

State Fiduciary Income Tax (*Kaestner*); S Corp. Ownership; Basis Step-Up Strategies

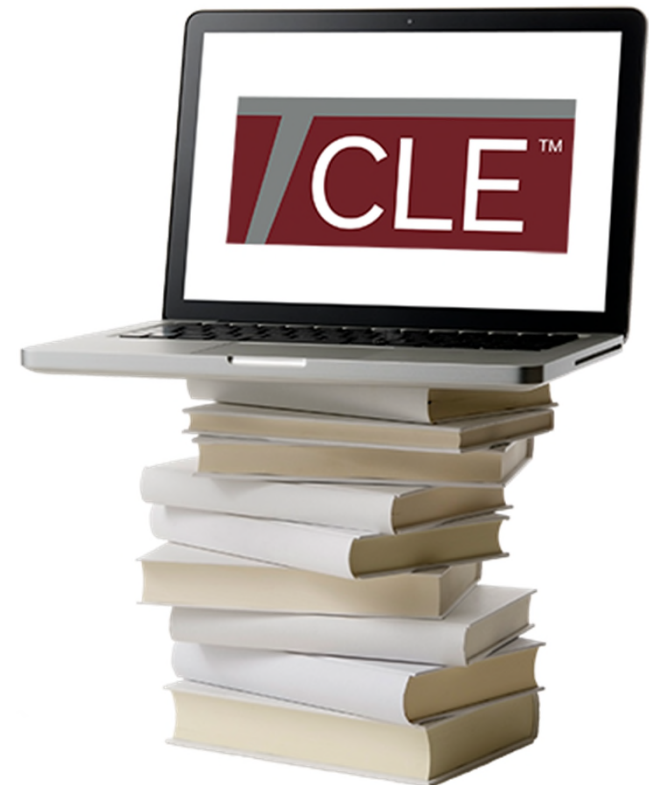
Steve Gorin

sgorin@thompsoncoburn.com

314.552.6151

<http://thompsoncoburn.com/people/steve-gorin>

<http://thompsoncoburn.com/insights/blogs/business-succession-solutions>



WELCOME

7360244

Overview

- What *Kaestner* did and didn't do regarding the constitutional limits imposed on state income taxation of trusts; overview of how state income taxation affects pass-through entities
- Recent developments in S corporation ownership and shareholder agreements
- Basis step-up; trust modifications

State Fiduciary Income Taxation – *Kaestner* (II.J.3.e.ii.)

*North Carolina Department of Revenue v. Kimberley Rice
Kaestner 1992 Family Trust*, 588 U.S. ___ (2019)

- Unanimous decision that NC cannot subject to income tax a trust whose only ties consisted of a beneficiary who may at some point receive distributions in the trustee’s “absolute discretion”
- Holding limited to “the circumstances in which a beneficiary receives no trust income, has no right to demand that income, and is uncertain necessarily to receive a specific share of that income”

State Fiduciary Income Taxation – *Kaestner* (II.J.3.e.ii.)

- The Court did not address whether, if the trust had made distributions to Kaestner, NC could have taxed her
- The Court noted in passing and without pause that, in a year after the taxable year that was subject to the litigation, the trust was to terminate when the beneficiary reached age 40, but the trustee decanted into a new trust (in a year after the taxable year being litigated), with no objection from the primary beneficiary

State Fiduciary Income Taxation – *Kaestner* (II.J.3.e.ii.)

Footnotes 12-13:

“The State directs the Court’s attention to 10 other state trust taxation statutes that also look to trust beneficiaries’ in-state residency ..., but 5 are unlike North Carolina’s because they consider beneficiary residence only in combination with other factors [citing statutes in Alabama, Connecticut, Missouri, Ohio, and Rhode Island]. Of the remaining five statutes, it is not clear that the flexible tests employed in Montana and North Dakota permit reliance on beneficiary residence alone Similarly, Georgia’s imposition of a tax on the sole basis of beneficiary residence is disputed Tennessee will be phasing out its income tax entirely by 2021 That leaves California, which (unlike North Carolina) applies its tax on the basis of beneficiary residency only where the beneficiary is not contingent”

“The Trust also raises no challenge to the practice known as throwback taxation, by which a State taxes accumulated income at the time it is actually distributed.” [citing California law]

State Fiduciary Income Taxation – *Kaestner* (II.J.3.e.ii.)

- Counsel for the state struggled to explain how state and federal income taxation are connected and later publicly admitted that he got raked over the coals by the Supreme Court justices
- The North Carolina bar has in the past proposed a statute that would pass muster, and the legislature declined to address the issue
- At least 400 protective claims for refunds had been filed by the end of June
- On July 2, NC Department of Revenue established procedures for refund claims in cases governed by the case:
https://files.nc.gov/ncdor/documents/files/2019-7-2_Kaestner_Important_Notice.pdf

State Fiduciary Income Taxation – *Kaestner* (II.J.3.e.ii.)

- Court since declined to review *Fielding v. Commissioner*, 916 N.W.2d 323 (Minn. 2018)
- That case involved a trust that owned shares in an S corporation
- In *Fielding v. Commissioner*, the Minnesota Supreme Court held that taxing the trust on that other income on that basis alone violated the Due Process Clauses of the U.S. and Minnesota Constitutions, which it viewed as identical to each other

State Fiduciary Income Taxation (II.J.3.e.ii.)

- Nobody disputed Minnesota's ability to tax the trust's distributive share of the S corporation's Minnesota source income
- Rather, the dispute was taxing the other income when the trust's sole potentially meaningful contact with Minnesota regarding that other income was the grantor's residence
- The very limited holding in *Kaestner* and denial of cert. to *Fielding* seems to indicate that the court looked into providing guidance then decided against it and no longer wishes to tackle the issue

State Income Taxation of Business Income

(II.G.3.)

- An owner of an interest in a pass-through entity such as an S corporation or partnership (including an LLC) will report income taxable to the states in which the entity does business, or the entity will pay tax on the income taxable to one or more of its owners instead of its owners reporting that income
- States that tax income have various methods to apportion a business' income, which tend to consider one or more of sales, property, or wages within the taxing state
- Potential for double taxation – use Multistate Tax Commission

State Income Taxation of Business Income

(II.G.3.)

- If the entity is a C corporation, it pays tax on its own income
- That avoids its owners needing to file income tax returns in multiple states
- C corporation deducts state income tax paid, but owner of a pass-through entity is subject to the \$10,000 limitation

State Income Taxation of Business Income

(II.G.3.)

Sale of business (II.Q.1.a., II.Q.8.e.iii.(f), II.Q.9, II. H.8.a., including II.H.8.a.ii.):

- When pass-through business sells its assets (or is deemed to do so), its owners are taxed wherever assets are sited, but their basis in their partnership/member interest or S corporation stock increases on account of that gain/income
- An owner's partnership/member interest or S corporation stock is sited to the state of the owner's residence
- If basis increase causes a loss on sale, it is deducted only in that state of residence

State Income Taxation of Business Income

(II.G.3.)

Sale of business (II.Q.1.a., II.Q.8.e.iii.(f), II.Q.9, II. H.8.a., including II.H.8.a.ii.):

- When a C corporation sells its assets (or is deemed to do so), it is taxed wherever assets are sited
- Its owners' stock's basis does not increase on account of that gain/income
- Stock is sited to the state of its owner's residence

State Income Taxation of Business Income

(II.G.3.)

Other nuances:

- Code § 199A deduction is available in only a few states
- *South Dakota v. Wayfair, Inc.*, 138 S.Ct. 2080 (2018), was a key decision regarding taxing nexus in the context of state sales tax
- The Council on State Taxation, cost.org, tracks not only the implications of that case but also which elements of federal law are integrated into state income taxation

Recent Developments in S Corporation Ownership and Shareholder Agreements (II.A.2.)

- Final regulations explain the consequences of a nonresident alien being a beneficiary of a trust owning stock in an S corporation
- Review of parameters of single class of stock
- Private letter ruling granted inadvertent termination relief after concluding that a redemption agreement violated the rule against having more than one class of stock
- Ownership of vested stock not yet taxed

Recent Developments in S Corporation Ownership and Shareholder Agreements



(II.A.2.f., III.A.3.e.ii.)

- Although a nonresident alien (NRA) may not hold stock in an S corporation, under 2017 tax reform an NRA is eligible to hold stock in an electing small business trust (ESBT)
- If an NRA is the deemed owner of part or all of an ESBT, new regulations provide that ESBT taxation supersedes grantor trust taxation with respect to the NRA
- Even before new regs, an ESBT must be a domestic trust, limiting how much the NRA may control

Recent Developments in S Corporation Ownership and Shareholder Agreements (II.A.2.i.)

- S corporations cannot have more than one class of stock
- Differences in voting rights do not by themselves create a second class of stock
- Look only to governing provisions, which are “the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds”

Recent Developments in S Corporation Ownership and Shareholder Agreements (II.A.2.i.)

- “Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances”
- Temporary Timing Differences; Other Varying Differences (II.A.2.i.ii.)
- Disproportionate Distributions (II.A.2.i.iii.)

Recent Developments in S Corporation Ownership and Shareholder Agreements (II.A.2.)

- Providing Equity-Type Incentives without Violating the Single Class of Stock Rules (II.A.2.i.iv.)
- Post-Redemption or Post-Sale Price Adjustments (II.A.2.i.v.)
- Special Price Protection for Leveraged ESOP Approved (II.A.2.i.vi.)
- Warrants Designed to Restore Original Shareholders' Equity Position (II.A.2.i.vii.)

Recent Developments in S Corporation Ownership and Shareholder Agreements (II.A.2.iv.)

Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining identical rights, unless:

- 1) a principal purpose of the agreement is to circumvent the single class of stock requirement, and
- 2) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock

Recent Developments in S Corporation Ownership and Shareholder Agreements

(II.A.2.iv.)

Letter Ruling 201918013

- Equity compensation plan
- Upon termination of employment, purchase price may be full value or nothing, depending on circumstances of termination
- No intent to circumvent the one class of stock requirement for S corporations
- Transfer restrictions and repurchase provisions not create second class of stock

Recent Developments in S Corporation Ownership and Shareholder Agreements (II.A.2.iv.)

Letter Ruling 201919005 - shareholder agreement provided:

- If a shareholder's voting stock is sold, a corresponding percentage of such shareholder's non-voting stock must be cancelled
- If remaining shareholders have other than equal ownership of the remaining shares of non-voting stock, those shareholders would be entitled to distributable earnings pro rata in accordance with the shares of non-voting stock

Recent Developments in S Corporation Ownership and Shareholder Agreements (II.M.e.ii.)

Letter Ruling 201919005

- Shareholder agreement provided that, if corporation sold, one shareholder would be entitled to receive from the proceeds a payment in excess of the payments
- Shareholder agreement violated second class of stock prohibition
- Granted inadvertent termination relief in conjunction with removing offending provisions

Recent Developments in S Corporation Ownership and Shareholder Agreements (II.A.2.iv.)

Code § 83(i) election deferring income tax inclusion
(elaborated by Notice 2018-97)

- Income inclusion to be deferred (for income tax purposes and not for payroll tax purposes) for up to five years for qualified stock issued to a qualified employee
- The employee is treated as the owner for purposes of any activity relating to that stock, including allocating S corporation income if applicable

Basis Step-Up; Trust Modifications (II.H.2., III.B.1.)

Modifying irrevocable trusts to bring them back into the estate tax system to generate basis step-up

- How to get basis step-up
- Formula general power of appointment
- Tax consequences of modification

Basis Step-Up (II.H.2)

- Basis step-up discussion (II.H.2) is found within discussion of income tax vs. estate and gift tax (particularly for depreciable property) (II.H.)
- Formula general power is one of several basis step-up tools

Basis Step-Up (II.H.2)

Tools include:

- **Free Basis Step-Up When First Spouse Dies** (II.H.2.a.)
- **Basis Step-Up for All Property When First Spouse Dies** (II.H.2.b.)
 - **Community Property** (II.H.2.b.i.)
 - **Marital Estate Trust (the latter when community property treatment is not available)** (II.H.2.b.ii.)

Basis Step-Up (II.H.2)

Tools include:

- QTIP Trusts - Code § 2519 Trap (II.H.2.c.)
- Caution re: Depreciable Property Held in a Nongrantor Trust That Is Included in the Grantor's, Surviving Spouse's, or Other Beneficiary's Estate (II.H.2.d.)
- IRD Assets Not Eligible for a Basis Step-Up (II.H.2.e.)

Basis Step-Up (II.H.2)

Tools include:

- **Partnership Basis Shifting Opportunities**
(II.H.2.f.)
- **Partnership Basis Adjustments** (II.H.2.g.)
- **Basis Step-Up for Property Held Outside an Entity; Moving Liabilities Outside of an Entity to Maximize Deductions for Estate Tax Purposes** (II.H.2.h.)

Basis Step-Up (II.H.2)

Tools include:

- **Avoiding a Basis Step-Down** (II.H.2.i.)
- **Effect of Chapter 14 on Basis Step-Up**
(II.H.2.j.)
- **Taxable Termination vs. General
Power of Appointment vs. Delaware
Tax Trap** (II.H.2.k.)

General Power of Appointment (II.H.2.k.)

- The mere presence of a general power of appointment is effective for basis step-up so long as the estate tax system remains in place
- if the estate tax is repealed, the basis step-up for a general power of appointment may apply only if the decedent actually exercised the power

General Power of Appointment (II.H.2.k.)

- In *Estate of Kurz v. Commissioner*, 101 T.C. 44 (1993), the decedent had a 5% withdrawal right in a bypass trust, exercisable only if the marital trust had been exhausted
- Decedent also had an unlimited right to withdraw the marital trust.

General Power of Appointment (II.H.2.k.)

Kurz continued

- Thus, the decedent controlled whether the 5% withdrawal right applied
- The court concluded that the decedent's control over the scope of the general power expanded the power to as much as the decedent could have expanded it

General Power of Appointment (II.H.2.k.)

Kurz planning implications

- If the holder of a vested general power can change its scope, the full scope is included in the holder's estate
- Consider making the general power not be vested, which presumably would avoid the issue

General Power of Appointment (II.H.2.k.)

Before getting into sophisticated provisions, consider simplicity:

- If the holder's estate will never be big enough to generate estate tax, then consider making the general power plenary
- Consider whether the holder might move to a state that imposes estate tax

General Power of Appointment (II.H.2.k.)

- May want to require the consent of a nonadverse party if concerns about the holder
- Holder may be totally fine now, but anyone could lose capacity due to physical illness or may become frail and dependent on a person who is or becomes a predator

General Power of Appointment (II.H.2.k.)

Consider requiring the consent of a:

- Corporate trustee (liability concerns do not make the corporate trustee “adverse”)
- Any substitute nonadverse party approved by family members

General Power of Appointment (II.H.2.k.)

- Consent might be required only for the “general” aspects of the power, not for an exercise that keeps assets within the family
- Consent would not be required to the extent exercised to pay estate tax resulting from the general power

Formula General Power of Appointment (II.H.2.k.)

Any exercise of the Formula Power to Appoint must specifically refer to the power, shall be effected only by a written instrument with the prior or contemporaneous written consent of the Appointment Trustee (defined below) and delivered to the trustee and shall be revocable by either the primary beneficiary or the Appointment Trustee.

Formula General Power of Appointment (II.H.2.k.)

- Appointment Trustee can undo at any time, so not vested in holder
- “Appoint” is defined in other parts of the document to include will or inter vivos document, which may be revocable or irrevocable

Formula General Power of Appointment (II.H.2.k.)

The Appointment Trustee's decision to consent to, withhold consent from, or revoke (or otherwise limit) the exercise of the primary beneficiary's power to Appoint shall be in the Appointment Trustee's sole and absolute discretion. The Appointment Trustee may, in the Appointment Trustee's sole and absolute discretion, by written instrument delivered to the trustee, reduce or eliminate the primary beneficiary's power to exercise the Formula Power to Appoint, even without an attempted exercise of such power.

Formula General Power of Appointment (II.H.2.k.)

- The last sentence on the preceding slide drives home the point about the holder not having a vested power
- Also, I don't yet have complete confidence in this clause, plus the tax laws or situation of the holder of the power of appointment may change, so I like having an "out"

Formula General Power of Appointment (II.H.2.k.)

The trustee shall serve as the Appointment Trustee if the trustee is not the primary beneficiary and otherwise is not a Nonadverse Person. A “Nonadverse Person” is a person who is not adverse to the exercise of the power in favor of the creditors of the primary beneficiary’s estate under Code section 2041(b)(1)(C)(ii) and the regulations thereunder. If the trustee is not the primary beneficiary and otherwise is not a Nonadverse Person, upon the primary beneficiary’s written request the trustee shall appoint as the Appointment Trustee a Nonadverse Party who is not the primary beneficiary and is not a related or subordinate party (as described in Code section 672(c)) with respect to the primary beneficiary (an “Independent Person”).

Formula General Power of Appointment (II.H.2.k.)

- “Nonadverse Person” has no substantial beneficial interest
- Allowing the holder to mandate the appointment of the person whose consent is required should be sufficient, just as like the legal fiction that an incapacitated person can act (see *Crummey*)

Formula General Power of Appointment (II.H.2.k.)

The primary beneficiary's power to Appoint does not apply to the following assets held by the trust: (1) cash or cash equivalent accounts (such as savings accounts, certificates of deposit, money market accounts or cash on hand in any brokerage or equivalent accounts); (2) any interest in any Benefit Plan or other property that constitutes income in respect of a decedent as described in Code section 1014(c); and (3) any interest in any property that has an adjusted basis for federal income tax purposes that is greater than or equal to the fair market value of the property at the time of the primary beneficiary's death (the "Excluded Assets").

Formula General Power of Appointment (II.H.2.k.)

“Included Assets”

- (1) and (2) are to avoid including in estate assets that don't receive a basis step-up
- (3) is to avoid getting a new basis for assets with basis in excess of value – don't want to trigger a basis step-down!

Formula General Power of Appointment (II.H.2.k.)

If, after eliminating from consideration the Excluded Assets, the inclusion of the value of the other assets in the trust in the primary beneficiary's taxable estate for federal estate tax purposes would not increase the federal estate tax and state death taxes payable from all sources by reason of the primary beneficiary's death, this power of appointment shall apply to all remaining assets of the trust other than the Excluded Assets (the "Included Assets").

Formula General Power of Appointment (II.H.2.k.)

However, if including the value of the Included Assets in the trust in the primary beneficiary's taxable estate for federal estate tax and state death tax purposes would increase the taxes so payable, the assets of the trust appointed by this Section shall be further limited as follows: The trustee shall for each of the Included Assets evaluate the ratio of the fair market value at the time of the primary beneficiary's death to the adjusted basis immediately prior to the primary beneficiary's death first (the "Gain Ratio").

Formula General Power of Appointment (II.H.2.k.)

The trustee shall thereafter rank the Included Assets in order of their respective Gain Ratio. The appointment shall apply first to the Included Asset with the largest Gain Ratio, and thereafter in declining order of Gain Ratio to each of the subsequent Included Assets; however, as such point that inclusion of the next in order of the Included Assets would otherwise cause an increase in the primary beneficiary's estate's federal estate tax and state death tax liability as described above, the primary beneficiary's exercise of the Formula Power to Appoint shall be limited to that fraction or percentage of that Included Asset that will not cause any federal estate tax and state death tax liability, and all lower ranked Included Assets shall be excluded from the primary beneficiary's exercise of the Formula Power to Appoint.

Formula General Power of Appointment (II.H.2.k.)

- Thus, the power applies to all Included Assets if everything is below the holder's estate tax exemption
- If not, the power applies first to assets with highest appreciation
- However, some assets might be sold much sooner than other assets, so that might not best, so next slide:

Formula General Power of Appointment (II.H.2.k.)

The Appointment Trustee may, in the Appointment Trustee's sole and absolute discretion, by written instrument delivered to the trustee change the scope of Excluded Assets and Included Assets and vary the order in which assets are allocated to either category.

Trust Modification (III.B.1.b.)

- Modifying trusts can have gift tax consequences if they change beneficial interests and a beneficiary does not complain
- When a trust authorized the trustee to grant or eliminate a general power of appointment but the person serving as trustee was prohibited from exercising that power, Letter Ruling 201845006 held that amending the trust to appoint a special trustee authorized to exercise that power did not have any GST or gift/estate tax consequences

Conclusion

- February 12 webinar [Fiduciary Income Tax Refresher and Update 2019](#)
- Blog: [Business Succession Solutions](#)
- Reports on Heckerling:
<http://www.thompsoncoburn.com/forms/gorin-heckerling>
- [Gorin's Business Succession Solutions](#)
- October 29 webinar for Second Quarter Newsletter
- Leimberg – July 26 – see newsletter