# Case Study

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## Qualifying a Marital Deduction Trust as an Eligible S Shareholder

The marital deduction permits the estate of the spouse who dies first to claim an estate tax deduction for property passing to the surviving spouse if certain requirements are met. These requirements ensure that the property is not taxed twice but eventually will be included in and (if not disposed of before death) taxed in the surviving spouse's estate (Sec. 2056). While property passing to the spouse pursuant to an *inter vivos* trust can qualify for the marital deduction, the shareholder often is unwilling to part with any of the incidences of stock ownership, particularly the voting power, before death. Hence, a testamentary trust (established at death) is often used.

Two common trusts qualify for the marital deduction: power of appointment trusts and qualified terminable interest property (QTIP) trusts. An important difference between the two types of trusts concerns the surviving spouse's ability to appoint the stock to someone else during life or at death. The word "appoint" is synonymous with designate, so a surviving spouse with a power of appointment over trust property can transfer ownership of the stock (that is, designate a new owner) to anyone, including a subsequent spouse or children from a prior marriage. The flip side is that the surviving spouse has the authority to deal with changed circumstances after the shareholder's death.

**This case study has been adapted from *PPC's Tax Planning Guide—S Corporations*, 21st Edition, by Andrew R. Biebl, Gregory B. McKeen, George M. Carefoot, and James A. Keller, published by Practitioners Publishing Company, Ft. Worth, TX, 2005 ((800) 323-8724; ppc.thomson.com).**

As the name suggests, under the terms of a power of appointment trust, a surviving spouse must have the power to appoint trust property, giving the surviving spouse the ability to control the disposition of trust property, including S corporation stock. On the other hand, a QTIP trust's terms do not have to include a power of appointment over trust property for the surviving spouse, giving the decedent the ability to control the ultimate disposition of the stock after his or her spouse's death. The QTIP trust can provide that the surviving spouse will have the right to income from the stock until death, but after the spouse's death the stock will be distributed outright to, or continue in trust for the benefit of, persons designated by the shareholder before the shareholder's death (Sec. 2523(f)).

***Example:*** *B* is the founder and sole shareholder of a profitable S corporation

engaged in landscape design. *B* and his wife, *A*, have one child, *C*, who is 25 years old and an assistant manager of the company. *B* wants *C* to remain active in the company and to one day own it. *A* has two children from a previous marriage, *D* and *E*, who have never gotten along with *B*.

*B* currently has a simple will that leaves all of his assets outright to *A*. He wants to provide *A* and *C* with a source of income following his death but also to ensure that the S corporation stock passes intact to *C* after *A*'s death. Therefore, *B* wants to prevent *A* from transferring any of the stock to *D* and *E*. Furthermore, *B* wants to preserve the S election of the company after *A*'s death.

Although no estate tax will be owed if *A* is still alive (and married to *B*) at *B*'s death, due to the unlimited estate tax marital deduction, the current will presents a major problem for *B*. The will provides that the stock will be distributed outright to *A*, which would allow her to give or sell the stock to *D* and *E*, either by *inter vivos* or testamentary transfer.

To address this problem, *B* could revise his will so that the stock and other assets going to *A*'s benefit will be transferred from his estate to a qualifying marital deduction trust following his death. Although property passing to a spouse pursuant to an *inter vivos* trust can also qualify for the marital deduction, *B* is not willing to part with any of the rights of ownership of the stock, particularly the voting power, before his death. For this reason, a testamentary trust that qualifies for the marital deduction will be used.

From *B*'s perspective, the problem with a power of appointment trust is that *A* still has the opportunity, during her life or at death, to "appoint" the stock to someone else of her choosing (*D* or *E* or even another husband). Although *B* can designate in the trust document that *C* will get the stock after *A*'s death if *A* does not exercise her power of appointment, the stock will be ineligible for the marital deduction under Sec. 2056(b) if there is a prearranged agreement that *A* will appoint the stock to *C* (Regs. Sec. 20.2056(b)-5(g)(2)).

For this reason, power of appointment trusts are often avoided in second-marriage situations, if there are children from a prior marriage, or if the client is unwilling to give the spouse control over a substantial part of the estate. While the power of appointment trust can provide professional trust management and control over the stock, it enables the surviving spouse to dispose of the stock as he or she chooses. Under the facts of this example, it is no better than the present outright bequest of the stock to *A*.

Since nothing in the QTIP requirements prohibits *B* from controlling the ultimate disposition of the stock, the preferable approach is to use a QTIP trust. Such a trust can provide that *A* has the right to income from the stock during her lifetime, but at her death the stock will continue in trust for *C* for a certain period of time or be distributed outright to *C*.

**Distribution of Income**

There are two issues concerning the distribution of income. First, the QTIP trust document should specifically state the frequency of income distributions to *A* (at least annually). Second, the S shareholder's share of passthrough income will be taxed, regardless of whether the corporation makes any distributions. This can result in income tax without the money to pay it. In addition, property held by a marital deduction trust, including a QTIP trust, must be income producing, or the spouse must have the right to make the property income producing or compel conversion into income-producing property (Regs. Sec. 20.2056(b)-5(f)(4)).

A simple solution to both problems is for the company to make periodic (e.g., quarterly) distributions. Since the trust will own all of the outstanding stock of the S corporation, it can control the distributions. This will protect the marital deduction and ease *A*'s liquidity concerns by providing her with the money to pay income tax on the passthrough income.

Once the form of the marital deduction trust is selected, potential compatibility with the trusts that are eligible to hold S corporation stock should be considered. Either form of marital deduction trust can qualify as an electing small business trust (ESBT) or a qualified subchapter S trust (QSST) if the proper actions are taken.

**Sec. 678 Trusts**

A power of appointment trust is similar to a Sec. 678 trust because the surviving spouse "owns" both income and corpus. Thus, it will qualify as an S corporation shareholder. A QTIP trust will not satisfy the definitional requirements of a Sec. 678 trust (because the surviving spouse does not "own" the corpus). A QTIP trust can be drafted, however, to meet the QSST requirements. Both the QSST and the QTIP trust require the current distribution of all income to the surviving spouse as the current income beneficiary. While the trust can be drafted to authorize distributions of corpus to the surviving spouse during that person's life if necessary to maintain his or her living standards, the trust will provide that any corpus remaining at the surviving spouse's ultimate death will go to the beneficiaries named in the trust. These provisions are consistent with the requirements of a QSST.

**Choosing the Best Combination**

Continuing with the prior example, several types of trusts would remain eligible S shareholders after *A*'s death. The preferable combination is to match the power of appointment trust with the Sec. 678 trust and the QTIP trust with the QSST or ESBT.

*B* decides that a Sec. 678 trust would be undesirable because he does not want to give *A* control of the stock. An ESBT is undesirable because the trust would be taxed at the highest individual rates on income flowing from the S corporation, and the potential flexibility advantages of an ESBT are not needed in this situation. It is anticipated that *A* will not be subject to the highest

marginal income tax rate, and thus the income would be taxed at a lower rate if not subject to the ESBT rules.

Given *B*'s objective of controlling the eventual disposition of the stock, the planner recommends that a QTIP trust be used that is drafted to meet the QSST requirements. Both the QSST and the QTIP trust require the current distribution of all income to *A*. The trust can continue with *C* as sole beneficiary following *A*'s death because the QSST rules permit successive beneficiaries, and the QTIP rules do not prohibit *B* from naming a successor beneficiary.

Use of a combined QTIP trust and QSST also allows the S election of the company to continue for *C*'s benefit after *A*'s death, if *C* is named as the successor beneficiary, because the S election will continue during the life of the successor beneficiary. (*C* does not have to take any affirmative action to continue the status of the QSST as an eligible S shareholder following *A*'s death; that is, *C* need not consent to continue QSST status.) If, instead, the trust is terminated and the stock is distributed to *C* following *A*'s death, as long as the stock is distributed within the appropriate time (two years), the S election will continue because *C* is an eligible S shareholder.

*A* will be taxed on all passthrough income from the S corporation, whether or not distributed by the company to the trust. An ongoing company policy to distribute a reasonable amount of cash on a periodic (such as quarterly) basis should alleviate *A*'s liquidity concerns.

A QTIP trust matched with a QSST necessitates two elections. The executor of *B*'s estate must elect for the trust to be treated as QTIP property on the estate tax return. *A*, as the current income beneficiary, must elect to have the trust treated as a QSST within the two-month and 16-day period beginning on the date the stock is transferred to the trust.

**TTA**