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Death and Pass Through Entities

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DEATH
AND
PASS-THROUGH ENTITIES

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DEATH AND PASS-THROUGH ENTITIES

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FACT PATTERNS FOR DISCUSSION

CASE #1 -- Father, a widower, leaves his 49 percent interest in S Corp., Inc. by will to Son (who owns the other 51 percent) and leaves the residue of the estate equally to Daughter 1 and Daughter 2. The residue consists of Father’s remaining 20 percent interest in Family LLC. Daughter 1 is named as executor. Son is President of S Corp., Inc. and successor manager of Family LLC. Daughter 1 asks you the following questions:

► How is the income from S Corp., Inc. and Family LLC to be reported on Father’s final 1040 to be determined? What impact is there as a result of the 1996 and 1997 Tax Acts?

► Will the estate get any K-1s for the year of death?

► Should the lawyer who drafted the will have included in the will any special provisions or have recommended any shareholder or member agreements with respect to S Corp., Inc. and Family LLC?

CASE #2 -- Father is survived by Mother, his wife, and leaves a will that pours over to a funded revocable trust to which Father contributed his stock in S Corp., Inc. some years ago in order to avoid probate costs. The trust agreement provides for a fractional formula division into a QTIP marital trust and a sprinkling unified credit bypass trust. Mother and Son are named as co-executors and co-trustees. They ask you the following questions:

► Is the trust a permissible shareholder of the S Corp., Inc. stock? If so, for how long?

► Does it matter how long the trustees wait before funding the marital trust and the unified credit trust? Are any tax elections required?
Are any changes made by the 1996 and 1997 Tax Acts applicable to Father’s estate and trust?

CASE #3 -- Father, a widower, created an irrevocable insurance trust to provide liquidity for estate taxes. The trust is generation-skipping one with sprinkling provisions for the collective benefit of Father’s descendants. Father’s will leaves his estate equally to his children, Son, Daughter 1, and Daughter 2 and names Son and Daughter 1 as executors. They also serve as trustees of the irrevocable trust. The trustees propose to use the insurance proceeds to purchase from the estate the stock of S Corp., Inc. owned by the estate. The trustees ask you the following questions:

- What actions should Son and Daughter 1 take to avoid liability because of their positions of conflict and the self-dealing nature of the proposed purchase by the trust from the estate?

- Can the trust hold stock in an S corporation, and if so is any election necessary and who would make it?

- Does it make any difference if the trust was funded with Crummey gifts rather than unified credit gifts?

- What consent of the beneficiaries is required or desirable?

CASE #4 -- Father is survived by Mother, his wife, and by his will leaves his stock in S Corp., Inc. to Son and pours over the residue of his estate to a revocable trust to be held as a QTIP marital trust for Mother. Mother and Son are named as co-executors and co-trustees. They ask you the following questions:

- When may the S Corp., Inc. stock be distributed to Son? What difference is there if the tax clause in the will provides that all death taxes are to be apportioned instead of being paid as a cost of administration?

- Who is entitled to dividends paid while S Corp., Inc. stock is held by the estate?

- Who bears the income taxes on the S Corp., Inc. stock pending distribution to Son?

CASE #5 -- Because Father was predeceased by both Mother and Son, Father owned 100 percent of S Corp., Inc. when he died on July 1, 1997. Father’s will directs the executor to
sell the business of S Corp., Inc. as soon as practicable and leaves the residue of the estate in separate trusts for Son’s children and Daughter 1 and Daughter 2 and names Bank as executor and trustee. Buyer has been found who prefers to purchase assets but is willing to consider purchasing the stock of S Corp., Inc. Buyer wants to close purchase on December 15, 1997. Bank asks you the following questions:

- From the estate’s perspective, what are the differences between selling the stock and selling the assets of S Corp., Inc.?

- Will this transaction having any bearing on the Bank’s selection of a fiscal year for the estate?

CASE #6 -- Because Father was predeceased by both Mother and Son, Father owned 100 percent of S Corp., Inc. when he died. Father’s will leaves 10 percent of the estate to Charity and the residue of the estate in separate trusts for Son’s children and Daughter 1 and Daughter 2 and names Bank as executor and trustee. Bank asks you the following questions:

- If 10 percent of each and every asset is distributed to Charity, must a valuation discount be applied in determining the allowable charitable estate tax deduction?

- Is Charity a permissible S corporation shareholder?

- Is it permissible to pay Charity in cash and keep 100 percent of S Corp., Inc. stock in the estate?

CASE #7 -- Mother, as surviving spouse, leaves a will that pours over all of her estate in a sprinkling trust for her grandchildren and their descendants. One set of grandchildren live in Toronto and are not U.S. citizens. Among the assets in the estate is 100 percent of S Corp., Inc. which qualifies for the deferred payment provisions of section 6166. Bank is executor and trustee and asks you the following questions:

- Are any elections required in order to maintain the S election?

- Are any special steps necessary because of the Canadian grandchildren?

- What if the S Corp., Inc. stock was placed in the trust by Mother during her life?
Should a section 6166 election be made or are there other alternatives for maintenance of the S election?

CASE #8 -- While Father was living, C Corp., Inc. sold its operating business in exchange for some cash and the balance represented by an installment note that will be paid off in the near future. C Corp., Inc. has a highly appreciated portfolio of marketable securities. Mother is the executor of the estate and asks you the following questions:

- Can the estate make an S election for C Corp., Inc. at this time?
- If the estate will be liquidating C Corp., Inc. within the next year, is there any advantage in making an S election?
- Under what circumstances might it make sense to keep C Corp., Inc. in existence for a longer period and would an S election during the interim be beneficial?

CASE #9 -- Father’s estate owns 100 percent of S Corp., Inc. that is generating significant net operating losses, giving rise to passive losses in the estate that are suspended and will be part of basis at the end of the estate's administration when S Corp., Inc.'s stock will be likely be distributed partly to a unified credit bypass trust and the balance outright to Mother. The estate has nonincome-producing assets that will be sold over the next several years and reinvested in marketable securities. Mother has independent portfolio income of her own. Son, who is President of S Corp., Inc., earns a salary from S Corp., Inc. and through Family LLC receives rental income as a result of the properties leased by Family LLC to S Corp., Inc. It is anticipated that a QSST election will be made by the unified credit trust which will be held for the benefit of Mother for her life. Mother is the sole executor and asks you the following questions:

- What can be done to make current use of the operating losses?
- Will the suspended losses be usable by Mother and/or the unified credit trust in the future?
- Will Son, Daughter 1, and Daughter 2 be able to use any remaining losses after Mother dies?
I. INTRODUCTION

A. General Background.

1. While there has been a general trend in the law since 1954 to limit the opportunities for avoiding a double tax on C corporation income -- once at the corporate level and once at the shareholder level -- there has been a gradual and continuing liberalization in the rules of Subchapter S regarding the number of shareholders, the permissible character of shareholders, and the range of permissible investments.

2. This trend continued in the Small Business Job Protection Act of 1996, discussed in II below, although S corporations are still not true pass-through entities like partnerships and limited liability companies (LLCs).

3. The Taxpayer Relief Act of 1997, discussed in III below, made numerous other changes affecting owners of closely held businesses.

4. S corporations have continued to become a more and more useful tool in estate planning, and partnerships and LLCs have proliferated as vehicles for valuation discount planning.

5. The result is that more estates will contain S corporation stock, partnership interests, and LLC interests, thereby requiring executors and their advisors to have a full understanding of the rules relating to pass-through entities.

6. Because fewer problems are encountered in administering estates and trusts holding partnership and LLC interests, this outline will deal primarily with S corporation matters.
B. **S Corporation Rules Before the 1996 Act.**

1. The primary attribute of an S corporation is the passthrough of all items of income and deduction to its shareholders.
   
   a. When (and if) income is actually distributed in the form of dividends, it will not be re-subjected to tax.
   
   b. Taxable income passed through to a shareholder increases the shareholder’s basis; losses passed through decrease the shareholder’s basis.
   
   c. Distributions to a shareholder reduce basis; contributions to capital increase basis; distributions in excess of basis generate capital gain.

2. Since the Subchapter S Revision Act of 1982, S corporations have had no restrictions on the holding of passive investment assets and the realization of passive investment income.
   
   a. There is an exception for an S corporation with earnings and profits from an earlier period when it was a C corporation.
   
   b. If C corporation E&P exists, a corporate level tax is imposed on passive income in excess of 25% of gross receipts, together with other consequences.

3. An S corporation is permitted to have only one class of stock.
   
   a. Classes of stock which differ only in their voting rights are not considered separate classes for this purpose.
   
   b. Debt held by a creditor who would be an eligible S shareholder will generally not be a second class of stock even if the corporation is thinly capitalized.
   
   c. Although the regulations and rulings are generally favorable, a shareholders’ agreement can create a second class of stock if it gives certain preferential treatment to a shareholder or group of shareholders.

4. Only 35 shareholders were permitted.
5. An S corporation could not be a member of an affiliated group.

6. Shareholders are required to be individuals (other than nonresident aliens), estates, or certain trusts.

II. 1996 ACT CHANGES TO THE S CORPORATION RULES

A. Number of Permitted Shareholders Expanded to 75.

1. Under the former version of §1361(b) of the Internal Revenue Code, the number of permitted shareholders of an S corporation was 35.

2. Under the current version, as amended by the 1996 Act, the number of eligible shareholders has been increased to 75.

   a. Those individuals who would be likely to choose an S corporation but are close to or over the limit of 35 shareholders will now have reason to reexamine the possibility of electing S.

   b. For reasons to be discussed in the next subsection, this increase in the number of eligible shareholders will become very valuable to those individuals who desire to form an "Electing Small Business Trust" to be a shareholder in the S corporation.

B. Electing Small Business Trusts (ESBTs).

1. Under the former version of §1361(c), the only trusts eligible to be shareholders in an S corporation were grantor trusts, certain testamentary trusts, voting trusts, and qualified subchapter S trusts.

2. The 1996 Act permits the use of an "Electing Small Business Trust" as an additional permitted shareholder.

   a. Only individuals and estates otherwise eligible as S corporation shareholders in their own capacity are eligible as beneficiaries under these trusts, although charitable organizations may be contingent beneficiaries.

   b. Each potential current beneficiary of the electing trust is counted as a shareholder of the S corporation for purposes
of §1361(b). The increase of the limitation on the number of shareholders to 75 is highly welcome in light of the fact that all potential beneficiaries will be counted as shareholders. If for any period there is no potential current beneficiary, then the trust will be treated as the shareholder during that period.

c. No interest in the trust may be acquired through "purchase." All interests must be acquired through gifts or bequests.

d. The trust must elect to be treated as an ESBT. Once made, the election is revocable only with the consent of the Secretary. In Notice 97-12, 1997-3 I.R.B. 11, the IRS spells out what the trustee of an ESBT must include in the statement of ESBT election filed with the service center with which the corporation files its tax return. The trustee must file the election within the same time requirements that apply to qualified subchapter S trusts (QSSTs). The trustee may attach the ESBT election to Form 2553 in the case of newly electing S corporations. For the ESBT’s consent to the S corporation election under §1362(a), only the trustee needs to consent.

e. For purposes of computing the income tax attributable to the S corporation stock, the portion of the small business trust consisting of such stock will be treated as a separate trust.

(1) This portion of the trust is taxed at the highest rate for the type of income involved (39.6% for ordinary income; generally 20% for long-term capital gains) with no exception.

(2) The only items of income, loss deductions, or credit to be taken into account are the following: Those items of income, loss, or deduction normally allocated to an S corporation shareholder; gain or loss from the trust’s sale of its S corporation stock; and any state or local income taxes and administrative expenses properly allocable to the S corporation stock, but only to the extent permitted in regulations to be promulgated.
(3) No deduction is allowed for distributions from this portion of the trust to beneficiaries.

(4) The distribution is not counted as part of the trust's distributable net income. Therefore, the distribution is not included in the beneficiaries' gross income.

(5) The portion of the trust not attributable to the S corporation stock is treated for income tax purposes under the normal rules of subchapter J.

C. Post-Death Qualification Period Extended.

1. Under the former version of §1361(c)(2), both a grantor trust and a §678 trust were permitted to remain S corporation shareholders for 60 days after the death of the grantor. This 60-day period was extended to 2 years if the entire corpus of the trust was includible in the gross estate of the deemed owner.

2. Testamentary trusts, under the former version of §1361(c)(2), were permitted to remain S corporation shareholders for 60 days after funding of the trust with the S stock as well.

3. Under the 1996 Act, former grantor trusts, former §678 trusts, and all testamentary trusts may be S corporation shareholders for 2 years, regardless of whether the entire corpus of the trust was includible in the gross estate of the deemed owner.

4. The above amendment is another welcome example of the increased flexibility provided by the new law. Trustees and personal representatives will now have additional time to deal with the potentially difficult problem of termination of S corporation status after the death of a shareholder.

D. Safe Harbor Debt Held by Financial Institutions.

1. Under both the former and current versions of §1361, an S corporation may only have one class of stock.

2. Section 1361(c)(5) created safe-harbor debt which will not be reclassified as a second class of stock, provided that:

   a. The debt is a written, unconditional promise to pay on demand or on a specified date a sum certain in money;
b. The interest rate and payment dates are not contingent on profits, the borrower's discretion, or similar factors;

c. There is no convertibility into stock; and

d. The creditor is an individual (other than a nonresident alien), an estate, or an eligible trust.

3. Under the 1996 Act, §1361(c)(5) is amended, so that "straight debt" now also includes any debt held by creditors, other than individuals, that are actively and regularly engaged in the business of lending money.

4. Because of this amendment, owners of S corporations can now seek venture capital from those lenders who are in the business of lending, without risking termination of S corporation status.

E. Waiver of Terminating Event.

1. Under the former version of §1362(f), the Service could waive the effect of a terminating event so long as the corporation corrected the event and the shareholders and the corporation agreed to be treated as if the termination had not occurred. The corporation had to request a letter ruling in order to obtain a waiver of the terminating event. The Service did not have the power to waive an inadvertently invalid election.

2. Under the 1996 Act, §1362(f) is amended so that the Service may waive an inadvertently invalid election.

3. The Service may also now waive the effect of the failure to file an election in a timely manner if such failure was reasonable.

4. This amendment is effective with respect to elections for taxable years beginning after December 31, 1982. It is a welcome change to the previously rigid system in which, for example, taxpayers have been denied S status because they failed to file the election by certified mail and the election was lost in the mail, even though the taxpayers adduced strong proof of timely mailing.

corporations (1) that have not filed a timely S corporation election under §1362(a)(1), and (2) for which an S corporation election is filed within six months of the original due date of the election. To obtain relief under the new procedure, eligible corporations must, within six months of the original election due date, file a completed Form 2553, "Election by Small Business Corporation," with the applicable service center. The form must be signed by a corporate officer and all persons who were shareholders during the period that (i) began on the first day of the tax year for which the election takes effect and (ii) ends on the day the election is made. Additionally, the top of the form must state "FILED PURSUANT TO REV. PROC. 97-40." A statement explaining the reason for the failure to file the S corporation election must also be attached. To be eligible for relief under the procedure, a corporation must (i) fail to qualify as an S corporation solely because the Form 2553 was not filed timely under §1362(b)(1) and (ii) the due date for the tax return (excluding extensions) for the first year the corporation intended to be an S corporation has not passed.

F. Closing of Books.

1. Under former §1377(a)(2), all shareholders of an S corporation were required to consent to close the books for the taxable year of the corporation when one of its shareholders terminated his or her interest.

2. The 1996 Act requires that only the corporation and all "affected shareholders" consent to the closing of the books as to the terminating shareholder.

3. "Affected shareholders" are those who terminate their interest in the taxable year or those to whom the shareholder sold his or her interest.

4. In the case of a redemption of all of a shareholder’s shares, all persons who are shareholders during the taxable year are affected shareholders and therefore must still give consent.

5. This amendment is yet another example of Congress’ desire to simplify the rules relating to S corporations, making this entity a more attractive choice for business owners.
G. **Expansion of Post-Termination Transition Period (PTTP).**

1. Former §1377(b) provided that distributions made by the terminated S corporation during the PTTP were treated as if still made by an S corporation.
   
   a. The PTTP was defined as beginning 1 day after the last day of the taxable year of termination and continuing until the later of 1 year later or the due date for the filing of the return for the last taxable year, the latter being extended for 120 days if the Service determines that the S election had terminated in a previous taxable year. If such a determination is made, the PTTP is extended for 120 days from the date of the determination.
   
   b. As provided by the 1996 Act, the PTTP definition has been expanded -- it now includes the 120-day period beginning on the date of a determination pursuant to an audit which occurs after the termination of the corporation's S status but which adjusts an item of income, loss or deduction of the S corporation during the S period.
   
   c. The definition of "determination" now includes a final disposition of the Secretary of the Treasury of a claim for refund and certain agreements between the Secretary and any person pertaining to the tax liability of that person.

2. The 1996 Act also repeals the corporate level audit provisions enacted by the Tax Equity and Fiscal Responsibility Act of 1982 which required that the tax treatment of items was determined at the corporate, rather than the shareholder level.
   
   a. Section 6037 is amended to require the shareholder to treat all subchapter S items in a manner consistent with the treatment of the item at the corporate level. If the shareholder does not treat items consistently or if the corporation has not filed a return, he or she must file a statement of inconsistency with the Secretary.
      
      (1) Section 6037 now further provides that, if the shareholder fails to provide the statement of inconsistency, any deficiency caused by an adjustment made by the Service to make the treatment of an item by the shareholder consistent
with the treatment by the corporation must be paid by the shareholder before contesting the adjustment. The collection of the additional tax may not be delayed by filing protest with the Tax Court. See §6213(b) of the Code.

(2) There is also imposed an accuracy-related penalty for negligently failing either to file consistently or to file a statement of inconsistency.

b. An S corporation will no longer have to designate one of its shareholders as the equivalent to a "tax matters partner."

c. There is some risk that the repeal of the corporate level audit requirement will give rise to inconsistent treatment for shareholders residing in different jurisdictions.

H. S Corporations May Now Hold Subsidiaries.

1. Under the former version of §1361(b), an S corporation was not permitted to be a member of an affiliated group. Hence, the S corporation could not own 80% or more of the voting power and value of another corporation.

2. Under the 1996 Act, an S corporation may now own all of the stock of a C corporation.

3. The C corporation owned by the S corporation may file a consolidated return with C corporations which are members of the affiliated group.

4. The parent S corporation may not join in the filing of a consolidated return with the other members of the C corporations' affiliated group.

5. A qualified subchapter S subsidiary (QSSS) may be owned by another S corporation.

   a. A QSSS is a domestic corporation which is not an ineligible corporation (see below).

   b. Its S corporation parent must own 100% of its stock.
c. The parent must make an affirmative election to treat the subsidiary as a qualified subchapter S subsidiary. Notice 97-4, 1997-2 I.R.B. 24, contains temporary guidance on the manner in which a QSSS election must be made and the effective date of the election.

d. The subsidiary itself may not be an S corporation. Section 1361(b)(1)(B) which prohibits an S corporation from having a corporate shareholder is still in effect.

e. The qualified subchapter S subsidiary is not treated as a separate corporation.

(1) All of the assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as those of the parent.

(2) Transactions between the two S corporations will not be taken into account for tax purposes.

f. On termination of the subsidiary’s status as a qualified subchapter S subsidiary:

(1) The subsidiary will be treated as a new corporation which acquires all of its assets for its own stock; and

(2) It cannot reelect S subsidiary status or elect S status for 5 years without consent.

g. If an S corporation owns 80% of the vote and value of a C corporation, the dividends received from such subsidiary will not be treated as passive investment income, provided the dividends can be traced to the earnings and profits derived from the active conduct of a trade or business, for purposes of §1362(d)(3), which requires termination of S status if the S corporation has passive investment income which exceeds 25% of its gross receipts for 3 years.

h. This amendment once again demonstrates the intent of Congress to simplify the rules for S corporations and make the entity a more attractive one. Those individuals who want pass-through treatment, but who also want to establish separate entities for different divisions or businesses, may view the S corporation as a more feasible
choice because of these changes. Acquisitions by or of S corporations may also be facilitated.

I. Distributions to Shareholders During Loss Years.

1. Under former §§1366 and 1368, a shareholder's basis in his or her S corporation stock was adjusted for income and loss before distributions were taken into account.

   a. Under the 1996 Act, the order is reversed, so that a shareholder's basis is adjusted downwards for a distribution before the adjustment for income or loss.

   b. This amendment will generally improve the tax situation for shareholders in that more of a distribution will be tax-free in a loss year due to the lack of downward adjustment for loss prior to the distribution.

   c. On the other hand, the availability of deductions for losses may be limited if distributions have been made during a loss year.

2. The 1996 Act also provides that, in determining the Accumulated Adjustments Account for an S corporation making distributions in a taxable year with accumulated earnings and profits, net negative adjustments (the excess of losses and deductions over income) will be disregarded.

J. Treatment of S Corporations under Subchapter C.

1. Former §1371(a)(2) provided that, for purposes of subchapter C, an S corporation in its capacity as a shareholder of another corporation would be treated as an individual. Therefore, a C corporation liquidating into its parent S corporation could not liquidate tax free under §332 and §337 or make a §338 election.

2. The 1996 Act repeals the above-described rule by making subchapter C applicable to S corporations and their shareholders, except as otherwise provided and to the extent that its application would be inconsistent with subchapter S.

3. This rule does not change the rule that an S corporation may not claim a dividends-received deduction.
K. **Elimination of Certain Earnings and Profits.**

1. Prior to the amendments, an S corporation was required to take into account pre-1983 earnings and profits from S status years in determining its accumulated earnings and profits.

2. The 1996 Act provides that if a corporation had made an S election for any year beginning before 1983 and is an S corporation for its first year beginning after 1996, it may reduce its accumulated earnings and profits by any earnings and profits from a pre-1983 year in which an S election was in effect.

L. **Carry Forward of Losses Suspended Under At-Risk Rules.**

1. Under §1366, a shareholder cannot deduct a loss which exceeds his or her adjusted basis in his or her stock. This suspended loss, however, can be carried forward into the next taxable year until the shareholder acquires basis, and as far as the PTTP.

2. A shareholder may also not deduct any loss which exceeds his or her amount at risk. §465. These losses may also be carried forward. However, there was no provision under §1366 permitting these losses that were suspended under §465 to be carried forward into the PTTP.

3. Under the 1996 Act, §1366 is amended so that losses suspended by the at-risk rules of §465 may now be carried forward into the PTTP.

M. **Income in Respect of Decedents (IRD).**

1. Under the 1996 Act, the pro rata share of items of income which would have been income in respect of a decedent if acquired directly from the decedent will constitute gross income to the recipient of stock in the S corporation.

2. Because this item is treated as IRD, to the extent that estate tax is attributable to such items, an estate tax deduction is allowed.

3. The stepped-up basis of the S corporation stock is reduced to the extent that the value of the stock is attributable to the item of IRD.
N. **Capital Gains Presumption For Land.**

1. Under former §1237, if a parcel of land is held by a taxpayer other than a corporation, there is a presumption that the sale of such parcel gives rise to capital gains if:
   a. The land had not previously been held as ordinary income property;
   b. During the year of the sale, the taxpayer held no other real property for sale to customers;
   c. The taxpayer (or a related party, a lessee, or a government) had made no substantial improvements to the land; and
   d. The land had been held by the taxpayer for 5 years.

2. The 1996 Act extends this presumption to cover land held by S corporations.

O. **Financial Institutions Using Reserve Method For Bad Debts.**

1. Under former §1361, an eligible S corporation included any domestic corporation which was not an "ineligible corporation."
   a. Former §1361(b)(2) defined "ineligible corporations" as:
      (1) Members of an affiliated group;
      (2) Financial institutions which use the experience method or the percentage of taxable income method for accounting for bad debts;
      (3) Insurance companies subject to subchapter L;
      (4) Section 936 corporations; and
      (5) A DISC or former DISC.

2. The 1996 Act now allows all banks (as defined by §581) to be eligible S corporations except those that use the reserve method of accounting for bad debts.
3. Because of this change, many banks which formerly were ineligible may elect S status.

P. Certain Tax-Exempts May Hold S Stock.

1. The 1996 Act amends §1361(b)(1)(B) to allow profit-sharing and pension plans qualified as tax-exempt entities under §401(a), as well as charitable organizations qualified as tax-exempt organizations under §501(c)(3) to be shareholders in S corporations.

2. All items of income and loss of the S corporation as well as the gain or loss from the sale of the S stock will flow-through to the tax-exempt shareholders in the form of unrelated business taxable income (UBTI).
   a. Because the income attributable to the S corporation will be treated as UBTI, the tax rate applied to it will be the same as that applied to corporations under §11.
   b. The basis of stock acquired by purchase will be reduced by dividends received.

3. Section 170(e)(1), dealing with the donation of ordinary income property (as opposed to capital gain property) to charitable organizations, is amended to provide rules similar to the §751 "hot asset" rules in determining how much of the S corporation stock donated is attributable to ordinary income assets and how much is attributable to capital assets.

4. Exclusions:
   a. Section 404(a)(9), which allows a deduction for payments by a corporation to a trust which forms part of its Employment Stock Ownership Plan ("ESOP"), when such payments are made to reduce the principal of a loan incurred for the purpose of acquiring qualified employer securities, does not apply in the case of S corporation.
   b. Section 404(k), which allows a deduction by a corporation for dividends paid on stock owned by its ESOP, likewise does not apply to S corporations.
c. Section 1042, which gives taxpayers nonrecognition treatment on the sale of securities to ESOPs if the proceeds are used to buy other securities at a cost at least equal to the amount realized from the sale, does not apply if the securities sold are S corporation securities.

5. This change is effective for taxable years beginning after December 31, 1997.

6. Note that the law now allows a charitable organization to be an S corporation shareholder directly, but it may only be a contingent remainder beneficiary of an electing small business trust.

Q. Reelection of Subchapter S Status.

1. Under §1362(g), an S corporation which terminates its S status may not reelect S for 5 years unless the Secretary consents to the election.

2. Under the 1996 Act, any S corporation which terminated its S status during the years preceding enactment may reelect S without consent of the Secretary and without waiting 5 years.

III. SELECTED 1997 ACT CHANGES AFFECTING S CORPORATIONS, ESTATE PLANNING, AND ESTATE ADMINISTRATION

A. S Corporation Changes.

1. The 1997 Act contains no direct substantive provisions relating to S corporations from the estate planning and estate administration perspective.

2. Section 1361(e)(1) now makes it absolutely clear that a charitable remainder trust cannot be an ESBT or otherwise hold S stock.

3. Various provisions in the ESOP area represent continued liberalization of the S corporation rules.
B. **Closing of Partnership Taxable Year.**

1. The taxable year of a partnership shall close with respect to a partner whose entire interest in the partnership terminates by reason of death or otherwise. §706(c)(2)(A).

2. This brings uniformity to the treatment of income from S corporations and partnerships for the year of death.

3. This applies to partnership taxable years beginning after December 31, 1997.

C. **Increase in Unified Credit.**

1. Terminology is now the “applicable credit amount” or “applicable exclusion amount” which we customarily referred to as the “unified credit equivalent” or “exemption equivalent” in the past.

2. The schedule for increases in the $600,000 credit amount shows that the biggest bumps are to take place in 2004 and 2005. §2110.

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<td>2006</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

3. The tax savings for an estate in excess of $1 million is $153,000.

4. The failure to use both spouses’ credit amounts in the future could cost over $434,200 in unnecessary estate taxes.

5. The recapture range subject to the additional 5% surcharge is also broadened. This means very large estates (those over $24,100,000) will not benefit from the increased unified credit.
D. **Indexing of Certain Provisions for Cost-of-Living Adjustments.**

1. $10,000 annual exclusion under §2503 is indexed for inflation in increments of $1,000, with rounding down to the next lowest multiple of $1,000.

2. $1,000,000 GST exemption under §2631 is indexed for inflation in increments of $10,000 with rounding down to the next lowest multiple of $10,000.

3. $750,000 special use value under §2032A is indexed for inflation in increments of $10,000 with rounding down to the next lowest multiple of $10,000.

4. $1,000,000 ceiling on the value of a closely held business eligible for the low interest rate under §§6166 and 6601 is indexed for inflation, with rounding down to the next lowest multiple of $10,000.

5. These provisions are effective beginning in 1998.

E. **Reduced Capital Gains Rates.**

1. The maximum tax rate on long-term capital gains is reduced from 28% to 20% for gains recognized after July 28, 1997 on property held more than 18 months. Mid-term capital gains and gains on collectibles continue to be taxed at a maximum rate of 28%. The maximum long-term rate is reduced to 18% for gains on property held more than 5 years and whose holding period begins after December 31, 2000. To obtain the benefits of the reduction in rates for property held for more than 5 years, individuals may elect to treat certain assets held on January 1, 2001 as having been sold and reacquired. §1(h).

2. No change was made in section 1223(11) which continues to provide that an estate is deemed to have held the decedent’s assets for more than 1 year (not 18 months). However, on October 28, 1997 the Service issued Notice 97-59 which states that inherited property disposed of within 18 months after a decedent’s death will be deemed to have been held for more than 18 months. Without this relief, an executor could have incurred a 28% mid-term gain and not a long-term 20% long-term gain on the sale of appreciated estate assets to raise funds with which to pay estate taxes.
3. The reduction in the capital gains rate makes intrafamily sales more attractive as a way to freeze the growth in the seller’s estate.

4. Lower-income taxpayers (those in the 15% ordinary income bracket) can qualify for an 8% long-term capital gains rate beginning January 1, 2001 for assets held more than 5 years, regardless of when the holding period commenced. By making gifts of low-basis stock to grandchildren in the 15% bracket for them to sell, a family could more than cut in half its capital gains taxes on existing holdings.

F. Estate Tax Exclusion for Qualified Family Owned Businesses.

1. This exclusion under §2033A applies if an interest in a qualified family owned business is left to qualified heirs and if numerous other conditions and requirements are met.

2. The maximum exclusion is the excess of (a) $1,300,000 over (b) the applicable credit amount.

<table>
<thead>
<tr>
<th>Year</th>
<th>Credit Amount</th>
<th>Exclusion Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>$625,000</td>
<td>$675,000</td>
</tr>
<tr>
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</tr>
<tr>
<td>2006</td>
<td>$1,000,000</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

3. The value of the decedent’s interest in the business, plus lifetime gifts of interests in the business to family members, must exceed 50% of the adjusted gross estate with various additions and subtractions.

4. The decedent or the decedent’s family must have owned the business for 5 out of the last 8 years and materially participated in its operation.

5. Many §2032A principles apply for purposes of this exclusion.
6. Unlike §2032A special use valuation, there is no reduction in basis as a result of taking advantage of this qualified family owned business exclusion.

G. Reduced Rate of Interest on Portion of Estate Tax Extended Under §6166.

1. The 4% rate is reduced to 2%. The 2% rate will apply to the tax on the first $1,000,000 of value of the closely held business.

2. The interest rate on the balance of the tax extended under §6166 shall be paid at a rate equal to 45% of the interest rate applicable to underpayments of tax (that is 4.05% if the underpayment rate is 9%).

3. No deduction will be allowed for the payment of §6166 interest under §2053(c) for estate tax purposes or section 163 for income tax purposes.

4. Without the interest deduction, it will be more important than before to run the numbers to determine whether other estate tax funding alternatives may be less expensive.

H. Statute of Limitations on Revaluation of Gifts.

1. Gifts may not be revalued by the Internal Revenue Service for estate tax purposes once the gift tax statute of limitations has run. §§2001(f) and 6501(a)(9).

2. In order for this rule to apply, the value of the gift must be shown on the applicable gift tax return or disclosed in such return, or in a statement attached to the return, in a manner adequate to apprise the Internal Revenue Service of the nature of the gift. This rule applies to gifts made after August 5, 1997.

3. If the gift is not shown on the gift tax return, the gift tax statute of limitations will not run on the ability of the Internal Revenue Service to assess the tax at a later date. This rule applies to gifts made any time during calendar year 1997 and thereafter.

4. To take advantage of this prohibition on revaluation it is not necessary to pay any gift tax (as is the case under §2504(c) for purposes of the gift tax).
5. Intrafamily sales and other transactions, including corporate buy-sell agreements and compensatory arrangements, may require disclosure to prevent the Internal Revenue Service from arguing by hindsight that a bargain element was involved in the transaction.

I. Judicial Review for Eligibility for §6166 Election.

1. The Tax Court is authorized to issue declaratory judgments with respect to whether a §6166 election may be made or whether such extension has ceased to apply. §7479.

2. This applies to decedents dying after August 5, 1997.

J. Revocable Trusts Treated as Part of Estate.

1. If the executor and the trustee both so elect, the decedent’s revocable trust can be treated and taxed for income tax purposes as a part of the estate until the date that is 6 months after the final determination of estate tax liability (or 2 years after the decedent’s death if no estate tax return is required). §646.

2. The election must be made no later than the due date (including extensions) for the estate’s first fiduciary return.

3. Once made, the election is irrevocable.

4. The election will offer many planning opportunities. For example, making the election will allow trust income to escape the estimated income tax rules for the first 2 years even though the trust may not receive any poourover from the estate. Also, the election will effectively allow a trust to use a fiscal year during the period of estate administration.

5. This amendment applies to the estates of decedents dying after August 5, 1997.

K. Estates Eligible for 65-Day Election.

1. Like trusts, estates will be able to elect to treat distributions made within the first 65 days of the tax year as having been made during the previous tax year. §663(b).
2. This applies to taxable years beginning after August 5, 1997.

L. Separate Share Rule Applies to Estates.

1. Rules similar to those applicable to trusts shall apply to estates to treat substantially separate and independent shares of different beneficiaries in an estate as separate estates for purposes of determining distributable net income (DNI) allocable to the beneficiaries. §663(c).

2. The effect is to minimize the ability to allocate DNI disproportionately by making nonprorata distributions to beneficiaries.

3. This change applies to estates of decedents dying after August 5, 1997.

M. Transfers from Revocable Trusts.

1. In addition to rewording provisions governing gifts within 3 years of death, this change adds language to §2035 making it clear that the 3-year rule does not apply to gifts made from revocable trusts by treating the transfers as made directly by the decedent.

2. This applies to estates of decedents dying after August 5, 1997.

3. There is no longer any reason for a donor to withdraw assets from a funded revocable trust in order to make gifts. The grantor/donor may simply instruct the trustee to make the gifts directly from the trust.

N. Repeal of §644 2-Year Rule.

1. The special rule that imposed a tax on an irrevocable trust that sold a donated asset equal to the tax the donor would have paid if the donor had sold the asset has been repealed.

2. It will now be easier to fund new charitable lead trusts with appreciated assets that can be used, even during the first 2 years, to satisfy the annuity on unitrust obligation by distributing assets in kind.

3. This is effective for sales or exchanges after August 5, 1997.
O. **Disallowance of Losses, Expenses, and Interest.**

1. The rules disallowing losses, expenses, and interest with respect to transactions between related parties are extended to sales and other transactions between an estate and its beneficiaries. §267(b).

2. An exception is made in the case of a sale or exchange in satisfaction of a pecuniary bequest.

3. This applies to taxable years beginning after August 5, 1997.

P. **Consistency in Reporting.**

1. A trust or estate beneficiary must treat any reported item in a manner that is consistent with the treatment of such item on the return of the trust or estate, unless the beneficiary notifies the Internal Revenue Service. §6034A.

2. This applies to returns of beneficiaries filed after August 5, 1997.

IV. **PLANNING WITH TRUSTS AS S CORPORATION SHAREHOLDERS**

A. **Subpart E Trusts.**

1. Although many practitioners think primarily of qualified subchapter S trusts (and now electing small business trusts) when asked what trusts may hold S stock, perhaps the most useful and widespread eligible trust is "a trust all of which is treated (under Subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States." §1361(c)(2)(A)(i).

2. Subpart E includes the grantor trust provisions of §§671-677, as well as the "third-party" grantor trust provision of §678.

3. Probably the most common Subpart E trust is the typical revocable living trust customarily used in many states as a substitute for a will.

4. Less common but increasingly more important in sophisticated estate planning is the intentionally defective grantor trust, or
IDGT. An IDGT is generally defined as a trust which is income taxable to the grantor under the rules of Subpart E, but which will not be includible in the grantor’s taxable estate at death.

a. For clients who wish to make estate planning gifts in trust with S corporation stock, use of an IDGT will often provide both more flexibility and better tax results than a QSST or an ESBT.

b. The fact that the grantor is required to pay the income tax on all income earned by the IDGT -- in which the grantor probably has no economic interest -- results in the grantor in effect making additional tax-free gifts to the trust and its beneficiaries. PLR 9444033.

(1) The IRS has indicated its displeasure with this result.

(2) Many practitioners believe that the IRS has no effective basis for challenging this result short of changing the law.

c. Another important consequence of Subpart E status is that transactions between the grantor and the IDGT are generally ignored for income tax purposes.

(1) A grantor can purchase appreciated assets from the IDGT for their fair market value without triggering a gain (and without giving the purchaser a new cost basis), with the expectation that the assets will receive a stepped-up basis under §1014 upon the grantor’s death.

(2) Interest paid to the grantor on a loan to the IDGT will have no income tax consequences to either party, and the satisfaction of a loan or other obligation by the transfer of appreciated property to the grantor will not trigger a gain.

5. Section 678 can be very useful in making a trust a Subpart E trust and thus an eligible S corporation shareholder.

a. Where a trust has been funded entirely with gifts which were subject to lapsing withdrawal rights (Crummey powers) on the part of a single beneficiary, and it is a
grantor trust during the grantor’s lifetime, at the grantor’s death the lapsed (or unlapsed) withdrawal rights will cause the trust to be a §678 trust and thus an eligible shareholder.

b. The same principal applies where the beneficiary of a §2503(c) trust is given the power for a limited period of time to withdraw the trust principal upon reaching age 21.

6. If a surviving spouse is given an unlimited power of withdrawal over a marital trust, the marital trust will be treated as a Subpart E trust. §678.

7. In summary, when considering whether a proposed or existing trust can be an S corporation shareholder, first consider whether the trust is (or can easily be made) a Subpart E trust.

B. Qualified Subchapter S Trusts (QSSTs).

1. Requirements to be a QSST. §1361(d).

a. Only one income beneficiary during the life of the current income beneficiary.

b. Any principal distributions during the life of the current income beneficiary can only be to such beneficiary.

c. The beneficiary’s income interest shall terminate on the earlier of his or her death or the termination of the trust.

d. Upon termination of the trust during the income beneficiary’s lifetime, he or she must receive all the assets.

e. The income beneficiary (who cannot be a nonresident alien) must receive all the net fiduciary accounting income of the trust.

f. Note that all of the above requirements are governing instrument requirements except for the income distribution requirement.

g. If a trust meets the definition of a QSST, it becomes an eligible S corporation shareholder only if the income beneficiary so elects.
2. Consequences of QSST status.
   a. The trust is treated as a Subpart E trust and thus an eligible S shareholder.
   b. The income beneficiary of the trust is treated as the owner under §678 of that portion of the trust consisting of the S corporation stock.
   c. The beneficiary will thus report on his or her own 1040 the QSST's distributive share of the S corporation's taxable income, whether or not actually distributed by the corporation to the trust.

3. Miscellaneous QSST issues.
   a. A QSST election will not be valid if any person (other than the QSST beneficiary) is treated as the Subpart E owner of any part of the trust. Regs. §1.1361-1(j)(6)(iv).
      (1) In cases where a trust is a wholly grantor trust, and also meets the requirements of a QSST, there is no harm because the Subpart E status will permit the trust to hold S stock.
      (2) The problem arises when the trust is only partially a grantor trust and thus is not eligible to hold S stock under either provision. For example, if H creates an inter vivos QTIP trust for W, and does not include any power in the trustee to distribute corpus to W, the QTIP cannot be an electing QSST because under §677(a) H is treated as the owner of the income portion of the trust, and it is not an eligible Subpart E trust because H is not treated as the Subpart E owner of the principal portion of the trust.
   b. Any distribution to the income beneficiary which satisfies a legal support obligation of the grantor will cause the trust to cease to qualify as a QSST. Regs. §1.1361-1(j)(2)(ii)(B).
      (1) This result is both because the satisfaction of the support obligation would cause the grantor to be treated as the §677(b) owner of the income, thus
disqualifying the trust as a QSST, and also because the grantor would be treated as a second beneficiary of the QSST in violation of the one-beneficiary rule.

(2) It is critical in creating a QSST that such support payments be prohibited by the governing instrument.

c. If a QSST disposes of its S corporation stock, any gain or loss will be recognized and reported by the trust under normal fiduciary income tax rules, and not by the QSST beneficiary under §678. Regs. §1.1361-1(j)(8). This regulation in effect reversed the holding of Rev. Rul. 92-84, 1992-2 C.B. 216.


C. Electing Small Business Trusts (ESBTs).

1. The Small Business Job Protection Act of 1996 substantially liberalized the S corporation qualifying shareholder rules by permitting the electing small business trust, or ESBT.

2. In substance, many trusts that otherwise cannot qualify as S corporation shareholders, such as long-term dynasty trusts which either accumulate or sprinkle income, can now qualify as ESBTs, but with the tradeoff that they must pay tax on all the S corporation income at the highest individual rate.

3. An ESBT is any trust, if

   a. Such trust does not have as a beneficiary any person other than:

      (1) an individual;

      (2) an estate; or

      (3) a charitable organization described in §§170(c)(2), (3), (4), or (5), which holds a contingent interest and is not a potential current beneficiary. §1361(e)(1)-
(A)(i). Beginning January 1, 1998, those charitable organizations can own S stock and, therefore, will be eligible to hold a current, rather than a contingent, interest in the trust.

b. No interest in the trust may be acquired by purchase. §1361(e)(1)(A)(ii).

c. A trust must affirmatively elect to be treated as an ESBT. §§1361(e)(1)(A)(iii) and 1361(e)(3).

(1) The election must be made by the trustee of the trust. §1361(e)(3).

(2) The election applies to the taxable year of the trust for which made and all subsequent years. It can be revoked only with the consent of the Secretary of the Treasury or his delegate. §1361(e)(3).

(3) A qualified subchapter S trust, or a tax exempt trust, cannot elect to become an electing small business trust. §§1361(e)(1)(B)(i) and (ii).

4. Each potential current beneficiary of the trust is treated as a shareholder (or if there are no potential current beneficiaries, the trust will be treated as the shareholder). §1361(c)(2)(B)(v).

5. Taxation of ESBTs.

a. An ESBT must treat the portion of the trust consisting of stock in one or more S corporations as a separate trust for purposes of computing the income tax attributable to the S stock held by the trust. §§641(d)(1)(A) and (B).

b. The calculation of the ESBT's taxable income attributable to the S stock is determined as follows:

(1) The tax rate is the highest individual rate (currently 39.6% for ordinary income and generally 20% for long-term capital gains). §641(d)(2)(A).

(2) The §55(d) alternative minimum tax exemption amount is zero. §641(d)(2)(B). Normally, a trust is entitled to an exemption of $22,500 for purposes of
computing the alternative minimum tax. §55(d)(1)(C).

(3) The only items of income, loss, deduction, or credit taken into account when computing taxable income are:

(a) The trust’s allocable share of S corporation items of income, gain, loss, and deduction. §641(d)(2)(C)(i).

(b) Any gain or loss from the disposition of S stock. §641(d)(2)(C)(ii).

(c) To the extent provided in regulations, any state or local income taxes and administrative expenses of the trust properly allocable to the S corporation stock. §§641(d)(2)(C)(iii), (C)(i), (ii), and (iii).

c. On the termination of all or any portion of an electing small business trust, the loss carryovers, or excess deductions, referred to in §642(h) are taken into account by the entire trust, subject to the usual rules on termination of the entire trust. §641(d)(4). Section 642(h) provides rules for the carryover of unused net operating losses and capital loss carryovers to the beneficiary upon termination of an estate or trust.

6. Treatment of remainder of trust income.

a. The income tax for the portion of the ESBT that does not hold S stock is taxed without regard to any S corporation item of income or loss, any gain from the disposition of the S stock, or state or local taxes or administrative expenses attributable to the S stock. §641(d)(3)(A).

b. The calculation of the trust’s distributable net income (DNI) is determined without regard to S corporation items of income and loss, gain or loss from the disposition of the S stock, and state or local income taxes, or administrative expenses attributable to these items. §641(d)(3)(B).

7. The statutory language creating the ESBT raises numerous questions as to the operation of the ESBT rules. Many of these
issues were clarified in Notice 97-49, 1997-36 I.R.B. 8, which provides guidance regarding the definitions of beneficiary and potential current beneficiary under §1361 and guidance on the ordering of ESBT distributions under §641 when the trust has fiduciary accounting income in both the S portion and the non-S portion of the trust.

a. The notice provides that an ESBT beneficiary does not include: (i) a distributee trust; (ii) a person in whose favor a power of appointment could be exercised; or (iii) a person whose contingent interest is so remote as to be negligible. The term does, however, include those persons who have a beneficial interest in the property held by the distributee trust.

b. To define the term "potential current beneficiaries," the notice applies three rules. First, if a distributee trust becomes entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the intended ESBT, then the S corporation election will terminate unless the distributee trust meets the requirements of under §1361(c)(2)(A). Second, if the distributee trust meets the requirements of §1361(c)(2)(A), the persons meeting the requirements of §1362(c)(2)(B) must be treated as shareholders for purposes of determining whether the shareholder restrictions under §1361(b)(1) are satisfied. Third, a person who is entitled to receive a distribution only after a specified time or when a specified event occurs (such as the death of the holder of a power of appointment) does not become a "potential current beneficiary" until the time arrives or event occurs.

Whether a "potential current beneficiary" includes a person to whom a distribution is or may be made during a period pursuant to a power of appointment, the notice says, is currently under study.

c. As for ESBT distributions, the guidance addresses the treatment of ESBT distributions when a trust has fiduciary accounting income in both the S portion and the non-S portion of the trust. Because the S portion items are excluded under §641(d)(3) from the computation of the ESBT's distributable net income (DNI), they are treated in the same manner as any other item that does not enter into
the DNI computation, for purposes of determining the
treatment of trust distributions.

d. The notice defines the term "distributee trust" to mean a
trust that is receiving or may receive a distribution from an
intended ESBT, whether the rights to receive the
distribution are fixed or contingent, or immediate or
defered.

V. S CORPORATIONS IN ESTATE PLANNING AND ADMINISTRATION

A. Standard Estate Planning Involving S Corporations.

1. Dynasty trusts, either inter vivos or testamentary, are a
traditional means of taking advantage of the GST exemption to
maximize the amounts passed on to grandchildren or more
remote generations.

   a. Because the value of a dynasty trust is undercut by the
distribution of income to middle-generation beneficiaries,
it has generally been problematic to place stock in a
family S corporation in such a trust.

   b. With the availability of ESBTs, it will now in many cases
be feasible to put S stock in a dynasty trust, particularly
if all the potential beneficiaries are already in the highest
income tax bracket.

2. Stock in a successful family S corporation is often an attractive
asset with which to fund a grantor retained annuity trust (GRAT).
Because the GRAT will normally be a subpart E trust, there
should be no problem in funding it with the S stock.

3. Similarly, S stock may be an excellent asset with which to fund
an IDGT (which is by definition an eligible S shareholder),
because the grantor will pay the tax on the trust’s full
distributive share of the corporation’s income, whether or not it
is distributed.

B. Minority Discounts and S Corporation Stock.

1. Limited partnerships (and more recently limited liability
companies) have generally been the entity of choice where a
taxpayer wishes to place a basket of assets into an entity in order
to make gifts of minority interests (with the expectation of attracting a substantial minority and/or marketability discount), partly because:

a. S corporations have the disadvantage of causing gain recognition on the distribution to a shareholder of appreciated assets.

b. S corporations are in many states not treated entirely as passthrough entities for state income tax purposes and may be subject to expensive franchise taxes and other fees.

c. Ownership of S corporation stock is limited and may prohibit ownership by desired individuals or entities.

2. The IRS is now taking the position with regard to many transactions that pursuant to §2703 the limited partnership should be disregarded as an entity, thereby negating the taxpayer's claimed discount.

3. Practitioners should consider using S corporations for their clients' minority interest gifts.

a. The IRS typically focuses its attention on LPs and LLCs and will be less likely to challenge the discount on a gift of S corporation stock.

b. If challenged, it would appear to be more difficult for the IRS to challenge the entity nature of a corporation.

c. Control can be maintained in one or more key individuals by capitalizing the stock with both voting and nonvoting stock.

d. With the availability of ESBTs along with the other trusts which are eligible shareholders, there is much less limitation on the estate planning opportunities.

C. OSSTs as Estate Planning Tools.

1. The ability in an S corporation to control the flow of dividend income separately from the passthrough of taxable income to the
shareholders creates significant planning opportunities with QSSTs.

a. In a QSST, the beneficiary reports the trust’s share of the S corporation income on his or her personal 1040, as if he or she were the shareholder.

b. The beneficiary is also entitled to all the net fiduciary accounting income received by the trust. This includes dividends, but only if, as and when paid by the corporation.

c. Just as a large public company can decide to retain earnings and not declare dividends, so can an S corporation.

2. Assume that the trustee of a discretionary trust for a minor or a disabled beneficiary prefers for nontax reasons not to make distributions to the beneficiary, but yet the trustee would like to take advantage of the beneficiary’s relatively lower income tax rates as opposed to the trust’s income tax rates which reach 39.6% at $8,100 for 1997.

a. The trustee creates an S corporation and funds it with all (or virtually all) of the trust assets.

b. The trust makes a QSST election (which may require the appointment of a guardian for the beneficiary).

c. Each year the beneficiary reports all the passed-through S corporation net income, using his or her tax rates, and the trustee, as director of the corporation, declares a dividend only to the extent necessary to provide the cash for the payment of the beneficiary’s income tax liability from the QSST income.

d. Note that the same technique would work in the case of a simple trust where there are nontax reasons to try to avoid cash flow to the beneficiary.

3. Assume that B is the elderly beneficiary of a bypass trust created by B’s late husband, which provides for mandatory income distributions to B for life. B is otherwise very comfortable
financially and is looking to do aggressive estate planning. The remaindermen of the trust are also the beneficiaries of B’s estate.

a. The 3-4% income B receives from the trust’s balanced portfolio is not needed by B and serves only to increase her taxable estate.

b. The trustee incorporates the entire trust portfolio into an S corporation and B elects QSST status. The trustee, as corporate director, declares annual dividends equal to just over 1% of the value of the portfolio, which is distributed to B.

c. B, as QSST beneficiary, pays the income tax on all the portfolio income, although B is only receiving a portion of it.

d. B is achieving a substantial estate tax saving for each year she survives, but it is possible that the IRS will argue that B made a gift to the trust each year by allowing her income to be reduced, notwithstanding that she continued paying tax on all the income. However, the IRS should be unsuccessful in that argument if a 1% return is not considered underproductive pursuant to applicable state law.

e. Going one step further, the trustee learns from the trust’s presumptive remaindermen that they intend to sell the trust’s assets after B’s death, even though there will be a substantial capital gain.

(1) The trustee instead liquidates the portfolio prior to B’s death.

(2) The capital gains tax is paid by B rather than her beneficiaries, who will receive either cash or assets without substantial unrealized appreciation.

4. Assume that the stock of an operating S corporation is spread among several family members, including a QSST for one child.

a. The corporate directors wish to make a substantial cash distribution to the shareholders, but for nontax reasons it
would be preferable for the QSST beneficiary not to receive the income.

b. Rather than declaring a dividend, the corporation structures the distribution as a partial redemption, so that it is considered a principal receipt by the QSST and thus not distributable to the income beneficiary. See PLR 9349009.

VI. HOLDING S CORPORATION STOCK IN TRUSTS AND ESTATES

A. Trusts Permitted to Hold S Stock.

1. Revocable trusts, §678 trusts, and other grantor trusts under §§671-678 are permitted shareholders, but only if all of the trust is treated as such a subpart E trust and is treated as owned by an individual who is a citizen or resident of the United States. §1361(c)(2)(A)(i). After the death of the deemed owner the trust remains qualified for 2 years. §1361(c)(2)(A)(ii).

2. Qualified subchapter S trusts (QSSTs), which are trusts whose beneficiaries make the requisite election and that meet the requirements discussed earlier in this outline. §1361(d)(3).

3. Electing small business trusts (ESBTs), which are trusts whose trustees make the requisite election and that meet the requirements discussed earlier in this outline. §1361(e)(1).

4. A trust with respect to stock transferred to it pursuant to the terms of a will, but only for the 2-year period beginning on the day on which such stock is transferred to it. §1361(c)(2)(A)(iii).

5. A trust created primarily to exercise the voting power of stock transferred to it. §1361(c)(2)(A)(iv).

B. Trusts Not Permitted as S, QSST, or ESBT Shareholders.

1. Foreign trusts. §1361(c)(2)(A).


4. Separate share of a QSST where there is even a remote possibility that the corpus of the trust share will be distributed to someone else during the current income beneficiary’s lifetime. Rev. Rul. 93-31, 1993-1 C.B. 186.

5. GRATs, GRUTs, and charitable lead trusts unless structured as grantor trusts or able to make the election to be an ESBT.

C. Crummey Trusts as S Shareholders.

1. In PLR 8336018 the IRS held the trust was not a permitted shareholder under §1361(c)(2)(A)(i) where the beneficiary had "a special power to demand distribution of all trust income for the current year," plus a Crummey power "to withdraw from principal the lesser of the donor’s annual contribution or the donor’s gift tax exclusion." The beneficiary was deemed the owner of only a part of the trust.

2. Where the power of withdrawal is over all contributions made during the year, the IRS treats the beneficiary as the owner of the entire trust under §678, and the trust will be a permitted shareholder under §1361(c)(2)(A)(i). PLR 8342088, PLR 8805032, and PLR 9535047.

3. Even if the trust is not a wholly grantor trust so as to come within §1361(c)(2)(A)(i), it may be possible to make a QSST or ESBT election.

D. Special Consideration for QSSTs and ESBTs.

1. If there is a likelihood of a QSST or ESBT election, the trust should be drafted to cover all requirements and to eliminate the need to seek reformation later.

2. In a QSST, the trust beneficiary is "treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election" has been made. §1361(d)(1)(B). This may be less than the entire trust income where the trust has other income-producing assets.

3. Successive income beneficiaries are not required to reelect QSST treatment but may affirmatively refuse to consent. §1361(d)(2)(B)(ii).
4. A QSST election can be made by a beneficiary who is treated as the deemed owner under the grantor trust rules and would otherwise be a permitted shareholder. PLR 9422041.

5. Where a QSST is involved, if the trust document does not require current distribution of trust income, and distribution of all income is not in fact made, the trust will lose its QSST status as of the first day of the year following the year for which the failure to distribute took place. §1361(d)(4)(b). Because of the 65-day rule under §663(b), the trustee in effect has the unilateral right to terminate the S election retroactively to the beginning of the year. The other shareholders may wish to protect themselves against this possibility by entering into an agreement with the trustee, but the trustee may not wish to commit to others to make discretionary distributions to the beneficiary.

6. The requirements of §1362(d)(3)(B) are not violated where undistributed income at the income beneficiary’s death is distributed to his estate or to the successor beneficiary pursuant to state law. Rev. Rul. 92-64, 1992-2 C.B. 214.

7. A QSST beneficiary who is entitled only to fiduciary accounting income is nevertheless required to pay personally income taxes on capital gains and other nonfiduciary accounting income items passed through under §678(a). The drafter of the trust should include authority to invade corpus for the additional taxes borne by the income beneficiary or perhaps by including administrative powers in the trust document permitting the trustees to make equitable adjustments.

8. If possible, the trustee (and, in the case of a QSST, the beneficiary as well) should insist on a shareholders’ agreement before consenting to the S election and making the QSST or ESBT election. The agreement should address mandatory corporate distributions to cover anticipated tax liabilities as well as other issues deemed appropriate by the trustee or the beneficiary under the circumstances.

9. The final QSST regulations provide that, when a QSST sells all or part of its S stock, the QSST beneficiary will not be treated as the owner of the stock in determining and attributing the federal income tax consequences of the sale. Regs. §1.1361-1(j)(8). These regulations revoked Rev. Rul. 92-84, 1992-2 C.B. 216, which had held the gain was taxable to the beneficiary even
though under state law the proceeds were corpus and had to remain in the trust.

VII. HOLDING PARTNERSHIP AND LIMITED LIABILITY COMPANY INTERESTS

A. Fiduciary Authority.

1. Absent specific authority under state law, the governing instrument, or a court order, the fiduciary may not be permitted to retain the interest and may be required to convert the interest and reinvest in permitted investments. Section 3-715 (24) of the Uniform Probate Code permits the personal representative to continue any unincorporated business or venture for a period of not more than four months (or throughout administration if a corporation is formed).

2. Most state laws and governing instruments only refer to corporations and partnerships and do not mention limited liability companies (LLCs). Some statutes refer to all businesses conducted in unincorporated form.

3. The statutes contemplate that the fiduciary will be in a position to cause the partnership or other unincorporated entity to cease operations.

4. The fiduciary issues are becoming more critical with the prevalent use of family limited partnerships and LLCs structured for valuation discount purposes and pass-through tax planning.

B. Rights of Assignee.

1. An assignment by a partner or member of an interest in the partnership or LLC generally does not entitle the assignee to participate in the management of the entity, to require any information or account, or to inspect the books. Such assignment merely entitles the assignee to participate in distributions of profits.

2. If a partner or member transferring an interest to a trust wishes the trustee to have certain rights, the partnership agreement or operating agreement should be amended or the agreement of the other parties obtained. It may be possible for the transferor who
has not assigned his complete interest to exercise certain rights on behalf of the trustee.

3. A trustee who receives a partnership or LLC interest does not become a substituted partner or member unless the partnership agreement or operating agreement so provides or the trustee is admitted by the other partners or members.

C. Income Tax Considerations.

1. Distributive share of partnership or LLC income may be included in DNI of the trust even though the partnership or LLC has not made any current distributions.

2. In Fickert v. Commissioner, 15 T.C. 344-(1950), nonacq. 1951-1 C.B. 4, the trust (and not the beneficiaries) was taxed on the trust's distributive share of partnership income to the extent the distributive share exceeded the amount received by the trust from the partnership.

3. Regs. §1.652(a)-1 requires the beneficiary of a simple trust to include in gross income all amounts of income required to be distributed to the beneficiary currently, whether or not distributed. This is true even though distribution is delayed because of the unavailability of funds. See Bruchmann's Estate v. Commissioner, 53 T.C. 403 (1969), and Rev. Rul. 85-116, 1985-2 C.B. 174.

4. The rules of Subchapter K attempt to keep a partner's inside basis (the proportional interest in the basis of each partnership asset) equal to the partner's outside basis (the basis in the partnership interest). A partner generally receives a substitute basis in the partnership interest equal to the basis of the property contributed. Furthermore, a partner normally receives a carryover basis in property distributed, but this basis is limited to the distributee's outside basis: §732.

5. Upon distributions from a partnership and upon a sale or exchange of a partnership interest, a difference may arise between inside and outside basis. If a partnership makes a timely election under §754, this difference will be eliminated. Except in the limited case of a §338 election, including an (h)(10) election, no analogous provision exists when dealing with a corporation.
D. **Fiduciary Accounting Considerations.**

1. The fiduciary must decide whether to treat the LLC as a partnership or as a corporation for principal and income purposes.

2. The fiduciary must also determine whether nonliquidating partnership or LLC distributions are income or principal for fiduciary accounting purposes.

3. Under the Uniform Principal and Income Act and Virginia Code §55-261, proceeds from the severance of natural resources are generally considered principal.

4. Where the assets are subject to depletion (such as leaseholds or working interests), characterization may depend upon whether or not the fiduciary is under a duty to retain or dispose of the partnership or LLC interest. See Va. Code §55-262.

5. The Uniform Principal and Income Act and the Virginia Act do not mention depreciation with respect to improved real property, but §13 of the Revised Act provides for a charge to be made against income for a reasonable allowance for depreciation under generally accepted accounting principles.

6. Where the fiduciary uses principal in a business that the grantor had been carrying on, the net profits of such business attributable to the principal are generally deemed income. Uniform Principal and Income Act, §7; Revised Uniform Principal and Income Act, §8(a); and Va. Code §55-259(1). However, would go on the principal account and presumably would not be carried over to offset income in subsequent years.

7. The "business" requirement suggests that the partnership or LLC must be engaged in the active conduct of a business, and the "carrying on" requirement suggests that the grantor must have been involved in the management of the business and not merely a limited partner.

8. Where the decedent was not the controlling partner or member but votes with others to continue the partnership or LLC, this may constitute using principal in the continuance of a business. The result may be different if the decedent was a limited partner.
and no vote is required for the partnership to continue. Even more uncertainty can exist if the entity is an LLC and the personal representative is outvoted concerning the continuance of the entity.

VIII. CONCLUSION

With the recent liberalization in the Subchapter S rules, S corporation stock can now be integrated into most estate planning and estate administration techniques and structures. Furthermore, certain quirks of the S corporation rules permit estate planning and estate administration transactions which could not be accomplished with other entities.