INCOME TAX ISSUES EVERY "ESTATE PLANNER" SHOULD KNOW

JASON R. MAHON, J.D., CPA
The Mahon Firm, P.C.
1330 N. White Chapel Blvd.
Suite 200
Southlake, Texas 76092
Phone: (817) 251-9228
Fax: (888) 482-5053
Website: mahonfirm.com
Email: jrmahon@mahonfirm.com
@jasonrmahon

State Bar of Texas
INTERMEDIATE ESTATE PLANNING AND PROBATE COURSE
June 25, 2013
Houston

CHAPTER 3

Information set forth in this outline should not be considered legal advice, because every fact pattern in unique. The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein.

Author

Jason R. Mahon, J.D., CPA

Jason is a Board Certified Attorney in Estate and Probate by the Texas Board of Legal Specialization. Jason attended Texas Christian University where he received his Bachelors of Business Administration and a Masters of Accounting from the Neeley School of Business. He has been a Certified Public Accountant since 2002 and practiced in public accounting for 6 years, before transitioning to practice of law. Jason attended the night program at Texas Wesleyan University School of Law in Fort Worth, Texas while practicing in public accounting during the day. He was admitted to the state bar in November 2007. Upon completing law school, Jason went to work at the Fort Worth law firm of Bourland Wall & Wenzel, PC where he practiced law in the estate planning section for 3 ½ years. In February of 2011, Jason started The Mahon Firm, P.C.

Jason is a member of the American Bar Association; State Bar of Texas; Tarrant County Bar Association; Tarrant County Probate Bar Association; Tarrant County Young Lawyers Association; Fort Worth Business and Estate Council; and The Tax and Estate Planning Section of the Tarrant County Bar Association. Jason is a certified public accountant and has been since 2002. He is a member of the American Institute of Certified Public Accountants; and Texas Society of Certified Public Accountants, Fort Worth Chapter.

Jason has been a guest lecturer in various estate planning topics including the following:

- Texas Society of CPA's Advanced Estate Planning Conference – August 2008 – "Estate Planning for the Family Business Owner with Charitable Remainder Trust and Charitable Lead Trust."

- Pennsylvania Bar Institute – May 2010 and October 2010 – "Estate Planning Techniques for Mineral Interest Owners"

- Oklahoma Bar Association – November 2010 – "Estate Planning Techniques for Mineral Interest Owners" and "Estate Planning for the Family Business Owner with Charitable Remainder Trust and Charitable Lead Trust."

- 28th Annual Fort Worth Chapter of CPAs Tax Institute - August 2012 - "Family Limited Partnerships: When, What, Why and How - A Practical Workshop."

- 28th Annual Fort Worth Chapter of CPAs Tax Institute - August 2012 - "Intentionally Defective Grantor Trusts: When, What, Why and How - A Practical Workshop."

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INCOME TAX ISSUES EVERY "ESTATE PLANNER" SHOULD KNOW

I. INTRODUCTION

The purpose of this outline is to discuss income tax issues that every "estate planner" should be familiar with…hence the title. As a result of the American Taxpayer Relief Act of 2012 (ATRA) and the Affordable Care and Patient Protection Act of 2010, there has been some overall "permanency" provided in the transfer tax system and an increase in the overall income tax rates for individuals, businesses and estates.[1] With these increased income tax rates, and permanent transfer tax rates, there is a need on the part of estate planners to more carefully consider the income tax consequences resulting from the strategies that we propose on behalf of our clients. Our clients, who may now be less concerned with transfer taxes because of the permanency of the high exemption levels along with the inflation adjustments, will be more concerned with how to reduce income taxes.

This paper is not a thesis on the income tax system as a whole, but merely a guide to issues that will arise as estate planners continue to provide sound advice to our clients regarding issues such as testamentary planning, lifetime gifting, asset protection and choice of entity. The paper is intended to assist the planner in spotting income tax issues as they arise and does not vet every tax effect of each strategy.

II. INCOME TAX RATES

Before we can move too far down the line, it is good to get an understanding of the current income tax environment:

A. Individual

As a result of ATRA, the individual income tax rates increased from a high rate of 35% in 2012 to the highest rate of 39.6% in 2013 (applied to individuals with taxable income in excess of $400,000.00 and couples with income in excess of $450,000.00). Additionally, income tax rate on capital gains and qualified dividends changed from a flat 15% rate in 2012 to a bracket of a 15% and a 20% rate. The 20% rate applies to high income taxpayers to which the 39.6% income tax rate applies. In addition to the effects on the income tax rates as a result of ATRA, in 2013, what has come to be called the Medicare Tax under the Affordable Care and Patient Protection Act, went into effect. This tax is 3.8% and applies to "net investment income" if the "adjusted gross income" exceeds $250,000 for joint filers and $200,000 for single individuals. Therefore, it is possible that the top federal tax rate on investment income for high income tax payers could be 43.4%. This tax is before any state income tax that may be applicable to individuals who live in states with state income tax. A chart of the individual income tax brackets has been provided on Appendix "A" for reference.

B. Corporate

Corporate income tax rates range from 15% (income up to $50,000) to 35% (income over $10,000,000). The tax rate for income from $75,001 to $10,000,000 is 34%, but income over $100,000 comes with additional tax. Additionally, corporations do not receive the favorable capital gains rates as discussed in Section A. above. Capital gains are taxed at the ordinary income tax rate. Corporations that elect S Corporation status under IRC §1362, limited liability companies that are taxed as disregarded entities, S Corporations and Partnership, and Partnerships do not have separate income tax rates. Such earnings and income tax liability flows through to the owners of such entities and are taxed at the owners individual income tax rate.

C. Estates and Trusts

In general, taxable income for estates and non-grantor trusts is gross income less deductions. Trusts reach the highest income tax bracket at a quicker rate than individuals. As mentioned above, Individuals reach the top income tax rate at $450,000.00 for married filing jointly or $400,000.00 for individuals. Trusts reach the top income tax rate of 39.6% with undistributed income of only $11,950.00 in 2013. This is a significant difference. Additionally, with the introduction of the Medicare Tax of 3.8%, Section 1411(a)(2) imposes the Medicare Tax on the lesser of i) the trust or estate's undistributed net investment income, or ii) the estate's or trust's adjusted gross income in excess of the highest income tax bracket threshold (in excess of $11,950 in 2013 as noted above). Therefore, since most trust income will be considered net investment income, a trust will be paying 43.4% income tax on earnings in excess of $11,950.00

D. Reminder of Gift, Estate and Generation Skipping Transfer Tax Rates

With the introduction of ATRA, the gift, estate and generation-skipping transfer tax ("GSTT") remained unified. The gift tax rate, estate tax rate and GSTT rate were all increased from 35% to 40%. Technically, the rates on estate are scaled up to a highest rate of 40%, but because of the high exemptions, the effective rate on all gifts, estates and GSTT transfers will be 40%. The gift, estate and

[1] The Obama Administration's 2014 budget proposal already proposes reducing exemptions to 2009 levels in the year 2018.

GSTT exemptions are $5,000,000, as adjusted for inflation after 2011. For 2013, the exemptions are $5,250,000.

III. VARIOUS BUSINESS ENTITIES

A. Corporations

A corporation is a type of state law entity formed under Title 2 of the Texas Business Organizations Code (as it relates to Texas corporations). A Corporation has owners called Shareholders, who own units called shares of stock, and is usually managed by a board of directors. The Board of Directors is usually selected by the shareholders. Corporations can also have officers, as usually elected by the Board of Directors. The management and operations of the Corporation are governed by the Bylaws of the corporations. In order to restrict how shares of stock in the corporation can be transferred, the transfer restrictions are either spelled out in the Bylaws, or more commonly, the shareholders execute a Shareholder's Agreement or Buy/Sell Agreement that governs and limits the transferability of the shares.

1. <u>C Corporation</u>

As mentioned above, a corporation is formed under the laws of the state. Corporations also must be taxed, which falls under the federal laws of the Internal Revenue Code. All corporations, when formed, are technically C Corporations. The term "C Corporation" comes from the reference to Subchapter C, of Chapter 1 of Title A of the Internal Revenue Code. All corporations (except for S Corporations as discussed below) are taxed in accordance with Subchapter C, which involves Internal Revenue Code §§301-385.

There are no restrictions on the types of persons or entities that can own stock in a C Corporation. C Corporations can have different classes of stock, such as common and preferred, each class of ownership carrying with it different rights, as determined when such class of stock is authorized and issued.

Under IRC § 351, the general rule is that no gain or loss shall be realized upon the formation and contribution of property by a shareholder to the corporation. A shareholder's basis in the corporation is the amount the shareholder paid for the shares, or if the stock was a gift, the basis of the transferor. The basis of the stock of a corporation in the hands of the shareholder may be reduced by any amount distributed that is not considered a dividend.[2]

Under IRC §301, upon the distribution of property (cash or other property) to a shareholder of a corporation, the shareholder is taxed on the amount received that is considered a dividend and is included in the gross income of the shareholder. Taxation of dividends to the taxpayer depends on the type of dividend. Ordinary dividends are taxed at the individual's ordinary income tax rate. Certain ordinary dividends meet exceptions which make such dividends Qualified Dividends; Qualified Dividends qualify for a 0% or 15% maximum tax rate. In order to be Qualified Dividends, i) the dividend must be paid by a U.S. corporation or qualifying foreign corporation, ii) stock must have been held for 60 days during the 121 day period that begins 60 days before the ex-dividend date, which is the first day following the declaration the buyer will not receive the next dividend payment and iii) the dividends are not capital gain distribution, from a tax-exempt organization, from an ESOP, are not payments in lieu of dividends and are not actually treated as interest income.[3] Additionally, dividend income may be treated as "net investment income" and subject to the Medicare Tax. If a shareholder in a corporation is a corporate shareholder, the corporate shareholder may take advantage of the dividends received deduction to prevent double corporate taxation.[4] Upon a dividend being declared and paid by a corporation, the corporation generally is not allowed a deduction for such dividend, but the dividend shall reduce the earnings and profit of the company.[5]

C Corporations are separate entities that pay income taxes at the rates discussed above. All income and deductions of the corporation are reported on a corporate federal income tax return (Form 1120). The income tax rates and liabilities of the corporation are separate from the income tax liability of its shareholders. A common term used when discussing C Corporations is "double tax" or "double taxation." C Corporations pay tax on earnings, but shareholders also pay tax on dividends when distributions are made to the shareholder (discussed above). This is most times an unfavored result and is the reason many have moved away from C Corporation. Any corporation with an estimated tax liability in excess of $500.00 is required to make quarterly tax payments.

2. <u>S Corporation</u>

As opposed to being a C Corporation, an officer of a corporation can file a Form 2553 and elect for the corporation to be taxed as an S Corporation. Such election must be consented to by the shareholders. Again, this is a federal election. For state law purposes, the corporation is no different than a C Corporation. An S Corporation is a "Small Business Corporation" (defined below) for any taxable year in which an election under section 1362(a) is in effect.

[2] IRC §301(c)(2)

[3] IRC §1(h)(11)

[4] IRC §243

[5] IRC §312

An S Corporation gets its name from Subchapter S, of Chapter 1 of Title A of the Internal Revenue Code. An election under this subchapter brings the taxation of the corporation under IRC §§1361-1379. A main advantage to an S Corporation is the flow through treatment of income and deductions. As opposed to a C Corporation, which pays its own tax as mentioned above, an S Corporation files a Form 1120S and issues K-1's to all of its Shareholders. The shareholders of an S Corporation report all items of income and loss on the shareholder's personal return. This is considered to be an advantage over C Corporations, which pay the "Double Tax." S Corporations are very useful and very popular, but there are somewhat strict requirements on how an S corporation is structured, who can own the stock, and how many shareholders are allowed.

(a) Qualifications

A Small Business Corporation means a domestic corporation which is not an ineligible corporation and which does not i) have more than 100 shareholders, ii) have as a shareholder a person (other than an estate, certain trusts or certain organizations) who is not an individual, iii) have a nonresident alien as a shareholder, and iv) have more than 1 class of stock.[6] There are certain corporations that are ineligible to be S Corporations ("Ineligible Corporation"). Ineligible Corporation means any corporation which is i) a financial institution which uses the reserve method of accounting or bad debts under section 585 (banks qualify as S Corporations unless the bank uses this method of accounting), ii) an insurance company subject to tax under subchapter L (primarily life insurance companies, with some exceptions), or iii) a corporation to which an election under Section 936 applies, or a DISC or former DISC ("DISC" means Domestic International Sales Corporation, which has been altered several times).[7]

(b) Qualified Shareholders

As noted above, a shareholder of an S Corporation must be an individual who is a resident of the United States. There are a few exceptions to this rule.

i) A trust all of which is treated as owned by an individual who is a citizen or resident of the United States. This includes a revocable trust, a "grantor trust" as described in IRC Section 671-679, or a Qualified Subchapter S Trust ("QSST") which is discussed below.

ii) An estate is a qualified shareholder of an S Corporation for a period of 2 years subsequent to the shareholder's death. The same is true for a testamentary trust or a revocable trust that receives shares of stock as a result of a shareholder's death or becomes irrevocable upon the death of the shareholder.[8]

iii) An electing small business trust ("ESBT"). An ESBT is a trust that a) does not have as a beneficiary any person other than an individual, an estate, or certain charitable organizations, b) which no interest in such trust was acquired by purchase (this refers to the actual trust interest being purchased, not the assets inside the trust), and c) an election to be an Electing Small Business Trust has been filed with the Internal Revenue Service.[9] An election to be an ESBT is filed by the Trustee. An ESBT election is only required to be filed once and must be filed no later than 2 months and 15 days after the stock is transferred to the trust. If a trust owns more than one type of S Corporation stock, only 1 election is required. Trusts that do not qualify as an ESBT include 1) a QSST 2) a trust exempt from income tax, and 3) a charitable remainder annuity trust or charitable remainder unitrust.[10]

The effect of an ESBT election on a trust is important and should be discussed by the attorney and the client's certified public accountant. There are certain income tax reporting requirements that may make an ESBT election undesirable, especially in the current income tax environment. The taxation of ESBTs is governed under IRC Section 641(c). If an ESBT election is in place, an ESBT is technically treated as 3 different trusts for income tax reporting purposes: an S portion, a non-S portion and a grantor portion[11]. If a portion of the ESBT has a grantor portion, then those items of income, deduction and credit flow up to the grantor's individual income tax return, similar to a grantor trust. The non-S portion of the ESBT is taxed based on normal income tax rules applicable to trusts similar to a complex trust, discussed below. The S portion is the portion of the ESBT that owns the S Corporation stock and is not a grantor trust. This portion has special rules related to

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6 IRC §1361(b)(1)

7 IRC §1361(b)(2)

8 IRC Section 1361(c)(2)(A)(ii)-(iii)

9 IRC Section 1361(c)(2)(A)(v); Section 1361(e)

10 IRC Section 1361(e)(1)(B)

11 Treas. Regs. Section 1.641(c)-1

the taxation of the income, loss and deductions attributable to the S Portion. Overall, the important part to understand is that the S portion is taxed at the highest marginal rate for trusts and no portion of the income of the S portion may be attributable to any beneficiary. In other words, the S portion does not receive distribution deduction for distributions made to beneficiaries; therefore, all of the income of the S portion is taxed at the highest rate[12].

There are still benefits to making an ESBT election if the income tax results are understood and approved. The main benefit is the accumulation of the income and S Corporation distributions inside the trust, as opposed to a QSST, which is discussed below. An ESBT is likely a better asset protection vehicle than a QSST, but the income tax results are less favorable. Again, there may be needs for an ESBT that make it attractive, but it is important to discuss these issues with your client's CPA before making the election, to ensure everyone understands the tax implications.

iv) A Qualified Subchapter S Trust ("QSST") is a trust that is treated as wholly owned by the beneficiary and is treated as a trust described in IRC Section 1361(c)(2)(A)(i). In order to qualify as a QSST, the terms require that 1) during the lifetime of the current income beneficiary, there shall be only 1 income beneficiary of the trust, 2) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary, 3) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust, and 4) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary.[13] All of the income shall be distributed currently to 1 beneficiary who is a citizen or resident of the United States.[14] There have been rulings that state the trust does not have to require all income to be distributed, as long as all income is actually distributed.

The election for a QSST must be made by the beneficiary and there must be a separate election with respect to each S corporation owned by the Trust. If an election is in place with respect to any beneficiary, the election shall be treated as made by each successive beneficiary unless such beneficiary affirmatively refuses to consent to such election. An election can be made effective no later than 2 months and 15 days subsequent to the desired effective date, so it is imperative to be protective when contributing S Corporation stock to a trust.

For income tax purposes, the QSST is favorable in comparison to the ESBT because all income flows out to the beneficiary; therefore, the income is taxed at the beneficiary's income tax rate instead of the trust income tax rate, which will usually result in lower income taxes.

The negative side of a QSST when compared to an ESBT is the asset protection…because a QSST is required to distribute all income annually to the single beneficiary, the corpus is protected, but if the S corporation is making large distributions, then those distributions will end up in the hands of the beneficiary and cannot remain in the trust. This may not be desirable if the beneficiary is unable to manage large amounts of money due to spendthrift issues. It is also not desirable if a beneficiary is going through a divorce or other creditor issues…again, the corpus is protected, but the income must be distributed.

v) An S Corporation can also be owned by another S Corporation, but only if 1) the S Corporation is a 100% owner of the subsidiary and 2) an election has been made by such subsidiary to be treated as a Qualified Subchapter S Subsidiary ("Q-Sub").[15] In those instances where a Q-Sub election is in place, the subsidiary is treated much like a disregarded entity, and all income, deductions and expense items flow up to the parent S Corporation and are reported on the parent's Form 1120S.

(c) <u>Number of Shareholders</u>

An S Corporation cannot have in excess of 100 Shareholders. For purposes of counting Shareholders, a husband and wife can be counted as 1 shareholder (including the estate of the husband or wife) and all members of a family (or the families' estates). For purposes of this section, "members of a family" means a common ancestor, any lineal descendant of such

[12] IRC Section 641(c)(2)

[13] IRC Section 1361(d)(3)(A)

[14] IRC Section 1361(d)(3)(B)

[15] IRC Section 1361(b)(3)(B)

common ancestor, and any spouse or former spouse of such common ancestor or any such lineal descendant.[16] A "Common Ancestor" shall not include an individual, if on the applicable date, the individual is more than 6 generations removed from the youngest generation of shareholders who would be members of the family.[17] In the instance of a revocable trust or grantor trust as the shareholder, the "grantor" shall be treated as the shareholder.[18] In the instance of a revocable trust that becomes irrevocable upon the death of a shareholder, the shareholder's estate shall be considered the shareholder.[19] For a testamentary trust or a trust that receives stock by will upon the death of the shareholder, the estate of the shareholder shall be considered the shareholder of the S Corporation.[20] For a voting trust described in IRC Section 1361(c)(2)(A)(iv), each beneficiary of the trust shall be considered separate shareholders (considering the attribution rules discussed above as to the number total shareholders).[21] In the case of an ESBT (defined below), each potential current beneficiary shall be considered a shareholder.[22]

(d) Classes of Stock

In order to qualify as an S Corporation, the corporation can only have 1 class of stock; therefore, an S Corporation cannot have common stock and preferred stock.

However, an S Corporation may have stock that carries with it voting rights and stock that carries with it non-voting rights.[23] This provides flexibility in business succession planning options for S Corporations, especially when a patriarch desires to pass along ownership while maintaining control.

(e) Taxation

An S Corporation is a type of hybrid between a C Corporation and a Partnership and borrows rules from both Subchapter C and Subchapter K of the Code. In general, an S Corporation is a pass through entity and is exempt from tax; all items of income and loss pass through separately to the Shareholders and are reported on their individual returns.[24] This is the primary benefit of an S Corporation over a C Corporation.[25]

Although the taxation of an S Corporation flows through to the shareholders, an S Corporation still has a requirement for computing the tax and preparing an income tax return, which is a Form 1120S. The income of the corporation is generally computed in the same manner as an individual's taxable income, but there are certain exceptions, which are laid out in IRC Section 1363(b) and Treas. Reg. 1.1363-1(b). Once the income and loss is calculated for the S corporation, a K-1 is issued to each shareholder, which aids the shareholder in reporting his or her proportionate share of the income, loss and deductions related to the company on the shareholder's personal income tax return.

(f) Shareholder's Basis

A shareholder's basis in the stock of an S corporation is determined by the amount a shareholder has contributed to the corporation, increased by the amount of income allocated to the shareholder, and reduced by the amount of distributions and losses allocated to the shareholder.[26] The basis of the stock is important when advising a client on transferring stock in the S Corporation or holding it to receive a step-up in basis in the estate; it is also important when determining the deductibility of losses and the taxability of operating or liquidating distributions from the S Corporation. It is important to determine the tax implications of a transfer of S Corporation, whether the transfer is through a gift or sale transaction.

B. Partnership

The term partnership is both a state law term and a federal income tax term. For state law purposes, a partnership is an association of two or more persons who organize as co-owners to carry on a business for profit.[27] Partners of a partnership can be individuals, other entities, trusts or estates. This is a big difference from an S Corporation, which has restrictions on who can be an owner. In Texas, partnerships are formed and governed by Title 4 of the Texas Business Organizations Code. In Texas a partnership is defined

[16] IRC §1361(c)(1)(B)

[17] IRC §1361(c)(1)(B)(ii)

[18] IRC Section 1361(c)(2)(B)(i)

[19] IRC Section 1361 (c)(2)(B)(ii)

[20] IRC Section 1361(c)(2)(B)(iii)

[21] IRC Section 1361(c)(2)(B)(iv)

[22] IRC Section 1361(c)(2)(B)(v)

[23] IRC Section 1361(c)(4)

[24] IRC Section 1363

[25] There are certain instances when an S Corporation will be subject to a separate tax. Those instances are beyond the scope of this outline, except to say that they primarily are related to items that were present when a C Corporation converted to an S Corporation. A tax professional should be consulted regarding a conversion to an S Corporation and the potential income tax effects of such conversion, before the conversion is affected.

[26] Generally IRC §1367

[27] Uniform Partnership Act §6(1)

as an association of two or more persons to carry on a business for profit as owners, regardless of whether the persons intended to create a partnership, or the association is called a "partnership," "joint venture" or other name.[28]

There are various types of partnerships, including a General Partnership, a Limited Partnership, a Limited Liability Partnership and a Limited Liability Limited Partnership.

Whether an entity is an entity separate from its owners for federal tax purposes is a matter of federal law and does not depend on whether the entity is recognized as an entity under local law.[29] For tax purposes, in order for an entity to be taxed as a partnership, the entity must have at least two owners or partners. Generally, if an entity is owned by a husband and wife, the entity can be taxed as a disregarded entity, meaning all items of income and expense are reported on the partner's Schedule C of the individual income tax return. With a disregarded entity, there is no filing requirement for an entity return or K-1 that must be issued. A husband and wife can elect treatment as a partnership as opposed to being treated as a disregarded entity. If an entity is formed with two or more partners who are unrelated, the default classification for the entity (non-corporate) is a partnership. This can be changed as will be discussed below.

A partnership income tax return is a Form 1065. A partnership does not pay income tax, but passes through all items of income or loss to the individual partners.[30] As was discussed above related to corporations, there is no recognition of gain or loss upon the contribution of property to a partnership.[31] Each partner has a capital account, which is basically the partner's basis in the partnership. The capital account is increased by profit of the partnership allocated to the partner and by contributions by the partner to the partnership. The capital account is decreased by distributions from the partnership to the partner and by loss of the partnership allocated to the partner.[32] Capital accounts are beyond the scope of this outline, as an entire outline could be composed just on the topic of capital accounts and basis. The important part to take away regarding basis for purposes of this outline is that the tax basis of a partner's interest in a partnership is governed based on the partner's capital account and this basis determines the potential tax implications of a transfer of a partnership interest.

Depending on the type of partner and the type of partnership, self-employment income tax may be an issue. Self-employment tax can be as high as 16.2% (12.4% for old age survivor and disability insurance, 2.9% for hospital insurance and .9% additional Medicare Tax for some taxpayers).[33] "Net earnings from self-employment" includes the gross income derived from any trade or business carried on by a sole proprietor.[34] In general, sole proprietors and partners in a partnership are subject to self-employment tax, meaning that the partner picks both sides of the social security tax, the employer portion and employee portion. If a partner is active in the business, then such tax will apply. If the partner is really passive, such tax shall not apply.

Another potential benefit of partnerships is related to special allocations of income. In general, a partner's share of income, gain, loss, deduction, or credit is normally determined by the partnership agreement.[35] If the partnership agreement does not specifically address allocations, then allocations are based on ownership percentages. The partnership agreement may provide for disproportionate allocation of income if the allocation has "substantial economic effect." While the discussion of what constitutes "substantial economic effect" may be beyond the scope of this paper, it is important to realize that there may be opportunities to allocate income from the partnership to a partner who is in a lower tax bracket, thereby reducing the overall income taxes associated with the partnership operations.

1. <u>General Partnership</u>

A general partnership is an association of two or more persons organized in a more informal fashion to carry on a trade or business.[36] With a general partnership, all partners are liable for the actions of the partnership. There is no asset protection with a general partnership. Property can be taken and titled in the name of the general partnership. The partnership can be managed by a partner appointed as the managing partner, but in reality, each partner has the right to act on behalf of the entity. For tax purposes, the entity is a partnership for income tax purposes. There is no difference in taxation. All items of income and loss flow through to the individual partners.

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[28] TBOC §152.051(b)

[29] Treas. Reg. §301.7701-1(a)(1)

[30] IRC §701

[31] IRC §721(a)

[32] Generally IRC §704

[33] IRC§1401(a), (b) & Prop Regs. §1.1401-1(b)(2)(ii)

[34] IRC §1402(a)

[35] IRC § 704(a)

[36] TBOC §152.051

2. Limited Partnership

A limited partnership is a partnership that is governed by Chapter 153 of the TBOC. In order to have a limited partnership for state law purposes, an entity must have at least one limited partners and one general partner. A general partner is the partner who is responsible for the day to day operations of the partnership. The general partner is also liable for the activities of the limited partnership. The limited partner is a partner, who by its terms, is limited in his activity and also his liability in relation to the activities of the partnership. The limited partner is only liable to the extent of the funds that he or she has contributed to the partnership.

A limited partner, by his nature, is not usually actively involved in the management of the company. The Medicare Tax, as discussed above, applies to "net investment income" which is passive income. For income tax purposes, if a limited partner is not active in the business, then the additional 3.8% Medicare Tax may be assessed on the partners earnings related to the limited partnership as "net investment income." This tax should not apply to a general partner, or a limited partner who takes an active role in the partnership.

Because of the liability issues related to the general partner, many practitioners recommend that the general partner also be an entity, such as a corporation or a limited liability company, to further limit the liability of the general partner. If the general partner is an individual, self-employment tax will apply. Limited partnerships have been used in the past in the arena of estate planning referring to them as "family limited partnerships." A family limited partnership is simply a limited partnership that is owned by a family or closely held. There may be transfer restrictions in the limited partnership agreement to prohibit the interests from being transferred out of the family. Generally, the liability protection, the transfer restrictions and the control aspects of a limited partnership are what make this type of entity preferred over a general partnership, but make note that taxation to the limited partner could be different than taxation to the general partner.

The general partner is the one who makes all management decisions related to the limited partnership, which is why the general partner has more liability exposure, as mentioned above. There are many estate planning opportunities with limited partnerships and the control piece is always an issue, which is why the general partner planning should not be taken lightly.

3. Limited Liability Partnership

A limited liability partnership ("LLP") is a state law concept that has been created primarily for professionals. The LLP follows the basic structure of a general partnership but has features which allow the partners to benefit from partial limited liability. Because of the nature of professional partnerships, all partners are usually active in the business as to not qualify as limited partners. An LLP allows the partners to be liable only for their own wrongful acts and the acts of those whom they may supervise, but their personal assets are protected from the wrongful acts of their partners. For taxation purposes, whether a partner is considered a general partner or a limited partner can have side effects, such as the deductibility of passive activity losses as well as the 3.8% Medicare Tax on net investment income. A limited partner is limited to the types of losses he or she can take because by the nature of the limited partner, they are considered to be non-active. A general partner on the other hand, is an active partner and may have fewer limitations on the types of expenses that he or she may deduct for income tax purposes. Because all partners in an LLP are likely active, the Medicare Tax should not apply; however, the self-employment tax may apply.

4. S Corporation Election

Although a partnership is considered a partnership for state law purposes, an election may be made with the IRS to be treated as an S Corporation for federal income tax purposes. A reason that a partnership may determine to elect S Corporation status is related to self-employment tax. In a limited partnership, the self-employment tax many times is not an issue for limited partners, because by their nature, their activity is limited. This does not hold true for limited partners in a service oriented limited partnership such as a law firm, accounting firm, etc… All partners are deemed to be active in the partnership and for that reason, the self-employment tax will likely still apply. For this reason, the limited partnership may elect to become an S Corporation for income tax purposes in order to avoid the self-employment tax. Ultimately, it is beneficial to know that there are options; formation under state law does not necessarily equate to treatment under federal tax law.

C. Limited Liability Companies

Limited liability companies ("LLC") are solely a state law entity and are not currently recognized for federal income tax purposes as a separate entity. In Texas, LLC's are governed by Title 3 of the Texas Business Organizations Code. A LLC acts much like a corporation for state law purposes. The ownership can be broken up into percentage ownership (like partnerships) or into units (much like shares of stock). A LLC can be managed by one or more managers, by a board of managers (much like a board of directors) or by officers, as appointed by the members or managers. A LLC may also be considered a "member managed" limited liability company, meaning that the members are the managers of the company. Whether the LLC is a "member managed" LLC or "manager managed"

LLC, the states provide complete personal liability protection from the company's debts or obligations as long as the LLC is operated appropriately under state laws. One benefit to a LLC is that it can operate much like a corporation with a high level of liability protection, but can be taxed and managed somewhat like a limited partnership.

1. Taxation

The taxation of a LLC for federal income tax purposes depends on the elections that are made for tax purposes after the LLC is formed. An LLC is likely the most flexible of the entities because it can be taxed as a disregarded entity, an S corporation or a partnership.

(a) Disregarded Entity

If an LLC has only one member, or if it has two members who are husband and wife, an LLC may elect to be treated as a disregarded entity (DRE) for income tax purposes, or as an S Corporation (discussed below). For tax purposes, electing to be treated as a disregarded entity removes any federal income tax filing obligation on behalf of the company. All items of income, loss, deduction, credit, etc… are passed through to the owner and are reported on Schedule C of the individual's income tax return, much like a sole proprietorship. Another result of electing to be treated as a disregarded entity is related to the self-employment income issues as discussed above. "Net Earnings from Self-employment" includes the gross income derived from any trade or business carried on by a sole proprietor.[37] A disregarded entity is considered a sole-proprietor for federal income tax purposes; income related to the LLC being taxed as a disregarded entity would be considered net earnings from self-employment and subject to these taxes.

(b) Partnership

As opposed to being classified as a disregarded entity, an LLC which has two or more members, even if the members are husband and wife, can elect to be classified as a partnership for federal income tax purposes. In general, the members are treated similar to partners in a limited partnership.

If an LLC is a member-managed LLC, and all members are involved in the management of the Company, then the members will be able to take certain deductions as would a general partner of a limited partnership. If the members are active in the management of the business, then such members are not considered passive members (as would be limited partners) and therefore should not be subject to the Medicare Tax on "net investment income." A negative implication of the classification of the limited partnership comes back to the self-employment tax. Depending upon the type of business in which the LLC is engaged, it is possible that the members, because the LLC is a Member managed LLC, will be subject to the self-employment tax issues as discussed above.

Alternatively, if the LLC has elected to be a manager-managed LLC, then it is possible that one or more members is a non-active participant in the day to day operations of the company. If that is the case, then such members will likely not be subject to the self-employment tax, but will also not have the benefit of certain business expense deductions that a manager or general partner may be entitled to obtain. Additionally, depending upon the member's income, it is possible the non-active member would be subject to the 3.8% Medicare tax on "net investment income" as a result of his or her passive ownership in the entity.

The tax basis in the membership interests of an LLC which is classified as a partnership for income tax purposes is similar to the calculation for basis of a limited partnership interest as discussed above.

(c) S Corporation

A LLC may also elect treatment as a subchapter S Corporation. The qualifications to be treated as a S Corporation are discussed above and are the same for a LLC which makes such an election. One reason an LLC would make an S Corp election is if the LLC was a single member LLC. If an individual forms an LLC, but does not want the LLC to be treated as a disregarded entity, the only option is to elect for the LLC to be treated as a corporation. If the LLC elected S corporation status, then all of the tax issues related to S Corporations as discussed above would apply to such LLC, including restrictions on ownership, the tax implications of distributions, allocations of income and loss, and basis in the membership interests.

(d) C Corporation

Under the check the box rules, a LLC can also elect to be taxed as a C Corporation. If the owners are content to pay the corporate rates, plus margin tax, and then pay additional tax on dividends from the earnings of the Company, then the C Corporation is the correct election. Although all of the above may sound negative, the benefit to the C Corporation is the flexibility with corporate structure and governance.

2. Management

As mentioned above, LLC's can elect to be a Member Managed LLC or a Manager Managed LLC. In a Member Managed LLC, there is no manager, and unless expressed otherwise, the Member's manage and make decisions based upon each member's respective ownership interest. Members in a member managed LLC can still elect officer to act on a day to day basis,

[37] IRC §1402(a)

but the Members, act like both the shareholders in a corporation and the board of directors in a corporation, making all business decisions and management decisions, unless they have appointed officers to act on the company's behalf.

As opposed to a Member Managed LLC, a Manager Managed LLC appoints one or more managers to operate the company and make day to day decisions. The Members, if not serving as a manager, act like a shareholder or a limited partner. The manager is more like the general partner, president, etc… which operates the business day-to-day. A Manager Managed LLC may still have officers as well. Many times, an LLC may have more than one manager, and the managers serve in more of a board of director capacity…more involved than the members, but less involved than the officers.

The business operations of the LLC as well as what role each Member may serve is important in determining the tax treatment of the income and loss related to such Member's LLC interest; the decision should not be made without such considerations.

IV. TRUSTS

A. Simple Trusts

For purposes of this outline, and in general, when referring to a simple trust, it usually refers to an irrevocable trust that is required to distribute all of its income annually. The IRS classifies a trust as a simple trust for a taxable year if 1) the terms of the trust require that all of the trusts income be distributed annually, 2) the terms of the trust does not allow any portion of the trust to be paid to charity, and 3) the trust does not distribute any amounts during the year other than the income actually required to be distributed.[38] Although by its terms, a trust is a simple trust, the determination is technically a year-to-year determination. In general, a simple trust receives a deduction for all income distributed to beneficiaries on an annual basis.[39] The income beneficiary or beneficiaries must report the distributed income on his or her personal income tax return.[40] It is not a matter of if the income is actually distributed to the beneficiary, but whether it was required to be distributed. The beneficiary includes as income the amount that was required to be distributed.

The character of the income reported on the beneficiary's income tax return shall be the same character as the income distributed.[41] If there are multiple beneficiaries, then the allocations shall be proportional. For example, if the trust incurred 60% ordinary income and 40% capital gains income, and all is counted as income for purposes of the distribution, then 60% of whatever the beneficiary receives will be ordinary income at the beneficiary's ordinary income tax rate and 40% will be capital gains at the beneficiary's capital gains rate.

The benefit of a simple trust, as opposed to a complex trust discussed below, is the income tax efficiency. Because a simple trust is by its terms required to distribute all income, a simple trust should not have any taxable income; the income tax rate on the income should be reported and paid at the beneficiary level at the individual tax rate, which is more favorable than the trust rate.

B. Complex Trusts

A complex trust is any trust which is not a simple trust. Based on the definition of a simple trust, a complex trust is a trust that is required to accumulate income during any one year, for a year in which the trustee has the discretion to accumulate or distribute income, even if all of the income is distributed, for a year in which principal is distributed, and for a year in which a charitable contribution is made.

The taxation of complex trusts is governed generally by IRC §§661 and 662. A complex trust, like a simple trust, receives a deduction for income tax purposes for any distribution of income made to a beneficiary during the year.[42] Likewise, the beneficiary, like a simple trust, must include the distributed income on his or her personal income tax return.[43] Since a complex trust does not require all income to be distributed, and there is only a deduction to the extent the income is distributed, this may allow some income tax planning opportunities with trust income. If a trustee has discretion to distribute income, the trustee may take into account the income tax liability of the trust verses the income tax liability of the beneficiaries and decide to make a distribution to decrease the income tax liability. The trustee has up to 65 days after the end of the year to make this evaluation. A trustee may elect to treat a distribution made up to 65 days after the end of the year as the distribution was made in the prior year.[44] This rule provides some planning opportunities to shift income between years and between taxpayers to defer or reduce income tax.

[38] IRC§651(a)(1)&(2)

[39] IRC §651(a)

[40] IRC §652(a)

[41] IRC §652(b)

[42] IRC §661(a)

[43] IRC §662(a)

[44] IRC §663(b)

C. Grantor Trusts

Trusts which are considered "Grantor" Trusts are governed by Sections 671-679 of the Code and carry with them special rules regarding taxation. When using the term "Grantor" trust, it can have different meanings to different persons. Some persons think of a "Grantor" trust as a state law term referring to a revocable trust. Other's think of a grantor trusts as a tax term referring to an irrevocable trust that is taxed to the grantor for income tax purposes. It can get confusing, especially when two professionals are discussing planning or other issues and each has a different idea of what a grantor trust is. Actually, both ideas are correct. A grantor trust in the typical sense is a trust that is taxable to the creator (or possibly some other individual) for income tax purposes. In this category can be both revocable and irrevocable trusts.

Additionally, referring to the "grantor" of a trust can also be confusing. Some professionals use the term to refer to the person who created a trust…synonymous with the term "Settlor." Other professionals use the term simply to refer to the person who is taxed on the income of the trust. Many times, these are the same person, but not in every situation.

It is important to ensure that everyone is on the same page when discussing grantor trusts, especially when you are involved in planning for a client.

Overall, Section 671 of the Code states "where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual." There are many different powers that, when retained by the Settlor of a trust, or another person, will cause all or a part of a trust to be a grantor trust as to the Settlor and included in his or her estate for income tax purposes. These powers are discussed in IRC §§673-678.

There are different types of grantor trusts, but only three of the more common will be discussed below.

1. Revocable

A revocable living trust is a type of trust that is usually prepared and used in an estate planning situation to 1) avoid probate, 2) to assist in administration during a time of incapacity, or 3) to consolidate the planning of spouses into one trust, as opposed to having testamentary trusts created under both wills. These are not the only uses, but the primary uses. A revocable trust, as the name suggests, is a trust that can be revoked by the creator or another party. Revocable trusts do not provide creditor protection or asset protection and provide no estate tax benefits while the trust is revocable.

A revocable trust is taxable to the creator of the revocable trust as long as the trust can be revoked by the creator or a party who is non-adverse to the creator.[45] There is no tax return filing requirement for a revocable trust. If the revocable trust is funded prior to death in order to avoid probate or assist in administration of assets, then bank accounts or investment portfolio accounts are opened in the name of the trust in which case a tax identification number is obtained. Some practitioners obtain a separate tax identification number for revocable trusts. Others recommend using one of the grantor's social security numbers. I prefer the latter approach. Because all income, losses and deductions are reported on the grantor's income tax return, it is administratively easier to use the grantor's social security number to avoid confusion or hassle of having an additional tax identification number. As mentioned, all items of income, loss, deduction, credit, etc… of a revocable trust are reported on the grantor's income tax return.

2. Intentionally Defective Grantor Trust

Typically, when referring to an intentionally defective grantor trust ("IDGT") a practitioner is referring to an irrevocable trust that has intentionally violated one of the provisions of the internal revenue code in Sections 673-678 to achieve the purpose of the trust being taxable to the Settlor or another person for federal income tax purposes. Usually, the purpose of creating an IDGT is two-fold: 1) to create a trust that provides flexibility for future planning through installment sales, and 2) to have the grantor pay the income tax of the IDGT having the effect of annual gifts to the trust and, further reducing the grantor's estate. With the current income tax and estate tax environment, an additional benefit of an IDGT is to obtain more favorable income tax treatment on the income generated inside the trust. The income tax savings could be significant by creating a trust that continues to be taxed to the grantor for income tax purposes while removing the assets from the grantor's estate for estate tax purposes. As noted early on in this outline, a trust reaches the top income tax rate quickly and the Medicare Tax is imposed on most trust income. By creating a trust as an IDGT, the individual income tax rates of the grantor are applicable. As a rough example assume we have two trusts, a complex trust and an IDGT. The complex trust (discussed above) reports income on a separate return and pays the trust tax rates. The taxable income of the complex trust is $150,000 in income. The approximate income tax

[45] IRC §676

liability of the trust would be $65,000. Alternatively, if the trust were an IDGT, the approximate tax liability to the grantor would be $35,000, which is before any other exemptions, deductions, etc… of the individual are applied. It is apparent from this rough calculation that there are significant differences in the tax rates and the income tax liabilities depending on the type of trust.

a. Settlor IDGT

What this outline refers to as a Settlor IDGT is an IDGT that was created by the grantor, which is for the benefit of another person, such as the grantor's spouse or descendants, but continues to be taxed for income tax purposes to the grantor (Settlor). This is the most common use and what is most commonly referred to as an IDGT. In this strategy, as discussed above, taxpayer has created a trust as an IDGT and transferred assets to the IDGT, but continues to be taxed on the income of the IDGT individually. The payment of tax by the grantor is likely a lower tax liability and has the effect of the grantor making additional gifts to the IDGT and the assets in the IDGT grow free from income tax liability.

b. Beneficiary IDGT

What this outline refers to as a Beneficiary IDGT ("B-IDGT")(I prefer to refer to this trust as a "678 Trust") is an IDGT created by a Settlor for the benefit of another person, who is the beneficiary. Because of the nature of the trust terms and the design of the gift made to the trust (using IRC §678), the trust is taxed as a grantor trust as to the beneficiary; therefore, for income tax purposes, the beneficiary, and not the Settlor, is the grantor for income tax purposes. This is where the term grantor can be confusing. In this situation, "grantor" and "settlor" are not synonymous. As discussed above, the potential confusion in these terms is one of the main reasons it is good to have effective and clear communication between all professionals representing a mutual client.

The B-IDGT is advantageous because the taxpayer can transfer his or her assets to the B-IDGT by installment sale (not by gift) and continue to be taxed individually on the assets transferred. The assets are protected from creditors and the appreciation is removed from the estate and free of estate tax, but the income tax is still on the taxpayer's personal return. Effectively, the taxpayer has obtained the most favorable income tax treatment and the most favorable estate tax treatment.

3. Grantor Retained Annuity Trust

A Grantor Retained Annuity Trust (GRAT) is an irrevocable trust created by a taxpayer with the taxpayer typically retaining a partial interest in the trust for a period of time while transferring the remainder of the assets to a third party beneficiary through a remainder interest. The remainder interest is not received until some future event, which is specified in the trust agreement. A GRAT is sanctioned by IRC Section 2702 and is considered a grantor trust for income tax purposes, meaning that the grantor continues to pay the income tax of the trust.

The goal of a GRAT is for the taxpayer to transfer assets to the GRAT that are expected to appreciate in value over time. The taxpayer typically receives back an annuity interest that, by applying acceptable valuation principals, the present value of the future payments is very high in comparison to the remainder interest, resulting in a minimal gift tax upon creation (the gift tax is only calculated on the remainder interest). The annuity payment is based on the 7520 rate. As long as the assets inside the GRAT appreciate at a rate exceeding the 7520 rate, the GRAT has been successful. The greater the appreciation of an asset, such as in a liquidation or realization event of a company interest, the more successful the GRAT. This is a leverage technique designed to leverage a gift that uses a small amount of gift exemption into a large gift, as the gift appreciates. There are plenty of comparisons available to the use of a GRAT versus an installment sale to an IDGT. Both have advantages, but for purposes of this outline, both trusts are advantages for income tax purposes.

The grantor of a GRAT will be treated as the owner of the income portion of the trust as long as the retained interest exceeds 5% of the value of the trust.[46] If the value of the income interest exceeds 5% of the trust value, the grantor will be taxed on all trust income, even though the income payment may be less than all of the income. If the grantor retains certain power over corpus, such as a swap power,[47] the grantor would report on his or her income tax return all income, deduction, and credits attributable to the trust property, regardless of the 5% trust.

There are several income tax advantages to having a GRAT taxed entirely to the grantor during the annuity period. The first advantage is the obvious, dealing with the income tax differences between trusts and individuals, as discussed above. Second, if the GRAT must distribute assets in kind to the grantor to satisfy the GRAT payment, there will be no recognition of gain or loss on the distribution. Third, if the grantor actually exercised a power to substitute assets in the GRAT for other assets, there would be no gain or loss on such exchange. A GRAT is also considered to be a qualified shareholder of S Corporation stock, as the trust is wholly taxed to the

[46] IRC §673

[47] IRC §675(4)(c)

grantor, as is one of the exceptions to qualified shareholders.

V. ESTATES

In general, the taxable income of an estate is gross income minus deductions. Income of an estate is calculated in much the same manner as income of individuals, with some exceptions. The definition of gross income under IRC §61 applies to estates. Gross income from an estate is income from whatever source derived, including (but not limited to) the following items: compensation for services, gross income derived from business, gains derived from dealings in property, interest, rents, royalties, dividends, alimony and separate maintenance payments, annuities, income from life insurance and endowment contracts, pensions, income from discharge of indebtedness, distributed share of partnership gross income, income in respect of decedent and income from interest in an estate or trust.[48] It is not the intention in this outline to go through each of the types of income above, but more to point out that the gross income of an estate is similar to that of an individual. The deductions and exclusions allowed to an estate are different than that of an individual.

An estate is entitled to the deductions allowed to individuals with some exceptions. An estate may deduct expenses and losses for its activities if 1) such activity is engaged in for profit, or 2) the Code allows deductions for such activity whether or not such activity is engaged in for profit.[49] Some more common deductions allowed to estates include deductions for ordinary and necessary expenses incurred in a trade or business[50] or for the production of income[51], interest[52], taxes[53], losses[54], bad debts[55], depreciation and depletion[56], charitable contributions[57] and net operating losses.[58] Estates also are allowed special personal exemptions under IRC §642(b).

A. Income in Respect of Decedent

Income in respect of a decedent ("IRD") is an item of gross income in respect of a decedent which is not properly included on the decedent's final income tax return or any prior return, but would have been included in the decedent's income tax return as gross income if the decedent had lived to collect it.[59] IRD is based around the step up in basis rules under IRC §1014. In general, a decedent's assets receive a step up in basis at the decedent's death; therefore, any potential capital gain upon transfer to decedent's heirs and devisees is foregone. IRD attempts to classify certain items, that is, items that are treated more as a receivable in the hands of a decedent prior to death, such that the income tax on such items cannot be avoided due to death. Generally, an IRD receivable exists if (i) the decedent acted or put into motion some action that results in the receipt of money or property after the decedent's death that would have been gross income in the decedent's hands had the decedent lived, and (ii) no further material action to get the receivable would have been required by the decedent prior to his death in order to receive such income. Examples of IRD items are as follows: 1. compensation paid to the Decedent's estate after decedent's death, 2. dividends, rents or royalties received by decedent's estate after decedent's death that were earned during decedent's lifetime, 3. sales proceeds from a business transaction that was substantially completed prior to Decedent's death. All of these items of income are considered IRD and would be reported as such on the appropriate return.

Once a particular receivable is determined to be an item of IRD, the statute limits the parties who can recognize IRD to the following: 1. the decedent's estate, if the right to receive the amount is acquired by the decedent's estate from the decedent, 2. the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; and 3. the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.[60] The IRD in the hands of the recipient retains the same classification as that if such income had been received by the decedent; i.e. ordinary income is received as ordinary income and capital gains are received as capital gains.

In a discussion of IRD, it is only fair to mention deductions in respect of a decedent ("DRD"). If Congress has provided regulations for making sure items of income not otherwise captured on a

[48] IRC §61(a)

[49] IRC §183

[50] IRC §162

[51] IRC §212

[52] IRC §163

[53] IRC §164

[54] IRC §165

[55] IRC §166

[56] IRC §§167, 168, 611, 642(e)

[57] IRC §642(c)

[58] IRC §§172, 642(d)

[59] IRC §691(a)(2)

[60] IRC §691(a)(1)(A),(B)&(C)

decedent's final tax return are accounted for, then "fairness" assumes that deductions not otherwise accounted for on an income tax return will also be allowed to a decedent's estate. DRD is enacted and legislated under IRC §691(b). There are only six specifically legislated items of DRD, meaning all other items must be excluded and lost upon the decedent's death: 1) business expenses under §162, 2) deductions for interest under §163, 3) deductions for taxes under §164, 4) expenses for production of income under §212, 5) deductions for depletion under §611 and 6) foreign tax credits under §27. Unless an item of DRD falls under one of these categories, then such items is lost upon the decedent's death, and cannot be taken into account by the estate's income tax return or by a beneficiary of the estate. Notable items of expense or deduction excluded from the list are any loss carryovers, charitable deduction carryovers, or medical expenses that are unpaid at death.

An item of IRD is technically a receivable at the decedent's death and is included on the estate tax return as an asset, if an estate tax return is filed. Additionally, such amount should be applied against the decedent's estate exemption; if such exemption is not fully used by decedent, then the unused exemption would be transferred to the surviving spouse. Because the receivable is technically taxed in the decedent's estate as an asset, and because income is also realized upon receipt of the IRD item, which is subject to income tax, a deduction is allowed on the income tax return for the amount of estate tax paid related to such item's inclusion in the estate.[61] This deduction for estate taxes paid is an attempt to avoiding an item of IRD being taxed under the estate tax system and under the income tax system.

B. Election to Treat Revocable Trust as Part of the Estate

A Trustee of a "qualified revocable trust" and the executor of the decedent's estate may make an irrevocable election to treat the trust as part of the decedent's estate for federal income tax purposes.[62] A "qualified revocable trust" is any trust that on the date of death was treated as owned by the decedent under §676 by reason of a power held by the decedent.[63] By having the option to treat a revocable trust as part of the estate for income tax purposes, it provides flexibility with planning to reduce income taxes i.e. estates are allowed a charitable deduction for amounts permanently set aside for charitable purposes but post-death revocable trusts are allowed deductions only for amounts actually paid to charities.

The decision must be made with care. Once the election is made, it is irrevocable and the election lasts for a period from the date of decedent's death to two years after the decedent's death.[64]

VI. MARGIN TAX

Because this is a Texas bar course, it is difficult to discuss tax issues associated with estate planning and business entity formation without at least touching on Margin Tax. Just like every other topic covered under this outline, Margin Tax is a topic that can take up an entire outline on its own. The goal here is to point out high level facts associated with the Margin Tax to help Estate Planners in counseling clients on general effects of the formation of different entities.

The Margin Tax is a tax that replaced the Texas Franchise Tax. The Margin Tax is imposed on all businesses except (i) sole proprietorships, (ii) general Partnerships (as long as the partners are natural persons), (iii) certain passive entities, (iv) certain entities exempt from tax and grantor trusts with natural persons or charitable entities as the sole beneficiary, (v) estates of natural persons, (vi) passive investment partnerships, and (vii) real estate investment trusts and qualified REIT subsidiaries.[65] One entity that is subject to the Margin Tax that is not included in the list of exceptions is a LLC that is taxed as a disregarded entity; a LLC that is disregarded for income tax purposes is still subject to the Margin Tax.

Passive entities are not subject to Margin Tax. A passive entity is described as a general or limited partnership or a trust that (i) at least 90% or more of the income of the entity is derived from passive sources, such as dividends, interest, distributive shares of partnership income, capital gains from sale or property, royalties, etc… and ii) the entity does not have more than 10% of its federal gross income from an active trade or business.[66] An income source that is notably missing from the definition of passive income is rent income. Rent income is not considered passive for Margin Tax purposes.

The Margin Tax is imposed on businesses with gross revenue in excess of $600,000.[67] This floor is intended to provide an exemption for small businesses. If an entity is subject to the Margin Tax by receiving gross revenues in excess of the floor, the tax is calculated on the entire amount of gross revenues. The calculation is summarized as follows: The Taxable

[61] IRC §691(c)

[62] IRC §645

[63] Treas. Reg. §1.645-1(b)(1)

[64] IRC §645(b)(2)

[65] Generally see Texas Tax Code §171.0002

[66] Texas Tax Code §171.0003

[67] Texas Tax Code §171.002

Entity's gross receipts, after electing to deduct either (i) compensation or (ii) cost of goods sold (COGS). This is considered the "tax base."[68] The election must be made on or before the due date of the return and may not be amended thereafter. The Margin Tax rate is primarily 1% on the receipts (some retail and wholesale business have a rate of 0.5%)[69]; however, the tax base for the Margin Tax may not exceed 70% of a business's total revenues.[70]

Although an entity may be a pass through entity for federal income tax purposes, the Margin Tax is a tax on the entity and must be paid by the entity. Even if an entity does not owe Margin Tax in any given year, a report must still be filed with no tax due.

VII. INCOME TAX CONSIDERATIONS IN DIFFERENT PLANNING STRATEGIES

A. Entity Planning

The choice of entity should not be a decision based solely on ease of operations and level of asset protection. As noted above with the different entities, there are tax implications to each type of entity that should always be considered. If a client has a CPA, then the CPA should also be consulted. If the client does not have a CPA, then the attorney has the opportunity to refer a new client to a CPA and work with the CPA to make sure the most efficient business form is created and managed.

1. <u>Business Formation</u>

In considering the formation of a business, the practitioner should consider the issues related to income tax, self-employment tax, the Medicare Tax and Margin Tax. In addition to the usual "asset protection" planning, the practitioner needs to consider the tax ramifications to the particular client. Depending on who the practitioner represents, the type of business entity proposed may be less desirable or more desirable to one partner or member than another. It is important to understand your client and his or her role in the business. As discussed above, if the client is passive, then the Medicare Tax is likely to apply. If the client is active, depending on the business structure, there could be self-employment tax implications. If the entity is determined to be a passive investment type entity, then the client needs to consider a limited partnership to plan for Margin Tax issues.

2. <u>Conversions</u>

Although a client may have already formed an entity and may even be operating within a certain structure, it does not mean that the client must continue in that manner. There may be reasons and opportunities for the client to change corporate form; convert from one form to another for income tax purposes. The practitioner should understand the differences in the taxation of each entity and discuss these differences with the client. In recommending conversions, it is important to have a good idea of the client's business, where they are headed and where they have been. It is very important when discussing and considering entity conversions, to involve the client's CPA in the discussions. Conversions can be very beneficial, but it is most likely that the CPA is going to have a good idea of the tax ramifications of the conversion based on the history of the Company. There may be short-term tax disadvantages to a conversion, but make sure the long-term is evaluated. In the long-term, the conversion may be a valid option and more economically viable.

An example of short-term versus long-term tax considerations is a conversion from a C Corporation to an S Corporation. As discussed in this outline, there are certain income tax advantages to S Corporations and many shareholders of C Corporations have decided to execute a conversion. One of the tax effects of converting to an S Corporation from a C Corporation relates to built-in capital gains. If there are assets with built-in gains upon the conversion, any sell of those assets and recognition of gain related to such sell within 10 years of the conversion date is taxed as if the sell occurred in a C Corporation. The gain is taxed at the corporate rate.[71] Short-term, this may be a negative tax consequence, but long-term the conversion my still make sense.

3. <u>Dividing Business Lines</u>

With all of the different taxes to plan for, it may be necessary to evaluate the effects of dividing businesses into two or more lines of business. A company may be operating multiple lines of business under one entity; said business lines may be taxed differently and there may exist tax efficiencies that can be achieved by breaking entities into two or more entities to achieve different tax advantages.

A simple example is a limited partnership which owns investments in stocks, bonds, royalties, etc… and also owns real estate that earns rental income. Depending on the percentage of income each contributes to the whole, it may be desirable to divide the partnership into a real estate partnership and an investment partnership, the real estate partnership

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[68] Texas Tax Code §171.101

[69] Texas Tax Code §171.002

[70] Texas Tax Code §171.101

[71] IRC §1374. The 'recognition period" is only 5 years (IRC §1347(d)(7)(B)(ii) for 2013, which may be a good opportunity to recommend clients convert from a C Corporation to an S Corporation, if the client has been considering it.

being subject to the Margin Tax and the investment partnership being exempt from the Margin Tax.

A more complicated example of a division is the division of a corporation into different business lines under the tax-fee reorganization statutes.[72]

B. Estate Considerations

1. Step-up in Basis

As discussed in the introductory paragraph, as the estate tax has been made "permanent" at 40%, and the income tax has increased to 39.6%, plus the Medicare Tax, there is a shift in focus from saving on estate taxes to planning for income taxes. A primary way practitioners are beginning to shift this focus is in the arena of bypass trusts. With the inception of Portability under the Tax Relief, Unemployment Insurance Reauthorization and Jobs Creation Act of 2010, spouses can now use their deceased spouse's unused exemption amount. Now it is more important than ever to ensure that a client's estate plan is i) in accordance with the client's wishes and ii) appropriately structured to provide the most tax efficiencies. It is important to consider whether the Bypass Trust is a good fit for each client. Using a testamentary bypass trust, or revocable bypass trust, in the creation of an estate plan may still be desirable if there are asset protection concerns for the surviving spouse. A step-up in basis is still achieved at first death and the assets are protected in the trust.[73] The negatives to the bypass trust is the possible income taxation of the assets inside the trust and the loss of ability to achieve another step-up in basis at the death of the surviving spouse. These are issues that must be considered and discussed with clients as the estate plan is being structured. The clients are going to look to the practitioner for the practitioner's expert opinion.

Step-up in basis considerations also play into the consideration of making a lifetime gift to an inter-vivos trust or keeping the assets in the estate until death. The donor's basis in an asset is carried over if a gift is made outright or to an inter-vivos trust. It may be more desirable to take the chance on paying estate tax and keeping the asset in the estate as opposed to making a lifetime gift. The type of trust also goes into this consideration, which is discussed below.

2. Charitable Giving

Charitable giving may take on a more extensive role as clients not only wish to avoid estate tax, but also wish to reduce, defer or eliminate income taxes associated with the assets that are left in the estate at the client's death. Consider the uses of split interests trusts as remainder beneficiaries to provide a reduction or elimination of estate taxes and a deferral of income taxes, depending upon the type of structure used. A charitable lead trust will pay income tax during its term, but will receive charitable income tax deductions upon distributions of the income interest to a charity. The estate tax deduction is calculated based upon the present value of the gift to charity based upon future payments. Upon termination, the remainder beneficiaries receive the assets. A charitable remainder trust will pay an income interest to individuals and the income tax character of the assets inside the trust flows out to the income beneficiaries and is reported on the beneficiaries' returns. The CRT is tax free except to the extent distributions are made to beneficiaries. The remainder of the CRT goes to charity. Upon the grantor's death, an estate tax deduction is received for the present value of gift of the remainder interest to charity.

3. Gifting to Parents

Another strategy is to use a portion of a taxpayer's estate tax exemption to give low basis assets to the taxpayer's parents. Upon the taxpayer's parent's death, they may leave the assets in trust to the taxpayer. The taxpayer receives the assets back with a step-up in basis and the assets are out of the taxpayer's estate. There are many technicalities that would need to be worked out with this strategy, but it does have some merit in the right situation. The taxpayer may be concerned about the possibility of mom and dad leaving the assets to taxpayer's sibling. The taxpayer may want to consider using a revocable trust and granting a general power of appointment over the assets for the benefit of mom and dad. In this manner, mom and dad have a right to assign the assets elsewhere. This should work to include the assets in mom and dad's estate and achieve the step-up in basis. Again, there are technicalities that would need to be worked out with this strategy.

C. Trust Considerations

If a client has determined that he or she would like to make an inter-vivos gift, or otherwise remove assets from his or her estate for estate tax purposes, it is important to consider the following when determining what type of trust to recommend.

1. Types of Assets

The first consideration is the type of asset that will be transferred to the trust.

a. Long-Term Appreciation

If the asset is a long-term appreciation asset, then a complex trust, in which the trust pays income tax, may be a good option. The asset does not produce a high amount of income on a regular basis and annual

[72] Generally covered by IRC §355. An outline by Bourland and Willey is referenced in the reference materials

[73] IRC §1014

income tax liability may not be an issue. A GRAT may also be considered with this type of asset, especially if it is expected to appreciate quickly in the future. If the taxpayer desires to remove the asset from his or her estate today, and is not worried about receiving the benefit from the future realization event, a GRAT will allow the trust to be taxed to the taxpayer, but the appreciation will be distributed to the GRAT remainder beneficiaries.

b. Income Producing

If the asset produces a high amount of income, then a complex trust is likely not the most tax efficient trust. A simple trust may work well if the taxpayer is not worried about distributing all of the income to the beneficiary. If the grantors are concerned about mandatory distributions or distributing all of the income out annually because of creditor or spendthrift issues, the taxpayer will not be interested in creating a simple trust. The taxpayer may still consider a complex trust if the taxpayer would like the option to make distributions. By using a complex trust, distributions can be made or withheld. The income flows out to the beneficiary to the extent the distribution is made and the trust receives a deduction. Additionally, the Trustee can elect for distributions made up to 65 days after the calendar year-end to be reported in the previous year. This allows the trustee to evaluate the income of the trust for the period and determine if it is "good planning" to make distributions of income to the beneficiaries. If the income stays in the trust, then it will likely be subject to the Medicare Tax on most of the income, as it is likely the income will be classified as net investment income. The income will be classified the same when distributed to the beneficiaries, but the level at which the Medicare Tax applies to individuals is much higher than trusts, as noted above.

The taxpayer may consider making the trust a grantor trust, where the tax flows through to the taxpayer (grantor), providing flexibility in distributions and receiving individual income tax rates. If a swap power is added to the trust document, another advantage of the grantor trust is the ability of the taxpayer to swap assets from the taxpayer's estate to the grantor trust and take the assets of the trust back into the taxpayer's estate. This may be important where the assets gifted are low basis assets and have appreciated in value. By the taxpayer pulling the assets back into his or her estate, the assets will receive a step-up in basis at the taxpayer's death.

c. S Corp Stock

As discussed above there are restrictions on the type of trust that can be an S corporation shareholder. If the taxpayer wishes to make a gift of S corporation stock, then the trust must be a grantor trust, a complex trust that qualifies and elects to be an Electing Small Business Trust or a trust that qualifies and elects to become a Qualified Subchapter S Trust. As mentioned above in the discussion of S Corporations, the practitioner should understand the tax implications of each trust.

2. Goals

a. Asset Protection for Beneficiaries

An intentionally defective grantor trust is the most tax efficient manner to provide asset protection for trust beneficiaries. Depending on the terms of the trust, the Trustee may withhold trust distributions from the trust beneficiaries without being concerned about increased income taxes at trust income tax rates. If the taxpayer is not willing to pay the income taxes, the next best option is a Complex Trust, such trust not requiring income distributions. The complex trust will pay income tax at trust tax rates and will receive deductions only when income is actually distributed to beneficiaries.

b. Protect Corpus – Provide Income

If the goal of the taxpayer is just to protect the corpus but to provide income to the beneficiary, then a grantor trust or simple trust will be most tax efficient. The simple trust will distribute all income resulting in the beneficiary paying taxes at the individual tax rate while protecting the corpus. The grantor trust will allow the taxpayer to pay taxes at the individual tax rate and provide more flexibility in distribution of income.

3. Manner of Funding

The manner of funding a trust is an important consideration when creating a trust.

a. Gift or Devise

If the taxpayer wishes to make a gift and retain no future enjoyment of the assets, then a complex trust, simple trust or IDGT will all be suitable. The taxpayer's basis will transfer to the trust. If the trust is a complex trust or simple trust, the trust will pay income tax (reduced by income distributed) at trust tax rates. If the trust is a grantor trust, then the grantor will pay the income tax. If the taxpayer wishes to retain flexibility for future funding, then the taxpayer may wish to create an IDGT and make a gift to such trust. In the future, the taxpayer can transfer assets to the IDGT by an installment sale, discussed below. The benefit of the IDGT in this situation is the ability to swap assets (assuming this provision is in the terms of the trust agreement). By retaining the ability to swap assets, the taxpayer may place different assets in the trust of equivalent value in exchange for the trust assets. This may be done to receive a step-up in basis of the assets upon the taxpayer's death.

A simple trust, complex trust or grantor trust will all be sufficient to receive assets from the estate upon the taxpayer's death. A revocable trust is also a good option for receive assets from the taxpayer's estate upon the taxpayer's death, but asset transferred to a revocable trust during life do not qualify as a gift for gift tax purposes.

b. Loan

A taxpayer may wish to create an irrevocable trust and make a loan to the trust at the applicable federal rate. This is an underused technique and provides the trust the advantage of obtaining assets at a low interest rate to invest. It also freezes the growth of the assets in the taxpayer estate at a very low interest rate. If the loan is made to a complex trust or simple trust, then the taxpayer must report interest income upon the receipt of interest payments. Likewise, the trust may deduct the interest expense against the trust income. However, if the loan is to a grantor trust, and the taxpayer is the grantor, then the transaction is not recognized for income tax purposes and no interest income or expense is reported.

c. Installment Sale

In addition to making gifts, a taxpayer may wish to transfer assets to an IDGT or B-IDGT by installment sale. In this transaction, assets are transferred to a trust in exchange for consideration based upon the fair market value of the assets transferred. The consideration is usually in the form of an installment note or private annuity. In an installment sale, the basis in the hands of the taxpayer is transferred to the IDGT. Although this transaction is a sale to the IDGT and "adequate and full consideration" is paid to the taxpayer from the IDGT, the transaction is not recognized for income tax purposes; therefore, the basis of the asset is not increased. This type of transaction is not a gift and is not considered a taxable sale by the internal revenue service, assuming the taxpayer transferring the assets is also considered the grantor of the trust. The benefits to this transaction are as follows: 1) this type of transaction does not use the taxpayers gift, estate or generation-skipping transfer tax exemption, 2) the taxpayer freezes the value of the assets in the taxpayer's estate, and 3) the value remaining in the taxpayer's estate is reduced with future distributions (assuming a note) or in the case of annuity, is not included in the taxpayer's estate at death. From an income tax perspective, the trust is a grantor trust, so the income of the IDGT or B-IDGT is taxed to the grantor for income tax purposes, avoiding the trust income tax rates. The interest charged on the promissory note (if used) is not recognized due to the nature of the transaction. As mentioned above, the assets transferred retain the taxpayer's basis, but the same power to substitute assets can exist, therefore providing flexibility in the future to receive a step-up in basis if the power is exercised.

If a grantor transfers assets to an IDGT by installment sale using a promissory note, and the taxpayer dies while the promissory note is still outstanding, there is likely a taxable event that occurs at that moment. There are different theories of what occurs, but the main issue is when did the transfer of the assets received for the promissory note from the grantor to grantor's estate occur. If the transfer is deemed to have occurred immediately prior to death, then gain is reported on the decedent's final income tax return to the extent the value of the note exceeds the decedent's basis in the property sold to the IDGT. If the sale would qualify for installment treatment under IRC §453, gain or loss is reported on the decedent's estate's annual income tax return as payments on the note are received. In this instance, gain would be deemed income in respect of a decedent and no basis adjustment would occur. Another theory is that the instant of death is the triggering event. If this is the case, then the transfer could not have occurred immediately prior to death, but by reason of death. Therefore, since the seller of property is not the decedent but his or her estate, the provisions of IRC §1014(a) would apply to revalue the basis of the asset and no gain or loss would apply. Finally, there is the Rev. Rule 85-13 argument that all the estate owns at the decedent's death is a note which receives a basis adjustment, that the assets in the trust were always owned by the trust at the grantor's basis upon transfer of the assets to the trust.

d. Retain Future Benefit

If the taxpayer would like to remove assets from his or her estate, while retaining some future benefit, the options become more limited.

All of the options involve a grantor trust and have the same income tax treatment related to the trust, but there are certain advantages to the different options.

A GRAT may be used to transfer assets out of the taxpayer's estate, while retaining a benefit. The taxpayer receives an annuity interest for a set time and at the end of the term of the GRAT, the remainder of the assets are transferred to the remainder beneficiary. One negative to the use of a GRAT is GST exemption; A GRAT cannot be allocated GST exemption until the term of the GRAT. This is usually not an ideal option. Additionally, if a taxpayer dies during the term of the GRAT a portion of the assets are included in the taxpayer's estate.

An installment sale to an IDGT is another option. The taxpayer can retain a future benefit through note or annuity payments based on the assets transferred. This is technically not a future benefit, but consideration for the assets transferred, but it works much the same way. As long as the taxpayer is comfortable with the amount of income that he or she will receive, then the installment sale acts as future benefit received. There is an income and estate tax risk with this method. As discussed in 3.c. above, there are income tax risks if a grantor dies with a promissory note still in his or her estate. There are also estate tax consequences. If the taxpayer dies while the note is still outstanding, the value of the note is also included in the taxpayer's estate.

An installment sale to a B-IDGT is another option. In this option, the installment sale works exactly the same. The difference is, the taxpayer retains benefit as a creditor as well as a beneficiary. As the taxpayer receives note payments, the taxpayer can use those note payments to make income tax payments. Once the note is paid off, the taxpayer continues to receive benefit as a beneficiary of the trust. The difference between the use of an IDGT and B-IDGT is that the taxpayer continues to receive the benefit of the trust assets; the taxpayer should not be as concerned about the continued income tax liability associated with the B-IDGT.

Lastly, a taxpayer may wish to create a Charitable Remainder Trust. This type of trust allows the taxpayer to retain a benefit of the assets during his or her lifetime with the remainder going to charity. By creating this type of trust, as discussed above, the only income tax that is paid is the income that flows out to the taxpayer through unitrust or annuity payments. Any income inside the CRT is deferred until distributed to the taxpayer or is not recognized upon the ultimate distribution to the charitable remainder. The taxpayer receives an income tax charitable contribution deduction that he or she can report on his or her personal income tax return. The amount of the deduction is based upon the calculated remainder interest transferred to charity upon the creation of the CRT.

4. Basis Step-Up

It is difficult for a taxpayer to make a gift or otherwise transfer assets to an irrevocable trust and retain the ability to obtain a step-up in basis at the taxpayer's death. The only real option is the option that has already been mentioned several times above; the taxpayer may create an IDGT or a third party may create a B-IDGT for taxpayer and the taxpayer can transfer the assets by gift or installment sale to such trust. In the trust document, the taxpayer should retain a right to substitute assets of equivalent value. If the taxpayer believes there is a financial benefit from receiving a step-up in basis on the assets currently in the trust, and the taxpayer has assets of equivalent value in his or her estate which can be transferred to the trust, the taxpayer can swap the assets. In this manner, new assets are in the trust and the trust assets are included in the taxpayer's estate upon his or her death, receiving a step-up in basis to the then fair market value without incurring any capital gains tax.

APPENDIX "A"

Tax Rate	Single Filers	Married Filing Jointly or Qualifying Widow/Widower	Married Filing Separately	Head of Household
10%	Up to $8,925	Up to $17,850	Up to $8,925	Up to $12,750
15%	$8,926 - $36,250	$17,851 - $72,500	$8,926 - $36,250	$12,751 - $48,600
25%	$36,251 - $87,850	$72,501 - $146,400	$36,251 - $73,200	$48,601 - $125,450
28%	$87,851 - $183,250	$146,401 - $223,050	$73,201 - $111,525	$125,451 - $203,150
33%	$183,251 - $398,350	$223,051 - $398,350	$111,526 - $199,175	$203,151 - $398,350
35%	$398,351 - $400,000	$398,351 - $450,000	$199,176 - $225,000	$398,351 - $425,000
39.6%	$400,001 or more	$450,001 or more	$225,001 or more	$425,001 or more

APPENDIX "B"

ATTENTION ENTITY CONTROL – CONVERSION OF AN ESBT TO A QSST PURSUANT TO SECTION 1.1361-1(m)

Department of Treasury
Internal Revenue Service Center
Ogden, Utah 84201-0012

Re: Conversion to Qualified Subchapter S Trust

This is an election by The __________________ Trust – Trust S (EIN _______________) (the "Trust") as a shareholder of ______________________ (EIN _______________) (the "Corporation") to convert from an Electing Small Business Trust "ESBT" under section 1361(b)(3) of the Internal Revenue Code to a Qualified Subchapter S Trust under Section 1361(d)(2) of the Internal Revenue Code. This conversion is made in accordance with Treasury Regulation 1.1361-1(m)(7). All of the required information is provided below:

1. The Current Income Beneficiary of the Trust is:

   ____
   SS#: ______________
   Address: ______________________

2. This is an election under §1361(d)(2) of the Internal Revenue Code.

3. The effective date of this election is __________________.

4. This trust meets all the requirements to qualify as a Qualified Subchapter S Trust as follows:

   a. All trust income will be distributed currently to one individual beneficiary who is a citizen of the United States

   b. There will only be 1 current income beneficiary

   c. Corpus will only be distributed to the income beneficiary

   d. The income beneficiary's interest terminates upon the earlier to occur of the beneficiary's death or termination of the Trust.

   e. If the Trust terminates during the lifetime of the current income beneficiary, the assets of the Trust will be distributed to the income beneficiary.

Sincerely,

The ______________________ Trust – Trust S

____
___________________, Trustee and Current Income Beneficiary

APPENDIX "B"

SAMPLE ESBT ELECTION

Department of Treasury
Internal Revenue Service Center
Ogden, Utah 84201-0012

RE: ELECTING SMALL BUSINESS TRUST (ESBT) ELECTION

The trustee of the ____________________________ Trust hereby elects under IRC §1361(e)(3) to treat the trust as an electing small business trust that is qualified to hold S corporation stock pursuant to IRC §1361(c)(2)(A)(v). The following information is also provided:

Corporation Name, Address, ID#:

1. Corporation: _______________________
   Address: ________________________
   EIN: ________________________

2. Trust: _____________________
   Address: _____________________
   EIN: _______________________

3. Beneficiaries

   Name: ______________________
   Address: ______________________
   EIN: ________________________

   Name: ______________________
   Address: ______________________
   EIN: ________________________

4. This election is made under IRC §1361(e)(3).

5. The date (or dates) on which the stock of the corporation was transferred to the trust is ________________________.

6. The date on which the election is to be effective is ________________________.

The trustee meets the definitional requirements of IRC §1361(e)(1) and all potential current beneficiaries of the trust meet the shareholder requirements of IRC §1361(b)(1).

Signed:

______________________________ ______________________
Trustee Date

APPENDIX "B"

SAMPLE QSST ELECTION

Department of Treasury
Internal Revenue Service Center
Ogden, Utah 84201-0012

Re: Qualified Subchapter S Election

This is an election by The _________________ Trust (EIN _______________) (the "Trust") as a shareholder of ___________________ (EIN _______________) (the "Company") to convert elect treatment as a Qualified Subchapter S Trust under section 1361(d)(2) of the Internal Revenue Code. All required information is provided below:

1. The current income beneficiary of the Trust is:

    ____
    Social Security Number ________________
    Address ____________________

2. This is an election under §1361(d)(2) of the Internal Revenue Code.

3. The effective date of this election is ____________________.

4. This trust meets all the requirements as a Qualified Subchapter S Trust as follows:

    a. All trust income will be distributed currently to one individual beneficiary who is a citizen of the United States

    b. There will only be 1 current income beneficiary

    c. Corpus will only be distributed to the income beneficiary

    d. The income beneficiary's interest terminates upon the earlier to occur of the beneficiary's death or termination of the Trust.

    e. If the Trust terminates during the lifetime of the current income beneficiary, the assets of the Trust will be distributed to the income beneficiary.

Sincerely,

____

____

_________________, Beneficiary

APPENDIX "C"

Listed of Other Helpful Materials
The Materials Below Expand on Different Topics Addressed in this Outline

1. Heckerling Musings 2013 and Other Current Developments. The Estate Planner's Playbook for 2013 and Going Forward Under the Post-ATRA "New Normal" of Permanent Large Exemptions and Portability. February 2013. Steve R. Akers, Bessemer Trust.
2. Estate Planning with GRATs, Amanda R. Doslich, presented at the State Bar of Texas Intermediate Estate Planning Course, June 26, 2012.
3. Funding Testamentary Trusts: Tax and Non-Tax Issues. Mickey R. Davis, State Bar of Texas 19th Annual Advanced Estate Planning Strategies Course, April 4-5, 2013.
4. Drafting Grantor Trusts and the Documents that Go With Them. William B. Rasmussen, State Bar of Texas 22nd Annual Estate Planning and Probate Drafting Course, October 20, 21, 2011.
5. How to Organize Your Business with Respect to the Estate Tax Situation. Michael V. Bourland and Dustin G. Willey. State Bar of Texas Essentials of Business Law, April 14-15, 2011.
6. Choice of Entity Decision Tree. Byron F. Egan. Choice and Acquisition of Entities in Texas 2012. May 25, 2012.