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Estate Planning for Subchapter S Corporation Stock

Barbara B. Hipple
My topic today, “Estate Planning for Subchapter S Corporation Stock”, concerns the unique estate planning problems and opportunities which exist when stock in a Subchapter S corporation is an asset in a client’s estate. Estate planning for this kind of asset can involve not only pre-death planning for maximum tax benefits, simplification of administration and ultimate transfer to beneficiaries, but also post-death planning.

Initially, it should be noted that a Subchapter S corporation is, in fact, a corporation for all purposes, including tax purposes. The Treasury Regulations expressly state that a Subchapter S corporation is recognized as a corporation under Subchapter C of the Internal Revenue Code, the basic corporate income tax subchapter. Election of Subchapter S status for a corporation merely engrafts certain additional benefits and restrictions, some of which bear resemblance to certain of the partnership tax provisions, on the normal corporate tax rules. Nonetheless, the Subchapter S corporation is not taxed as if it were a partnership. Although partnership and Subchapter S corporation tax treatment are in many ways similar, there are also many differences. So, it would be incorrect to think of a Subchapter S corporation as being “like” a partnership for tax purposes, generally.

All of you are undoubtedly familiar with the basic rules of Subchapter S, but I would like to review briefly the fundamental tax treatment of the Subchapter S corporation before we specifically consider estate planning for Subchapter S corporation stock. If a qualifying corporation elects to be treated as a small business corporation under Subchapter S, it will be treated essentially as a conduit for federal income tax purposes and will not be subject to income tax at the corporate level, except with regard to a portion of any capital gains recognized at that level. As a result, for the most part, corporate income passes through the corporate entity and is taxed directly to the shareholders. Corporate losses also pass through to, and are deductible as trade or business losses of, individual shareholders. However, both the pass-through of income and the pass-through of losses are subject to special limitations and rules.

Thus, for example, each stockholder in the electing small business corporation must include as dividend income on his personal income tax return his share of any distributions of current corporate earnings and profits received during the tax year of the corporation, and he must also include, as a constructive dividend, his proportionate share
of the remaining undistributed taxable income of the corporation at the end of its tax year. The corporation's distributed and undistributed income is taxed to the shareholder for his tax year with which, or within which, the fiscal year of the corporation ends. These actual and constructive distribution rules for tax purposes also apply to corporate capital gains realized during the year, so a proportionate part of each actual distribution, as well as a proportionate part of the undistributed income at the end of the corporation's tax year, includes corporate capital gains, if there are any.

To the extent a shareholder is taxed on undistributed corporate income, that income (which has been retained at the corporate level) becomes previously taxed income, or P.T.I. (It is interesting that the Code itself does not use the term "previously taxed income" but, rather, refers to "undistributed taxable income previously taxed to the shareholder".) (To account for the fact that the Subchapter S shareholder has been taxed on income which he has not actually received from the corporation, the shareholder's basis in his stock in the corporation is increased by his proportionate share of the P.T.I.)

Because a corporation is usually unable to precisely determine its total income as of the last day of its taxable year until sometime after the date and would, therefore, have some difficulty in distributing all of its income even if it desired to do so, cash distributions during the first two-and-one-half months of the next fiscal year of a Subchapter S corporation may be treated as distributions of P.T.I. of the previous year, thereby becoming tax-free distributions to the shareholders instead of distributions out of current earnings. A distribution of P.T.I. must always be made in cash. An in-kind distribution can never be a distribution of P.T.I. Furthermore, a distribution of P.T.I. to a shareholder, whenever made, results in a proportionate reduction in that shareholder's basis in his Subchapter S stock. This combination of constructive dividends, with consequent basis adjustments, contributes to the assumption made by many persons that a Subchapter S corporation is treated like a partnership for tax purposes.

A major departure from partnership tax treatment occurs on the disposition of the stock of a Subchapter S corporation. A stockholder's P.T.I. account with the corporation, which he can draw down in cash on a tax-free basis (having already paid tax on that amount) is personal to the shareholder and may not be transferred to anyone else by any transfer of the stock, whether a sale, a gift, or an involuntary transfer caused by death of the shareholder. Any such transfer of the Subchapter S stock, whether voluntary or involuntary, will trigger the automatic elimination of the P.T.I. account of the transferor-stockholder. As we shall discuss, this treatment of the P.T.I. account of the stockholder as being purely personal to him is a major estate planning problem.

If a Subchapter S corporation makes a distribution in excess of its
current earnings and profits in a given fiscal year, that excess distribution, if in cash, is considered, first, to be a distribution of the shareholder's P.T.I. account and, thereafter, a distribution of accumulated earnings and profits from prior years of the corporation, either to the extent the corporation has accumulated earnings and profits for years in which it had not elected Subchapter S status or because, for example, it had claimed accelerated depreciation on its assets, had tax exempt income or had received life insurance proceeds. The fact that a distribution of P.T.I. may only be made in cash can cause some unexpected results.

If a Subchapter S corporation makes a distribution partly in cash and partly in property, the cash distribution will first be treated as a distribution of current earnings and profits and, then, to the extent it exceeds current earnings and profits, as a distribution of P.T.I. The in-kind distribution will then be considered to be a distribution of any accumulated earnings and profits, and, thereafter, a distribution in return of basis under section 301(c)(3). This means that a corporation desiring to make a distribution of P.T.I., but without sufficient cash to do so, either must borrow the funds in order to be able to make a cash distribution or must sell one or more corporate assets, triggering recognition of any inherent capital gains. The capital gains realized by the corporation on such a sale will, of course, also pass through to the shareholders as income for the current year.

If the Subchapter S corporation suffers a net operating loss in any year, that loss passes through to its shareholders on a proportionate basis and each of the shareholders must reduce his basis in his Subchapter S stock by the amount of the loss claimed on his personal income tax return. However, a shareholder may not claim a deduction which would reduce his Subchapter S stock basis below zero. Although this rule is also similar to the partnership rule, it differs from the partnership rule in that the basis of a shareholder to a Subchapter S corporation does not include his proportionate share of corporate liabilities while a partner's basis in his partnership interest does include his proportionate share of partnership liabilities.

In order to be treated as a Subchapter S corporation, the corporation and its shareholders must elect that status and satisfy the particular requirements set out in the relevant provisions of the Internal Revenue Code. As a result of changes to the Code made by both the Tax Reform Act of 1976 and the Revenue Act of 1978, these requirements for the Subchapter S election have been relaxed in ways that particularly aid estate planning. The number of shareholders a Subchapter S corporation can have has been increased from ten to fifteen. The permitted types of shareholders have been expanded so that, in addition to individuals and estates, Subchapter S shareholders may also include a grantor trust during the lifetime of the grantor; a grantor trust which continues after the death of the grantor, but only for a period of sixty
days unless the entire corpus of the trust is includable in the gross
estate of the grantor for federal and state estate tax purposes, in which
case it can be a stockholder for a period of two years following the
death of the grantor; a voting trust; and, for a sixty-day period be-
ginning on the date on which Subchapter S stock is transferred by the
estate representative to the trust, any other trust receiving Subchapter S
corporation stock under the terms of the deceased stockholder’s will.
The pre-1976 requirements that Subchapter S shareholders be citizens
and residents of the United States and that a Subchapter S corporation
have only one class of stock have been continued.

Once made, the Subchapter S election is effective for the year of the
election and for all subsequent years until the election is voluntarily
or involuntarily terminated. Termination can be affected by the
unanimous consent of the shareholders or by the transfer of any of the
Subchapter S corporation stock to a new shareholder who affirmatively
refuses to consent to the election on or before the 60th day after the
date on which he acquires the stock. The pre-1976 rule automatically
terminated the election unless the new shareholder affirmatively elected
to continue the Subchapter S status within 60 days after he acquired
the stock. That old rule led to so many unintentional terminations that
the burden was shifted by the Tax Reform Act of 1976 to require
affirmative action by the acquiring shareholder to terminate the election.
Consistently, the personal representative of a deceased shareholder
whose estate includes Subchapter S stock must also affirmatively act to
terminate the election within 60 days after the day on which he qualified
or within 60 days after the last day of the tax year of the corporation
during which the decedent died, whichever is earlier. This requirement
should be carefully noted because it is often assumed that no action
need be taken with regard to the termination of the Subchapter S
election until sometime after the personal representative for the estate
has been duly appointed and qualified. However, because the statute
expressly states that it is the earlier of 60 days after appointment of
the representative or 60 days after the last day of the tax year of the
corporation during which the decedent died, it is possible that a
decedent could die late in the fiscal year of a Subchapter S corporation
and the executor or administrator of his estate not be appointed until
some time after the running of the 60-day period from the end of the
corporation’s fiscal year.

The details of the election and the taxation of a Subchapter S cor-
poration are, of course, much more complex than this brief summary
would indicate, but this summary is intended only to provide a frame-
work for our consideration of some of the estate planning possibilities
and requirements when the client owns Subchapter S stock. Those
estate planning considerations will be dealt with for three distinct situa-
tions: pre-death planning for a client owning Subchapter S stock; post-
death planning for an estate having Subchapter S stock as an asset; and, finally, contemplation of death planning for a client owning Subchapter S stock.

Pre-death planning for a client holding stock in a Subchapter S corporation forces the estate planner to consider the same general problems he would confront in planning for a client owning stock in any closely-held corporation. However, several currently popular and frequently used estate planning devices for closely-held corporations are either not available or must be substantially modified when pre-death planning is done for a client holding Subchapter S corporation stock. For example, the currently fashionable estate-freezing technique for a closely-held corporation, which involves either a recapitalization with preferred stock or the creation of a holding company to fix the value of the stock for estate tax purposes, cannot be used for a Subchapter S corporation, since the corporation can have only one class of stock and cannot have a corporation as a shareholder.

Also, the special characteristics of Subchapter S stock require that considerations not relevant for closely-held corporations generally be taken into account. Perhaps the most crucial of these additional considerations, and the one which can create the most difficulty in planning, is the one mentioned a few minutes ago—that the death of a stockholder in a Subchapter S corporation terminates his P.T.I. account. Termination of the P.T.I. account of the shareholder would also occur prior to his death upon his transfer or other disposition of that stock. Therefore, regardless of whether the stock is to be held until the death of a client or is to be disposed of earlier, sufficient cash should usually be distributed from the Subchapter S corporation to remove the client’s P.T.I. account, either prior to his death or prior to the pre-death transfer. If the P.T.I. has not been withdrawn before the stockholder dies or makes a gift of the stock, additional adverse tax consequences could result because the value of the stock for estate or gift tax purposes would be higher as a result of these retained earnings, unless valuation of the stock is done solely on an earnings projection. Obviously, if the Subchapter S corporation has sufficient liquid assets to make the necessary cash payments, then withdrawal of the P.T.I. account amount is a very simple matter. Unfortunately, the typical Subchapter S corporation will not have sufficient cash to make distributions to eliminate the P.T.I. account and still have enough cash left on hand to meet other corporate needs. Therefore, additional cash to draw out the P.T.I. must often be found.

One technique to accomplish this result which has been attempted on a number of occasions, with mixed results, is to structure a shareholder loan. Thus, a distribution of cash might be made from the corporation to eliminate the P.T.I. of a shareholder, who could then loan back to the corporation an amount necessary to provide the corporation with
operating funds. As an alternative, the transaction might be structured as a loan to the corporation to provide it with funds in excess of its operating needs, followed by a distribution of cash to the shareholders designed to reduce or eliminate the P.T.I. The Internal Revenue Service is, of course, aware of both of these techniques and has attempted to curb their use. Initially, the Service argued that a loan transaction between a shareholder and a Subchapter S corporation following receipt by the shareholder of a cash distribution of his P.T.I. account created a second class of stock, represented by the note or other security instrument used in conjunction with the loan. The existence of a second class of stock would terminate the Subchapter S election automatically. However, this line of reasoning was generally unsuccessful. The Service has recently adopted a new approach, which treats the distribution of cash to the shareholders, followed by a shareholders' loan back to the corporation, as a single transaction which amounts to the distribution by the corporation of the note itself, a non-cash distribution that would not qualify to remove P.T.I. The guidelines in this area are few and controversy with the Service should be expected.

If the necessary cash to make a distribution of P.T.I. is not available, it would be preferable to structure any loan to the corporation from a third party rather than from the shareholder receiving the distribution of P.T.I. If it is nevertheless necessary for the shareholder whose P.T.I. is being removed to assume or guarantee the third party loan, interposition of the third party to "improve" the transaction as far as the Service would be concerned would be problematic.

If a buy-sell agreement between the shareholders or between the shareholders and the corporation is contemplated for post-death redemption or disposition purposes or to prevent termination of the Subchapter S election, certain additional terms must be included in the agreement to make it more likely to accomplish the objectives of the parties. For example, any earnings definition in a buy-sell agreement for a Subchapter S corporation should take into account the fact that the corporation is not subject to federal income tax, and therefore, will produce higher earnings than would a comparable non-Subchapter S corporation. Similarly, the salary and other compensation benefit figures of the Subchapter S corporation must be readjusted in the agreement because shareholder-employees will not necessarily receive full compensation for their services to the corporation since they, as shareholders, are taxed on the corporate income nonetheless. Also, in determining the value of the Subchapter S corporate stock in the buy-sell agreement, consideration should be given to the fact that a disposition of the stock at any time other than the end of the fiscal year of the corporation will cause the recipient of the stock, as the owner at the end of the fiscal year, to be taxed on all of the undistributed income of the corporation for the full tax year, including the portion of the
year prior to his acquisition. This potential additional tax liability should be taken into account in the valuation formula.

At one time, there was some question whether a buy-sell agreement would be construed to create a second class of stock if it gave different shareholders different rights. It now appears that the Service has abandoned this position and no recent cases reflect that argument. Nonetheless, the possibility that this argument could be raised again should not be ignored entirely, because any agreement which provides markedly different rights for one or more shareholders than for the rest of the shareholders of that single class of stock could be claimed by the Service to have created a second class of stock.

Despite the fact that, after the Tax Reform Act of 1976, a new Subchapter S stockholder must affirmatively act to terminate the Subchapter S election following a transfer of Subchapter S stock to him, it is still necessary to carefully plan in the agreement for the continuation or the termination of the election on the transfer of the stock. Otherwise, the new stockholder might unilaterally terminate the election if a termination would be of benefit to him, even though it might be detrimental to the other shareholders. It would even be possible for the new shareholder to extract some concessions from the other shareholders for his forebearance from termination in the absence of a binding agreement. Therefore, rather than leave this issue unresolved, a buy-sell agreement should expressly anticipate the potential termination of the election on transfer of the stock. A provision in the agreement precluding transfer without the consent of the other shareholders might be of some benefit, but would not itself be sufficient protection, since the transfer to a new shareholder who then disregards that term of the agreement and terminates the election may only entitle the other shareholders to sue for damages. To increase the protection from such a termination, the agreement could also provide that the corporation's transfer agent may not transfer any stock on the books unless the transferee is an eligible shareholder who has agreed not to elect to terminate the Subchapter S status. However, again, if a new shareholder agrees not to terminate, but then within the 60-day period after his receipt of the stock, files such a termination election nonetheless, the Subchapter S election will be terminated for tax purposes, regardless of the fact that the shareholder is in violation of the agreement and liable to the other shareholders for damages. Possibly, the most effective protection against termination of the Subchapter S status by a new shareholder would be to provide in the agreement that the election can be terminated only if all shareholders unamiously consent and to further provide that the agreement is binding on successors-in-interest and that any successor-in-interest to an original shareholder who wishes to terminate the election must give the other shareholders notice a fixed number of days before exercising his election to terminate. The agreement should
also provide that receipt of notice of the successor-in-interest's intention to terminate triggers immediate redemption of his shares at a formula price fixed in the agreement and that, if the shareholder fails to give notice of his intention to terminate, his shares will be treated as having been redeemed at the formula price, as of the date notice was required to be given and, he will not be considered to be a shareholder thereafter. The share certificates should, of course, bear a legend reciting the existence of the agreement. I must tell you that I know of no case or ruling specifically dealing with this kind of restriction on the power of a successor-in-interest to terminate the election, so it is impossible to predict just how the Service would view such provisions.

In addition to carefully drafting any buy-sell agreement between the shareholders or between the shareholders and the corporation, thorough pre-death planning for a client owning Subchapter S stock also requires the inclusion of certain provisions in that client's will in order to provide his personal representative with maximum flexibility with regard to that stock after the client's death. The will should specifically give the personal representative the authority to terminate the Subchapter S election, if such termination is determined by the personal representative to be in the best interests of the estate. A general clause in a will permitting an executor or administrator to exercise all elections permitted for tax purposes presumably would give the personal representative this power; however, specific inclusion in the will of the personal representative's power to terminate the election will make the personal representative aware of that power so he will be more likely to make a reasoned decision after weighing the benefits and drawbacks of making such an election.

Consideration should also be given to providing the personal representative with the discretion to decide whether or not to terminate the Subchapter S election, not only based on his view of the best interests of the estate, but also based on the best interests of the beneficiaries of the estate who are ultimately to receive the stock and perhaps even taking into consideration the best interests of other shareholders of the corporation. Without such a provision, the personal representative is bound to exercise his discretion to protect only the best interests of the estate.

Discretion should also be given to the personal representative to allocate the Subchapter S corporation stock among one or more of the residuary beneficiaries if the stock is to pass under the residuary clause. With such a provision, the personal representative can direct the stock away from a residuary beneficiary not qualified to own such stock, receipt of the stock by whom would otherwise cause the automatic termination of the Subchapter S election. The personal representative could also utilize such a provision to avoid making a pro rata allocation of the stock among all the residuary beneficiaries if such an allocat-
tion would otherwise result in there being more than 15 shareholders of the corporation, which also would cause automatic termination of the Subchapter S election.

If one of the estate planning recommendations to the client is to reduce the client’s income tax by transferring certain of his income producing assets to other family members who are in lower income tax brackets, and if one of the income-producing assets which might be transferred is Subchapter S corporation stock, the estate planner must again be alert to the unique problems of transferring such an asset. In making pre-death transfers to obtain income tax savings, exhaustion of the transferor’s P.T.I. account prior to the transfer should be accomplished, if possible, as has already been mentioned. The outright transfer of the Subchapter S stock would divert a proportionate share of the corporate earnings to the recipient of the stock and would result in lower overall income tax if the recipient is in a lower income tax bracket than that of the transferor. But if the potential recipient is a minor (or perhaps even an incompetent), an outright transfer of the stock to such a person would be unsatisfactory and, because a trust is not a permissible Subchapter S corporation shareholder except in limited circumstances, none of which would be relevant if income-shifting is desired, the indirect transfer of the stock to a trust for the benefit of that potential recipient who is a minor or incompetent is not feasible. The only available method of transfer, at least in the case of a minor, would be to make a custodial gift under the Uniform Gift to Minors Act. As with any custodial gift, adverse tax consequences would result if the transferor of the stock to the custodial account named himself as custodian and then died prior to the time the beneficiary reaches the age of majority.

One final aspect of pre-death planning with Subchapter S stock is the limitation imposed by the Service on recognition of a transfer of that stock among family members. Treasury Regulations issued under the Subchapter S provisions recognize the assignment-of-income potential inherent in Subchapter S corporation stock, and, therefore, contain a provision to the effect that transactions between family members will be closely scrutinized and a transfer of stock between family members will not be recognized for income tax purposes if the transfer is less than complete and absolute. The Regulations are similar to the family partnership provisions of section 704(e) of the Code. In the few cases which have dealt with this part of the Regulations, the courts appear willing to disregard a transfer of Subchapter S stock for income tax purposes if the primary motive for the transfer seems to have been to achieve tax savings and if the transferees are not really in control of the stock transferred to them or if there was no business motive for the transfer in the first place.

In addition, the Code itself incorporates a reallocation provision (at
section 1375(c)), pursuant to which the Service can shift dividend income from Subchapter S corporation stock among the stockholder members of a family group in order to properly reflect the value of services which have been rendered by the members of that family group to the corporation. These reallocation provisions are similar to the reallocation provisions of the family partnership area which are designed to restructure partnership income when the partnership has underpaid one or more family members who are active in the partnership while larger partnership shares are provided to other less actively involved family member partners who are in lower income tax brackets. Applying these principles to the Subchapter S area, if one Subchapter S shareholder is an employee and is involved in the active management of the business for a nominal salary, section 1375(c) permits the Service to reallocate part of the actual or constructive dividends taxable to the other family member shareholders to the stockholder-employee instead, as salary. A similar reallocation could occur if inflated salaries are paid to younger, lower income tax bracket stockholder family members without regard to the nature and extent of the services rendered by them to the corporation. Again, as is true under the family partnership provision of section 704(e), the ultimate test for reallocation seems to be whether or not tax savings appear to have been the motivating factor in the payment structure in question. The success rate of the Service in enforcing this provision of the Code has been mixed, as the cases noted at page 15 of the outline indicate.

When a Subchapter S corporation shareholder dies, the personal representative has a number of post-death estate planning decisions to make, especially with regard to the Subchapter S stock. The determination whether or not to continue Subchapter S status should be reexamined. The deceased shareholder may have been active in the business and earning a substantial salary which, of course, will not continue after his death. One way for any survivors who were dependent on that salary to replace it will be to become active in the business themselves, thereby replacing the salary directly. If this is not feasible, the surviving beneficiaries may be in need of income and may be in low tax brackets which would tend to support an election of Subchapter S status for the first time, if available, or a continuation of Subchapter S status if it has already been elected, to avoid the double taxation otherwise imposed on distributions of corporate income. However, if the stockholders themselves are not in a position to cause the corporation to pay out all or a substantial part of its current earnings or if the corporation is unable to do so, they will not have solved their financial problems in terms of actual receipt of income. In fact, they may have exacerbated their financial problems because ultimately they will be taxed on their proportionate shares of the undistributed corporate income each year as constructive dividends. Presumably, this problem of income flow will
have been considered and resolved prior to the death of the shareholder; otherwise, some other method must be used to obtain cash for the beneficiaries from the corporation. This can be done through use of the standard redemption provisions applicable to all corporations, or some attempt can be made to make distributions from the Subchapter S corporation possible, including the loan-distribution technique mentioned earlier.

Major overall income tax savings can be obtained if the surviving spouse or other estate beneficiaries entitled to the Subchapter S stock, as well as possibly the estate itself, happen to be in lower income tax brackets than the corporation would have been in if no Subchapter S election were made or if the election were terminated. These income tax savings result not only because of the ability to spread the Subchapter S income among the several taxpayers but also because of the tax benefits provided by careful timing of the distributions of the income and stock to the surviving spouse and other beneficiaries. For example, actual or constructive distributions of Subchapter S income to the estate, as stockholder, can be passed through to the surviving spouse for inclusion in the decedent's final joint income tax return to offset other losses or deductions or could be allocated to other estate beneficiaries by a distribution of a portion of the estate's distributable net income (D.N.I.) for its year within which the fiscal year of the corporation ends.

On the other hand, there could be circumstances when it would be beneficial to the estate, and perhaps to the beneficiaries and other stockholders, to terminate the Subchapter S election following the death of the shareholder. For example, if a Subchapter S corporation's financial position will not permit it to make any income distributions, the estate will be forced to pay tax on its share of the undistributed income even though it won't receive it. And the eventual distribution of the stock from the estate to the beneficiaries will cut off the estate's P.T.I. account.

Another situation in which it might be better to terminate the Subchapter S election is presented if the ultimate recipients of the stock are currently employees or can be hired as employees of the corporation and if the corporation is in a position to be able to institute qualified benefit plans for its employees. Since a Subchapter S corporation is limited to HR-10 type qualified plans while a non-Subchapter S corporation has no such limitation, termination of the election and institution of a qualified corporate plan might provide greater overall tax benefits for the individual shareholder-employees than would a continuation of the Subchapter S status.

As mentioned earlier, because each Subchapter S stockholder's P.T.I. account is personal to that stockholder and terminates on the death of the stockholder, a distribution to the estate of a deceased shareholder of Subchapter S income taxed to the deceased shareholder prior to his
death will not necessarily be distributed on a tax-free basis to the estate. Rather, such a distribution will be treated, first, as a distribution of current earnings and profits, taxable as a dividend, and, then, to the extent the distribution exceeds current earnings and profits, as a distribution of any accumulated earnings and profits.

This same rule applies if the stockholder who had been taxed on the undistributed income of the Subchapter S corporation died within the first two-and-one-half months of the next fiscal year of the corporation, the period of time within which the corporation is permitted to distribute the P.T.I. of the previous year to its shareholders. Section 1375(f) provides that only the stockholder who owned the stock on the last day of the corporation's fiscal year can receive distributions within the first two-and-one-half months of the next fiscal year on a tax-free basis. So, for example, if a calendar year Subchapter S corporation were to make distributions to its shareholders within the first two-and-one-half months of the following calendar year and if one of the recipients was the estate of a stockholder who died sometime after December 31 but prior to the distribution, that distribution can be a distribution of P.T.I. to all of the shareholders except the estate, with respect to which it will be a distribution first, of current earnings and profits and, then, of accumulated earnings and profits, if any. Only undistributed taxable income of the Subchapter S corporation for the tax year of the corporation ending after the estate becomes a stockholder will constitute P.T.I. of the estate.

The treatment of the estate's P.T.I. in a redemption is illustrated by Revenue Ruling 71-272, in which the Service ruled that a distribution of cash in a section 303 redemption of Subchapter S stock held by an estate would be treated, first, as a distribution of current earnings and profits, taxable as a dividend, second, as a distribution of P.T.I., to the extent of the estate's P.T.I., and, third, as a distribution in redemption of the stock under section 303 or if applicable, section 302. If the ultimate recipient of the Subchapter S stock is a trust, the Subchapter S election will automatically terminate at some point in time after distribution of the stock to the trust, regardless of the potential benefits to the trust if the election were able to be continued indefinitely. Thus, if the stock has been held in a grantor trust during the life of the grantor-stockholder, and the stock continues to be held by the trust after the death of that grantor, the election can continue for only 60 days unless the entire trust corpus is included in the deceased grantor's estate, in which case the stock may be held by the trust for two years. Obviously, within either the 60 day or the two year period, the trustee should take steps to remove the stock from the trust to avoid termination of the election. Hopefully, pre-death planning will have provided the trustees with the discretion to make the necessary arrangements for the disposition of the stock. Otherwise, if the remaining
stockholders desire to continue the Subchapter S election, they will have to work out some way to obtain the stock from the trust, presupposing the cooperation of the trustee.

While Subchapter S stock is held by the estate of a deceased stockholder no involuntary termination problem exists, although the 4th Cir. decision in *Old Virginia Brick Company*, cited in the outline at page 20, makes it clear that the estate may not hold Subchapter S stock indefinitely merely to delay its ultimate passage to a testamentary trust or other non-qualified recipient. On the other hand, if the estate is able to elect installment payment of the estate tax under either section 6166 or section 6166A of the Code, the estate can properly be held open and retain the Subchapter S stock until the end of the period for the payment of the installments, which, in the case of a section 6166 election, can be 15 years.

Timing of distributions of Subchapter S income from the estate or trust and timing of distributions of the Subchapter S stock itself are important aspects of post-death estate planning that require prompt attention by the personal representative because some planning flexibility can be lost by delay. The planning opportunities with regard to income result from the fact that the Subchapter S corporation and the estate or trust can be fiscal year taxpayers while the ultimate individual beneficiaries will be calendar year taxpayers for income tax purposes, which permits the splitting of income among the several different tax years of the several different beneficiaries. Selection of the estate’s or trust’s fiscal year for income tax purposes can determine the taxpayer who will be required to recognize the undistributed taxable income of the corporation and the year in which it will be recognized by that taxpayer. The estate can choose a fiscal year which either accelerates or defers recognition of the Subchapter S income, depending upon whether acceleration or deferral provides the best overall tax benefit to the estate.

For example, if a Subchapter S corporation has a fiscal year ending June 30 and the stockholder dies on May 1, if the estate chooses a fiscal year ending May 31, the estate’s first fiscal year will be the one month period from the date of death to the end of May and none of the undistributed Subchapter S income will be included on the first tax return of the estate, due three-and-one-half months later. The undistributed taxable income of the corporation for its fiscal year ending June 30 and distributions during the two-and-one-half months thereafter, characterized as P.T.I. although in this instance not “previously taxed”, will not in fact be taxed until the termination of the fiscal year of the estate within which the Subchapter S year terminates, which will be the fiscal year of the estate ending the following May 31. This choice of a May 31 fiscal year effectively defers recognition of the Subchapter S income and payment of the tax on that income for more than one year.
During the second and ensuing fiscal years of the estate, any actual distributions of earnings from the corporation (which would constitute distributable net income of the estate as dividend distributions, to the extent of current earnings and profits of the Subchapter S corporation) could then be distributed by the estate to the beneficiaries, spreading the income among the estate and those beneficiaries.

On the other hand, if the goal is to accelerate the income and cause it to be recognized immediately, perhaps because the corporation is expected to have substantial capital gains or other income in the next fiscal year or because there are losses against which the income can be offset, the estate or trust could choose a fiscal year ending June 30 or shortly thereafter. This would result in the undistributed Subchapter S income being included in full in the estate’s short fiscal year beginning May 1 and ending June 30, or some subsequent date chosen as the end of the estate’s fiscal year.

Rather than dwell at greater length on these timing questions, suffice it to say that considerable flexibility exists in this area and the key to taking advantage of the flexibility is to remember that the stockholder who owns the stock on the last day of the tax year is the one who bears the tax consequences for the full year’s undistributed income of the Subchapter S corporation. Furthermore, the undistributed income is included in the income of the stockholder for the stockholder’s tax year with which or within which the Subchapter S year ends, providing the estate or trust, as a stockholder, with the opportunity to choose a fiscal year which can be timed to include or to exclude the Subchapter S undistributed taxable income, depending upon whether current or deferred recognition is the better choice.

Distribution of Subchapter S stock itself from the estate or from the trust can cause unanticipated, undesirable tax consequences unless timing considerations in connection with such distributions have been fully taken into account. If the estate or trust holds the Subchapter S stock at the end of the fiscal year of the corporation, the estate or trust will, of course, be taxed on its proportionate share of undistributed corporate income, which will then constitute distributable net income of the estate or trust, even though no actual cash has been received by the estate or trust. Then, if the stock is distributed during the same tax year of the estate or trust within which the fiscal year of the corporation ended, the beneficiary will be considered to have received income equal to the value of the stock, to the extent of the distributable net income of the estate or trust, which includes the undistributed corporate income from the Subchapter S corporation. As a result, the distributee of the stock has income subject to tax, but without any accompanying cash distribution. To further complicate the problem, the P.T.I. account of the estate or trust attributable to the stock distributed to the beneficiary will have been terminated by the distribution. If the Subchapter S cor-
poration thereafter makes a distribution which would have been characterized as made up of previously taxed income for the original stockholder, for example, because the distribution occurs within the first two-and-one-half months of the fiscal year of the corporation following the year the income was earned, the distribution of that amount to the trust or estate beneficiaries, pursuant to the distribution of the Subchapter S stock to them, will be a distribution of current income rather than of P.T.I. Thus, the trust or estate beneficiaries will be taxed on the distribution of the Subchapter S stock to them, to the extent of the distributable net income of the trust or estate, including Subchapter S income for purposes of the calculation of distributable net income, and, thereafter, will be taxed on the distribution by the corporation which would have been P.T.I. but for the distribution made by the trust or estate of the stock. Overall negative tax consequences to the trust or estate beneficiaries can be reduced if the P.T.I. can be distributed to the trust or estate prior to the distribution of the Subchapter S stock to the beneficiaries of the trust or estate.

Adverse consequences to the ultimate beneficiaries because of insufficient attention to timing problems can be more severe when distributions are made from a trust than when made from an estate because distributions from a trust may also be subject to the throwback rules. In other words, a distribution to an estate beneficiary would be taxable only to the extent of the estate's distributable net income for the year of the distribution while the distribution to a trust beneficiary may be taxable to that beneficiary not only to the extent of current distributable net income of the trust but also to the extent of accumulated distributable net income for prior years, including any Subchapter S income for those prior years.

When the Subchapter S corporation stock is to pass ultimately to a testamentary trust, which may be a qualified shareholder only for a period of 60 days after the distribution to it, there are still some timing benefits which can result from careful selection of the date of distribution to the trust and the election of the fiscal year for the trust. Thus, for example, if the stock of a Subchapter S corporation having a June 30 fiscal year is distributed to the trust on June 2 and that trust chooses a fiscal year ending July 31, within the 60-day period during which it may hold the stock, the following consequences can be anticipated. The distribution of the stock to the trust may or may not constitute income to the trust, depending upon whether the estate had distributable net income for its fiscal year within which the stock distribution was made. Of course, if the estate's fiscal year had been chosen to terminate one or two months before the end of the corporation's fiscal year and then if the estate itself was terminated not long after the distribution to the trust, which occurred shortly before the corporation's year end, there would be little or no distributable net income of the estate to support an income
distribution to the trust. Then, if, in our example, during the period between the June 2 distribution of stock to the trust and the July 31 end of the trust's fiscal year, the trust, in turn, distributes part of the stock to its beneficiaries, timing the distributions so that both the trust and the beneficiaries are Subchapter S stockholders as of the June 30 corporation year end, the undistributed taxable income for the fiscal year ending June 30 will have been spread among the trust and its beneficiaries. Even greater benefits might be obtained if a portion of the stock was retained by the estate for distribution to the trust just after the June 30 corporation year-end, since the estate would also be a shareholder subject to tax on its retained share of the Subchapter S corporation stock on June 30. Then, if the Subchapter S corporation can make a cash distribution prior to the July 31 end of the trust's fiscal year, that distribution will be a distribution of P.T.I. to all of the shareholders as of June 30, since it will be made within the first two-and-one-half months of the corporation's next fiscal year. Following receipt of its share of P.T.I., the trust could then distribute the balance of the Subchapter S stock retained by it and still be within the 60-day period during which it can hold the stock.

The final time when special estate planning concerns for a client with Subchapter S stock must be reviewed is when a Subchapter S stockholder is expected to die within a relatively short period of time. Obviously, in this circumstance, a serious attempt should be made to withdraw the shareholder's P.T.I. account, since if this is not done, the P.T.I. account will be lost on the death of the shareholder. Consideration must also be given to the distribution of all or part of the current year's income of the Subchapter S corporation in order to divide the dying shareholder's portion of the year's income between himself and his estate, which will be taxed on the undistributed income for the entire fiscal year of the corporation in which it becomes a shareholder after the death of the dying stockholder.

Additionally, consideration should be given to making gifts of the Subchapter S stock even though that stock will be included in the shareholder's estate under section 2035 as a gift made within three years of death if the shareholder dies within that period. The major benefit of making such a gift within three years of death is that all undistributed income for the fiscal year of the corporation in which the gift is made and all undistributed income and current distributions of income of the corporation thereafter will not be brought back into the estate of the transferor under section 2035, but, instead, will be attributed to the transferee.

This talk has only touched upon some of the estate planning considerations and some of the estate planning problems you will confront when you have a client who owns stock in a Subchapter S corporation or
when you are dealing with an estate or trust which holds Subchapter S stock. Obviously, the area is complex and planning in any particular instance requires careful attention to all of the particular facts and circumstances of that situation within the framework of the Subchapter S rules.