Small Business Trusts:
Drafting Tax-Advantaged QSSTs and ESBTs, Reconciling Trust and S-Corp Documents

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

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

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

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

1. **Use of Trusts.** S-corp stock may be held in only certain kinds of trusts. This restriction will have an important impact on planning for many clients. If planning will or may require trusts, the problems associated with S-corps described in this outline need to be understood. The concerns over the future use of trusts lead many estate planners to favor the LLC form over the S-corporation. Although planning with LLC interests is by no means simple, in most situations there at least exists a much wider range of possibilities than is available for S-corporations. Naturally, how the S-corp fits in the overall investment and business situation of the client will be of great importance; a modest S-corp holding is one thing, but having substantially all family wealth in an S-corp is something else altogether.
1.1. **General.** There are only a few sorts of trusts which can hold S-corp stock, a situation which makes estate planning with S-corp stock considerably more difficult. Certain types of trusts may not be available for use or will carry with them restrictions or income tax disadvantages. Not using trusts will make some planning goals difficult or impossible to achieve, thus, the planner will generally be forced to fit the plan to the best available trust type and have the client be ready to live with the consequent restrictions or disadvantages. Also, the failure to plan properly can destroy a valuable tax election for the client and his or her co-shareholders. Many S-corps have agreements among shareholders to restrict certain transactions which could jeopardize the election and these restrictions need to be taken into account by the planner. The types of available trusts are:

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

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

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

(b) **Grantor Trust.** Grantor trusts, called “qualified subpart E trusts” in the regulations are (in general) trusts where some significant power is reserved by the grantor (or
the grantor’s spouse) so that for income tax purposes (see IRC §§ 671 et seq.), the grantor is taxed on the trust’s income even if it is actually paid to someone else. Some typical grantor trusts would include:

- revocable estate planning trusts;
- “defective” irrevocable trusts intentionally created to have one or more of the proscribed powers retained by the grantor; such trusts may be created, for example, to enhance a gift by having the grantor pay the income tax, or to freeze values for estate tax purposes by sales of productive assets (e.g., real estate) to the trust in return for a note (no gain or loss to grantor since it is a sale to oneself, and future appreciation will be out of the gross estate); some charitable lead trusts are created as grantor trusts, usually by retaining a reversionary interest under IRC § 673 or sometimes by retaining or, usually better yet, by granting to another a right to substitute property of equivalent value (see PLR 200011012); however, actually exercising such a right by the grantor would be an act of self-dealing.
- grantor-retained annuity trusts or grantor-retained unitrusts (GRATs and GRUTs) where grantor has a proscribed power; charitable remainder trusts, however, cannot be grantor trusts and still qualify under IRC § 664.
- Such grantor trusts may continue to hold the S-corp stock for up to two years after the death of deemed owner, the grantor. The estate of the grantor (deemed owner) will be treated as the stockholder. If the stock is not disposed of prior to end of that two-year period, the S election will be disqualified. This can be a problem for the estate of a person holding the stock in a typical revocable estate planning trust. However, grantor trusts may elect to be treated as QSSTs if they meet the QSST requirement. This may be quite useful but will not be much help to a trust with sprinkling provisions allowing distributions among two or more beneficiaries, but an ESBT election could save the day for the sprinkling trust

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

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

(e) Estate. The decedent’s estate itself may be an S-corp stockholder during a reasonable actual period of administration. IRC § 1361(b)(1)(B). If the administration of an estate is unreasonably prolonged, the estate is considered terminated for federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the
duties of administration. Reg. § 1.641(b)-3(a). The estate is then treated as a trust, and an election to be treated as a QSST or ESBT would be needed to preserve the S-corp election. *Old Va. Brick Co. v. Com’r*, 44 TC 724 (1965), *aff’d*, 367 F2d 276 (4th Cir. 1966). During the period for which IRC § 6166 allows the deferral of estate taxes (this could be up to 15 years), the estate may remain open without destroying the S-corp election. *Rev. Rul. 76-23*, 1976-1 CB 264. No such automatic deferral is allowed for the period of tax audits. *PLR 7951131* (1979).

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

1.3. **Elective Trusts.** The key planning tools for S-corporation stock are the use of QSST or ESBT trusts which require the filing of special elections in order to be allowable as shareholders.

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

- It must actually distribute income to only one current income beneficiary, or be required to distribute to one beneficiary; naturally, the instrument should specify the requirement to distribute and not to accumulate income, but actual distribution to but a single current income beneficiary is sufficient.

- The income beneficiary must be a U.S. citizen or resident.

- The trust instrument must require that during the life of the current income beneficiary, there will be but one current income beneficiary. A trust with multiple beneficiaries, each with a separate share, may be treated as if the separate shares were separate trusts, even without asset segregation. Thus, equal distribution or percentage distribution, but not sprinkle distribution, provisions may qualify as such separate shares.

- The trust must require any principal distributed during the current income beneficiary’s lifetime must only go to that beneficiary.

- The trust must provide that the income beneficiary’s income interest terminates on the earlier of his or her death or the termination of the trust.

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

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

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

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

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

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

Once the trust is qualified as an ESBT, each “potential current beneficiary” is treated as a shareholder of the S-corporation for the 100 shareholder limit (75 shareholders before 2005; also beginning in 2005 there is a family election to be treated as a single shareholder), and if none, the trust itself is treated as the shareholder. With respect to any period, any person who at any time during the period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust, is such a “potential current beneficiary.” IRC § 1361(e)(2); Treas. Regs. § 1.1361-1(m)(4)(I). (The regulation is effective for taxable years of ESBTs beginning after May 14, 2002; see Notice 97-49, 1997-2 C.B. 304 for prior periods.) Potential recipients under currently exercisable powers of appointment are included here through 2004, and may cause disqualification (unless and until the power is permanently released). After 2004, unexercised powers of appointment may be disregarded. Also after 2004, the time to dispose of stock after an ineligible shareholder becomes a potential current beneficiary increased from 60 days to one year. Over time if shares become separate shares, each income beneficiary can make an election under IRC § 1361(d)(2) to revoke the ESBT election for the separate share for that beneficiary and treat it as a QSST. The revocation of the ESBT election for one or more separate shares won't affect the current ESBT election for the shares of the remaining income beneficiaries (e.g., last remaining spray trust beneficiary, with separate shares for descendants of other former spray trust beneficiaries). See, PLR 201122003.

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

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

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

- The S portion is the portion consisting of S-corp stock not treated as a grantor portion. It, too, is treated as a separate trust and in determining its income, it takes into account specified items (“S portion items”) aggregated from all S-corps of which it owns stock. Except for capital gains, these items are taxed at the highest trust marginal rates, with no exemption for alternative minimum tax (IRC
§ 55(d)) purposes, and are not apportioned to (or included in income by) any beneficiary, are included in the overall actual trust’s distributable net income (DNI) but are not deductible from it. The effect is to create an income tax disadvantage because § 641(c) will prevent the apportionment of S portion items to beneficiaries at their potentially lower tax brackets.

- If an S corporation makes charitable donations, a pro rata share passes through to the ESBT that owns stock and the share is treated as being contributed by the S portion, subject to deduction limitations. Regs. § 1.641(c)-1(d)(2)(ii).

- If the ESBT donates S stock to charity, neither the S portion nor the non-S portion gets a deduction. See Regs. § 1.641(c)-1(l), Ex. 4.

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

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

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

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

2.3. **Pass-through taxation.** Corporations with an S-election are pass-through entities. Partnership taxation features, including pass-through income, deductions, and credits, tax deferral on liquidating transfers of capital assets in kind, step-up basis in underlying assets on
the death of an owner or on asset distributions or the sale of an interest, etc., are generally better for clients than are S-corp taxation features, in part because there are fewer restrictions and more flexibility than for S-corporations. For example, loans to S-corporations (even where guaranteed by the shareholder) do not increase a shareholder’s basis, yet this basis is a cap on the shareholder’s ability to take losses against other income. For partnership-taxed organizations, basis will increase in such cases (even without a guaranty).

2.4. Additional Charitable Issues. Tax deductible charitable contributions by a partnership-taxed organization can continue even after the owner’s basis in the company interest has been used up; this has not been possible for S-corporations. See IRC §§ 705(a) (basis determination), 703 (partnership computations), 704(a) and (d) (allocations by partnership agreement; limitation on losses); McKee, Nelson, & Whitmire, 1 Federal Taxation of Partnerships and Partners ¶ 10.05 [1][b] (3d ed. 2004); PLR 8405084; Treas. Regs. § 1.704-1(d)(2) (list of losses under IRC § 704(d) does not include charitable deductions). However, under revised IRC § 1366(d)(4) (effective for contributions made in 2006 or later) the basis limit won’t apply to the extent of the excess, if any, of the S corp shareholder’s share of the charitable contribution over the shareholder’s share of the basis of the contributed property. On the other hand, after 2014, the rather favorable rule that the shareholder’s basis in shares is reduced only by his or her share of the basis of the property contributed, will revert to its prior requirement that the basis of stock be reduced by the full fair market value of the donated property. IRC ’ 1367(a)(2). This could put the shareholders of S-corporations at a disadvantage due to the quicker basis reduction, even if under the basis limit rules the deduction for the contribution can be used by the shareholders.

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

2.5. Self-employment Tax. The S-corp may have a modest edge on Social Security and self-employment taxes, however. Interest owners in LLCs and other partnership-taxed organizations may be subject to self-employment tax on some income, which might be excluded if the owner was paid a salary by an S-corp. Partners and LLC interest owners are generally treated as if their entire distributive shares (less express statutory exceptions to self-employment income) are self-employment income; S-corp shareholders are generally (absent abuse) treated as if only their W-2 compensation is subject to the Social Security taxes on employer and employee. Although the difference is usually modest, an S-corp management company with a management agreement with the LLC or partnership may effectively solve the problem if it is expected to be a substantial issue. The S-corp management company hires the individuals and pays reasonable compensation for their services in managing the asset held by the LLC. The tax saving, if any, is the tax on the portion of the LLC or partnership distributive share which is not personal-service income (this income should be taxed like employment income in any event) and which is not subject to a statutory exception, after taking into account that half of the self employment taxes are deductible (IRC ’ 164(f)) for income tax purposes.
2.6. **Step-up Basis on Death.** Partnership-taxed organizations allow tax-free, in-kind liquidating distribution and allow (with the proper IRC § 754 election) the basis of the underlying assets of the partnership to be stepped up on the death of a member or partner and also on some asset distributions or on some sales of an interest in the company; these important benefits are simply unavailable to corporations with or without the S election. The poor S-corp results which are particularly important for estate planning are earlier taxation on gains in distributed property, and no elimination of gains in corporate assets on death. Since built-in gains remain on the assets inside the corporation, buyers will pay the family less for the interest in the S-corp. This may allow an estate tax discount in value, but the net economic loss to the family is quite real and not fully offset by the deduction.

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

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

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

   (c) **Passive Activity Loss.** Any passive activity loss that is suspended under IRC § 469 expires and disappears to the extent the S corporation stock gets a step-up in basis under IRC § 1014 but any loss that exceeds the amount of the step-up is not subject to the limits on passive activity losses. Where the estate has a suspended passive activity loss when it distributes S-corp stock to the beneficiaries, the loss increases the basis of the stock so the loss is capitalized rather than deducted. IRC § 469(j)(12)(B).

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

   (a) **Redemptions.** A corporation recognizes no gain or loss on a cash redemption of stock by the corporation, but if property is distributed as part of the redemption, it will be deemed sold by the corporation whether the corporation is a C-corporation or an S-corporation. Usually the stockholder is treated as having sold the stock in a capital gain transaction.
(i) **Dividend Issue.** Where a S-corp has at one time been a C-corp, and where the corporation has accumulated earnings and profits from the earlier time when it was a C-corp, then it is possible for a shareholder to receive a dividend taxed at ordinary income rates on a redemption (and on certain other events, as well, such as current distributions sufficiently large to go through the other available accounts for distributable income and reach into the earnings and profits account, or on a liquidating distribution. If the redemption is treated as a dividend, the whole amount (not just the gain portion) is taxed to the redeemed shareholder at ordinary income rates rather than as capital gain.

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

Dividend treatment may also be avoided if: (i) The redemption completely terminates the shareholder’s interest in the corporation. IRC § 302(b)(3). (ii) The redemption is substantially disproportionate under IRC § 302(b)(2) because it reduces the shareholder’s percentage interest below 80% of the shareholder’s percentage interest before the redemption, and the shareholder ends up with less than 50% of the voting power. (iii) The redemption is not substantially equivalent to a dividend under IRC § 302(b)(1). This is a very difficult provision to use. (iv) The redemption is from a noncorporate shareholder and other requirements are met so as to qualify as a partial liquidation under IRC § 302(b)(4).

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

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

(i) **Redemption Loss.** However, a loss on the stock might not be deductible on a stock redemption (where the distribution does not exceed basis). IRC § 1368(b) compared to IRC § 301(c)(2); see Eustice and Kunz Federal Income Taxation of S Corporations at ¶ 13.08{[4]}. To avoid this issue, where a loss is expected, a third party sale or cross purchase may be better.
(ii) **Basis of Stock.** The basis of the stock will have been adjusted up and down over the years reflecting income and loss passing through the corporation and certain tax-free distributions. IRC § 1367. Also, the income or loss of the corporation in the year of sale will likely affect the basis of the stock sold so that the shareholders as sellers generally would not know the exact basis for their stock until after the end of the corporation’s taxable year. If a party takes a position inconsistent with prior tax reporting, the adjusted basis element would allow the Service (or the seller) to adjust certain errors that may have been made in prior S-corporation years. The seller may want to consider asking the buyer for an agreement that the buyer and the corporation will maintain consistency with prior tax reporting. This should last for a minimum of three years after the seller files the tax return with respect to gain on the sale; perhaps the chance that a return extension will be needed should be taken into account in establishing the time period.

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

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

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

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

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


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

(B) The effective date of the sale.

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

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

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

(vi) **Tax Indemnity.** Sometimes a buyer will agree to a tax indemnity provision and not close the corporate books. This may help with solving the foregoing problems. However, it may be a good idea for the tax indemnity from the buyer to cover not only the income tax on the corporate income itself, but also the additional tax from reduction of capital gain treatment on the stock, and the tax on receipt of the indemnity payment itself.
2.9. **State Tax Law.** State tax effects should also be considered. Some jurisdictions do not recognize the S-election, have special taxes on S-, or require additional elections or other conditions on S-corp treatment. See BNA State tax portfolio 1510- 1st, State Taxation of S- Corporations, worksheet 1 (2008).
Bylaw provision regarding transfers of shares.

ARTICLE XI. CERTIFICATES FOR SHARES AND THEIR TRANSFER.

11.1. Certificates for Shares. Certificates representing shares of the corporation shall be in such form as shall be determined by the Board of Directors. Such certificates shall be signed by the President or a vice president and by the Secretary or an assistant secretary. The signatures of the President or vice president and the Secretary or assistant secretary may be facsimiles if the certificate is countersigned by a transfer agent, or registered by a registrar, other than the corporation itself or an employee of the corporation. All certificates for shares shall be consecutively numbered or otherwise identified. The name and address of the person to whom the shares represented by the certificate are issued, with the number of shares and date of issue, shall be entered on the stock transfer books of the corporation. All certificates surrendered to the corporation for transfer shall be cancelled and no new certificate shall be issued until the former certificate for a like number of shares shall have been surrendered and cancelled, except that in case of a lost, destroyed, or mutilated certificate, a new one may be issued upon such terms and indemnity to the corporation as the Board of Directors may prescribe, or absent action by the Board, as the Secretary may prescribe.

11.2. Transfer of Shares. Subject to Sections 11.3 and 11.4 of this Article, transfer of shares of the corporation shall be made only on the stock transfer books of the corporation by the holder of record of such stock or by such holder’s legal representative, who shall furnish proper evidence of authority to transfer, or by such holder’s attorney-in-fact authorized by power of attorney duly executed and filed with the Secretary of the corporation, and on surrender for cancellation of the certificate for such shares. The person in whose name shares stand on the books of the corporation shall be deemed by the corporation to be the owner of them for all purposes, subject, however, to Section 3.11 above (relating to the acceptance of votes by certain representatives).

11.3. Consideration and Payment for Shares. Shares may be issued for such consideration expressed in U.S. dollars as shall be fixed from time to time by the Board of Directors. The consideration for the issuance of shares may be paid, in whole or in part, with any tangible or intangible property or benefit to the corporation, including cash, promissory notes, labor or services performed, contracts or arrangements for services to be performed, or other securities of the corporation. The terms and conditions of any tangible or intangible property or benefit to be provided in the future to the corporation, including contracts or arrangements for services to be performed, shall be set forth in writing. When such consideration is received by the corporation, such shares shall be deemed to be fully paid and nonassessable. The determination of the Board of Directors as to the value and adequacy of the consideration received for the issuance of shares shall be conclusive.
11.4. **Agreement Regarding Shares.** Anything in these By-laws to the contrary notwithstanding, the corporation, by action of the Board of Directors, shall have the authority to contract with the shareholders of the corporation to restrict the transfer of shares, to purchase or redeem the shares of the corporation, to value the shares of the corporation, to require the purchase of life insurance on the lives of the shareholders, to make or maintain any tax elections or preserve the availability of tax losses or other tax attributes, to govern the allocation of control, the exercise of corporate power, the management of the business affairs of the corporation, or the relationship among the shareholders, the directors, and the corporation, or any of them, or to accomplish such related goals as the Board of Directors shall deem in the best interests of the corporation and the shareholders. Any such agreement shall be kept on file by the secretary of the corporation. Once such agreement is entered into, the terms and conditions of that agreement shall govern the transfer of shares and the other matters covered by such agreement in addition to the provisions of these By-laws and shall govern to the extent inconsistent with these By-laws. Without limiting the generality of the foregoing, so long as such agreement is in force, the corporation shall not issue any shares without the action of the shareholders approving such issuance as may be required by such agreement and shall not transfer any shares on the books of the corporation except pursuant to the terms of such agreement. Any shares of the corporation subject to such an agreement, whether issued before or after such agreement, shall be caused by the corporation to bear on the certificate for such shares an endorsement which, absent a requirement for a different form, shall be substantially in the following form but may include additional information:

The shares represented by this certificate are subject to and are transferable only in compliance with an agreement among the corporation and the shareholders, a copy of which is on file in the office of the secretary of the corporation. By acceptance of this certificate the holder agrees to be bound by the terms of such agreement.
Electing Small Business Trust Provision.

Section 8  Electing Small Business Trust.

8.1  **Separate Shares.** The trustee may hold all shares of S corporation stock held by the trustee (the ESBT share) as a separate trust or share, under this article. The trustee shall have discretion to use a separate trust or separate share to the extent allowable under the rules relating to electing small business trusts (ESBT) for the stock of corporations with the S-corporation election for federal income tax purposes. The trustee shall apportion expenses of the trust between the two (2) shares (the ESBT share and the remaining share), in a manner that is not inconsistent with the Internal Revenue Code of 1986, as amended (the Code) and regulations promulgated under it.

8.2  **U.S. Beneficiaries Only.** No child or more remote descendant of mine and no other person shall be a beneficiary of the ESBT share of the trust, unless that person is either a citizen of the United States or a resident of the United States, as defined for federal income tax purposes (a “U.S. person”), notwithstanding any other provision of this instrument. Any person who would otherwise be entitled to a beneficial interest in the ESBT share of the trust but for the fact that he or she is not a U.S. person, shall not regain that beneficial interest even if he or she later becomes a U.S. person.

8.3  **Election.** The trustee shall make the election required by Section 1361(e)(3) of the Code, to qualify the ESBT share as an electing small business trust, for purposes of subchapter S of the Code.
Qualified Subchapter S Trust Election Provisions.

1.1 Subchapter S Qualification. Trustor intends that any trust created by this instrument which holds stock subject to a current S-corporation election be a qualified subchapter S trust under Section 1361(d) of the Internal Revenue Code of 1986, as amended (“Code”), and all provisions of this instrument shall be interpreted in accordance with this intention. The Trustee shall have the power and authority in its discretion to divide any trust under this instrument into two or more trusts in order that some or all of such trusts may qualify as qualified subchapter S trusts, and should do so prior to the receipt of any S-corporation stock where feasible. The Trustee [Trust Protector] shall have the power and authority in its discretion to amend this instrument, without the approval of any court, for the purpose of allowing a trust to qualify as a qualified subchapter S trust. Notwithstanding any other provision in this instrument with respect to any trust created by this instrument which holds such S-corporation stock:

1.1.1 During the life of the current income beneficiary within the meaning of Section 1361(d)(3)(A) of the Code (“Current Income Beneficiary”), there shall be only one income beneficiary of the trust;

1.1.2 During the life of the Current Income Beneficiary, distributions of income, corpus, or principal from the trust shall be made only to the Current Income Beneficiary;

1.1.3 The income interest of the Current Income Beneficiary in the trust will terminate on the earlier of the death of the Current Income Beneficiary or the termination of the trust;

1.1.4 If the trust terminates during the life of the Current Income Beneficiary, the trust shall distribute all its assets, including any accumulated and undistributed income, to the Current Income Beneficiary; and

1.1.5 All the trust’s income (within the meaning of Section 643(b) of the Code) shall be distributed to the Current Income Beneficiary currently (within the meaning of Section 1361(d)(3)(B) of the Code). Any income that is accrued, accumulated, or undistributed at the time of the death of the Current Income Beneficiary shall be distributed in a manner permitted by Section 1361(d)(3)(B) of the Code.

1.1.6 No distribution of income or corpus by the trust shall be made in satisfaction of the legal obligation to support or maintain an income beneficiary.

1.2 Qualified Subchapter S Trust Election. If any trust created by this instrument holds stock in a corporation that has elected, or proposes to elect, to be an S corporation (within the meaning of Section 1361 of the Code), Trustor strongly encourages the beneficiary of the trust (or the beneficiary’s representative) to consider electing under Section 1361(d)(2) of the Code. Trustor also hopes that any successor beneficiary will permit the election under Section 1361(d) of the Code to continue in effect.

SECTION 7
Continuation of Restrictions; S-Corporation Status

7.1. Continuation of Restrictions. This Agreement shall continue to apply to shares of the Stock Transferred by any Stockholder, and the Corporation or any other Stockholder may require as a condition of such a Transfer that the transferee execute an Agreement substantially identical in form to this one (which may be accomplished by a certificate of acceptance and adoption of this Agreement), to which all of the transferee’s shares of the Stock will be subject, and which Agreement will be treated as a part of this Agreement.

7.2. S-Corporation Status. The Corporation has elected to be treated as a small business corporation under Subchapter S of the Internal Revenue Code ("IRC" or "the Code"). Except for Transfers required by this Agreement, unless the proposed transfer is consented to in writing signed by all other Stockholders then existing, and without limiting any other restrictions on a Transfer of any Stock, no Stockholder shall Transfer any shares of Stock to anyone other than an individual who is not a nonresident alien, or an estate, or other person or entity qualified to hold shares in a corporation which has elected to be taxed as an “S” corporation pursuant to Sections 1361 et seq. of the Code, without affecting the continuance of such tax treatment, and which individual or estate or other person or entity consents to the election of the corporation pursuant to IRC Section 1362 to be taxed as an “S” Corporation if required by law to continue such election or prevent its termination, and which individual or estate or other person or entity executes this Agreement. Furthermore, all Stockholders agree that they will not cause the Corporation to lose its “S” corporation status and will use their best efforts to maintain such status, unless all Stockholders consent and agree in a writing signed by all Stockholders that the Corporation should not maintain such status. Without limiting the generality of the foregoing, the following Transfers are specifically prohibited without the consent of all Stockholders:

(i) The transfer of any such shares to a partnership, limited liability company, corporation, nonresident alien individual, estate (other than the estate of the Stockholder himself or herself) or trust (other than a trust that, under the Code, may hold S corporation stock without terminating an S election);

(ii) the transfer of any such shares to a person if such transfer will increase the number of Stockholders to more than the maximum permissible number of Stockholders of an S corporation; and

(iii) the pledge or other encumbrance of any shares of the stock with respect to any loan from any person or entity if it reasonably could be believed that a transfer of such shares to such secured lender would violate the restrictions of this Section 7.2.
7.2.1. **Effect of Purported Transfer.** Any purported Transfer or acquisition of shares of Stock in violation of this Section 7.2 of this Agreement shall be null and void. The purported transferee shall have no interest in any of the shares of Stock purported to be transferred. Each Stockholder agrees that any such Transfer or acquisition may and should be enjoined.

7.2.2. **Beneficial Ownership.** Any purported Transfer in violation of this Agreement will not affect the beneficial ownership of Shares. Thus, the Stockholder making the purported Transfer will retain the right to vote (if any) and the right to receive dividends and liquidation proceeds. Additionally, a Stockholder making the purported Transfer shall continue to report the portion of income or loss allocated by the Corporation in accordance with the provisions of the Code as then in effect.

7.2.3. **Opinion.** Any Stockholder who believes that an attempted Transfer (which includes any encumbrance) of any shares of the Stock is invalid under this Section 7.2 or that any proposed action or inaction of the Corporation or any of its officers or directors or other Stockholders may jeopardize the S-Corporation election of the Corporation may request from the Corporation an opinion on the application of this Section 7.2 or on such matter. Such request shall be made to the Corporation's president in writing, setting forth the details of the proposed Transfer or of the action or inaction of concern and the reasons why the requesting Stockholder believes the Transfer to be invalid or the action or inaction to be dangerous to the S election of the Corporation. The Corporation's president shall then promptly request a written opinion from the Corporation's counsel (who may be an employee of the Corporation or independent outside counsel) and such written opinion shall be binding on the Corporation and on all Stockholders. The Board of Directors may impose a binding stay or act to maintain the status quo or otherwise act to protect the S-election for a reasonable time pending receipt of such a requested opinion.

7.2.4. **Assessment.** The Corporation may assess against any Stockholder who attempts any Transfer that is invalid or prohibited under this Section 7.2 a fee in an amount to cover the Corporation’s expenses (including attorneys’ fees) in evaluating whether or not a Transfer is invalid or prohibited under this Section 7.2, plus an additional amount of $1,000 or 20% of those expenses, whichever is greater, to cover disruption and other detriments to the Corporation not easily determinable. Such assessed amounts shall bear interest at 10% per year on the unpaid balance from the date written demand for payment is sent to the Stockholder, until paid in full.

7.2.5. **Citizenship Changes.** Any Stockholder who is a U.S. citizen not residing in the United States who ceases for any reason to be a U.S. citizen, and any Stockholder who is not a U.S. citizen who ceases to be a resident of the United States, shall be deemed to have offered to sell all of his or her shares of the stock to the Corporation for the agreement price and on the agreement terms. The Corporation shall be deemed to have accepted such offer and such shares shall be canceled and shall become treasury stock of the Corporation. Such cancellation shall be effective on the date immediately preceding the date of such Stockholder's change in citizenship or residency. The Corporation shall pay such Stockholder for his or her purchased
shares in accordance with Section ____ of this Agreement by delivery of a note or other required form of payment or by cash or by corporate check, within sixty (60) days of the date such shares are canceled.

7.2.6. **Protected Fiscal Year.** Whenever the Corporation files its federal income tax returns on a fiscal year (other than one ending on December 31), no Stockholder may Transfer all or any portion of his or her shares of the stock to any person or entity, if such Transfer will or reasonably may be expected to complete or cause a cumulative Transfer of fifty percent (50%) or more of the Corporation's stock ownership and also terminate the Corporation's right to report its profits and losses on a fiscal year (other than one ending on December 31) for federal income tax purposes. No attempted transfer of any shares of the stock in breach of the provisions of this item shall be valid or recognized on the Corporation's books.

7.3. **Tax-year Election.** The Stockholders and the Corporation agree that unless all Stockholders agree otherwise at the time of a sale of Stock pursuant to this Agreement, the Corporation shall elect under Code Section 1377(a)(2) and Treasury Regulation Section 1.1377-1(b) to treat the taxable year as if it consisted of two separate taxable years with respect to the sale by a Stockholder (or Representative), as seller, to the other Stockholders, or any of them, or to other buyers under the terms of this Agreement where the S-corporation election is not terminated and a tax-year closing is available under the Code or Treasury Regulations, where all of the shares in the Corporation held by such Seller are sold. The hypothetical year-end closing of the earlier of such years affected by the election shall be effective as of the date of the closing of such sale. The Corporation shall attach an appropriate statement making such election to its timely filed form 1120S. The Stockholders shall each execute and deliver to the Corporation within ten (10) days of receiving a written request, such further consents, authorizations, or acknowledgments as may reasonably be requested by the other Stockholder or the Corporation in order that such election shall be fully effective. The buyer shall fully exercise such control of the Corporation as it may have in order to cause such election to be made and the provisions of this Section 7.3 to be carried out by the Corporation. The Corporation shall prepare and deliver to the seller and the buyer(s) an accounting with respect to the year thus closed under the election as soon as practical after such closing of the sale, but in no event later than sixty (60) days after such closing.

7.3.1. On any such sale, the corporation shall continue its S-corporation tax election to be taxed as a small business corporation for the remainder of the corporation’s tax year.

7.3.2. After any such sale, the corporation shall not without the consent of the selling shareholder make any retro-active change to its accounting methods (with or without the consent of the Internal Revenue Service) which could have any negative effect on the selling shareholder.
7.4. **Distributions to Stockholders.** Subject to any limitations on distributions imposed by statute, the Corporation and Stockholders agree that while an S-corporation election is effective:

7.4.1. Subject to terms of this Section 7.4, the Corporation shall make pro rata distributions of money, based on ownership of shares of Stock, to pay the federal and state income taxes on the income (net of any tax benefits produced for the Stockholders by the Corporation’s losses, deductions, and credits) that passes through from the Corporation under the applicable provisions of the Code.

7.4.2. The total amount required to be distributed shall be determined by conclusively presuming that all taxable income passed through to each Stockholder will be taxed at the maximum federal rate (without regard to exemptions or phaseouts of lower tax rates) and the maximum State of Utah rate at which income of any individual can be taxed in the calendar year that includes the last day of the Corporation’s taxable year. It shall further be conclusively presumed that the Stockholder can deduct the State of Utah tax for federal income tax purposes, and the calculations shall be made using the net effective State of Utah rate.

7.4.3. The Corporation shall make the distributions required above in a timely manner to allow the tax (including, without limitation, estimated tax payments) attributable to the income passed through the Corporation to any Stockholder to be paid when due.

7.4.4. No provision in this Section 7.4 shall cause the total dividend paid with respect to any outstanding Stock to differ from the amounts paid with respect to any other outstanding Stock.

7.4.5. No provision of this Section 7.4 shall be construed to limit the ability of the Corporation to declare and pay additional dividends to the Stockholders out of the assets of the Corporation legally available for such payment at such time or times as the Board of Directors of the Corporation may determine. No dividend shall be payable to the extent the payment of a dividend would violate the Utah Revised Business Corporations Act.

7.5. **Waiver of Termination of S Status.** If the Corporation’s status as an S-corporation is terminated inadvertently and the Corporation wishes to obtain a ruling under Section 1362(f) of the Code or take other allowable corrective action, each Stockholder agrees to make any adjustments required pursuant to Section 1362(f)(4) of the Code or other applicable provisions of the Code or regulations under the Code and approved by the Corporation’s Board of Directors. A Stockholder’s obligation to make such adjustments shall continue after the Stockholder has ceased to own Stock in the Corporation and after this Agreement has otherwise terminated.

7.6. **Cooperation and Further Assurances.** Each Stockholder shall on written request of the Corporation or any other Stockholder take such action, execute such documents, and exercise such authority as may be necessary or desirable to maintain and comply with the
restrictions and provisions of this Agreement, to maintain the S-election of the Corporation, and to allow the distributions described in this Section 7.