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Taxing a Trust's Income: When Distributions Are Surprisingly Not the Key

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INTRODUCTION

Our fiduciary income tax system generally computes taxable income as if the trust were an entity, then allocates taxable income between the trust and its beneficiaries.[1]

A trust, all of the accounting income of which is required to be distributed currently to one or more noncharitable beneficiaries, deducts the lesser of its accounting income or distributable net income (DNI).[2] It also deducts any other amounts of DNI that are ''properly paid or credited or required to be distributed'' for the taxable year.[3] Thus, a mandatory income feature is simply a proxy for other distributions, without the requirement that the distribution be made during the year or within 65 days thereafter.[4] The beneficiary includes in income the amount of the trust's deduction for DNI.[5]

Shifting income subject to tax to beneficiaries who receive cash makes a lot of sense. However, it does not necessarily produce the tax results that benefit the trust and its beneficiaries:

1. Suppose the trust is resident of a state that imposes high income tax. The trust cannot change its residency, perhaps because the settlor resided in a state that just won't let go of its taxing authority or for some other reason. However, the beneficiary lives in a state without an income tax. Perhaps the trust distributes income to the beneficiary, needs to accumulate capital gain for the remaindermen, but would like to avoid state income tax on that capital gain. If the beneficiary could pay tax on the capital gain but the trust merely distributes enough to reimburse the beneficiary

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[1] Technically, the trust allocates distributable net income to the trust and beneficiaries, then takes into account other items in computing the trust's taxable income. The text in the body is a convenient way to describe the system to clients.

[2] §651, §661(a)(1), §661(c). Section 643(a) defines DNI, §643(b) defines accounting income. All section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise specified.

[3] §661(a)(2), §661(c). A beneficiary's use of a residence generally should not constitute a deemed distribution unless the trust is a foreign trust and the beneficiary is a U.S. person. For the latter rule, see §643(i). For various cases analyzing the former issue, see *DuPont Testamentary Trust v. Commissioner*, 66 T.C. 761 (1976), *aff'd* 574 F.2d 1332 (5th Cir. 1978); *Commissioner v. Plant*, 76 F.2d 8 (2d Cir. 1935); TAM 8341005 (following *Plant* — real property taxes and the cost of the caretaker were carrying costs allocable to corpus, and income used to pay those expenses were not deemed distributed to the beneficiary who used the house; the beneficiary paid for electricity, heating and personal expenses); *Commissioner v. Lewis*, 141 F.2d 221 (3d Cir. 1944) (carrying charges and depreciation were chargeable to trust accounting income under local law and deductible in computing amounts taxable to the mandatory income beneficiaries). *Moreell v. United States*, 221 F. Supp. 864 (W.D. Pa. 1963), is a sloppy, confusing, unreasoned opinion involving a mandatory income trust that was partly a grantor trust. I have not read but have seen cited *Fuller v. Commissioner*, 9 T.C. 1069 (1947), *aff'd* 171 F.2d 704 (3d Cir. 1948); *Prince v. Commissioner*, 35 T.C. 974, 978 (1961).

[4] §663(b).

[5] §651, §652.

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for that tax, then the trust is effectively reducing its tax rate to the beneficiary's tax rate.

2. Same as above, but, instead of playing on state income tax rates, the beneficiary has a lower capital gain tax rate than the trust. If the beneficiary could pay tax on the capital gain but the trust merely distributes enough to reimburse the beneficiary for that tax, then the trust is effectively reducing its tax rate to the beneficiary's tax rate.
3. Perhaps the trust is sheltered from transfer tax and the beneficiary would like the trust to grow and is willing to pay tax on the trust's income without receiving any distributions. For example, the trust is a bypass trust for the surviving spouse or a GST-exempt trust for an already very wealthy beneficiary.
4. Suppose the trust is not considered to be resident of any state that imposes income tax. However, the beneficiary lives in a high-tax state. Although taxing the beneficiary on income distributions would be fair, it may be better for the trust to pay the tax and reduce the distributions to take into account the tax that the trust paid on the income that was distributed.
5. Suppose the beneficiary is taxed at a higher rate than the trust, because of various phase-outs in deductions, exemptions, and other tax benefits based on an individual's income.

Scenarios 1, 2, and 3 cry out for a way to tax income (including capital gains) to the beneficiary even when not all of it is distributed to the beneficiary. The other situations need a mechanism that allows income to be trapped in a trust, notwithstanding making distributions.

This article discusses:

- How to tax all of the trust's income to the beneficiary while distributing none, part, or all of the trust's income (including capital gains).
- How to trap all of the trust's income, notwithstanding making distributions; this also includes a mechanism for fine-tuning how much is taxed to the beneficiary.
- Planning tips for business interests held in trust.
- Disadvantages to using S corporations in the manner suggested by this article.
- Structuring to have a flexible exit strategy.

HOW TO TAX ALL OF THE TRUST'S INCOME TO THE BENEFICIARY WHILE DISTRIBUTING NONE, PART, OR ALL OF THE TRUST'S INCOME (INCLUDING CAPITAL GAINS)

Suppose the trust contributes its assets to an S corporation. The beneficiary then elects to treat the trust as a qualified subchapter S trust (QSST); the trust might need to be modified to qualify as a QSST. All of the assets' investment income (including capital gain) would be reported on a K-1 that the trust receives from the corporation; the trust then files a tax return with a grantor information statement showing that all of the items reported on the K-1 are taxed to the beneficiary.

In a QSST, the trustee is required to distribute all of the trust's fiduciary accounting income to the beneficiary. However, the trust's fiduciary accounting income would merely be the actual distributions it receives from the S corporation. If the trustee also runs the S corporation, the trustee can control distributions to the trust, thereby regulating distributions to the beneficiary. In such a situation, the QSST's income distribution requirement is, as a practical matter, not such of a requirement at all.

Now that the stage has been set for making the trust taxed to the beneficiary, and we have outlined on a simple level how the strategy works, let's get into the details.

QSSTs Generally

A qualified subchapter S trust (QSST) may have only one beneficiary[6] (who also must be a U.S. citizen or resident) who may receive income or corpus

[6] §1361(d)(3)(A); Reg. §1.1361-1(j)(1)(ii), §1.1361-1(j)(1)(iii). A trust cannot qualify as a QSST if it provides that, if the trust does not hold shares of an S corporation, the trust may terminate during the life of the current income beneficiary and distribute its corpus to persons other than the current income beneficiary. Rev. Rul. 89-55, 1989-1 C.B. 268. Consistent with this limitation, Reg. §1.1361-1(j)(2)(iii) restricts powers of appointment.

Note, however, that failure to make a trust a spendthrift trust (and therefore allowing the beneficiary's interest to be assignable) will not disqualify the trust as a QSST unless it gets assigned (and then it might or might not disqualify the trust). Reg. §1.1361-1(j)(2)(iv). On the other hand, PLR 9437021 viewed the possibility of distribution from the QSST to another trust for that same beneficiary as an error, but ruled that it was harmless error in that case because the recipient trust never existed and therefore could never receive a distribution (see also n.8, below, regarding the distribution of income other than directly to the beneficiary); however, one might not want to assume that the IRS's national office will repeat this kind and gentle approach. Thus, one may need to avoid authorizing the merger or decanting of any trust that has a QSST election in place. The Uniform Trust Decanting Act allows decanting to be done by trust amendment rather than actual transfer of assets, in which case a QSST need not prevent decanting.

Also, the grantor trust treating a person other than the current income beneficiary as the owner of a part or all of that portion of a trust which does not consist of the S corporation stock does not disqualify the trust from making a QSST election. Reg. §1.1361-1(j)(2)(vi). Does that, by negative implication, suggest that the settlor (who is not the beneficiary) being treated as deemed owner of the portion of a trust that includes the S corporation stock precludes a QSST election? Reg. §1.1361-1(j)(4) suggests that prohi-

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during the beneficiary's lifetime, and all of its income[7] must be distributed currently to that beneficiary[8] while the trust[9] holds S stock.[10] The income distribution rule is that all income either actually is distributed each year or is required to be distributed each year;[11] inadvertent termination relief may be available if the income is not distributed and catch-up distributions are made.[12] Special rules apply to an inter vivos QTIP or another trust for a spouse.[13]

bition exists; Reg. §1.1361-1(k)(1) *Ex.* 10, paragraph (iii) (reproduced in n.13, below) confirms that result.

[7] All of the trust's income, not just the income from the S stock, must be distributed or distributable currently. PLR 9603007. This refers to trust accounting income, not taxable income. Reg. §1.1361-1(j)(1)(i). PLR 200446007 ruled that the amount of a deemed dividend under §1361(d)(3)(B) was not required to be distributed. PLR 200451021 clarifies that, when §302(d) taxes a partial liquidation as a distribution rather than as a redemption, the trust itself is not taxed on any income on the distribution if the trust has sufficient AAA to absorb the basis reduction (Ruling Request 1) and the proceeds from the sale of stock in partial liquidation are principal that the QSST does not need to distribute (Ruling Request 2).

[8] §1361(d)(3). PLR 9014008 ruled that a distribution to a grantor trust created by the beneficiary would not qualify, but PLR 9442036, PLR 9444022, PLR 9444024, and PLR 9444059 permitted distributions to a disability trust because the beneficiary did not have legal capacity.

[9] In PLR 200404037, the IRS accepted the representation that applicable state law deemed a life estate in the shares of stock to give rise to a trust relationship between the life tenant and the remaindermen and that the deemed trust satisfies the requirements for treatment as a QSST. PLR 200247030 elaborated on the basis for this deemed trust treatment:

> It is represented that under State law, a life tenant, with the power to sell or dispose of property devised to him or her for life with remainder to designated persons, is a trustee or quasi trustee and occupies a fiduciary relationship to the remaindermen. In the exercise of that power, the life tenant owes to the remaindermen the highest duty to act honorably and in good faith. A life tenant is a trustee in the sense that he cannot injure or dispose of property to the injury of the rights of the remaindermen, but differs from a pure trustee in that he may use property for his exclusive benefit and take all income and profits.

[10] Rev. Rul. 92-20, 1992-1 C.B. 301, ruled that a provision in a trust agreement authorizing the trustee to accumulate trust income if the trust does not hold any shares of an S corporation does not, by itself, preclude the trust's qualification as a QSST.

[11] §1361(d)(3)(B); Reg. §1.1361-1(j)(1)(i), the latter which expressly recognizes that income distributed in the first 65 days of the year may be treated under§663(b) as being distributed in the immediately preceding year. PLR 8508048, PLR 8836057, and PLR 199927011 approved trusts in which the income must be distributed currently, but the beneficiary may elect in any year to have the trustee retain all or any portion of the income of the trust (it is not clear whether the trusts expressly permitted their beneficiaries to elect that retention or whether that was simply a practice that was contemplated).

[12] PLR 201710001.

[13] Reg. §1.1361-1(j)(4) approves testamentary QTIP trusts but, for inter vivos ones, prohibits a QSST election during marriage and requires one to ensure that the grantor is treated as wholly owning the trust.

Reg. §1.1361-1(k)(1) *Ex.* 10. Paragraph (iii) illustrates two points. First, to qualify as a wholly owned grantor trust, the trust must have not only its income but also its principal deemed owned wholly by the same individual; therefore, when drafting a trust for a spouse that holds stock in an S corporation for which an ESBT election is not in effect, one should consider including a grantor trust power beyond merely §677, to make sure that the entire trust is taxed to the grantor. Second, no part of a QSST may be deemed owned by a person other than the beneficiary; see n.6, above.

Reg. §1.1361-1(k)(1) *Ex.* 10. Paragraph (ii) offers insight into the application of §677(a) after divorce. Reg. §1.677(a)-1(b)(2) concludes with:

> With respect to the treatment of a grantor as the owner of a portion of a trust solely because its income is, or may be, distributed or held or accumulated for future distributions to a beneficiary who is his spouse or applied to the payment of premiums for insurance on the spouse's life, section 677(a) applies to the income of a trust solely during the period of the marriage of the grantor to a beneficiary. In the case of divorce or separation, see sections 71 and 682 and the regulations thereunder.

Reg. §1.682(a)-1(a)(1)(i) is quite clear that §682 shifts only so much of the income as is paid, credited, or required to be distributed to the ex-spouse beneficiary. Therefore, the cross-reference to §682 might lead one to believe that §677(a) would apply to the extent that distributions are not made to the ex-spouse, consistent with certain legislation history to the Tax Reform Act of 1969:

> Both versions of the bill provide that in the case of a trust created by a taxpayer for the benefit of his spouse, the trust income which may be used for the benefit of the spouse is to be taxed to the creator of the trust as it is earned. However, this provision is not to apply where another provision of the Code requires the wife to include in her gross income the income from a trust.

However, Reg. §1.1361-1(k)(1) *Ex.* 10, paragraph (ii), indicates that the more expansive reading of the next-to-the last-sentence of Reg. §1.677(a)-1(b)(2) applies, so that §677(a) will never tax the grantor on distributions that are accumulated for possible future distribution to the ex-spouse. Note, however, that the next-to-the last-sentence of Reg. §1.677(a)-1(b)(2) does not apply to a spouse who is separated, so the more limited rules of Reg. §1.682(a)-1(a)(1)(i) would apply. Thus, if distributions are made after separation, the trust no longer qualifies as a grantor trust and a QSST election is unavailable; therefore, an ESBT election must be made. Section 672(e) does not seem to coordinate with §682. However, Reg. §1.1361-1(k) was promulgated after §672(e) was enacted, so Reg. §1.1361-1(k)(1) *Ex.* 10, would appear to clarify somewhat the scope of §672(e).

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Some annual expenses are ordinarily allocated one-half to income and one-half to principal. Generally, these include (1) the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee, and (2) expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests.[14] If S corporation distributions are the trust's only source of cash, this rule is impractical, because the trust would be unable to pay the portion of the expense allocated to principal. Accordingly, I often suggest that the trustee make an adjustment, allocating the entire expense to income, which might be authorized under either state law or the governing instrument. If the business or the stock is sold later, the proceeds are taxable to the trust, rather than the beneficiary; at that time, some of the proceeds might be allocated to income to make up for these prior allocations of administrative expenses, which would help move taxable items from the trust's high rates to the beneficiary's potentially lower rates.

A trust that has substantially separate and independent shares, each of which is for the sole benefit of one beneficiary, may qualify as a QSST with respect to each separate share.[15] For example, a grantor sets up an irrevocable trust for the benefit of his four children, who are the only children he will ever have. Each child receives one-fourth of the income and corpus distributions. Each child would be considered the owner of one-fourth of the stock owned by the trust.[16] This could also work well for a vested trust for a grandchild, which qualifies for the GST annual exclusion.[17]

To avoid the requirement that all of the trust income — not just its S corporation income — be distributed to the beneficiary, it is not uncommon for a trust agreement to divide the trust so that the QSST is a separate trust.

The beneficiary of a QSST is taxed on all of the QSST's K-1 income and losses from the S corporation[18] (although the trust still needs to get its own tax ID).[19] However, when the QSST sells the stock, the trust itself is taxable on any gain on the sale,[20] including any gain the corporation incurs after adopting a plan of complete liquidation[21] or from deemed asset sale resulting from a §338(h)(10) election.[22] If the corporation actually sells its assets without adopting a plan of liquidation, I am unsure of the result. From the above, one can glean that depreciation recapture on the actual or deemed sale of personal property is ordinary income that is principal but might be best taxed to the beneficiary, who might either be in a lower tax bracket or might have losses from operations during the year of sale passing through the grantor trust portion to offset; thus, consider including in one's trust the flexibility to distribute principal or to reallocate principal to income.

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[14] Uniform Principal and Income Act (UPIA), §501, available at http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008).

[15] §1361(d)(3). Although the statute cites to the separate share rules under §663(c), the test is more stringent than that. Section 663(c) provides for that distributions to other beneficiaries be ignored in determining separate share treatment if the possibility of distribution is remote. Rev. Rul. 93-31, 1993-1 C.B. 186, holds:

> A substantially separate and independent share of a trust, within the meaning of section 663(c) of the Code, is not a QSST if there is a remote possibility that the corpus of the trust will be distributed during the lifetime of the current income beneficiary to someone other than that beneficiary.

For example, if an inter vivos QSST includes a clause requiring the payment of estate tax if the grantor dies during the beneficiary's life, and that payment clause might benefit the grantor's estate beyond whatever applicable law would provide but for that clause, the IRS's view is that mere possibility of such a diversion might disqualify the QSST from inception. PLR 201451001 (which I obtained to get inadvertent termination relief at the insistence of the CPAs for the company that was acquiring my client). However, paying transfer tax on the beneficiary's death should not cause any QSST problem. PLR 9014008 (GST tax).

[16] However, it would not work if trust provided that the birth of another child after the trust is created would cause the trust to be divided five ways, essentially diverting one-fourth of each existing trust. Rev. Rul. 89-45, 1989-1 C.B. 267.

[17] Section 2642(c)(2) provides that the GST annual exclusion applies to a trust that uses *Crummey* withdrawal rights only if the grandchild (or other skip person) is the sole beneficiary of the trust, and the trust's assets must be includible in the beneficiary's gross estate upon her death. Section 2654(b) provides that substantially separate and independent shares of different beneficiaries shall be treated as separate trusts under the GST rules. Suppose a grantor sets up an irrevocable trust for the benefit of his four grandchildren. Each grandchild receives one-fourth of the income and corpus distributions; the trust distributes all of its income each year; and each of the four living grandchildren would be considered the owner of one-fourth of the stock owned by the trust. If a grandchild who dies before or after trust termination holds a general power of appointment over one-fourth of the trust's assets, the trust will qualify for the GST annual exclusion and as a QSST.

[18] §1361(d)(1)(B). Reg. §1.1361-1(j)(7)(i), Reg. §1.1361-1(j)(8).

[19] Reg. §1.671-4(b)(6)(iii).

[20] Reg. §1.1361-1(j)(8). However, for purposes of recognizing any losses suspended due to the at-risk rules of §465 or the passive activity rules of §469, the regulation treats the beneficiary as having sold the stock so that the suspended losses can be triggered.

[21] PLR 9721020, PLR 199905011. This includes gain from the actual sale of assets as well as gain on the §336 deemed sale of assets distributed to shareholders. Of course, §331 gain on the deemed sale of stock on dissolution is also taxed to the trust.

[22] PLR 9828006, PLR 199920007, PLR 201232003.

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The beneficiary must make a separate QSST election with respect to each corporation whose stock the trust holds.[23]

To explore a QSST's unique attributes as a grantor trust deemed owned by its beneficiary, see ''QSST as a Grantor Trust,'' below.

Also note that a QSST election might enhance (or perhaps reduce) the trust's ability to deduct charitable contributions made by the S corporation.

QSST as a Grantor Trust

Because the beneficiary pays tax on not only the S corporation's distributed income but also its undistributed income, a QSST can be a way to:

- Avoid high trust income tax rates and take advantage of a full run through the beneficiary's graduated tax rates.
- Allow the beneficiary to deduct a loss before the trust's termination, if the stock has sufficient basis.
- Have the beneficiary pay tax on any reinvested earnings used to grow the S corporation, increasing the trust's value and reducing the beneficiary's gross estate.
- Allow the beneficiary to sell S corporation stock (and, indirectly, other assets) to the trust on what appears to be a tax-free basis. A sale to an irrevocable grantor trust is a powerful estate planning technique. Clients sometimes balk at selling assets to a trust where they are not beneficiaries, because they might need the assets for their living expenses. For a client who refuses to part with all of the enjoyment of sufficient assets, consider suggesting that he or she sell assets to a trust in which he or she is a beneficiary and is the deemed owner (a beneficiary grantor trust), by reason of a lapsed withdrawal right.[24] Beneficiary grantor trusts involve complex tax issues, including the risk that the IRS, which generally has stopped issuing private letter rulings regarding such trusts,[25] might at some point take a position inconsistent with its many past favorable private letter rulings. The complexity involved often includes a sale being highly leveraged (often using a trust funded with no more than $5,000), which might invite IRS scrutiny. QSSTs do not face the funding issues that apply to many other beneficiary grantor trusts. They can be funded very substantially and still be entitled to grantor trust treatment. However, a sale to a QSST is not as tax-efficient and flexible as a sale to a beneficiary grantor trust.[26]

QSST Issues When a Beneficiary Dies

QSSTs have excellent post-mortem planning flexibility:

- A QSST may hold stock for two years after the beneficiary's death without making any election at all.
- If a QSST continues as separate QSST-eligible shares for each beneficiary after termination but before the new QSST trusts are actually funded, no new election is required until actual funding of the new trusts; in other words, the QSST election stays in effect, with the individual remaindermen taxed as the QSST beneficiaries until actual post-mortem trust funding occurs.[27]

The latter is a very important tool. Consider what happens after the beneficiary dies and before the stock is retitled in the remaindermen's names. If the S corporation does not distribute all of its taxable income, the trust might not be able to obtain an income distribution deduction to carry out all of the income to the remaindermen, thereby trapping the income at the trust's presumably higher income tax rates.[28] Keeping the QSST election intact post-mortem before stock retitling to make sure that individual beneficiaries are taxed directly on the S corporation's K-1 income might save income tax during that period.

However, challenges arise when the remaindermen are not the residual beneficiaries of the beneficiary's estate plan. The S corporation might make distribu-

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[23] Reg. §1.1361-1(j)(6)(i). Inadvertent termination relief is available when the trust acquires stock in another S corporation if a timely QSST election is not made with respect to that other S corporation. PLR 201618003.

[24] §678(a)(2).

[25] Rev. Proc. 2017-3, 2017-1 I.R.B. 130, §4.01(43), provides that ordinarily the IRS will not rule on:

> Whether a person will be treated as the owner of any portion of a trust over which that person has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner of the trust under §671 if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of §2041, if the trust purchases the property from that person with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.

[26] *See* Gorin, Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications, ''QSST as a Grantor Trust; Sales to QSSTs,'' Part III.A.3.e.vi.

[27] *See* Reg. §1.1361-1(j)(9)(ii), contrasting *Ex.* 1 with *Ex.* 2.

[28] *See* ''Why Partnership Income Is Trapped and Taxed and How a QSST Can Help,'' below, describing this issue as its applies to partnership interests.

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tions to pay the shareholders' income taxes after the beneficiary dies, and then how will the beneficiary's estate pay tax on the beneficiary's allocable share of the S corporation's income? What happens when a QSST's beneficiary dies, the beneficiary's estate is taxed on pre-mortem income, and the remaindermen are different than the beneficiaries of the beneficiary's estate? This might occur, for example, in a second marriage situation. Although the UPIA discusses issues along these lines to a certain extent,[29] drafting to address this issue would be advisable:

- If the beneficiary does not control disposition of the trust's assets, the beneficiary might consider negotiating income tax reimbursement provisions with the trustee as a condition of making the QSST election.
- If the beneficiary does control disposition, the beneficiary might consider exerting that control to require that the remaindermen reimburse the beneficiary's estate for income tax on the pre-mortem income. On the other hand, if the QSST's remaindermen are the same as under the beneficiary's estate plan generally, the opportunity to create a debt (taxes on the earned but undistributed income) on the beneficiary's estate tax return might prove beneficial. In the latter case, the beneficiary might exercise any power of appointment he or she might have to provide for the QSST election to remain in place after the beneficiary's death during trust administration before the trust is divided.

Sample Provision: One might consider a provision along the following lines:

(1) If the individuals to whom the S corporation stock is allocated do not share in the residue of the deceased beneficiary's estate (in this Agreement, Article 5 determines the sharing of the residue of my estate, because my will bequeaths my estate to the Revocable Trust and Article 5 bequeaths the residuary trust assets), then any distributions the S corporation makes to pay its shareholders' taxes with respect to their distributive shares of taxable income before the date of death shall be treated as income earned before the beneficiary's death and paid to the beneficiary's estate.

(2) If and to the extent that paragraph (1) does not apply, during trust administration, after the beneficiary's death and before separate trusts can be funded, the trust will not terminate but rather will continue as a single trust with separate shares pursuant to U.S. Treas. Reg. section 1.1361-1(j)(9)(ii), Example (1), and the trusts for the beneficiaries will be amended under [the QSST provisions].

Such a provision would not cause any marital deduction problems for the trust that is terminating.[30] However, if the trust is included in the beneficiary's estate and the beneficiary is bequeathing the stock to a QTIP trust and income otherwise payable to the QTIP trust is diverted, query whether that violates the requirement that QTIP exclusively benefit the surviving spouse.

The amount of income allocated before and after death is also potentially subject to considerable uncertainty, unless an election to close the corporation's books is made.

If the stock is bequeathed to a person other than the persons receiving the trust's residue, consider timing issues relating to distributions to pay taxes on the trust's distributive share of the entity's income.

HOW TO TRAP ALL OF THE TRUST'S INCOME, NOTWITHSTANDING MAKING DISTRIBUTIONS

Just as when we wanted to tax all of the trust's income to the beneficiary, a similar strategy applies when one wants to trap all of the trust's income notwithstanding making distributions: The trust contributes its assets to an S corporation. However, instead of the beneficiary electing to treat the trust as a QSST, the trustee elects to treat the trust as an electing small business trust (ESBT). All of the assets' investment income (including capital gain) would be reported on a K-1 that the trust receives from the corporation; the trust then files a tax return with an ESBT statement taxing all of the K-1 income to the trust, notwithstanding any distributions made to the beneficiary(ies). (Any distributions would carry out the trust's other income, an issue that creates a planning opportunity described further below.)

[29] UPIA §201 (last amended or revised in 2008); see http://www.uniformlaws.org/shared/docs/principal%20and%20income/upia_final_08_clean.pdf) addresses actions when a trust terminates.

[30] Rev. Rul. 92-64, 1992-2 C.B. 214, generally allows income earned during the surviving spouse's life but paid after the surviving spouse's death to be paid to either the surviving spouse's estate (if allowed under state law) or the successor beneficiary. State corporate law often limits the gap between record date (the date on which the shareholder actually owned the stock) and payment date; generally, an LLC taxed as an S corporation would not face this problem. Of course, in a trust situation, with either type of entity the trust would receive the distribution and then direct it according to the beneficiaries' respective interests, if the ownership interest was not transferred between death and date of the distribution from the corporation.

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Qualification as an ESBT

To qualify to make an ESBT election, the trust cannot have as a beneficiary any person other than an individual, estate, or charity within certain definitions.[31] ''Beneficiary'' includes a person who has a present, remainder, or reversionary interest in the trust.[32] A distributee trust is the beneficiary of the ESBT only if the distributee trust is a §170(c)(2) or §170(c)(3) organization.[33] In all other situations, any person who has a beneficial interest in a ''distributee trust'' is a beneficiary of the ESBT, rather than the trust itself being considered to be a beneficiary.[34] A ''distributee trust'' is a trust that receives or may receive a distribution from the ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred.[35]

If an impermissible shareholder might become a potential current beneficiary, one might consider taking steps to exclude that person from being a potential current beneficiary (PCB) of the ESBT portion.[36] A potential trap applies when an ESBT terminates in favor of trusts (the ''downstream trusts''). After the event terminating the ESBT (such as the primary beneficiary's death) and before the trust distributes its assets to the downstream trusts, the downstream trusts might become PCBs, applying the following rules:

(1) Generally, a trust that exists is a distributee trust if it becomes entitled to, or at the discretion of any person, may receive a distribution from principal or income of an ESBT.[37] A trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit.[38] A trust that is not yet funded is not currently a distributee trust.[39]

(2) If the trust is a wholly owned grantor trust, then the persons who would be its PCBs if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT.[40] However, if the distributee trust is a former grantor trust or is a testamentary trust, in either case during the special initial 2-year period, then the relevant estate is treated as the ESBT's PCB during that period.[41]

(3) If the distributee trust is not a wholly owned grantor trust, then the distributee trust is the potential current beneficiary of the ESBT and the corporation's S corporation election terminates.[42] However, if the distributee trust would be a valid QSST or ESBT if the relevant election were made and the election is not made because the trust does not hold S stock, then the distributee trust does not count as a PCB,[43] and the distributee trust's PCBs would count as PCBs of the trust that does hold the S stock.[44] Another option is for the main trust to partially fund the distributee trust and have the distributee trust then qualify as a shareholder.[45]

Each potential current beneficiary is treated as a shareholder for the purposes of the 100-shareholder limitation.[46] A potential current beneficiary means any person who at any time during a particular taxable year may receive a distribution of principal or income from the trust, whether the distribution was mandatory or discretionary.[47]

Regulations had provided that an open-ended inter vivos power of appointment violates the 100-shareholder limitation; however, Congress modified that provision for years beginning after December 31, 2004, to provide that powers of appointment are considered during a period only to the extent exercised during that period,[48] and the regulations now reflect this change.[49] If a distribution can be made to an existing trust, that trust must qualify under the general

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[31] §1361(e)(1)(A)(i). Permitted charities include an organization described in §170(c)(2), §170(c)(3), §170(c)(4), or §170(c)(5) or, if it has a contingent interest in the trust and is not a potential current beneficiary, a §170(c)(1) organization.

[32] Reg. §1.1361-1(m)(1)(ii)(A).

[33] Reg. §1.1361-1(m)(1)(ii)(B).

[34] *Id.*

[35] *Id.*

[36] PLR 200913002 ruled that such a modification did not affect GST grandfathering.

[37] Reg. §1.1361-1(m)(4)(iv)(A).

[38] *Id.*

[39] *Id.* PLR 200816012 and PLR 200913002 approved as an ESBT a trust prohibiting distributions to a nonresident alien for so long as (1) the trust has an ESBT election in effect, and (2) a nonresident alien is not permitted to be a PCB of an ESBT under the Code and regulations. (I do not know why the rulings cited Reg. §1.1361-1(m)(4)(iv) instead of Reg. §1.1361-1(m)(4)(v). I wonder whether that is a typo.)

[40] Reg. §1.1361-1(m)(4)(iv)(C).

[41] *Id.*

[42] Reg. §1.1361-1(m)(4)(iv)(B).

[43] Reg. §1.1361-1(m)(4)(iv)(D); Reg. §1.1361-1(m)(8) *Ex.* 6. For the purposes of Reg. §1.1361-1(m)(4)(iv)(C) of this section, a trust will be deemed to be described in §1361(c)(2)(A) if such trust would qualify for a QSST election under §1361(d) or an ESBT election under §1361(e) if it owned S corporation stock.

PLR 200912005 approved a distributee trust that would have been eligible to make an ESBT election even though its sole remainderman was a charity (it did not, as drafted, qualify as a charitable remainder trust).

[44] Reg. §1.1361-1(m)(4)(iv)(B). *See* Reg. §1.1361-1(m)(8) *Ex.* 6, parts (i) and (iii), reproduced in n.43, above.

[45] Reg. §1.1361-1(m)(8) *Ex.* 5.

[46] §1361(c)(2)(B)(v).

[47] §1361(e)(2).

[48] *Id.*

[49] Reg. §1.1361-1(m)(4)(vi)(A).

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rules for trusts as S corporation shareholders;[50] similar to the power of appointment rule, that rule does not apply until the distributee trust has been created.[51]

An ESBT cannot have a beneficiary whose interest was acquired by purchase.[52] This prohibition does not have anything to do with whether the trust has purchased or might later purchase S stock.[53]

ESBT Income Taxation

ESBT income taxation is complicated. An ESBT is treated as two separate trusts for purposes of Chapter 1 of the IRC.[54] The portion that consists of stock in one or more S corporations is treated as one trust, and the portion that consists of all the other assets in the trust is treated as a separate trust.[55] The grantor trust rules trump this treatment.[56] The ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return.[57]

The income from the Schedule K-1 that the S corporation files for the trust is separately taxed to the trust at the highest individual income tax rate for that type of income.[58] Very few deductions are allowed against this income, and the income distribution deduction is not available;[59] the IRS has taken the position that net operating losses (NOLs) are not allowable deductions,[60] but capital loss carryforwards appear to be allowable.[61]

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[50] Reg. §1.1361-1(m)(4)(iv)(B).

[51] Reg. §1.1361-1(m)(4)(iv)(A), which further provides:

> For this purpose, a trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit. Thus, if a trust instrument provides for a trust to be funded at some future time, the future trust is not currently a distributee trust.

[52] §1361(e)(1)(A)(ii). For whether a change in a beneficiary's interest in a trust might cause an interest in the trust to be obtained by purchase in violation of this rule, see Daniel J. Potter, *Trust Decanting of S Corporation Shareholders: Avoiding Inadvertent Termination of the Company's S Election*, 40 Tax Mgmt. Est. Gifts & Tr. J. 117 (Mar./Apr. 2015).

PLR 201436006 and PLR 201436007 ruled that the following transactions did not constitute a prohibited purchase of an interest in a trust:

> X created Trust 1 on D1. Trust 1 is a grantor trust wholly owned by X. X proposes to create Trust 2 which will be a grantor trust wholly owned by X. X proposes to contribute S corporation stock to Trust 2 and sell the Trust 2 remainder interest to Trust 1. Trust 2 will elect to be an electing small business trust (ESBT) under 1361(e) upon creation.
>
> . . . .
>
> [W]e conclude that the sale of the Trust 2 remainder interest to Trust 1 will not disqualify Trust 2 from being an ESBT under §1361(e) during the period when Trust 1 is a grantor trust as to X because the sale of the remainder interest is not a purchase within the meaning of §1361(e). The sale of the remainder interest is not a purchase within the meaning of 1361(e) because the sale is not governed by §1012(a). However, to the extent that the sale is treated as a gift, the sale will be covered by §1015(a). In addition, we conclude that Trust 2 will not cease to be or fail to qualify as an ESBT after the termination of Trust 1's grantor trust status because Trust 1's acquisition of the remainder is not a purchase within the meaning of §1361(e).

[53] Reg. §1.1361-1(m)(1)(iii).

T.D. 8994, 67 Fed. Reg. 34,388 (May 14, 2002) stated:

> Two commentators requested clarification on whether a trust is eligible to be an ESBT if it acquires property in a part-gift, part-sale transaction, such as a gift of encumbered property or a net gift, in which the donor transfers property to a trust provided the trust pays the resulting gift tax. Section 1361(e)(1)(A)(ii) provides that a trust is eligible to be an ESBT only if "no interest in the trust was acquired by purchase." Section 1361(e)(1)(C) defines *purchase* as "any acquisition if the basis of the property acquired is determined under section 1012." The proposed regulations provide that if any portion of a beneficiary's basis in the beneficiary's interest is determined under section 1012, the beneficiary's interest was acquired by purchase. The final regulations clarify that the prohibition on purchases applies to purchases of a beneficiary's interest in the trust, not to purchases of property by the trust. A net gift of a beneficial interest in a trust, where the donee pays the gift tax, would be treated as a purchase of a beneficial interest under these rules, while a net gift to the trust itself, where the trustee of the trust pays the gift tax, would not.

Staff on the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-96) (Dec. 18, 1996) (Blue Book), stated:

> No interest in the trust may be acquired by purchase. For this purpose, "purchase" means any acquisition of property with a cost basis (determined under sec. 1012). Thus, interests in the trust must be acquired by reason of gift, bequest, etc. The trust itself may acquire property (including stock of an S corporation) by purchase.

[54] §641(c); Reg. §1.641(c)-1(a).

[55] Reg. §1.641(c)-1(a).

[56] *Id.*

[57] *Id.*

[58] §641(c)(1); Reg. §1.641(c)-1(e).

[59] §641(c)(2).

[60] The IRS has taken the position that a net operating loss (NOL) carryover arising from pre-ESBT activity is not deductible because an NOL carryover is not one of the specifically enumerated expenses. CCA 200734019 (consider whether the logic in that CCA might also be applied to NOLs generated from post-ESBT activity).

Making a §645 election for a revocable trust to be taxed as an estate avoids this issue for short-term post-mortem planning, because estates can hold S stock during a reasonable administration period, whereas revocable trusts are limited to two years under §1361(c)(2)(A)(ii). Trusts created under a revocable trust are considered trusts created under wills pursuant to Reg. §1.1361-1(k)(1) *Ex.* 3, paragraph (ii) if a §645 election is in place and therefore

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State and local income taxes and administrative expenses directly related to the S portion and those allocated to that portion are taken into account by the S portion.[62] These items may be allocated in any manner that is reasonable in light of all the circumstances, including the terms of the governing instrument, applicable local law, and the trustee's practice with respect to the trust if it is reasonable and consistent.[63]

Complications arise if the ESBT is a grantor trust in whole or in part or if the trust is a charitable lead trust or other trust eligible for a charitable income tax deduction.[64]

If the nongrantor trust portion of an ESBT is included in a person's estate, the ESBT election might prevent a basis step-up of depreciable property.

ESBT Dual Trust Structure Maximizes Utility

Suppose the trust receives more from the S corporation than it distributes to the beneficiary and then reinvests those excess receipts. Distributions from the trust will now carry out this investment income, even if the distributions are traced directly to the S corporation K-1 income that is trapped inside the trust.[65]

The trustee might consider dividing the ESBT into two separate trusts — one that holds S stock and makes distributions to the beneficiary and one that holds any receipts that the trustee reinvests. The separate trust that holds the investments would accumulate income and trap the investment income.

Therefore, when the trustee of the trust that holds S stock receives a distribution, the trustee would retain enough to pay income tax and administrative expenses, distribute to the beneficiary as appropriate, and then transfer the balance of the cash to the trust that generates investment income.

Can the IRS combine these two trusts? Section 643(f) authorizes the IRS to issue regulations to do so (although in a more general sense, because ESBTs did not yet exist when it was enacted). However, the only regulation about combining trusts, Reg. §1.641(a)-0(c), authorizes combining trusts only if the principal purpose of separation is to blunt the impact of "(a) the progressive rates of tax (including mitigation as a result of deferral of tax) or (b) the minimum tax for tax preferences imposed by section 56," neither of which is the point of this separation.[66]

SPECIAL APPLICATIONS FOR BUSINESSES

Long-term rental activity and operating businesses have special concerns. Nongrantor trusts tend to be taxed on partnership income in the highest tax bracket — even when required to distribute all of their income. Another concern is avoiding the 3.8% tax on net investment income. Finally, an S corporation with an ESBT or QSST can help avoid the new rules on partnership audits, which were intended to apply to partnerships with many partners but may also apply to many partnerships with only a few partners.

Why Partnership Income Is Trapped and Taxed and How a QSST Can Help

Often a partnership may report significant earnings on its K-1s, but may distribute a much smaller amount in cash to its partners.

For example, a trust could receive a partnership K-1 with $100,000 of taxable income, but may only receive $60,000 of cash as a distribution. The $60,000 is all the accounting income, because the amount distributed does not exceed the amount of income attributable to the trust.[67] When this happens, the trust will have trust accounting income equal to $60,000 and will be unable to distribute the additional $40,000 of "phantom income" from the K-1, meaning the trust will be taxed on the $40,000. This can lead to cash flow problems when the trust has no other income: once the trust distributes the $60,000 to the beneficiary, it will have no available cash to pay the taxes.

The UPIA[68] provides a solution to this cash flow problem. Under old UPIA §505(c)(1), a tax that is required to be paid by a trustee on the trust's share of an entity's taxable income is proportionally divided

can hold S stock for up to two years after funding before making an ESBT or QSST election, flexibility that is not present absent a §645 election.

[61] Reg. §1.641(c)-1(d)(3)(i) disallows deductions for capital losses that exceed gains by more than $3,000 under §1211(b) but does not refer to capital loss carryforwards under §1212. Nothing directly addresses whether capital losses incurred before making an ESBT election, but relating to S corporation items can be deducted against capital gain incurred while an ESBT.

[62] Reg. §1.641(c)-1(d)(4)(i).

[63] Reg. §1.641(c)-1(h).

[64] The charitable deduction is not allowed against ESBT income if made directly by the trust. See §641(c)(2)(C) and Reg. §1.641(c)-1(d)(1), disallowing all deductions except those expressly listed (but the deduction should be allowed against the non-S portion of the trust). However, Reg. §1.641(c)-1(d)(2)(ii) describes charitable deductions passing through a K-1 the ESBT receives from an S corporation.

[65] Reg. §1.641(c)-1(i).

[66] Reg. §1.641(a)-0(c)(3).

[67] UPIA §401(b).

[68] Citations to the "old" UPIA are to the version adopted in 1997, as amended or revised in 2000, published August 21, 2003, by the National Conference of Commissioners on Uniform State Laws.

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between principal and income based on the receipts allocated to each. Thus, the trustee would be able to keep some of the cash to pay the taxes on the trust's undistributed income; whether the trustee would be required to keep enough to pay tax was uncertain. Fortunately, the 2008 amendments to UPIA §505 make sure that the trustee has enough money to pay the tax.[69]

However, the trust's cash flow is not the only issue. Although the trust will be able to pay the income tax, a significant portion of the K-1 income is trapped inside of the trust in the example above, notwithstanding the trust being a mandatory income trust. Much of this trapped income will be taxed in the highest bracket. If having all of this income taxed to the beneficiary would save taxes, consider the trust contributing the partnership to an S corporation and the beneficiary making a QSST election. In the example above, all $100,000 of the partnership's income would be taxed to the beneficiary, allowing the trust to distribute the entire $60,000 to the beneficiary without the trust paying any tax. Instead of a large part of the income being taxed in the highest income tax bracket inside the trust, all of the income may get the full run-through of the beneficiary's individual income tax brackets.

3.8% Tax on Net Investment Income

ESBTs might avoid the §1411 3.8% NII tax by appointing a trustee who is active in the business if the beneficiary is not active in the business. A QSST's income does not constitute NII if the beneficiary is active in the business[70] or has income below the threshold; however, because the trustee's participation is what counts when the QSST sells the stock, consider making the trustee active well in advance of a potential sale. Also note that, if the trust directly or indirectly owns real estate that is rented to the S corporation, a QSST election might complicate a trust's qualification for the self-rental exception, which exception would enable the taxable rental income to avoid the 3.8% NII tax, so the trustee might consider retaining some stock in an ESBT, rather than moving all of the stock into a QSST.

See ''QSST Issues When a Beneficiary Dies,'' above, for a discussion of various issues one should consider when a beneficiary makes a QSST election.

Other than possible complexity regarding taxes on the earned but undistributed income, a QSST generally has more flexibility than an ESBT. A QSST offers options for deferring S corporation trust tax elections.[71] If the trustee of an irrevocable grantor trust makes an ESBT election as a protective measure,[72] the trust's ESBT taxation continues after death,[73] in effect springing into place without any of the savings that other former irrevocable grantor trusts (including QSSTs) have.[74]

On the other hand, ESBTs might provide more flexibility that QSSTs in avoiding adverse taxation of certain related party sales of depreciable or amortizable property (§1239), which may provide the chance to replicate an inside basis step-up if the stock receives a basis step-up.

Contributing Partnership Interest to S Corporation to Avoid New Partnership Audit Rules

Effective in 2018, changes in partnership audit rules may apply the following (and other) consequences to partnerships (including LLCs taxed as such):

- If errors were made in the tax return, the entity could not just file an amended return and give amended K-1s to its owners. Instead, it would need to file an administrative adjustment request with the IRS, exposing the change to more scrutiny.
- The highest income rate regarding that type of income would apply.
- Because the entity pays the tax, the current partners essentially bear the burden of changes to tax items reported by whoever were the partners during the year being audited.
- The entity may need to include as a balance sheet liability any taxes relating to adjustments for prior years.
- Partner-level defenses would not apply.

A ''push out'' election can move the taxation to the people who were partners in the year being audited,

[69] Citations to the ''new'' or 2008 UPIA are to the version approved in 2008 and published February 9, 2009, for which I was the ABA Advisor and secured the endorsement of the American College of Trust & Estate Counsel and the Real Property, Trust & Estate Law Section of the American Bar Association.

[70] A QSST is a grantor trust deemed owned by the beneficiary. The 3.8% tax looks to the character of the income in the hands of the deemed owner.

[71] See text accompanying n.27, above.

[72] A trustee cannot make a conditional ESBT election. Reg. §1.1361-1(m)(2)(v). If the trustee of a grantor trust makes an unconditional current ESBT election, the election is in effect but does not control the trust's taxation to the extent trumped by the grantor trust rules. Reg. §1.641(c)-1(c).

[73] Reg. §1.1361-1(m)(8) *Ex.* 4.

[74] A grantor trust is eligible to hold S stock for two years after the deemed owner's death. Normal trust income tax rules, which generally are more favorable than ESBT income tax rules, apply during that time. See text accompanying nn.58–61, above, for ESBT taxation.

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but it does not solve all of the problems caused by the new regime.

Many entities would be better off simply opting out of the new partnership audit rules altogether. Because entities with no more than 100 owners may be able to opt out of the new rules, the new rules often are viewed as applying only to large partnerships. However, all of the owners must be eligible for the entity to be able to opt out.

To be eligible, an owner must be an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner.

However, the law allows the IRS to add to this group of eligible partners. A report issued by the Staff of the Joint Committee on Taxation suggested authorizing single member LLCs and revocable trusts that are taxed as disregarded entities to be eligible if their owners are eligible.[75] The report also authorized making eligible a former grantor trust that continues in existence for the two-year period following the death of the deemed owner, a trust receiving property from a decedent's estate for a two-year period, and tiered partnerships. The report suggested rules that would apply if the IRS added to the group of eligible partners in this manner.

However, proposed regulations this past June declined to expand the list of eligible owners.[76] Under the proposed regulations, nongrantor trusts would not be eligible owners, which would subject to these new rules any entity that has a revocable trust or other trust as one of the owners. I led a task force of the American College of Trust & Estate Counsel (ACTEC) that suggested that revocable trusts and other trusts be included in the list of eligible owners.[77] The American Institute of Certified Public Accountants has asked Congress to postpone these new rules for a year to give everyone more time to think about the law and respond to it.[78]

However, the proposed regulations authorize S corporations to be owners, even if they have one or more shareholders who are not eligible owners. Thus, a trust may contribute its partnership interest to an S corporation to prevent the trust's ownership from disqualifying the partnership from opting out of the new audit rules. However, I would not consider that approach until the regulations are finalized and the disadvantages of S corporation ownership are fully vetted.[79]

FLEXIBLE TRUST DESIGN WHEN HOLDING S CORPORATION STOCK

Consider a GST-exempt trust with only one beneficiary, with discretionary distributions of income and principal under an ascertainable standard. An independent person is authorized to direct that, for a period of no less than 36 months, all of the income is required to be distributed, based on the following:

- The minimum period of time between ESBT and QSST conversions is 36 months. This minimum period applies between conversions but does not apply to the first conversion. In other words, once the first ESBT or QSST election is made, a conversion to the alternate form (QSST or ESBT) can be made at any time. However, once one converted from a QSST to an ESBT or vice versa, the 36-month period applies in reversing the conversion.[80]
- Mandatory distributions ensure no missteps in distributing income to maintain QSST status, because mandatory income trusts are not required to prove actual distributions of all of the income. However, a trust that actually distributes all of its income qualifies even without a mandatory distribution clause.[81]
- Before converting, split the trust if it has assets other than S corporation stock, so that the other assets are not subjected to the QSST distribution scheme.
- The independent person would also be authorized to turn off the mandatory income direction for any trust taxable year that begins after the date the mandatory income direction is turned off. (Otherwise, the IRS might argue that the mandatory income provision is illusory because it could get turned off at any time during the year.)

This would open up the opportunity to toggle between QSST and ESBT taxation, while allowing any ESBT income to accumulate inside an environment protected from estate taxes and creditors. After a trust has been an ESBT for 36 months, it may be divided into a separate trust for each beneficiary, and each new trust can separately either continue as an ESBT

[75] Staff on the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 2015* (JCS-1-16) (2016).

[76] REG-136118-15, 82 Fed. Reg. 27,334 (June 14, 2017).

[77] *See* https://www.thompsoncoburn.com/docs/default-source/default-document-library/list-of-eligible-owners.pdf?sfvrsn=0.

[78] *See* https://www.thompsoncoburn.com/docs/default-source/default-document-library/respond-to-it.pdf?sfvrsn=0.

[79] *See* "Additional Steps the Trust Should Take to Preserve Flexibility at the Beneficiary's Death, When Using Either Strategy," below.

[80] Reg. §1.1361-1(j)(12)(iii), §1.1361-1(m)(7)(iii).

[81] See n.11, above.

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or become subject to a QSST election.[82] Thus, every three years the trustee can consider how much of the trust should be a QSST and how much an ESBT and then ask the independent person to adjust the mandatory income direction as appropriate. This toggling decision would take into account the expected annual S corporation income, the beneficiary's adjusted gross income, and the beneficiary's participation in the business (see below).

Note that, if the beneficiary has an inter vivos limited power of appointment, the beneficiary can hold the power of appointment during an initial ESBT period,[83] but once the trust converts to a QSST the beneficiary must permanently renounce the power of appointment.[84]

S corporation business income is free from the 3.8% tax on net investment income (NII) if the recipient significantly participates in the S corporation's business activity. For a QSST, one would look to the beneficiary's participation, whereas for an ESBT the IRS would look to the participation of a trustee; however, for a QSST, the IRS would look to trustee participation when the trust sells S corporation stock or the S corporation sells substantially all of its business assets. If the beneficiary materially participates in the business, then either QSST or ESBT taxation could avoid the tax, the latter if the beneficiary is appointed as a trustee for purposes of holding the S corporation stock and satisfies the rules for trustee participation. If the beneficiary does not materially participate in the business, the S corporation income would constitute NII; however, the beneficiary might be in a sufficiently low tax bracket that the 3.8% tax on NII might not apply to the beneficiary at all.

Additionally, if the beneficiary already owns stock in the S corporation, the trust might buy the stock from the beneficiary, perhaps without any capital gain tax on the sale.

Finally, QSSTs provide more post-mortem tax options than ESBTs, so pre-mortem toggling to QSST status can provide this enhanced flexibility.

CONVERTING A MULTIPLE BENEFICIARY ESBT INTO ONE OR MORE QSSTs

Strategic Issues

Income tax rates increased January 1, 2013, so that every dollar of ESBT income is taxed at 39.6% federal income tax and 3.8% tax on net investment income (NII). The beneficiaries' federal income tax brackets might be significantly lower,[85] and the NII tax would not apply except to the extent that their modified adjusted gross income exceeds $200,000 for a single individual or $250,000 for a married person filing jointly.

However, any trustee and tax preparation fees might be deductible by the beneficiaries as miscellaneous itemized deductions (and disallowed for AMT purposes) rather than being deducted directly against the S corporation income.[86]

This might increase the state income tax on the business income. As an ESBT, only the trust's state income tax posture is considered. Depending on the ESBT's state of residence, the ESBT might not be responsible for tax on the trust's income (particularly investment income) that is not sourced to a particular state. If the trust is converted to QSSTs, each beneficiary would need to file an income tax return for each state in which the S corporation does business, reporting his or her share of each state's income, thereby complicating each beneficiary's income tax return preparation. Additionally, each beneficiary who lives in a state with income tax would need to pay state income tax on his or her share of income, ameliorated in whole or in part by a credit for income taxes paid to other states.

The ESBT might have been accumulating income or perhaps distributing income to separate GST-exempt trusts for beneficiaries, the latter so that each beneficiary decides on a case-by-case basis whether to accumulate income in a protected trust. This accumulation might be important for estate tax reasons, as well as perhaps for nontax reasons. Now, however:

- With the $5+ million estate tax exemption, this accumulation strategy has less estate tax benefit, if the beneficiaries do not have estates near the exemption.
- Trusts that accumulate income face the same increase in federal income tax and NII tax as described above if they are ESBTs or have more than $12,000[87] in taxable income, so the accumulation strategy would have additional income tax costs.

[82] PLR 201122003.

[83] See text accompanying nn.48–49, above.

[84] See n.6, above.

[85] Consider the effect of phase-outs based on adjusted gross when evaluating the beneficiaries' income tax rates.

[86] Reg. §1.67-2T(b)(1).

[87] 12,150, $12,300, $12,400, $12,500, $12,700 in 2014, 2015, 2016, 2017, and 2018, respectively. Rev. Proc. 2013-35, 2013-47 I.R.B. 537 (2014); Rev. Proc. 2014-61, 2014-47 I.R.B. 860 (2015); Rev. Proc. 2015-53, 2015-44 I.R.B. 615 (2016), Rev. Proc. 2016-55, 2016-45, I.R.B. 707 (2017); Rev. Proc. 2017-58, 2017-45 I.R.B. __ (2018); presumably higher in future years.

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Implementation

The trustee might consider the following:

- Evaluate the trustee's authority to divide trusts and to convert separate trusts into QSSTs. If the trust has beneficiaries of more than one generation (e.g., children and grandchildren), the trustee needs to consider any fiduciary duties to the lower generations (e.g., grandchildren) in dividing the trust into separate trusts for the upper generation (e.g., children). The trustee might obtain ratification from all adult beneficiaries to protect the trustee. The parent (who is not a beneficiary) of any minor or unborn descendant would sign on behalf of that descendant; this can be problematic if the child who is a beneficiary is divorced or otherwise having marital troubles. A consent by a beneficiary might raise §2702 issues; this is less of a concern if the beneficiary had not been receiving distributions and never expected to receive distributions before that beneficiary's parent's death.

- If centralized management is a concern:
  - Determine whether the trustee is authorized to commingle the QSSTs, treating them as separate shares.[88] The trustee might maintain a single new bank account for new deposits, which would then either distribute anything it receives or reimburse the existing account for administrative expenses the trust incurs. The division of shares would be done simply by recording the shares on a spreadsheet.
  - See whether the beneficiaries have the right to change the trustees of their separate trusts, which rights they might not have had in the main trust.
  - Determine whether paying 100% of annual trustee fees and administrative expenses regarding the QSST portion out of income reasonably and fairly balances the interests of the income and remainder beneficiaries, as the trust might not have another source to pay those fees; the trustee would want to reserve the right to allocate them to principal in the year of sale.[89] Normally such fees and expenses are allocated one-half to income and one-half to one-half to principal.[90] Perhaps the corporation would pay the fees, but note that the payment might need to be a separately stated K-1 item, if the character of the fees would change on a beneficiary's income tax return.[91]

Timing Tax Deductions in Year of Conversion

Consider which expenses would be better deductions against ESBT or QSST income and pay them in the appropriate time period.

K-1 items from the S corporation need to be prorated.

Presumably, administrative expenses relating to S corporation income would be allocated to the time before and after the conversion, and any expenses allocable to the QSST portion would be deductible by the beneficiary.[92]

ADDITIONAL STEPS THE TRUST SHOULD TAKE TO PRESERVE FLEXIBILITY AT THE BENEFICIARY'S DEATH, WHEN USING EITHER STRATEGY

An S corporation that does not engage in a trade or business would not be able to be divided income-tax free under §355. This would trap all family members in a single investment entity, unable to manage investments suitable for each person's goals. A distribution of investments would be taxed as a sale. Thus, distributing marketable securities to family members so that they go their separate ways would subject them to capital gain tax on the deemed sale of the investments. Distributing depreciable property might subject them to tax on ordinary income.

However, pre-mortem planning might help. Suppose the trust is a credit shelter trust or a GST-exempt trust and the beneficiary's estate is subject to estate tax. If the QSST sells its investments that have unrealized gain, the income (capital gain) tax liability will be a debt deductible on the beneficiary's estate tax return. Harvesting gain would prevent the distribution of securities from being a taxable event at the shareholder level. However, the distribution of securities in a corporation would generate income tax to the extent that the fair market value of the distribution exceeds the basis (and might generate dividend income if and to the extent the corporation had been a C corporation and the distribution constituted a distribution of earnings and profits); on the other hand, the recognition of gain on the sale of securities would increase the stock's basis. Just be sure that the pre-mortem gain

[88] This is permitted under the last sentence of §1361(d)(3) and Reg. §1.1361-1(j)(3).

[89] Gain on sale of stock, including any gain reported on a K-1 form the S corporation issues reporting gain by reason of a §338(h)(10) election to treat a stock sale as an asset sale, is taxable to the trust, rather than the being taxable as the grantor trust portion.

[90] UPIA §501.

[91] See text accompanying n.86, above, and §1366(a)(1)(A).

[92] CCA 201327009 allows the beneficiary to deduct the interest when the QSST buys from a third party using a promissory note.

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harvesting is not pursuant to a plan of liquidation or a sale of stock combined with a §338(h)(10) election; either event would subject the sale of assets for stock at the trust's level, rather than the beneficiary's level.

Income tax difficulties in splitting an S corporation after the beneficiary's death might be addressed as follows:

- ***Form a Partnership.*** By forming an entity taxed as a partnership with the beneficiary, other family members, or other trusts, a QSST might be able to access investment opportunities not otherwise available to it or might be able to facilitate their access to investment opportunities not available to them. Although such a partnership could preserve the expected annual cash flow, the commitment to retaining funds in the partnership would reduce the fair market value of the S corporation's partnership interest. This value reduction would also reduce the tax if the corporation distributes some or all of assets when the QSST divides upon the beneficiary's death. Such a partnership should be formed well in advance of the beneficiary's death. When the beneficiary dies, perhaps the S corporation would distribute some of its partnership interests right away so that the trust could immediately fund part of the bequests; then, later, after the trustee is satisfied that all tax and other fiduciary liabilities have been resolved, the S corporation could distribute the remaining partnership interests. Furthermore, the partnership could later divide in a variety of ways on a tax-free basis, so that each family member can implement his or her own investment strategy over time; however, if the family members do not have strategies that either are consistent with each other's or complement each other's, pursuing different investment strategies would tend to require asset sales that might generate capital gain tax.[93]
- ***Create Separate Corporations.*** Suppose a trustee decides to contribute its assets to an S corporation with the expectation that the beneficiary will make a QSST election. Instead, consider forming a separate S corporation for the future benefit of each of the beneficiary's children. When the beneficiary dies, each of the beneficiary's children will be allocated a separate S corporation, thereby eliminating the need to divide the corporation or distribute its assets. This solution merely postpones the issue, because these issues would need to be addressed when a child of the beneficiary dies (or if a child predeceases the beneficiary, but that postponement might be sufficiently beneficial to address concerns for a while).

CONCLUSION

Generally, our fiduciary income tax system tracks taxable income to the last person in the chain to receive it. Although this result makes sense, it does not necessarily produce the best result for taxpayers, in light of varying state income tax rules or disparities in a trust's and its beneficiary's relative income tax brackets.

Special rules for trusts owning S corporation stock provide opportunities to change these rules, so that taxable income is trapped in a trust for tax purposes even though it is distributed or so that taxable income is taxed to the beneficiary even though none or part of it is distributed. These strategies can help trusts that own partnership interests or marketable securities and never before had considered using an S corporation.

These opportunities require extra attention to provide a palatable exit strategy when the beneficiary dies. They will require several additional income tax returns each year, so tax savings need to be significant to justify the annual cost.

If a taxpayer already has an S corporation, consider various drafting tips or administrative strategies to try to make trusts holding the stock more flexible.

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[93] If the strategies are consistent with each other's, then the partnership could simply divide the assets pro rata. If the strategies complement each other's, then each person could take the assets that interest him or her. Anything else would require post-division adjustments, most likely accomplished through sales.

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