



There are several issues an estate's executors and advisers must consider when an S corporation shareholder dies. Three of the most common are income tax reporting in the year of death, income tax basis of the decedent's stock passing to heirs and protecting the company's S corp status during estate administration.

Subchapter S of the Internal Revenue Code allows the shareholders of an eligible small-business corporation to make an election to tax the corporation as a pass-through entity, an S corp, thereby avoiding the double taxation of income inherent in regular C corporation income.

For example, a C corp pays tax on its income at the entity level, then the shareholders pay tax on the income again when it's paid out as dividends. An S corp, though, typically does not pay tax at the entity level, but taxable income is reportable on the individual shareholders' tax returns directly—thereby bypassing the entity-level tax. This is a tremendous break for the shareholders, and it's critical that executors and advisers handle S corps appropriately and protect the S election status.

### Tax Reporting in the Year of Death

S corp income is prorated on a per-share-per-day basis among shareholders. When a shareholder dies, income allocable to that person's shares is prorated between the individual tax return and the estate. Alternatively, if all affected shareholders agree, the books may be closed at the date of death and pre-death and post-death income allocated among shareholders accordingly.

# Postmortem

## Issues to Consider After Death of an S Corp Shareholder

An analysis of the impact of this election will need to be done in time for filing any affected tax returns or extensions of time to file those returns, and may impact shareholders' current year estimated tax payments.

### Tax Basis of Inherited Stock

Following normal tax rules, S corp stock held as the separate property of the decedent will receive a Sec. 1014 step-up in basis to date-of-death or alternate-valuation-date fair market value. Stock held as community property will also receive a basis step-up as to both the decedent's and surviving spouse's community property shares. For 2010 deaths only an election out of the estate tax regime to modified carryover basis treatment is available, in which case a new set of laws will apply that are beyond the scope of this article.

If S corp stock was used to fund a marital trust or bypass trust at the death of the first spouse, then care should be taken at the second death because only the stock owned by the marital trust will receive a stepped-up basis at the second death. Stock held in a bypass trust will not receive another step-up at the death of the surviving spouse.

### Suspended Losses, Tax Basis Limitations

Generally, S corp losses suspended by tax-basis limitations are personal to the shareholder and cannot be transferred to another person [Reg. 1.1366-2(a)(5)]. Thus, suspended losses on stock held by the decedent at death are permanently disallowed to beneficiaries of the stock.

### Income in Respect of a Decedent

The stepped-up basis of S corp stock is reduced by the amount of the stock's fair

market value that is attributable to items of income in respect of the decedent (IRD) [Sec. 1367(b)(4)(B)].

For example, if a cash basis S corp held uncollected accounts receivable at the date of death (or applicable alternate valuation date) that would have been treated as IRD if held directly by the decedent, then the basis of the inherited stock is reduced by the IRD amount. When the corporation receives the accounts receivable payments and the income is reported to the stock beneficiaries, the stock basis is increased by the amount of the pass-through income. To the extent any estate taxes were paid by the decedent's estate, the beneficiaries would be entitled to deduct on their own tax returns the portion of the estate taxes attributable to the IRD.

### Passive Activity Losses

The S corp may have generated passive activity losses to the shareholder if it conducted rental activities or if the shareholder did not materially participate in the business activity of the corporation.

At death, the shareholder's suspended passive-activity loss from the corporation is reduced dollar for dollar by the amount of the step-up in basis of the stock to its date-of-death—or alternate valuation date—value. The amount of suspended loss in excess of the basis step-up is deductible in full on the final Form 1040 [IRC Sec. 469(g)(2)]. This rule governs only the calculation of the deceased S corp shareholder's passive activity loss deduction and has no effect on the amount of the estate or heir's basis in the stock.

### Estate as Participating Shareholder

Material participation by a deceased

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shareholder's estate in the business activities of the S corp is measured at the fiduciary level with no reference to the decedent's prior involvement. If the executor does not meet the tests for material participation, income or loss from the S corp's business will likely be treated as arising from a passive activity.

Suspended passive losses generated while the estate holds the stock are not passed through to the beneficiaries (and, therefore, cannot be deducted by them) when the estate terminates. Rather, the suspended losses are added to the estate's basis in the stock immediately before distribution [IRC Sec. 469(j)(12)].

### Protecting S Corp status

A key rule for electing and maintaining S corp status is that the company can only be owned by eligible shareholders, otherwise the S election will automatically terminate as of the date stock is transferred to an ineligible shareholder. In general, only the following are eligible shareholders:

- U.S. citizens or residents;
- Natural persons (i.e. no corporations or partnerships);
- 501(c)(3) exempt entities, Sec. 401(a) qualified pension plans or Sec. 408 IRAs;
- Estates; and
- Certain trusts.

A decedent's probate estate remains an eligible shareholder for the duration of the administration of the estate without the need for any specific action by the executor. However, this treatment is only extended to a qualified revocable trust, generally referred to as a living trust, for two years after death.

If a Sec. 645 election is made for a qualified revocable trust, it will be treated as part of the probate estate for two years after the decedent's death. Although this does not extend the time the revocable trust qualifies as an eligible S corp shareholder, it does enable the trust to transfer the stock to testamentary trusts [typically qualified terminal interest (QTIP) or bypass trusts] for an additional two years of S corp eligibility after the transfer without the need for special elections by the testamentary trusts.

### Trusts as Eligible Shareholders

Only specific types of trusts are eligible S corp shareholders, including:

- Wholly owned grantor trusts.

- Wholly owned grantor trusts that continue after death of the shareholder, but only for two years after the date of death.
- Testamentary trusts (i.e. trusts receiving stock pursuant to a will, or pursuant to a qualified revocable trust that made a Sec. 645 election), but only for two years after receipt of the stock. Typically this will be QTIP or bypass trusts.
- Voting trusts.
- Qualified Subchapter S Trust (QSST).
- Electing Small Business Trust (ESBT).

Transfers to ineligible trusts, or stock held by certain trusts past the after-death two years of initial eligibility, will cause the company's S corp status to terminate immediately.

### QSST

A trust that has only one beneficiary, is required to distribute all income annually and meets additional, specific qualifications will be eligible to make an election to be treated as a QSST—and thus be an eligible shareholder. By design, a QTIP trust qualifies as a QSST. However, a timely election by the beneficiary of the qualifying trust must be made in order to obtain QSST status.

The election must be filed within 2.5 months after the trust ceases to otherwise qualify as an eligible S corp shareholder (note the election is retroactive 2.5 months), but can be made at any time the trust qualifies to do so. The beneficiary is then treated as the grantor of the QSST and pays tax on the S corp pass-through income.

### ESBT

An ESBT is permitted to have more than one beneficiary and is not required to distribute all income annually. A trust that also meets additional, specific qualifications will be eligible to make an election to be treated as an ESBT and thus be an eligible shareholder. However, as with a QSST, a timely election must be made to obtain ESBT status.

In this case, the trustee must make the election. Again, the election must be filed within 2.5 months after the trust ceases to otherwise qualify as an eligible S corp shareholder, but can be made earlier if the trust qualifies to make the election. The trust will then pay taxes on the S corp pass-through income under normal trust taxation rules.

### Administrative Trusts

How is an administrative trust treated

for S corp purposes? The concept of an administrative trust was created for convenience in administering estates so is not specifically addressed in the trust rules, but must qualify as an eligible S corp shareholder under one of the rules previously discussed. Thus, it must be specifically created by will or by the terms of the revocable trust to be considered a testamentary trust. If the decedent had a qualified revocable trust that is used as the administrative trust, it may qualify under that exception.


However, caution should be taken when other assets are commingled with the decedent's assets in the administrative trust as it may then be deemed that the qualified revocable trust has been replaced and a new trust has been created. In this case, depending on the terms of the trust, a timely filed ESBT election may be necessary to preserve eligible shareholder status and avoid termination of the company's S corp election. These issues should be carefully analyzed and reviewed with the trustee and executor in planning for the estate's administration.

### Relief for Late Elections

What if the QSST or ESBT election was not filed on time? Rev. Proc. 2003-43 provides a simplified method to request relief for late elections and does not require a user fee. However, the application for relief under this procedure must be filed less than 24 months after the election was originally due.

If the taxpayer's situation does not qualify under this revenue procedure, a private letter ruling may be requested for relief from inadvertent termination, inadvertent invalid election or late election. However, a user fee of up to \$14,000 will be required with the request.

### Beware the Consequences

The estate of a decedent owning S corp stock has special considerations that could impact the estate and its beneficiaries, as well as the corporation and other shareholders. Inadvertent termination of the S corp election could have disastrous consequences, so advisers must be aware of the issues and be prepared to discuss planning options with executors and trustees. 

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