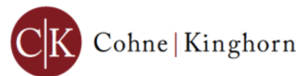
Some S-Corporation Estate Planning and Estate and Trust Administration Issues

Langdon Owen
Cohne Kinghorn, P.C.
(801) 363-4300
lowen@cohnekinghorn.com



Some S-Corporation Estate Planning and Estate and Trust Administration Issues

TABLE OF CONTENTS

1. Use of Trusts 1
   1.1. General 1
   1.2. Nonelective 2
      (a) Voting Trust 2
      (b) Grantor Trust 2
      (c) Deemed Owner 3
      (d) Will Recipient 3
      (e) Estate. 3
      (f) Charitable 4
   1.3. Elective Trusts 4
      (a) QSST 4
      (b) EBST 5
2. QBI Deduction. 7
   2.1. Qualified Business Income. 7
   2.2. Limits and Phase-In 8
      (a) Wage and Unadjusted Basis Limit. 8
      (b) Service Business Limit 8
   2.3. QSSI and ESBT Effects.. 8
3. Other Factors 9
   3.1. Creditors 9
   3.2. Cancellation of Debt Income 9
   3.3. Pass-through taxation 9
   3.4. Additional Charitable Issues 10
   3.5. Self-employment Tax 10
   3.6. Step-up Basis on Death 11
   3.7. Passive Income Issues 11
      (a) Investment Company 11
      (b) Excess Passive Income 11
      (c) Passive Activity Loss 11
   3.8. Stock Sales and Redemptions 12
      (a) Redemptions 12
         (i) Dividend Issue 12
         (ii) Avoiding Dividend 12
      (b) Sale of Stock for Cash 13
         (i) Redemption Loss 13
         (ii) Basis of Stock 13
         (iii) Book Closing 13
         (iv) Planning for Book Closing 14
         (v) Matters for Agreement 14
         (vi) Tax Indemnity 15
   3.9. State Tax Law 15

Langdon Owen
Cohne Kinghorn, pc
(801) 363-4300
lowen@cohnekinghorn.com

Some S-Corporation Estate Planning and Estate and Trust Administration Issues

S-corporations are very popular for operating businesses, and planning for them or with them can produce significant benefits for the client. However, their use either as a closely-held business vehicle or as a family estate planning tool needs to be evaluated in light of the other available alternatives for such a company. Special attention needs to be paid to S-corporation stock on the death of the owner.

S-corporations are domestic corporations with a valid S-election in place under IRC § 1361. In order to have a valid election, certain conditions must be met, including (but not limited to) (i) no more than 100 shareholders (certain family members can be aggregated as one shareholder for this purpose; IRC § 1361(c)), (ii) all shareholders are individuals (other than nonresident aliens or, in most cases, their spouses), decedents' estates, bankruptcy estates, certain limited kinds of trusts, or charities, or the corporation's stock may be 100% owned by another S-corporation (for example, an LLC may not be a shareholder unless the LLC is a single member LLC disregarded for tax purposes with a member otherwise eligible to be an S-corp stockholder (PLR 200303032)), and (iii) there is only one class of stock. As long as the economics are the same (such as rights to dividends or liquidating distributions), there may be different classes varying only as to voting rights without violating the one class of stock requirement. IRC § 1361(b). If the corporation has a valid S-corp election in place, then with some exceptions, income is not taxed at the corporate level, but income, loss, deductions, and credits pass through to its shareholders. The pass-through feature of S-corporations makes them different from other corporations without the S-corp election (called "C-corps").

1. **Use of Trusts**. S-corp stock may be held in only certain kinds of trusts. This restriction will have an important impact on planning for many clients. If planning will or may require trusts, the problems associated with S-corps described in this outline need to be understood. The concerns over the future use of trusts lead many estate planners to favor the LLC form over the S-corporation. Although planning with LLC interests is by no means simple, in most situations there at least exists a much wider range of possibilities than is available for S-corporations. Naturally, how the S-corp fits in the overall investment and business situation of the client will be of great importance; a modest S-corp holding is one thing, but having substantially all family wealth in an S-corp is something else altogether.

1.1. General. There are only a few sorts of trusts which can hold S-corp stock, a situation which makes estate planning with S-corp stock considerably more difficult. Certain

types of trusts may not be available for use or will carry with them restrictions or income tax disadvantages. Not using trusts will make some planning goals difficult or impossible to achieve, thus, the planner will generally be forced to fit the plan to the best available trust type and have the client be ready to live with the consequent restrictions or disadvantages. Also, the failure to plan properly can destroy a valuable tax election for the client and his or her co-shareholders. Many S-corps have agreements among shareholders to restrict certain transactions which could jeopardize the election and these restrictions need to be taken into account by the planner. The types of available trusts are:

- a voting trust (IRC § 1361(c)(2)(A)(iv));
- a deemed owner trust where the grantor is the deemed owner (IRC §§ 673-677; 1361(c)(2)(A)(I)) (sometimes called a "grantor trust");
- a trust with a deemed owner other than the grantor (IRC §§ 678; 1361(c)(2)(A)(I)) (these are quite similar to true grantor trusts and sometimes are loosely included in the term "grantor trust");
- a will recipient trust, that is, a testamentary trust receiving the stock pursuant to the will (IRC § 1361(c)(2)(A)(iii));
- certain tax-exempt trusts such as for qualified plans or for certain charities (IRC § 1361(c)(6) allows qualified plan trusts described in IRC § 401(a) or charitable organizations described in IRC § 501(c)(3) and, in either event, which are exempt under IRC § 501(a), to be S-corp shareholders);
- a qualified subchapter S trust or QSST (IRC § 1361(d));
- an electing small business trust or ESBT (IRC § 1361(e)).

1.2. Nonelective. Some trusts do not require special elections (although some of these may be allowed to make such an election, if it is desirable to do so). Two trust types, the QSST and ESBT require elections. The trusts which do not require these two special elections are:

(a) Voting Trust. A voting trust may be useful in establishing management control over the corporation, sometimes to deal with a particular issue, sometimes to avoid time limitations and irrevocability issues on proxies, and sometimes as a substitute for classified stock under the articles of incorporation. Generally, nothing but voting control is involved and economic rights such as the right to dividends or distributions are unaffected.

(b) Grantor Trust. Grantor trusts, called "qualified subpart E trusts" in the regulations are (in general) trusts where some significant power is reserved by the grantor (or the grantor's spouse) so that for income tax purposes (see IRC §§ 671 *et seq.*), the grantor is

taxed on the trust's income even if it is actually paid to someone else. Some typical grantor trusts would include:

- revocable estate planning trusts;

- intentional deemed owner trusts (sometimes called intentionally "defective" grantor trusts), which are irrevocable trusts intentionally created to have one or more of the proscribed powers retained by the grantor; such trusts may be created, for example, to enhance a gift by having the grantor pay the income tax, or to freeze values for estate tax purposes by sales of productive assets (*e.g.*, real estate) to the trust in return for a note (no gain or loss to grantor since it is a sale to oneself, and future appreciation will be out of the gross estate); some charitable lead trusts are created as grantor trusts, usually by retaining a reversionary interest under IRC § 673 or sometimes by retaining or, usually better yet, by granting to another a right to substitute property of equivalent value (see PLR 200011012); however, actually exercising such a right by the grantor would be an act of self-dealing.

- grantor-retained annuity trusts or grantor-retained unitrusts (GRATs and GRUTs) where grantor has a proscribed power; charitable remainder trusts, however, cannot be grantor trusts and still qualify under IRC § 664.

- Such deemed owner trusts may continue to hold the S-corp stock for up to two years after the death of deemed owner, often the grantor. The estate of the grantor (deemed owner) will be treated as the stockholder. If the stock is not disposed of prior to end of that two-year period, the S election will be disqualified. This can be a problem for the estate of a person holding the stock in a typical revocable estate planning trust. However, deemed owner trusts may elect to be treated as QSSTs if they meet the QSST requirement. This may be quite useful but will not be much help to a trust with sprinkling provisions allowing distributions among two or more beneficiaries, but an ESBT election could save the day for the sprinkling trust

(c) Deemed Owner. Deemed owner trusts (IRC § 678) where someone other than the grantor is treated as the deemed owner, are treated similarly to grantor trusts and are subject to the same two-year rule for holding the S-corp stock after the death of the deemed owner.

(d) Will Recipient. A will recipient trust only qualifies as a shareholder for two years beginning on the day the stock is transferred to it from the estate. The QSST and ESBT elections may be available if a longer term holding is desirable.

(e) Estate. The decedent's estate itself may be an S-corp stockholder during a reasonable actual period of administration. IRC § 1361(b)(1)(B). If the administration of an estate is unreasonably prolonged, the estate is considered terminated for federal income tax

purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. Reg. § 1.641(b)-3(a). The estate is then treated as a trust, and an election to be treated as a QSST or ESBT would be needed to preserve the S-corp election. *Old Va. Brick Co. v. Com'r*, 44 TC 724 (1965), *aff'd*, 367 F2d 276 (4th Cir. 1966). During the period for which IRC § 6166 allows the deferral of estate taxes (this could be up to 15 years), the estate may remain open without destroying the S-corp election. Rev. Rul. 76-23, 1976-1 CB 264. No such automatic deferral is allowed for the period of tax audits. PLR 7951131 (1979).

(f) Charitable. The availability of certain charitable trusts as shareholders makes some charitable planning possible using S-corp stock in trust.

1.3. Elective Trusts. The key planning tools for S-corporation stock are the use of a QSST (Qualified Subchapter S Trust) or a ESBT (Electing Small Business Trust), trusts which require the filing of special elections in order to be allowable as shareholders.

(a) QSST. A QSST is, essentially, a one beneficiary trust; for example, marital trusts are commonly QSSTs, as are IRC § 2503(c) minor trusts and charitable remainder trusts. If the qualifications for a QSST are not met, consider using corrective modification agreements or disclaimers. For a trust to qualify as a QSST, it needs to meet these requirements:

- It must actually distribute income to only one current income beneficiary, or be required to distribute to one beneficiary; naturally, the instrument should specify the requirement to distribute and not to accumulate income, but actual distribution to but a single current income beneficiary is sufficient.
- The income beneficiary must be a U.S. citizen or resident.
- The trust instrument must require that during the life of the current income beneficiary, there will be but one current income beneficiary. A trust with multiple beneficiaries, each with a separate share, may be treated as if the separate shares were separate trusts, even without asset segregation. Thus, equal distribution or percentage distribution, but not sprinkle distribution, provisions may qualify as such separate shares.
- The trust must require that any principal distributed during the current income beneficiary's lifetime must only go to that beneficiary.
- The trust must provide that the income beneficiary's income interest terminates on the earlier of his or her death or the termination of the trust.
- The trust must provide for distribution of the entire trust to the current beneficiary if the trust terminates while the current income beneficiary is alive.

- Also, the current income beneficiary must timely elect QSST treatment, generally within two months and 16 days after the stock is transferred to the trust, or after the S election is effective if the S election is made while the trust holds the stock. Rev Proc. 98-55, 1998-2 C.B. 645. A separate QSST election is required for each S-corp held by the trust. Once made, it continues in effect for successive beneficiaries, unless the beneficiary affirmatively refuses consent. This gives the current income beneficiary a right to unilaterally terminate the S election by refusing consent, something other shareholders cannot do. It may be important to have a shareholder's agreement expressly prohibiting such unilateral action.

- If an S-corp shareholder is a QSST, the single beneficiary of such trust is treated as the shareholder for most purposes (as a deemed owner of the trust under IRC § 678), but not on disposition of the stock itself. Regs. § 1.1361-1(j)(8). The election under IRC § 338(h)(10) to treat a stock sale like an asset sale does not change this. The sale of the stock is still treated as a stock sale by the trust itself and the gain is that of the trust rather than the beneficiary. PLR 201232003.

(b) EBST. The ESBT is a multiple beneficiary trust. It may sprinkle or accumulate income. Common examples include credit-shelter trusts or grantor trusts with multiple beneficiaries which continue after the death of the grantor. To be eligible for ESBT treatment, the trust must meet these requirements:

- It can have only individuals, estates, or charities as beneficiaries (*i.e.*, a charity described in IRC § 170(c)(2)-(5) (private charity, veterans post, fraternal lodge, cemetary society), or one described in § 170(c)(1) (governmental organization) if it only holds a contingent interest in the trust and not an interest as a potential current beneficiary). IRC § 1361(e)(1). Beneficiaries include present, reversionary, or remainder beneficiaries; other trusts are looked through and their beneficiaries are treated as the beneficiaries of the ESBT; the potential recipients under an exercise of a power of appointment are not treated as beneficiaries (for this purpose) until exercised in that recipient's favor (but see below as to pre-2005 potential current beneficiaries and the 75 shareholder limit); and nonresident aliens are permitted to be eligible beneficiaries, and after 2017 can also be potential current beneficiaries (prior to 2018 they could not be potential current beneficiaries). Regs. § 1.1361-1(m)(1)(ii); IRC § 1361(c)(2).

- No interest in the trust may be acquired by purchase.

- The trustee must elect ESBT treatment, generally two months and 16 days after the stock is transferred to the ESBT. Regs. § 1.1361-1(j)(6)(iii); see Rev. Proc. 98-55, 1998-2 CB 645 for relief for inadvertent failure to timely file the election. Only one election per trust is needed unless different IRS service centers are involved. An ESBT may convert to a QSST; otherwise, the election is irrevocable and protective elections are not allowable. Treas. Regs. § 1.1361-1(m)(2)(v), and §§ 1.1361-1(m)(6) and (7).

Once the trust is qualified as an ESBT, each "potential current beneficiary" is treated as a shareholder of the S-corporation for the 100 shareholder limit (75 shareholders before 2005; also beginning in 2005 there is a family election to be treated as a single shareholder), and if none, the trust itself is treated as the shareholder. With respect to any period, any person who at any time during the period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust, is such a "potential current beneficiary." IRC § 1361(e)(2); Treas. Regs. § 1.1361-1(m)(4)(I). (The regulation is effective for taxable years of ESBTs beginning after May 14, 2002; see Notice 97-49, 1997-2 C.B. 304 for prior periods.) Potential recipients under currently exercisable powers of appointment are included here through 2004, and may cause disqualification (unless and until the power is permanently released). After 2004, unexercised powers of appointment may be disregarded. Also after 2004, the time to dispose of stock after an ineligible shareholder becomes a potential current beneficiary increased from 60 days to one year.

Over time, if shares become separate shares, each income beneficiary can make an election under IRC § 1361(d)(2) to revoke the ESBT election for the separate share for that beneficiary and treat it as a QSST. The revocation of the ESBT election for one or more separate shares won't affect the current ESBT election for the shares of the remaining income beneficiaries (*e.g.*, last remaining spray trust beneficiary, with separate shares for descendants of other former spray trust beneficiaries). See, PLR 201122003.

ESBTs, although tricky, add considerable flexibility for dealing with S-corp stock, but such flexibility comes at an income tax cost because ESBTs are subject to a rather unusual tax regime under IRC § 641 and Treas. Regs. § 641(c)-1. There are three portions with differing treatment: a grantor portion, and a nongrantor portion, which in turn is subdivided into a non-S portion and an S portion.

- The "grantor" or deemed owner portion is the part treated as owned by a grantor or other person under the grantor and deemed owner trust rules, and this portion is taxed to such grantor or person; it may include both S-corp stock or other assets.

- The non-S portion is the portion of the assets, other than S-corp stock, not treated as a deemed owner portion; this portion is treated as a separate trust using normal trust tax rules. The dividends from the S-corp (under IRC § 1368(c)(2)) and interest on the sale of S-corp stock are includible in income of such separate trust. The separate share rules do not apply.

- The S portion is the portion consisting of S-corp stock not treated as a grantor or deemed owner portion. It, too, is treated as a separate trust and in determining its income, it takes into account specified items ("S portion items") aggregated from all S-corps of which it owns stock. Except for capital gains, these items are taxed at the highest trust marginal rates, with no exemption for alternative minimum tax (IRC § 55(d)) purposes, and are not apportioned to (or included in income by) any beneficiary, are included in the overall actual trust's distributable net income (DNI) but are not deductible from it. The effect is to create an income tax

disadvantage because § 641(c) will prevent the apportionment of S portion items to beneficiaries at their potentially lower tax brackets.

- If an S corporation makes charitable donations, a pro rata share passes through to the ESBT that owns stock and the share is treated as being contributed by the S portion, subject to deduction limitations. Regs. § 1.641(c)-1(d)(2)(ii). Presumably after 2017, IRC § 170 would apply to the amount deemed donated by the ESBT's S-corp portion.

- IRC § 170 will govern ESBT charitable donations after 2017 without a sunset in 2026 so that such a trust will use the charitable contribution rules applicable to individuals, including percentage limitations and carry forward provisions. See 3.4 below.

- Before 2018, if the ESBT donated S stock to charity, neither the S portion nor the non-S portion would get a deduction. See 858 TD 8994, 2002-23 IRB 1078, 1082, Regs. § 1.641(c)-1(l), Ex. 4. After 2017, IRC § 170 will apply so that a deduction, subject to applicable percentage limits, could be obtained. See 3.4 below.

- The taxation of distributions stays the same for the overall actual trust, so that the DNI of the trust would follow a distribution to the beneficiary and be taxed to the beneficiary with a corresponding deduction for the non-S portion.

- The ESBT is treated as a single trust for purposes of the 3.8% tax on net investment income (NII), but the NII is calculated in two separate stages, the S-portion and the non-S-portion, and then these two amounts are combined. Reg. § 1.1411-3(c)(1) and (c)(2). The adjusted gross income (AGI) of the non-S-portion is increased or decreased by the S-portion's net income or loss, treated as a single item of ordinary income or loss. Reg. § 1.1411-3(c)(2)(ii).

2. **QBI Deduction**. Beginning in 2018 and ending in 2026 there is a 20% qualified business income ("QBI") deduction for flow through entities, including S-corporations. IRC § 199A.

2.1. Qualified Business Income. The qualified business income must come from a sole proprietorship, partnership, or S-corporation. The deduction applies at the partner or S-corp shareholder level and, subject to some limitations, is available to individuals, estates, and trusts. The qualified business income (or deduction or loss) must come from a qualified United States business. Any QBI loss is carried forward, apparently indefinitely until used; this loss will reduce the QBI potential deduction in the next or subsequent years. QBI includes ordinary business income, but not investment income like interest (other than "business" interest), dividends, or capital gain (whether long- or short-term). Also, QBI does not include the W-2 employee income of an S-corporation shareholder (or partner guaranteed payments for services); normal reasonable compensation principles continue to apply.

2.2. Limits and Phase-In. There are two limits to the QBI deduction which apply to taxpayers with incomes above $157,500 ($315,000 for married filing jointly). The limits phase in between $157,500 and $207,500 ($315,000 and $415,000 for married filing jointly); thus, the limits are fully effective at $207,500 ($415,000 joint), and don't apply for income levels below $157,500 ($315,000 joint). These amounts are indexed for inflation. Some married couples may want to consider filing separate returns to fit within the dollar limits.

(a) Service Business Limit. The first limitation that applies to taxpayers with the levels of income described above (with the same phase-in levels) is that QBI will not include income from certain service businesses: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or (the catch-all) any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners. Also, QBI will not include income from services that consist of investing and investment management, trading or dealing in securities, partnership interests, or commodities. Engineering and architecture are left out of the proscribed service businesses.

(b) Wage and Unadjusted Basis Limit. The second limit on the deduction for each trade or business is that the deduction can't exceed the greater of (i) 50% of W-2 wages allocable to the QBI, or (ii) the sum of 25% of W-2 wages plus 2.5% of the unadjusted basis (e.g., original purchase price) of tangible depreciable property (e.g., building, equipment) for which the period for depreciation has not ended (the later of 10 years after being placed in service or the last full year of the applicable recovery period). For purposes of the W-2 limitations, the W-2 wages of the S-corp shareholder count. So, in some situations an increase in the shareholder's W-2 income may be desired to increase the QBI deduction; however, recall that the QBI itself is reduced by the shareholder's W-2 compensation, thus a balance will be needed. The W-2 wages and the property basis used in calculating the limit is allocated pro rata to S-corp shareholders. (For partners, this allocation is by shares of wage expense as to the W-2 wages, and by shares of depreciation as to unadjusted basis, presumably subject in each case to special allocation among the partners.)

For a trust that is a shareholder (or partner), allocations of W-2 wages and unadjusted basis are made under rules similar to the former IRC § 199(d)(1)(B)(i) rules that were applicable to determining domestic production activities. Such allocations were based on the distributable net income (DNI) deduction deemed to be distributed to a beneficiary or retained by the trust for the tax year; if there was no DNI for a year the allocation was only to the trust. The DNI for this purpose was calculated without the qualified production deduction, so we can expect that for purposes of the QBI deduction, the DNI for allocation of the W-2 wages and unadjusted basis will be calculated without using the QBI deduction.

2.3. QSST and ESBT Effects. Where an S-corp has as a shareholder a QSST (qualified subchapter S trust for a single beneficiary) or an ESBT (electing small business trust for multiple beneficiaries), the QBI deduction, which applies at the shareholder level, will be taken by the trust that is the shareholder or by the trust's beneficiaries under normal allocation applicable to simple or complex trusts. It appears that the QBI itself is allocated among the trust and its beneficiaries and then the W-2 wages and unadjusted basis of property is separately

allocated among the trust and its beneficiaries. The items are then combined at the level of the trust or beneficiary to arrive at the QBI deduction for that particular trust or beneficiary. Thus, for a QSST it would appear that the QBI would be allocated as distributable net income between (i) the trust itself (to be taxed to the trust at the compressed trust tax rates after any QBI deduction is applied) to the extent the DNI is retained by the trust and (ii) the beneficiaries (to be taxed at their applicable rates after any QBI deduction is applied) based on the extent the DNI is distributed or deemed distributed among them. For an ESBT, the QBI passing through the S-corp would be allocated to the S-corp portion of the trust and would be allocated between the trust and its beneficiaries based on whether the DNI is distributed, or deemed distributed, or retained by the trust. As noted above, the W-2 wages and unadjusted basis would be allocated between the trust and beneficiares under the former IRC § 199 rules. At the taxpayer level (trust or beneficiary, as the case may be) the QBI deduction is available but is subject to the applicable W-2 or unadjusted basis limits using the wages or basis allocate under the IRC § 199 rules.

3. **Other Factors**. Some other S-corporation issues to consider in selecting a form of business organization or of using a form of organization, with estate planning or estate administration in mind, include:

3.1. Creditors. For partnerships or LLCs, charging orders provide creditors only with the right to receive distributions, if any, made to the debtor. Seized interests are assignee interests without vote or management say and generally find no market and partnerships and LLCs are difficult for creditors to force into liquidation. LLCs are superior to partnerships, because such things as general partner death, disability, or bankruptcy can trigger dissolutions of general or limited partnerships, but generally not for LLCs with more than one member. Stock, including of S-corps, seized by creditors carries with it any voting rights, and corporations are thus generally easier for creditors to liquidate in order to get at the underlying assets, for example, where a majority interest is seized or where minority interests can combine to force dissolution.

3.2. Cancellation of Debt Income. Insolvent S-corporations take into account the insolvency exception to cancellation of debt income at the corporate level (under IRC § 108) and nontaxable cancellation of debt income does not increases the shareholder's basis in stock, thus the shareholders ultimately lose the benefit of the exclusion by at some point recognizing a smaller loss or additional income (e.g., on liquidation). The insolvency exception applies at the partner and member level for partnership taxed organizations (this may not always be helpful to partners, however).

3.3. Pass-through taxation. Corporations with an S-election are pass-through entities. Partnership taxation features, including pass-through income, deductions, and credits, tax deferral on liquidating transfers of capital assets in kind, step-up basis in underlying assets on the death of an owner or on asset distributions or the sale of an interest, etc., are generally better for clients than are S-corp taxation features, in part because there are fewer restrictions and more flexibility than for S-corporations. For example, loans to S-corporations (even where guaranteed by the shareholder) do not increase a shareholder's basis, yet this basis is a cap on the

shareholder’s ability to take losses against other income. For partnership-taxed organizations, basis will increase in such cases (even without a guaranty).

3.4. Additional Charitable Issues. Under revised IRC § 1366(d)(4) (effective for contributions made in 2006 or later) the stock basis limit on deductions won’t apply to the extent of the excess, if any, of the S corp shareholder’s share of the charitable contribution over the shareholder’s share of the basis of the contributed property. Thus, gain in the contributed property might be deducted. The shareholder’s basis in shares is reduced only by his or her share of the basis of the property contributed, not by the full fair market value of the donated property. IRC § 1367(a)(2). A similar rule applies to partnerships after 2018 (IRC § 704(d)) eliminating a benefit the partnership taxed organizations earlier had where a full charitable deduction could be obtained even without any outside basis remaining; after 2017, with a zero outside basis, only the gain can be deducted.

Under IRC § 512(e), where a charity holds S-corp stock, the stock is treated as an unrelated trade or business, and gain from the sale of the stock is unrelated business taxable income to the charity.

For ESBTs, the charitable deduction was, before 2018, governed by IRC § 642(c) rather than IRC § 170. Thus, the distribution had to be made from gross income and had to be made pursuant to the governing instrument, and there was no carry forward. After 2017, however, the rules of § 170 governing contributions by individuals will apply, and will not sunset after 2025. The portion of the ESBT holding the S-corporation stock can now contribute property without having to have the contribution come from gross income, the strict governing instrument requirement won’t apply anymore, and there will be a five-year carry forward of any unused contribution. However, the percentage limitations applicable to individuals will now apply to the portion of the ESBT holding the S-corporation stock and the substantiation requirements under IRC § 170 will apply as well.

3.5. Self-employment Tax. The S-corp may have a modest edge on Social Security and self-employment taxes, however. Interest owners in LLCs and other partnership-taxed organizations may be subject to self-employment tax on some income, which might be excluded if the owner was paid a salary by an S-corp. Partners and LLC interest owners are generally treated as if their entire distributive shares (less express statutory exceptions to self-employment income) are self-employment income; S-corp shareholders are generally (absent abuse) treated as if only their W-2 compensation is subject to the Social Security taxes on employer and employee. Although the difference is usually modest, an S- corp management company with a management agreement with the LLC or partnership may effectively solve the problem if it is expected to be a substantial issue. The S-corp management company hires the individuals and pays reasonable compensation for their services in managing the asset held by the LLC. The tax saving, if any, is the tax on the portion of the LLC or partnership distributive share which is not personal-service income (this income should be taxed like employment income in any event) and which is not subject to a statutory exception, after taking into account that half of the self employment taxes are deductible (IRC § 164(f)) for income tax purposes.

3.6. Step-up Basis on Death. Partnership-taxed organizations allow tax-free, in-kind liquidating distribution and allow (with the proper IRC § 754 election) the basis of the underlying assets of the partnership to be stepped up on the death of a member or partner and also on some asset distributions or on some sales of an interest in the company; these important benefits are simply unavailable to corporations with or without the S election. The poor S-corp results which are particularly important for estate planning are earlier taxation on gains in distributed property, and no elimination of gains in corporate assets on death. Since built-in gains remain on the assets inside the corporation, buyers will pay the family less for the interest in the S-corp. This may allow an estate tax discount in value, but the net economic loss to the family is quite real and not fully offset by the reduction.

(a) An S-corporation shareholder may come close to the foregoing partnership results in some limited circumstances where the shareholder is able to offset gains with losses if the corporation is liquidated in the year the gain was recognized on the corporation's assets. For example: A is the sole shareholder of S-corporation S. S's sole asset is land worth $1.1 million with a basis of $100,000. When A dies, the S stock is valued at $1.1 million. A's son B inherits the S stock, then in a single tax year sells the land, and liquidates S. The $1 million gain on the sale of the land flows through to B and is taxed to him. B's basis in the S stock consequently increases to $2.1 million ($1.1 Million from the step up to fair market value at death, plus $1 Million from the passed through gain). When S is liquidated, B receives a cash distribution of $1.1 million, resulting in a $1 Million capital loss ($2.1 Million stock basis less the $1.1 Million distribution). If the loss on the sale of the stock is reported in a different tax year than the year in which the capital gain is reported, the loss will not offset the gain in the year of sale (although the capital loss may be carried forward until used, this is usually not very satisfactory). Also, to the extent the gain results from depreciation recapture (ordinary income), the loss will not offset the gain (only a very small portion of ordinary income can be offset by capital losses in a year).

3.7. Passive Income Issues. Holding passive investments can raise problems. For example:

(a) Investment Company. Transfers to either a corporate or partnership taxed investment company which diversify investment holdings will cause recognition of gain, but losses will not be recognized. IRC § 351 and § 721(b); see Treas. Regs. § 1.351-1(c)(1) for a definition of "investment company."

(b) Excess Passive Income. In addition, however, even if such investment company gain is avoided, the excess passive income rules will be an issue for S-corps which have been C-corps at some time. This can eliminate the S-corp benefit through the application of a corporate level tax (IRC § 1375(a)) where earnings and profits exist and passive income is over 25% of gross receipts (IRC § 1375(b)(2)).

(c) Passive Activity Loss. Any passive activity loss that is suspended under IRC § 469 expires and disappears to the extent the S corporation stock gets a step-up in basis under IRC § 1014 but any loss that exceeds the amount of the step-up is not subject to the

limits on passive activity losses. Where the estate has a suspended passive activity loss when it distributes S-corp stock to the beneficiaries, the loss increases the basis of the stock so the loss is capitalized rather than deducted. IRC § 469(j)(12)(B).

3.8. Excess Business Loss. Excess business losses for any taxpayer other than a C-corp are disallowed after 2017 and before 2026. The excess loss is one aggregating over $500,000 (individual joint return) or $250,000 for (single or other status) from trade or business deductions of all businesses of the taxpayer. For an S-corp, the limit applies at the shareholder level. The disallowed excess becomes a net operating loss in following year; NOLs are useable only against 80% of income after 2017. If a trust is shareholder, its loss appears to have the smaller limit. The loss limitation applies to non-passive losses, too, and is applied after the passive loss rules.

3.9. Stock Sales and Redemptions. The death of a stockholder often triggers a sale or redemption of the shares held by the deceased stockholder, either pursuant to a buy-sell agreement or by reason of pressing economic circumstances of the estate.

(a) Redemptions. A corporation recognizes no gain or loss on a cash redemption of stock by the corporation, but if property is distributed as part of the redemption, it will be deemed sold by the corporation whether the corporation is a C-corporation or an S-corporation. Usually the stockholder is treated as having sold the stock in a capital gain transaction.

(i) Dividend Issue. Where a S-corp has at one time been a C-corp, and where the corporation has accumulated earnings and profits from the earlier time when it was a C-corp, then it is possible for a shareholder to receive a dividend taxed at ordinary income rates on a redemption (and on certain other events, as well, such as current distributions sufficiently large to go through the other available accounts for distributable income and reach into the earnings and profits account, or on a liquidating distribution. If the redemption is treated as a dividend, the whole amount (not just the gain portion) is taxed to the redeemed shareholder at ordinary income rates rather than as capital gain.

(ii) Avoiding Dividend. A stock redemption to pay estate taxes and administrative expenses under IRC § 303 will avoid dividend treatment. Hybrid buy-sell agreements are possible where there is a corporate redemption for the amounts that qualify for IRC § 303 treatment, with the balance bought by the remaining stockholders, like a cross purchase agreement.

Dividend treatment may also be avoided if: (i) The redemption completely terminates the shareholder's interest in the corporation. IRC § 302(b)(3). (ii) The redemption is substantially disproportionate under IRC § 302(b)(2) because it reduces the shareholder's percentage interest below 80% of the shareholder's percentage interest before the redemption, and the shareholder ends up with less than 50% of the voting power. (iii) The redemption is not substantially equivalent to a dividend under IRC § 302(b)(1). This is a very difficult provision to use. (iv)

The redemption is from a noncorporate shareholder and other requirements are met so as to qualify as a partial liquidation under IRC § 302(b)(4).

The distributions from the corporation in redemption are treated differently from normal distributions, and, thus, who gets which type of distribution could be a matter for agreement. The seller would want to avoid regular distributions, which could carry out with them earnings and profits for dividend treatment. But where the corporation has no earnings and profits, this won't make a difference.

(b) Sale of Stock for Cash. The gain of S-corp stockholders on the sale of their stock for cash will be the difference between the amount realized for their stock and their adjusted basis in their stock. IRC § 1001(a). It will usually be treated as capital gain (assuming the stock is a capital asset, is not IRC § 306 stock, the corporation is not collapsible, and no deduction for intangible drilling and development costs has been taken). This is generally true of a cross purchase, a redemption (where dividend treatment does not apply), or a sale to a third party.

(i) Redemption Loss. However, a loss on the stock might not be deductible on a stock redemption (where the distribution does not exceed basis). IRC § 1368(b) compared to IRC § 301(c)(2); see Eustice and Kunz Federal Income Taxation of S Corporations at ¶ 13.08[4]. To avoid this issue, where a loss is expected, a third party sale or cross purchase may be better.

(ii) Basis of Stock. The basis of the stock will have been adjusted up and down over the years reflecting income and loss passing through the corporation and certain tax-free distributions. IRC § 1367. Also, the income or loss of the corporation in the year of sale will likely affect the basis of the stock sold so that the shareholders as sellers generally would not know the exact basis for their stock until after the end of the corporation's taxable year. If a party takes a position inconsistent with prior tax reporting, the adjusted basis element would allow the Service (or the seller) to adjust certain errors that may have been made in prior S-corporation years. The seller may want to consider asking the buyer for an agreement that the buyer and the corporation will maintain consistency with prior tax reporting. This should last for a minimum of three years after the seller files the tax return with respect to gain on the sale; perhaps the chance that a return extension will be needed should be taken into account in establishing the time period.

(iii) Book Closing. Income and loss generally pass through to shareholders on a per-share, per-day basis. IRC § 1377(a)(1). Where there is a 50% change of ownership during the year and the S-election terminates, then the normal per-share, per-day at-the- end-of-the-year rule does not apply. IRC § 1362(e)(6)(D). Also, however, where a stockholder's stock interest terminates during the year or the sale terminates the S-election, the corporation may close its books with appropriate consents or (in the case of a terminated S-election) the books may be closed automatically. IRC §§ 1362(e), 1377(a)(2). There are three book closing events which are applied in priority order so there is no overlap:

(A) the S-election is terminated (for example, by a sale to a nonqualifying person); this creates a new tax year;

(B) a complete termination of a shareholder's interest; the book closing is elective (IRC § 1377(a)(2)) with the consent of all affected shareholders (*i.e.*, the terminating shareholder and all to whom such shareholder transferred shares during the taxable year) and will be hypothetical as to the affected shareholders rather than actually creating a new return filing period, etc.; and

(C) a shareholder disposes of 20% or more of the outstanding stock during any 30-day period of the corporation's tax year, the corporation redeems 20% of its stock, or corporation issues to new shareholders shares equal to 25% of the prior shares outstanding; the book closing is elective, and this election allows separate treatment for the selling shareholders regarding income and other attribute allocations but does not create a new filing period. Regs. §1.1368-1(g)(2)(i).

(iv) Planning for Book Closing. The book closing rules may provide a planning opportunity for the buyer and seller who can calculate the effect of closing the books and compare this to the expected effects of not closing the books. For example, if the books were not closed in a situation where no income would pass to the seller and, say, $40 would pass to the buyer, but where if the books were closed $20 would pass to the seller and $20 to the buyer, then it may be better overall to close the books and for the seller to receive an allocation of income. Such a situation may arise when there is a sale at mid-year where the business results for the first part of the year were to break-even or incur a loss, and where the business results in the last part of the year more than make up for the poor first part of the year. The reason for this is that since the seller will be recognizing capital gain anyhow, the cost of the additional ordinary income to the seller is only the difference between the rates for capital gain and ordinary income, but the seller will have a $20 basis increase (the allocated income is not distributed) in his stock, reducing his gain on the sale. The buyer will save current ordinary income tax on the amount of income allocated to the seller. If these were the economics, it may be possible to structure a transaction better for both the buyer and the seller and not so good for the U.S. Treasury.

(v) Matters for Agreement. Buyer and seller will want to agree on some tax related points in the sale transaction. See J. Eustice and J. Kuntz, Federal Income Taxation of S Corporations, Fourth Edition, Warren Gorham and Lamont, 2001 at ¶13.05[5]:

(A) Whether the S-election will continue through the end of the corporation's tax year. A retroactive revocation could lead to a nasty surprise. The S-corp revocation would only be an issue if it occurred on or before the 15th day of the third month of the corporation's taxable year and, thus, depending on the corporation's tax year, may or may not create a risk.

(B) The effective date of the sale.

(C) Whether the corporation will attempt to change its accounting methods, which it could do retroactively with the consent of the Service even to the detriment of the selling shareholder.

(D) Whether an election to close the corporation's books will be made. If income flowed through to the seller, the seller's stock basis will increase and its favorably taxed capital gain will consequently decrease.

(E) If the S-election will end (*e.g.*, too many or wrong kind of shareholders will exist) whether an election under IRC §1362(e)(3) to allocate income and deductions between a short S-election year and a short C-corp year will be made.

(vi) Tax Indemnity. Sometimes a buyer will agree to a tax indemnity provision and not close the corporate books. This may help with solving the foregoing problems. However, it may be a good idea for the tax indemnity from the buyer to cover not only the income tax on the corporate income itself, but also the additional tax from reduction of capital gain treatment on the stock, and the tax on receipt of the indemnity payment itself.

3.10. State Tax Law. State tax effects should also be considered. Some jurisdictions do not recognize the S-election, have special taxes on S-, or require additional elections or other conditions on S-corp treatment.