Selected factors in estate planning

Allen Tomlinson

Follow this and additional works at: https://egrove.olemiss.edu/dl_hs

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
Haskins & Sells Selected Papers, 1962, p. 232-243
Selected Factors in Estate Planning

by Allen Tomlinson
Partner, Miami Office

Presented before the Estate Planning Council of Broward County, Florida, and the Sixteenth Annual Tax Clinic of the University of Alabama—October 1962; and before the Saint Louis Estate Planning Council—December 1962

ESTATE PLANNING WHERE THE TESTATOR HOLDS SUBCHAPTER S STOCK

INCREASED USE OF SUBCHAPTER S CORPORATIONS CALLS FOR PROFESSIONAL RESPONSIBILITY IN ESTATE PLANNING

Since 1958 when Congress first amended the Code to permit certain corporations to escape corporate income tax, there have been more and more individuals who hold stock in these so-called Subchapter S corporations at a time when estate planning is being considered.

Most professional advisors by now know that the privilege of avoiding corporate tax carries with it a responsibility of awareness of unusual complex rules and that a misunderstanding of these rules may result in most unfortunate tax consequences.

The Subchapter S corporation with its tantalizing advantages of passing through of capital gains and operating losses and income to stockholders has influenced many taxpayers to avail themselves of these aspects sometimes for an indefinite period or for a limited period. The results of an election, continuance of the election, or voidance of the election, may have beneficial or detrimental tax effects on the stockholders concerned. The personal interests of stockholders may be adverse and in many cases unilateral acts purposely or innocently undertaken may bring tax disaster to fellow stockholders. Professional advisors may become involved in liability suits where Subchapter S status is lost and the client claims that his resulting tax detriment was caused by inefficient or inadequate advice.

If it appears at the time of estate planning that Subchapter S stock will be held by the testator indefinitely and that he might possibly die possessed of this stock, a review of the tax aspects should be undertaken with him and his attorney.
THE ELECTION PROBLEMS FACED BY THE EXECUTOR

It should be pointed out to the testator that on his death the stock, unless jointly held, will pass to his estate and that his executor has a prescribed period within which to elect to continue the Subchapter S status. The Regulations 1.1372-3(b) state that where the new stockholder is an estate, the thirty-day period for election shall not begin until the executor or administrator has qualified under local law to perform his duties but in no event shall such period begin later than thirty days following the close of the corporation's taxable year in which the estate became a stockholder.

The testator should be informed that generally speaking, the responsibility of an executor with regard to an estate is such that he ordinarily does not wish to take a position where the estate will be charged with income whether or not the corporation distributes the income. In addition, there is the problem, if the executor does elect, of the uncertainty of the result owing to some other stockholder's inadvertently causing the Subchapter S election to become revoked retroactively. To overcome this latter objection, there has been recommended and discussed by certain authorities the possibility of an agreement between Subchapter S corporation stockholders as a preventative against hostile or inadvertent lapse of Subchapter S status.

This agreement generally contains the provision that the corporation be given the first refusal before any stock transfer is made. Thus a barrier is set up against a disposition to a stockholder who will not consent or against an inadvertent transfer to any entity such as a trust for a minor child which causes automatic termination of the election.

Such an agreement would not only protect an executor but should also be presently considered by the testator. The agreement should cover instances where a stockholder dies or sells his stock near the year end. If we assume exercise of the election, the continuing stockholders will be required to report their portion of income for the entire year on the last day of the corporate year and where the stock transfer is prior to the end of the year, the selling stockholder will be bought out at capital gain leaving the continuing stockholders in the position of picking up his portion of ordinary income. To avoid this, some agreements provide that the purchase price be set as of the first day of the year of death or sale, and leave out of consideration any increment from that time to the date of death or sale. Another solution
is to defer the closing on the sale until the first day of the next year. Finally, this problem can be met by passing out the income for the year before the "buyout."

These agreements may have untested aspects under both local law and the Internal Revenue Code but are conceded to be better than leaving such a vital area completely unprotected.

Experience has shown that many executors are unaware of the presence of election stock in the estate. Where the time for election has inadvertently lapsed and good cause is shown, since the estate is considered a new stockholder, an executor may be able to qualify for an extension of time for filing a consent under a 1961 Ruling. (Rev. Proc. 61-30, IRB 1961-44, 18)

If the executor decides not to elect, he may find that by this action he has caused material tax detriment to family members and business associates of the deceased who also hold the stock. Because of the above-mentioned problems facing an executor, it might be considered prudent by the testator to provide in his will specific instructions concerning the election and perhaps afford complete discretion as to the election, and in any event relieve the executor of the responsibility and the consequences of such an election.

One other problem not as yet mentioned concerns the ordinary situation where after estate administration the stock concerned would end up in a testamentary trust. This requirement would, of course, bring about the automatic termination of the status of the election corporation. In some instances where the will provides a residual marital bequest in fee simple to the surviving spouse and provides also for a residuary trust, the additional provision that the executor can select the assets out of the residue with complete freedom may prevent automatic disqualification.

Care must also be taken under the ten-stockholder rule, to prevent stock from being distributed as a specific bequest under the will to too many beneficiaries as this also may result in disqualification.

In cases where the testator and his wife hold S stock as tenancy by the entirety the stock will, of course, pass to the survivor outside the probate estate and the survivor will have the status of a new stockholder. The decision to consent or not to consent will thus fall on an individual, usually a wife, and she will need proper advice; the testator should advise her to seek such advice.

SIGNIFICANCE OF CORPORATE OPERATIONS

Next to be considered are the possible tax results where the Subchapter S corporation has an operating loss in the year of death.
In this instance, under Section 1374(b), effective September 24, 1959, if a loss occurs, the loss, assuming a consent, will be allocated between the decedent's last income tax return and the estate's first income tax return on the basis of the days in the corporation's taxable year before and after death. The estate becomes entitled to its share of the loss only if a proper consent to continue the Subchapter S status is made. The testator should see that under these circumstances it may be difficult for his executor to let the election lapse.

On the other hand where the corporation has a gain there is no such allocation, and if there is a consent by the executor, the entire undistributed taxable income at the end of the corporation's taxable year will be taxed to the estate in its income tax return.

The undistributed earnings up to the day of death usually will be considered in valuing the corporate stock for estate tax purposes. A double tax situation thus occurs when the election is exercised that Congress sought to eliminate by Section 691. However, some authorities feel that this amount would not qualify as income in respect of a decedent within the meaning of Section 691 because the estate technically under Subchapter S is a new or different stockholder and because the income pass-through to stockholders does not occur on a daily basis as it does for losses, but arises only on the last day of the corporation's taxable year. Accordingly, there would be no deduction for estate tax paid on the earnings up to the date of death.

**UNDISTRIBUTED TAXABLE INCOME AT DEATH**

If undistributed tax paid earnings are in the corporation at the time of death, authorities now feel that it may be impossible for the estate to obtain this income without ordinary dividend treatment. Section 1375(d) is pointed out as limiting the amount of the prior taxed income that may be distributed tax-free to the amount included in the gross income of the stockholder in prior years. The estate in this instance is considered a new stockholder.

Rev. Rul. 62-116 emphasizes the position of the Service in this regard. The ruling cites as authority *Herbert's Estate et al. v. Commissioner* (139 F.2d 756 (1943)), certiorari denied, 322 U.S. 752 (1944) wherein the court stated, "whatever status a personal representative may have for other purposes, he is treated by the Revenue Acts as a new owner of the decedent's property for income tax purposes." Missouri law was under consideration in the ruling and in that State personal property passes to persons to whom devised in the will on the date of death but nevertheless such property is subject
to estate administration and possession of the executor or administrator. The question raised was whether under these circumstances the estate or the heir or legatee was a "new stockholder" for Subchapter S purposes. Citing cases to the effect that even though legal title passes to the devisees or heirs at law, the estate is still a taxable entity during administration and any income earned on the property is taxable to the estate, the ruling concludes that the decedent's estate under the Missouri-type statute is a "new stockholder" under Section 1372(e)(1) of the Internal Revenue Code.

The majority of authorities* take the position that, regardless of Sections 1375(d) and 1374(e)(1), after all current year's earnings and all prior accumulated earnings have been distributed, the source of distribution will then be governed by Section 301(e)(2) and then will be deemed to be from tax-paid earnings, i.e., return of capital. This view they believe is supported by the fact that the Code Section 1377(a) holds that undistributed earnings having been subject to tax at the stockholder level do not increase the accumulated earnings and profits of the corporation. Other authorities** take the position that on death or loss of S status, undistributed taxable income should be restored to corporate accumulated earnings and profits, and Section 1377(a) only applies as long as Subchapter S status is effective.

ESTATE VALUATION OF SUBCHAPTER S STOCK

Where estimates are being made of estate tax in connection with planning studies, novel aspects may arise because of the peculiarities of this type of stock.

Broadly, the valuation will be affected by many new factors such as whether the corporation has old accumulated earnings or significant undistributed taxable income and also will be affected to some extent by whether or not the election is continued by the executor.

In practice, it is possible to have the fair market value of the stock be less than the tax basis the stockholder had immediately before death. This situation may arise because of the rule that during the life of the stockholder, any undistributed taxable income increases his stock basis. Upon death however, the right to receive this tax-paid income ceases, as discussed above, and therefore a lower basis may result for estate tax purposes.

If election is continued, the earnings factor in the stock valuation

---

* See for example, Mertens, Law of Federal Income Taxation, Para. 41B. 34.
** See CCH, Tax-Option Corporations, April 1962, Pages 13 and 14.
should not be adjusted for corporate income tax. Where the election is not continued, it would seem proper to reduce earnings for corporate income tax.

The limited market for stock in these corporations and the hazards of unexpected disqualification have raised questions as to whether some discount factor should not be applied in the valuation where election is continued. The two primary results of losing Subchapter S status are the reimposition of corporate tax and locked-in tax-paid earnings. It would seem that such a discount factor could not be adequately developed to be allowable.

Finally, Section 303 redemptions of stock from an estate for payment of estate tax and funeral and administrative expense should apply even though an electing corporation status is in effect. Subchapter S corporations are still corporations for Section 303 purposes.

PROPOSED LEGISLATION AND CAUTION AGAINST UNDERDISTRIBUTION

A recommended change in existing law provides that in the case of death of a stockholder, his estate should be bound by the decedent’s previous election without requiring any new consent. If this becomes law then as the estate is not a new stockholder it should become possible for the estate to obtain undistributed income tax-free. The rule should also apply to the survivor of a tenancy by the entirety; it should also provide that the recognized category of qualifying stockholders be enlarged to include testamentary trusts of former qualifying stockholders.

Upon reflection, it can be understood that one of the major problems in the Subchapter S area concerns locked-in tax-paid earnings. Not only in advising our estate planning client, but also any client who holds such stock, we should emphasize that every caution should be taken to avoid accumulations of tax-paid earnings. If this procedure is closely followed, then no major tax detriment concerning these earnings can arise if the corporation’s Subchapter S status is lost by transfer or death.

The 1962 Revenue Act provides that the new 7 per cent investment credit on new and used personal property purchases passes through to the shareholders of S Corporations as of the last day of the corporate year. Accordingly, the immediate tax reduction savings from qualifying property acquisitions will inure to the benefit of the estate and the beneficiaries on the basis of income allocable to each. If the S Corporation disposes of such assets before the
original assigned useful life is completed or the estate disposes of the stock, an additional tax will arise in the year of disposition. Thus fiduciaries must weigh the advantages and disadvantages of the new investment credit in deciding whether to exercise the election.

ESTATE PLANNING AND THE CREDIT FOR TAX ON PRIOR TRANSFERS

In estate planning there should be taken into consideration in many instances the effect of Section 2013 of the Internal Revenue Code which deals with the credit allowed for tax on prior transfers. Although this credit only arises after the death of our client-testator, understanding and preparation for such a credit frequently becomes a part of the estate-planning factors to be used in projecting our estate into the future and may affect the drafting of the will.

Section 2013 of the 1954 Internal Revenue Code entitled Credit for Tax on Prior Transfers replaces Section 812(c) of the 1939 Internal Revenue Code which was entitled Property Previously Taxed. The Committee Report on the 1954 Code states that the basic policy concerned is the prevention of subjecting the same property to tax twice within a short period of time. Without some such specific relief the same property would on many occasions be subject to several estate taxes. The mechanics of obtaining this relief have materially changed in the 1954 Code and a more realistic and equitable method is now in operation.

BACKGROUND OF THE CREDIT

Without getting too much into the technical details of the computation for the credit it can simply be stated that the adjustment for previously taxed property is now given as a tax credit, instead of a deduction from the gross estate as under prior law.

The 1939 Code had a five-year interval rule between deaths that gave full benefit regardless of when the second death occurred, if both deaths fell within this period. As stated before, the present statute provides a ten-year interval with a percentage reduction of tax credit. The theory seems to be that the longer the period the transferee has use of the property, the less hardship results and accordingly a reducing tax credit would properly balance the need for relief. Under prior law where a succession of estates was concerned, the deduction was available only once even though the identical
property passed along through three or more estates during the five-year period. In other words, no deduction was allowed in the current estate if a deduction had been allowed in the previous estate. There had to be an intervening estate paying tax on the property in order to remove the right to deduction. The present statute does away with this restriction so that if three or more deaths took place during the ten-year period, the tax credit of the current estate in each instance is the amount of tax paid on the immediately preceding transferor's estate plus the tax credit allowed to the immediately preceding transferor's estate.

One interesting feature in the present statute is that the percentage of credit allowed where successive estates are concerned is determined by the period of time passing between the current decedent's death and that of the immediate transferor. So if the original or second preceding transferor's estate that was taxed on the property transferred was nine years ago and the current decedent died within two years of the immediately preceding transferor, a 100 per cent credit would be allowed.

Now that we have reviewed the general aspects of the credit for tax on prior transfers with perhaps the dangers inherent in over-simplification, there are two matters concerning this credit that should be recognized in estate planning. The first has to do with complete testamentary disposition to a surviving spouse and the second has to do with any life estates held by our client-testator.

PRESENT STATUTE REMOVES MAJOR TAX DETRIMENT IN TRANSFERS TO SPOUSE

Under prior law, no deduction for property previously taxed was allowed for any property passing from one spouse to another. This restriction applied to all property so passing regardless of whether or not the marital deduction was taken in the transferor's estate. Now this rule has been changed so that we can consider for the purposes of the estate-tax credit the property transfers between spouses. However, the value of the property transferred will have to be reduced by the part that qualifies for the marital deduction.

Under prior law, we made every effort to discourage a husband from leaving all his estate to his spouse, for part of the estate would be double taxed in the event of the early death of the wife. If, under the present law, other circumstances warrant such a testamentary disposition, what effect does the new law have where tax credit is now permitted with respect to the excess value over the maximum
marital deduction transferred to the surviving spouse? A study of
typical cases of this kind, where it is presumed that the surviving
spouse dies within, say, one year and there has been no opportunity
to pass on or dissipate the testamentary bequest, we find that because
of the new tax credit, we can no longer definitely state that the
excess property over the marital deduction in the first estate is
doubly taxed.

It is obvious that this excess of property over the maximum
marital deduction in the first estate causes the entire estate tax in
the first estate, and this estate tax thus becomes the first tentative
credit on our Section 2013 computation. Next, it is also obvious that
the second tentative credit in the second estate will usually produce
a greater tentative credit because the second estate, having no marital
deduction, will reach higher estate-tax brackets so that the tax
allocated to the excess property at the top brackets will exceed the
total tax on the first estate. Consequently, by following the rule
of using the lesser of the tentative credits, we will always be getting
back as a tax credit against the second estate, all the tax paid on the
first estate. By this analysis, then, there is in substance no federal
estate tax paid on the husband's estate and all the assets transferred
to the spouse are fully taxed at regular bracket rates in her estate
in the event of the sudden death of the surviving spouse. The con­
clusion seems to be that in any event the net tax result of complete
transfers of an estate to a surviving spouse where warranted under
certain circumstances has been greatly relieved by the new tax credit.
The following example will illustrate the point:

EXAMPLE—All Estate to Spouse

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted Gross Estate</td>
<td>$620,000</td>
</tr>
<tr>
<td>Marital Deduction</td>
<td>$310,000</td>
</tr>
<tr>
<td>Exemption</td>
<td>$60,000</td>
</tr>
<tr>
<td>Taxable Estate</td>
<td>$250,000</td>
</tr>
<tr>
<td>Gross Estate Tax</td>
<td>$65,700</td>
</tr>
<tr>
<td>Credit for State Estate Tax</td>
<td>$3,920</td>
</tr>
<tr>
<td>Net Estate Tax Payable</td>
<td>$61,780</td>
</tr>
</tbody>
</table>

FIRST LIMITATION

\[
\frac{$620,000 - $310,000 - $65,700}{\$250,000 + \$60,000 - $65,700} \times \$61,780
\]

\[
\frac{$244,300}{\$244,300} = 1 \times \$61,780 = \$61,780
\]

240
**SECOND LIMITATION**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Survivor Estate = $620,000 - $65,700</td>
<td>$554,300</td>
</tr>
<tr>
<td>Exemption</td>
<td>$60,000</td>
</tr>
<tr>
<td>Taxable Estate</td>
<td>$494,300</td>
</tr>
<tr>
<td>Gross Estate Tax</td>
<td></td>
</tr>
<tr>
<td>Credit for State Estate Tax</td>
<td>$12,172</td>
</tr>
<tr>
<td>Net Estate Tax Payable</td>
<td>$131,704</td>
</tr>
<tr>
<td>Taxable Estate (as above)</td>
<td>$494,300</td>
</tr>
<tr>
<td>Less Net Value of Property Transferred</td>
<td>$244,300</td>
</tr>
<tr>
<td>Revised Taxable Estate</td>
<td>$250,000</td>
</tr>
<tr>
<td>Gross Estate Tax</td>
<td></td>
</tr>
<tr>
<td>Credit for State Estate Tax</td>
<td>$3,920</td>
</tr>
<tr>
<td>Revised Net Estate Tax</td>
<td>$61,780</td>
</tr>
<tr>
<td>Net Estate Tax Payable (as above)</td>
<td>$131,704</td>
</tr>
<tr>
<td>Revised Net Estate Tax (as above)</td>
<td>$61,780</td>
</tr>
<tr>
<td>Estate Tax Attributable to Property Transferred (Second Limitation)</td>
<td>$69,924</td>
</tr>
</tbody>
</table>

The credit under the first limitation of $61,780 is the lesser and death of surviving spouse within two years will allow 100% of the credit.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Survivor Estate Tax</td>
<td>$131,704</td>
</tr>
<tr>
<td>Credit for Tax on Prior Transfers</td>
<td>$61,780</td>
</tr>
<tr>
<td>Survivor Net Estate Tax Payable</td>
<td>$69,924</td>
</tr>
</tbody>
</table>

The tax credit of $61,780 represents the reduction of estate tax cost under the new law with respect to a transfer of all of an estate to a spouse who survives less than two years.

**LIFE ESTATES QUALIFY FOR CREDIT IN LIFE TENANT’S ESTATE**

Where our client-testator holds a life estate, we should be aware of an interesting situation: Section 2013 permits a tax credit in the estate of a life tenant even though the life estate is not valued in the gross estate of the life tenant. In calculating the amount of this credit, we are readily able to determine the actuarial value of the life estate in the transferor’s estate and the transferor’s estate tax allocable thereto. However, this is not the final credit, for we must next determine whether the tax on the property transferred in the present decedent's estate is the lesser. Although no value of the transferred life estate is in fact included in the gross estate of the life tenant, the statute apparently means that we will still deduct the value of the property transferred from the taxable estate of the life tenant in
order to determine the transferee's tax on this prior transfer. This seems to be in accord with the rule that there is no requirement that the property be identified in the transferee's estate or that it be in existence on the date of the transferee's death. It is of interest to note that we are engaged in making a determination of the estate tax allocable to a "fictional" interest that is not reflected in the estate tax base. The regulations give the following illustration of the application of principles where a life estate is concerned.

"A died on January 1, 1953, leaving Blackacre to B for life and, upon B's death, remainder to C. At time of A's death, B was 56 years of age. The property was included in A's gross estate at a value of $100,000. The part of that value attributable to the life estate is $44,688, and the part of that value attributable to the remainder is $55,312. B died on January 1, 1955, and C died on January 1, 1956. For purposes of computing the credit against the tax imposed on B's estate, the value of the property transferred to B is $44,688.* For purposes of computing the credit against the tax imposed on C's estate, the value of the property transferred to C is $55,312." (Reg. 20.201.3-4(a).)

NEED TO REVIEW ALL PROPERTY TRANSFERS TO TESTATOR

In getting together the estate-planning information, it is a recommended practice that a statement or check-off list be prepared, setting forth all property interests held by the testator given him as a bequest or a legacy. (Cash bequests are included.) The term property is held to include any beneficial interest in property, including a power of appointment.

Under this broad definition of property given in Section 2013(e) and the Regulations we must consider many types of property transfers such as (1) annuities, (2) life estates, (3) remainder interests, (4) dower, (5) estate in lieu of dower, (6) surviving joint tenant, (7) insurance beneficiaries, (8) donees of general powers, (9) appointees under the exercise of a general power, and (10) donee of any gifts where donor died within three years of gift.

In cases of contingent remainders and life estates, if such contingent interest is susceptible of valuation in the transferor's estate then credit is allowed in the transferee's estate even though the

* In a recent matter in our office, a reviewing estate tax Internal Revenue Agent has sought to discount the actuarial value of the life estate as determined from the Tables because the life estate income distributions are discretionary, i.e., a "spendthrift trust."
contingency never came to pass or the interest is not such that it is includable in the transferee's estate. On the other hand, where a contingency actually takes place but was not of sufficient possibility of occurrence to be actuarially valued in the transferor's estate, no estate-tax credit appears allowable.

It is important, therefore, when we are discussing estate planning with a client and his attorney to make inquiry as to all of the property transfers that have been made to him during the past ten years so that proper consideration can be given in estimating his ultimate estate-tax liability. Such information is valuable after death and once determined should be kept available with the testator's other important papers.