Best Practices Article

Income Tax Traps in Estate Planning and Administration

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Closely held business owners face challenges in transitioning ownership of the business to family (or non-family) members. Estate planners help closely held business owners to navigate these challenges, often suggesting and implementing sophisticated estate planning techniques. However, income tax considerations may not be the central focus in structuring the estate plan. This discussion highlights the complex income tax issues that can arise in both estate planning and administration involving closely held business interests. In addition, this discussion presents potential solutions to the income tax issues that could otherwise derail a successful estate plan.

Introduction

The Internal Revenue Code (the "Code") is amazingly complex, not to mention dense and overwhelming. For anyone who has held a printed copy of the Code and flipped through the rice paper thin pages of miniscule printed text of the thousands of sections comprising Title 26 of the United States Code, the physical enormity of the volume is eclipsed only by its elaborate and confusing text.[1]

To add insult to injury, there are a multitude of tax systems that taxpayers, and their professional advisers, need to be aware of. The most commonly thought of tax systems are the income tax and the transfer tax systems. These two systems are separate and based on different policies—the former being taxation on the realization of income and the latter being taxation on the privilege of transferring wealth.

Because the income tax and transfer tax systems do not operate to tax in the same manner, there are a number of discrepancies on how the sections of the Code in each of the tax systems relate to one another. These so-called "disconnects" between the income tax system and the transfer tax system are often used by estate planners to the benefit of taxpayers.

One of the most common examples is the sale to an intentionally defective grantor trust, which takes advantage of the provisions of the Code regarding the income taxation of trusts and the transfer taxation of irrevocable trusts. However, there are instances where estate and gift tax planning may be undermined by unexpected income tax consequences.

This discussion identifies a few of the income tax traps encountered in estate planning and administration. And, this discussion summarizes some considerations to address these issues.

Planning with Partnerships and Subchapter K

For the past several decades, planners have used limited partnerships, and more recently, limited liability companies (collectively, such entities are referred to herein as "partnerships"), as vehicles to transfer wealth between generations. Partnerships may accomplish a variety of client goals and objectives:

1. consolidating assets for investment management purposes
2. providing creditor protection

3. retaining assets for family use
4. reducing probate administration

In addition, interests in partnerships generally are subject to valuation discounts for transfer tax purposes. In other words, the fair market value for estate and/or gift tax purposes of an interest in a partnership is less than the value of the underlying assets of the partnership allocable to the partnership interest. Of course, with all these attendant benefits is the downside of partnerships—the complexity of the provisions of Subchapter K.

Sections 704(b) and (c)—Capital Accounts, Inside and Outside Basis

In order to understand the potential income tax pitfalls of partnerships, one must understand both (1) the mechanics of Subchapter K and (2) the importance of maintaining proper book and tax balance sheets for the partnership, as well as the terminology used by tax professionals when referring to partnership taxation matters.

Pursuant to relevant Regulations, each partner's capital account will be credited with the amount of cash and the fair market value of property contributed to the partnership and debited by the amount of cash and the fair market value of property distributed by the partnership.[2]

In addition, each partner's capital account is increased by the share of the partnership income and decreased by the share of the partnership losses and deductions allocated to such partner. However, tax capital accounts are maintained in accordance with different rules.

The tax balance sheet of the partnership reflects the tax basis of the partnership's assets (the "inside basis"). The tax basis generally is not adjusted upon contribution to a partnership. Therefore, the tax capital accounts cannot represent—in the aggregate—an amount greater than the total tax basis of the assets (less any liabilities).

Pursuant to Section 704(c), the appreciation inherent in property contributed to a partnership is allocated to the contributing partner upon the sale or disposition of the property. Essentially, a partner cannot shift or escape recognizing gain by contributing appreciated property to a partnership. And, under the principles of Section 704(c), the tax gain recognized on the sale of property contributed to the partnership is fully allocable to the partner who contributed the asset, to the extent of the fair market value of such asset at the time of contribution.

Another situation in which Section 704(c) may become applicable is the admission of a new partner to an existing partnership. If a new partner is admitted to a partnership that has "built-in gains" property (property with a fair market value that is greater than its tax basis at the time of admission), the applicable Regulations require the partnership to apply Section 704(c) principles to insure that the existing partners' built-in gain is not shifted to another partner.[3]

Finally, the term "outside basis" refers to each partner's tax basis in his partnership interest. Outside basis is not necessarily equal to a partner's tax capital account. There are a number of situations that may create a discrepancy between a partner's tax capital account and basis in the partnership interest, including, specifically, the acquisition of a partnership interest by purchase or inheritance.

Pursuant to the Regulations under Section 704, an acquiring partner inherits the tax capital account of the transferring partner.[4] Thus, the acquisition of a partnership interest will not have an effect on the inside basis of the partnership's assets and, thus, will not result in an adjustment to the tax capital accounts of the partners.

Therefore, discrepancies between inside and outside basis highlight a sale or transfer of an interest for which certain basis adjustments may be made.

With this background, regarding the mechanics of capital accounts and basis rules with regard to partnerships, let's evaluate a few situations where income tax issues can arise:

Transfers of Interests, Section 704(c) and the Retiring Partner

As explained above, Section 704(c) mandates that the appreciation inherent in property contributed to a partnership be allocated to the contributing partner upon the sale or disposition of the property.

One of the key exceptions to this general rule is if contributed appreciated property is distributed to the contributing partner. In this situation, the precontribution gain attributable to the property is not recognized. This exception is consistent with the general rule regarding distributions of partnership property to partners, in that generally gain is not recognized.

If partnership property with precontribution gain is distributed to a noncontributing partner within seven years of the date of contribution, any Section 704(c) gain attributable to the property will be allocated to the contributing partner as if the property had been sold for its fair market value on the date of distribution.[5]

The recipient of a partnership interest (the "transferee partner"), whether by sale, gift or otherwise, inherits the transferring partner's tax capital account and any Section 704(c) gain attributable to the interest. Therefore, a transferee partner is subject to the Section 704(c) gain allocable to the contributing partner on the sale by a partnership of the Section 704(c) property.

With respect to a distribution of the property, a transferee partner is considered the contributing partner as to any Section 704(c) property and a distribution of Section 704(c) property to the transferee will not result in any gain recognition.

Nonetheless, a distribution of Section 704(c) to another partner within seven years of the contribution will result in gain recognition and allocation of such Section 704(c) gain to the transferee partner.[6]

Section 737 deals with the income tax consequences resulting upon a distribution of partnership property, but instead focuses on whether the distributee partner contributed any appreciated property. Section 737 provides that if a partner contributes appreciated property and receives a distribution of property—other than the contributed property—within seven years of the date of contribution, the partner must recognize gain equal to the lesser of:

1. the amount by which the fair market value of the property received exceeds the partner's adjusted basis in the partnership interest, and
2. the net precontribution gain of the partner.

"Net precontribution gain" includes the Section 704(c) gain from all contributed property. Similar to the exception under Section 704(c), if the contributing partner receives the contributed property in the distribution, gain will not be recognized. Under Section 737, the transferee of a contributing partner's interest is not considered the contributing partner of the property contributed.[7]

A distribution of contributed property within seven years of the contribution may result in gain recognition under Section 737 to the transferee partner, even if it would not under Section 704(c).

Care should be taken to ensure that any distribution of property from a partnership to a partner, including a distribution in full liquidation of a partner's interest in the partnership, will not result in recognition of Section 704(c) gain. The so-called "seven year" rule is strict. With the dual application of Section 704(c) and Section 737, a distribution of partnership property may inadvertently trigger gain recognition.

Often, the recipient of an interest in a partnership, such as through inheritance, is anxious to dissolve and liquidate the entity in order to separate co-investments of assets and to pursue separate investment philosophies.

Liquidation of a partnership in which the underlying property is distributed to the partners may implicate the rules of Section 704(c) and Section 737 if the seven-year period has not expired. One strategy to accomplish the investment goals of the transferee partners, while potentially avoiding the recognition of gain under Section 704(c) and Section 737, is to structure a partnership division.

If the provisions of Section 708 and the "assets over form"[8] are followed, a partnership may be divided without income tax consequences into separate entities such that each partner in the original partnership is the sole partner/member of an entity with a pro rata portion of the original partnership's underlying assets. Thereafter, the partner/member of each new separate entity may liquidate the entity, sell the underlying assets, and recognize the resulting tax consequences, or "stay the course" as each may decide.

This strategy is also useful in situations involving family discord as to investment philosophy, or otherwise to separate the partnership while keeping the form intact to achieve other, nontax objectives (as noted above).

Another situation in which inadvertent income tax consequences may arise is when the partnership's assets are revalued and partner capital accounts are adjusted upon the withdrawal of a partner (via redemption) from a partnership. In this case, the partnership must determine how much the withdrawing partner is entitled to receive for his interest in the partnership based on the fair market value of the partnership's property.

The consequences of the withdrawal of a partner and the amount distributed to such partner in complete redemption of his interest are governed by Section 736.

Generally, with regard to a partnership in which capital is a material income-producing factor (i.e., a non–professional services partnership), the amount paid to the retiring partner is treated as a distribution pursuant to Section 736(b) to the extent that the amount paid does not exceed the retiring partner's pro rata share of the gross fair market value of the partnership's assets.[9]

The amount paid to the retiring partner in excess of such pro rata share of the fair market value of the partnership's assets is treated as a distribution pursuant to Section 736(a) and generally will result in:

1. recognition by the recipient partner of a guaranteed payment under Section 707(c), to the extent of such excess, and

2. a deduction to the partnership for the amount of such excess.[10]

As the partnership is "paying" the withdrawing partner for his share of the fair market value of the partnership's assets, the partnership may be entitled to increase its basis in (a portion of) its assets under Section 734.

However, when a partnership interest is redeemed for fair market value (taking into consideration valuation discounts) that is determined to be less than the retiring partner's pro rata share of the gross fair market value of the partnership's assets, then a "loss" presumably results.

In these situations, a loss may be recognized by the withdrawing partner and such loss allows the partnership to adjust the basis of the partnership's assets. The basis adjustment and other income tax consequences that result upon a redemption of a partner should always be considered.

Section 754 Elections and Adjustments to Basis

When a buyer acquires a partnership interest from a seller in an arm's-length transaction, the buyer presumably will pay fair market value for the partnership interest. Absent the appropriate discounts that may be applicable to the partnership interest for lack of control or marketability, the value of the partnership interest is presumably based on the value of the partnership's underlying assets.

The buyer's basis in the partnership interest will be the purchase price—or, fair market value of the undivided interest in the partnership's underlying assets, assuming the purchase price is based on the net asset value of the partnership.

The buyer will inherit the selling partner's tax and book basis capital accounts, as well as any allocations under Section 704(c) attributable to the interest.[11] There is a good chance that there will be a difference between the inside and outside basis of the transferred partnership interest.

Without adjustment, upon the disposition of any of the partnership's assets the transferee partner will be allocated his proportionate share of the net taxable gain despite having already paid for his share of this appreciation in the purchase price.

The result is a "double taxation" of the appreciation. This is because the transferee partner has in effect already paid for this appreciation in the purchase price of the partnership interest and will have to "pay" for it again when the assets are sold and he is allocated a proportionate share of the gain.

Similarly, when a partnership interest is transferred at death, the partnership interest is subject to a basis adjustment to its fair market value pursuant to Section 1014, or Section 1022 if the federal estate tax is not in effect (the basis "step up").[12]

Under Section 1014, the outside basis of the inherited partnership interest is the fair market value of the interest at the time of death. Under Section 1022, the outside basis of the partnership interest is the decedent's basis in the interest, subject to an optional adjustment as elected and allocated by the personal representative of the decedent's estate.

Regardless, the beneficiary acquires the tax capital account (inside basis) of the interest, so that any disparity between the inside and outside basis of the interest, again, is problematic.

The solution to this problem is Section 754, which permits the partnership to adjust the inside basis of its assets attributable to the transferred partnership interest "in the case of a transfer of a partnership, in the manner provided in Section 743."

It is not uncommon to have a partnership make an election under Section 754 in order to take advantage of the basis adjustment available under Section 743. The optional basis adjustment allows the partnership to adjust the basis of the partnership's assets to reflect the basis in the applicable partnership interest (i.e., the fair market value).

Once the election is made, it continues until revoked and applies for every subsequent transfer of a partnership interest.[13] The election may be revoked only with the consent of the District Director and for sufficient cause.[14]

There is no sufficient cause when the revocation is primarily to avoid stepping down the basis of partnership assets. In a down market, a Section 754 election may result in a step down in the basis of the underlying partnership property (i.e., the fair market value of the pro rata share of the partnership property allocable to the partnership interest is less than the partnership's basis in such property).

Where a discount is taken to value the partnership interest, such as in a taxable estate situation, the post-discount value of the partnership interest sets the value for purposes of establishing and allocating the basis adjustment.

It is important to recognize that a basis adjustment under Section 743 is permanent. If a downward basis adjustment results, the inherent loss in the underlying partnership property is permanently lost.

Where a Section 754 election already is in place, it is difficult, if not impossible, to revoke and a subsequent event in which a basis adjustment is applicable may result in a downward adjustment to the basis of the partnership's assets.

If it is anticipated that the basis adjustment will be significant, and the partnership had previously made a Section 754 election, it may be possible to avoid its future application through a partnership division if none of the resulting entities is considered a continuation of the divided partnership. The cost of undertaking this transaction may be significant and there are situations in which a downward basis adjustment is mandatory even where a Section 754 election is not in place.[15]

Sections 743(a) and (b) require a partnership to reduce the basis of partnership property upon a transfer after October 22, 2004, of an interest in the partnership by sale or exchange or upon the death of a partner, if, at the time of the relevant transfer, the partnership has a "substantial built-in loss." The partnership has a "substantial built-in loss" if the partnership's adjusted basis in the partnership's property exceeds by more than $250,000 the fair market value of the partnership's property.[16]

Sections 734(a) and (b) require a partnership to reduce its basis in partnership property upon a distribution of partnership property after October 22, 2004, if there is a "substantial basis reduction."

Under Section 734(d), there is a substantial basis reduction if a downward adjustment of more than $250,000 would be made to the basis of partnership assets if a Section 754 election were in effect at the time of the distribution.[17]

The impact a transfer of a partnership interest may have on the inside basis of the partnership's assets (through either an elective or mandatory basis adjustment) will continue to have importance, particularly with regard to discounts applicable in valuing partnership interests for estate tax purposes.

As there continues to be uncertainty as to the future of the federal estate tax, and the possibility that the estate tax exemption amount may return to $1 million and the maximum tax rate to 55 percent, the transfer tax savings resulting from valuation discounts will be more significant.

And while the estate tax rate would still exceed the capital gains tax rate, even assuming a return to higher income tax rates, meaning that valuation discounts are still more attractive than preserving the inside basis of partnership property, the potential downward basis adjustment may catch many estate planners and clients off guard.

S Corporations and Qualified Shareholder Issues

Generally, only certain types of trusts qualify to be shareholders of an S corporation:

1. trusts that are treated as wholly owned pursuant to Sections 673 – 678 by an individual who is both a U.S. citizen and resident (i.e., grantor trusts)
2. Qualified Subchapter S Trusts (QSSTs) that meet the requirements of Section 1361(d)
3. Electing Small Business Trusts (ESBTs) that meet the requirements of Section 1361(e)

Particularly with regard to nongrantor trusts, there are a number of issues to be aware of in structuring transactions in which a trust will be an S corporation shareholder. While generally it is preferable, from an income tax perspective, to have the trust qualify as a QSST, the grantor's planning goals and objectives may not permit the trust to be structured accordingly.

An understanding of the qualification requirements of both QSSTs and ESBTs is a necessary backdrop.

The requirements of a QSST are as follows:

1. There must be only one income beneficiary during the life of the current income beneficiary.
2. Any corpus distributed must be distributed to the current income beneficiary.
3. All income of the trust must be distributed or be required to be distributed currently to the income beneficiary.
4. The income interest must terminate on the earlier of the death of the beneficiary or the termination of the trust.
5. The trust must distribute all of its assets to the current income beneficiary upon termination during the life of the current income beneficiary.
6. The trust makes a qualified election to be treated as a QSST.
7. An ESBT election is not made with respect to the S corporation stock.

With regard to the requirement that there be only one income beneficiary of the trust, this requirement should be satisfied by the terms of the trust instrument. If there is any possibility that income may be distributed to more than one person, the requirement is not satisfied.[18]

Pursuant to Section 1631(d)(3), if there are substantially separate and independent shares of a trust, within the meaning of Section 663(c), the trust will meet the single beneficiary requirement.[19]

As to the requirement that all income of the trust must be distributed to the current beneficiary, if the trust instrument is silent on distributions of trust corpus, applicable state law will govern.[20] However, if the trustee is not required to distribute all income to the current beneficiary, the trust will satisfy the requirement if the trustee in fact distributes all income to the current income beneficiary within 65 days of the close of the tax year of the trust.[21]

If the trustee is required to distribute the trust's income, but does not, the trust satisfies the QSST requirements.[22]

The requirements of an ESBT are as follows:

1. The potential qualified beneficiaries of an ESBT must be, either: individuals, estates, or organizations described in Sections 170(c)(2)–(5).
2. The interest of the trust in the S corporation cannot have been acquired by purchase.
3. The trust makes a qualified election to be treated as an ESBT.
4. A QSST election is not made with respect to the S corporation stock.
5. The trust is not exempt from income tax.

A qualified beneficiary is one who has a present, remainder or reversionary interest in the trust.[23] An organization described in Section 170(c)(1) may hold a contingent interest, so long as it is not a potential current beneficiary.[24]

If the permissible beneficiaries of an ESBT are other trusts ("distributee trusts"), then the current permissible beneficiaries of the distributee trust are treated as the beneficiaries of the ESBT. Powers of appointment are disregarded, unless exercised, for purposes of determining the current permissible beneficiaries of the trust.[25]

In order to qualify for ESBT election, no interest in the trust may be acquired by purchase, which is determined if any portion of the beneficiary's basis in the beneficiary's interests in the trust is determined under Section 1012.

An interest acquired by gift or inheritance, where the beneficiary's basis is determined by Sections 1014 or 1015 would not violate this rule.

Tax Traps with QSSTs

One of the primary advantages of a QSST (as to an ESBT) is that all of the income from the S corporation stock of the QSST is taxed to the beneficiary of the trust, thereby avoiding the punitive compressed tax rates applicable to trusts.

The requirements of a testamentary QTIP trust and QSST are substantially similar such that generally a testamentary QTIP trust meets the requirements of a QSST. However, a typical credit shelter or family trust, which provides for distributions to a class of beneficiaries, will not be eligible to elect to be taxed as a QSST.

While the income taxation of QSSTs generally is preferential to ESBTs, there are some instances in which the general rules of taxation of QSSTs are not applicable and inadvertent income tax consequences may result. In a previous ruling, the Service held that upon the sale of S corporation stock by a QSST that the trust beneficiary recognized the gain or loss on such stock sale.

The Service reasoned that a QSST is treated as a grantor trust for income tax purposes and that pursuant to Section 678(a) the beneficiary of the QSST is treated as the owner of that portion of the trust consisting of S corporation stock.[26]

This ruling was reversed by the issuance of Regulation 1.1361-1(j)(8), which provides that a QSST is treated as the owner of the S corporation stock for purposes of taxation of the gain or loss on the sale of such stock.

The income tax issue that results in the context of such a transaction is highlighted in the following example: S corporation has assets with an aggregate fair market value of $10 million and adjusted tax basis of $2 million.

The sole shareholder of the S corporation is a QSST and the trust's adjusted basis in the S corporation's stock is $5 million. B proposed to purchase S corporation for $10 million, in either an asset or stock acquisition. Upon a purchase by B of all of the assets of S corporation, S corporation realizes $8 million gain, which passes through to QSST and increases the trust's basis in the S corporation stock to $13 million.

S corporation would distribute net proceeds of $8 million to QSST in a liquidating distribution. The $8 million gain realized on the asset sale is allocated to the QSST beneficiary under Section 678 and 1368(d)(1)(B). The gain may be comprised of ordinary income, depreciation recapture and capital gain depending on the assets held and sold by S corporation.

However, the QSST will realize a $5 million loss on the liquidating distribution from S corporation, and this loss does not pass through to the QSST beneficiary.[27] Alternatively, upon a purchase by B of QSST's stock for $10 million, the net gain realized on the stock sale is $5 million. Again, this capital gain does not pass through to the QSST beneficiary.[28]

In order to avoid a trapped loss at the QSST level, the trustee could consider a distribution of the stock to the QSST beneficiary, particularly if a gain results from the underlying transaction that otherwise passes through to the QSST beneficiary, so as to (potentially) offset the taxable gain and for overall tax efficiency.

Further, with regard to a gain recognized at the trust level, the QSST may not have sufficient cash to pay the resulting tax liability to the extent that the cash distributions received by the QSST are distributed to the trust beneficiary.

This raises another issue with regard to the taxation of trusts with interests in pass-through entities. Under the provisions of Sub-Chapter J of the Code, a trust receives a deduction for the amount of net income distributed to a trust beneficiary.[29]

Therefore, to the extent that a trust, including a QSST, distributes its net income to the beneficiary, the trust effectively is treated as a pass-through entity and will issue a Schedule K-1 to the beneficiary (or beneficiaries) that receive distribution(s) of income from the trust and such beneficiaries will report such taxable income on their individual income tax returns.

What constitutes trust accounting income for state law and fiduciary accounting purposes is not necessarily the same as what constitutes income for federal tax purposes. In particular with regard to pass-through entities, trust accounting and taxable income likely will not be the same.

Pursuant to Section 401(b) of the Principal and Income Act, the distributions received by a trust from a pass-through entity, unless treated as a liquidating distribution, are allocable to income and therefore constitute fiduciary accounting income. However, the trust will receive a Schedule K-1 reporting the trust's share of the pass-through entity's taxable income, which likely will not equal the distributions actually received from the pass-through entity.

The discrepancy between fiduciary accounting income and taxable income can result in an inability for the trust to pay the resulting income tax liability and is highlighted in the following example: Trust owns an interest in CHB, an S corporation, and receives $40 from CHB during the taxable year. Trust receives a Schedule K-1 from CHB reporting net taxable income of $100.

Trust is a simple trust and trustee pays to B, the sole income beneficiary of Trust, $40, the net accounting income of Trust during the calendar year. Trust will issue a Schedule K-1 to B reporting $40 of net income to B and Trust will receive a $40 distribution deduction.

However, Trust will have $60 of taxable income ($100 income from the Schedule K-1 received from CHB less the $40 distribution deduction), and it will have no cash with which to pay the resulting income tax liability.

In particular, with regard to QSSTs, the trustee would distribute all receipts received from the S corporation to the trust beneficiary, leaving the QSST with insufficient cash to pay its tax liability resulting from capital gain transactions.

This same issue arises in the context of other types of trusts. In an effort to deal with these issues, Section 505(c) of the Principal and Income Act provides that a trust's tax required to be paid with regard to a pass-through entity's taxable income is to be paid proportionately from income to the extent that receipts from the entity are allocated to income and to principal to the extent that receipts from the entity are allocated to principal.

Receipts allocated to principal or income are reduced by the amount distributed to the trust beneficiary from income or principal and for which the trust receives a deduction. The language of this provision has been considered ambiguous and still may have left a trust with insufficient liquidity to pay a resulting income tax liability.

To address this ambiguity, amended Section 505 was introduced. The general principle of this provision is to allow the trustee to retain a tax distribution received from a pass-through entity to pay a tax liability of the trust relative to such entity's taxable income allocable to the trust.

Revised Section 505(d) requires the trustee to "adjust income or principal receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for payments made to a beneficiary." In explaining the application of this Section, the official comment states that "[b]ecause the trust's taxes and amounts distributed to a beneficiary are interrelated, the trust may be required to apply a formula to determine the correct amount payable to a beneficiary.

Unfortunately, the resulting income tax liability of a trust may not be considered or known at the time of a distribution. This is because the fiduciary income tax return is not due until April 15 of the following year.

In the context of making distributions from a trust to the beneficiaries, the income tax consequences also should be evaluated at the time of the distribution to ensure that the distribution does not leave the trust (really, the trustee) without sufficient cash to pay the trust's income tax liability.

The relevant and applicable state law should be considered and if an issue still exists, the trustee should consider receiving an indemnification from the trust beneficiary as to the income tax liability.

Tax Traps with ESBTs

An ESBT is taxed as two separate trusts to the extent that the trust holds S corporation stock and other assets.[30]

The ESBT is taxed on the income attributable to the S corporation stock held in the trust at the highest individual income tax rate without the benefit of the personal exemption. The portion of the trust holding assets other than S corporation stock is taxed under the general principles of Subchapter J.[31]

The trust's distributable net income does not include any items from the S corporation stock such that no deduction is allowed to the ESBT for any portion of the trust's income attributable to the S corporation stock that is actually distributed to the trust's beneficiaries.

Because of the less favorable income taxation of ESBTs, trusts that hold S corporation stock often are intentionally designed to qualify as QSSTs. However, in some instances, the resulting income tax consequences may favor use of an ESBT.

With regard to ESBTs, where the S corporation's income is taxable at the trust level, the interest expense associated with the acquisition of the S corporation stock is deductible against the S corporation's income.[32]

Therefore, the net income tax consequences of the lost deduction should be analyzed in determining whether it is most efficient for the trust to be an ESBT or a QSST—as in some contexts the QSST election could be very costly.

S Corporations, Life Insurance, and Buy Sell Agreements

The shareholders of S corporations, as with most other corporate entities, often enter into agreements governing the transferability of the stock and how a shareholder's stock will be disposed of upon the occurrence of certain events (most commonly, separation of service, disability and death).

Of key importance in structuring shareholder or buy-sell agreements (collectively referred to herein as "Buy Sell Agreements"), is providing for how a shareholder's shares will be purchased upon death and contemplating the source of liquidity for such purchase. Probably the most common way to fund a Buy Sell Agreement is with insurance.

And, for corporations with multiple shareholders, in order to avoid the purchase of multiple separate policies on each shareholder, the corporation typically will purchase a deceased shareholder's shares and use the proceeds of corporate owned insurance on the shareholder's life to fund such acquisition.

While this structure is most simple in form, it may have unintended and adverse income tax consequences to the remaining shareholders, particularly with regard to S corporations.

In order to understand the income tax consequences of a shareholder redemption, it is necessary to review some basic rules regarding the income taxation of S corporations. An S corporation is a form of pass-through entity and thus, an S corporation's previously taxed but undistributed income is shielded from a second tax when distributed.[33]

Previously taxed and undistributed income is "tracked" through the Accumulated Adjustments Account (AAA). Items of taxable income and any non–separately computed income generally increase AAA, and items of loss or deduction, any non–separately computed loss, and any nondeductible expense not properly chargeable to a capital account generally reduce AAA.

In Revenue Ruling 2008-42,[34] the Service issued guidance on the impact of life insurance on an S corporation's AAA, ruling that life insurance proceeds received by an S corporation tax-free under Section 101 are tax-exempt income and therefore do not increase AAA and that the cost of the premiums for the policy do not reduce AAA.[35]

However, shareholders will increase their stock basis, pro rata, by the amount of life insurance death benefit proceeds received by the S corporation and, to the extent the death benefit proceeds are distributed to the shareholders, their stock basis is reduced, as is the S corporation's AAA.[36]

An S corporation shall maintain an AAA as long as the S corporation has accumulated earnings and profits from its years as a C corporation. AAA is a corporate based account, although it affects the tax treatment of distributions with regard to shareholders.

If an S corporation is on the accrual method, the timing of the death of the insured, the receipt of the proceeds and a resulting redemption from the estate of the deceased insured shareholder may have unintended, and unfavorable, income tax consequences.

First, the Service has ruled that the respective basis in the stock of the shareholders of an S corporation on the accrual method of accounting is increased, pro rata, by the death benefit payable upon the shareholder's death on a corporate owned policy on such shareholder. The S corporation proposed to redeem the stock of the deceased shareholder by issuance of a promissory note followed by an election to terminate the S corporation's taxable year, after which the S corporation would file a claim to receive the proceeds of the life insurance policy to be used to pay the promissory note issued to the estate of the deceased shareholder.

However, the Service ruled that the redeemed shareholder would benefit from the accrual of the death benefit proceeds from the policy, and the other shareholders would not benefit from the amount of the accrual allocated to the redeemed shareholder.[37]

Alternatively, if the S corporation were a cash method taxpayer, the above outlined plan should accomplish the objective of allocating the proceeds of the policy to the basis in the stock of the remaining shareholders.

Assuming the S corporation is subject to the AAA rules, any distribution of policy death benefit proceeds to the shareholders would be treated according to the general ordering rules described in Section 1368.

If the S corporation is not subject to the AAA rules, any distribution of policy death benefit proceeds to the shareholders generally will be received income-tax-free, with a corresponding reduction in the basis in their stock.

Thus, in the case where an S corporation is on the accrual method of accounting, receipt of the death benefit from an insurance policy will increase the adjusted basis of the stock of all shareholders, including the deceased shareholder, such that the remaining shareholders will not fully benefit from the S corporation's receipt of the death benefit proceeds.

Where an S corporation has an AAA balance, the use of a cross-purchase Buy-Sell Agreement rather than a redemption may be more advantageous for S corporation shareholders. While, as noted above, AAA is a corporate level account, the applicable Regulations do require a pro rata reduction of AAA upon the redemption of a shareholder, thus negatively impacting the remaining shareholders.

If the redemption is treated as an exchange under Section 302 or 303, the AAA is proportionately reduced.[38] In contrast, when a surviving shareholder purchases S corporation shares from a deceased shareholder's estate under a cross-purchase Buy-Sell Agreement, the purchase does not affect the S corporation's AAA as it effectively is inherited by the purchasing shareholders.

The amount of the gain recognized should be equal to the amount by which fair market value of the policy exceeds the basis in the policy. However, the gain is characterized as ordinary income extent of the cash surrender value of the policy.[39]

Therefore, it may be prudent to obtain a valuation of the policy in a policy distribution to establish the fair market value and determine the full amount of the gain and any portion that would be taxed as a capital gain.

While corporate-owned insurance may provide for a more simple method of effectuating a buy-sell arrangement, the potentially adverse income tax consequences may tip the scales in favor of a cross-purchase arrangement. However, in contemplation of any distribution of a policy from an S corporation to a shareholder, the potential gain and income recognition should be evaluated.

Where such a distribution may result in the recognition of gain, particularly to the extent characterized as ordinary income, the S corporation could take a loan against the policy cash surrender value before any distribution of the policy, which loan would reduce both the cash surrender value and the fair market value of the policy.

Conclusion

For clients with closely held business interests, estate planning can be particularly challenging and complex. In these situations, the attendant income tax consequences associated with the underlying business interests will result in additional considerations in connection with such planning.

Therefore, thoughtful analysis of the income tax results, including through the unwinding of any planning, is critical.

Notes:

1. The Internal Revenue Code contains more that 3.4 million words and would fill more than 7,500 typed pages. See www.fourmilab.ch/uscode/26usc/.
2. Reg. § 1.704-1(b)(2)(iv)(d).
3. Reg. §§ 1.704-1(b)(2)(iv)(f) and (g).
4. Reg. § 1.704-1(b)(2)(iv)(l).
5. § 704(c)(1)(B).
6. Reg. §§ 704-4(d)(1) and (2).
7. Reg. § 1.737-1(c)(2)(iii).
8. See Reg. § 1.708-1(d)(3)(i), wherein the partnership division takes the form of a distribution of the assets to subsidiary partnership entities, the interests of which are then distributed to the parent partnership's partners.
9. Reg. § 1.736-1(b)(1).
10. This analysis specifically does not address the income taxation of a liquidating distribution to the extent that the partnership has "hot" assets (See § 751), as such discussion is beyond the limited scope of this article, but planners should be aware of this additional potential income tax consequence to the withdrawing partner.
11. § 743(a) and Reg. § 1.704-1(b)(2)(iv)(l).
12. At the time of publication of this Article, the federal estate tax is repealed and the provisions of Section 1014, with regard to the adjusted basis for assets inherited at death, also is repealed. Instead, Section 1022 is applicable with respect to the adjusted basis of inherited assets, when there is no federal estate tax in effect, and provides for a carryover basis for inherited property, subject to limited basis adjustment at the election and allocation of the personal representative of the decedent's estate.

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A tax-exempt beneficiary is defined as:

1. the United States, any state or political subdivision thereof, any possession of the United States, any Indian tribal government, or any agency or instrumentality of any of the foregoing;
2. an organization (other than a cooperative described in Section 521) that is exempt from tax imposed by Chapter 1 (i.e., normal income taxes and surtaxes);
3. any foreign person or entity (within the meaning of Section 168(h)(2)); and
4. to the extent provided in the regulations, any person to whom property is transferred for the principal purpose of tax avoidance.

For these reasons, when an estate executor is planning the distributions of the estate assets to charities or to foreign persons, he/she should select those assets that do not have liabilities in excess of their basis.

Sunset of the 2010 Modified Carryover Basis Procedures

For a decedent who dies after 2010, the tax law will be applied as if EGTRRA "had never been enacted." For this reason, the modified carryover basis procedures will cease to apply after 2010.

The implications of these sunset provisions are uncertain. One possible interpretation is that even if a decedent dies during 2010, the step-up basis procedures of Section 1014 apply for property sales or exchanges after 2010.

The Treasury (and perhaps the courts) will need to provide guidance on the ultimate interpretation of these sunset provisions.

Summary and Conclusion

The transferee property modified carryover basis procedures became effective on January 1, 2010, and they are effective only for 2010. Lawyers, accountants, and other estate advisers will have to become familiar with a complex set of procedures related to the administration of a 2010 decedent's estate.

The burden on estate executors and other estate advisers to gather the necessary information to comply with the carryover basis procedures, especially finding the decedent's basis in certain transferred property, may be quite significant.

However, this information will be necessary in order to determine the transferee's tax basis in the 2010 estate transferred property.

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13. Reg. § 1.754-1(b)(1).
14. Reg. § 1.754-1(c); Sufficient cause includes: A change in the nature of the partnership business; A substantial increase in partnership assets, or; An increased frequency or shifts of partnership interests, so that an increased administrative burden would result to the partnership from the election.
15. See Service Notice 2005-32, 2005-1 C.B. 895.
16. § 743(d)(1).
17. In the case of a basis reduction to property distributed to the transferee partner in a non-liquidating distribution, Section 743(e)(5) provides that the amount of the transferor's recognized loss taken into account under Code § 743(e)(2) is reduced by the amount of the basis reduction under Section 732(a)(2).
18. See Rev. Rulings 89-45, 1989-1 CB 267, and 89-55, 1989-1 CB 268.
19. But see Rev. Ruling 93-31, 1993-1 CB 186, in which the Service ruled that a separate share of a trust does not meet the single beneficiary requirement if there is even a remote possibility that the trust corpus will be distributed to a person other than the current income beneficiary.
20. See Reg. § 1.1361-1(j)(1)(ii).
21. See PLR 9519036 and Reg. § 1.663(b)-1.
22. PLR 8508048.
23. See Reg. § 1.1361-1(m)(1)(ii).
24. See Section 1361(e)(1)(A)(i) and Reg. § 1.1361-1(m)(1).
25. See T.D. 9422, Fed. Reg. 47526 for amendment to Reg. § 1.1361-1(m)(4)(vi).
26. See Rev. Ruling 92-84, 1992-2 CB 216.
27. See Reg. § 1.1361-1(j)(8).
28. See Reg. § 1.1361-1(j)(8).
29. See Sections 651 and 661.
30. See Reg. § 1.641(c)-1.
31. See Section 1361(e)(1).
32. See Christopher J.C. Jones and Justin Steinschriber, "Income Tax Considerations in Structuring the Sale of S Corporation Stock to a Trust," *Probate and Property*, July 2010, p. 55.
33. Section 1368(c)(1).
34. 2008-30 IRB 160.
35. Reg. § 1.1366-1(a)(2)(viii).
36. Sections 1366(a)(1)(A) and 1367(a)(1)(A). See also, Reg. § 1.1367-1(d)(2).
37. PLR 200409010.
38. Sections 1368(e)(1)(B).
39. Section 72(e); See also, Rev. Ruling 2009-13, 2009-21 IRB 1029.

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