Continue Election.**

1. Section 1362(f) provides that if the Internal Revenue Service determines the termination was inadvertent, if steps were taken within a reasonable period of time after discovery of the event so that the corporation is once more an S corporation, and if the corporation and all shareholders agree to make any necessary adjustments, the S election of the corporation shall be treated as continuing notwithstanding the terminating event.


3. However, formal private letter ruling procedures must be followed to obtain this relief. Rev. Proc. 91-1, 1991-1 C.B. 9.


C. **Alternatives to IRS Ruling.**

1. Playing the audit lottery is dangerous. Overlooking a possible inadvertent termination and continuing to file as an S corporation can be detrimental for all parties. Particular problems can arise later upon a sale of all or a portion of the stock or assets of the corporation.

2. Foregoing the continuation of the S election can have adverse tax consequences, such as the loss of future increases in the basis of the stock.

3. Re-electing S status in five years may be inadvisable because of the loss of the intervening benefits and the beginning of a new built-in gain period under section 1374.

V. **UNANSWERED QUESTIONS**

A. **Manner of Reporting.**

1. What K-1s does the QSST beneficiary receive? Does the S corporation issue a K-1 to the trustee or the QSST beneficiary?

2. Is gain (or loss) on the sale of S stock by a QSST taxed to the trust or the beneficiary? Is
the result different if only a portion of the S stock is sold by the trust?

3. Is there anything to report when S stock held in a GRIT-type trust grantor trust is repurchased by the grantor?

B. Other Issues.

1. Does a QTIP marital trust always qualify for QSST treatment?

2. How do the successive income beneficiary rules apply at the death of the QSST beneficiary when the trust is subdivided into a number of separate trusts or is distributable to a number of beneficiaries?

3. How is income ascertained when the QSST is included in the estate of the income beneficiary and the trust must contribute its share of death taxes?

4. Who makes the QSST election when S stock is held in an inter vivos QTIP trust? To whom is the income taxable?