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WHAT HAPPENS TO SUSPENDED LOSSES
WHEN S CORP SHARES
MOVE INTO OR OUT OF A TRUST?

Decedent held S corporation shares in his living trust. The shares are now in a Section 645 administrative trust that is treated as an estate for S corp *eligibility* purposes. The trust is the shareholder for S corp *pass-through* purposes. While in the admin trust, the S corp incurred losses that exceeded the trust's basis in the shares. The trust did not have any loans receivable (which could also have absorbed losses) from the S corp. So the losses were suspended. Now the trustee is ready to distribute the shares to a QTIP trust (that will make a QSST election) and to a credit shelter trust (that will make an ESBuT election). What will happen to the suspended losses?

When a trust distributes S corp stock, losses that were suspended for lack of basis can disappear. It all depends on who is treated as the shareholder for S corp pass-through purposes (not for S corp eligibility purposes) before and after the distribution from the trust.¹ If the same taxpayer is

treated as holding *some* of the shares *both* before *and* after the trust distribution, then all of that taxpayer's suspended losses are preserved. If a taxpayer is treated as a shareholder of the

(footnote continued from preceding column)

¹ It's important to distinguish two sets of rules. One set tells us whether a particular trust is eligible to hold S corp shares. A different set tells us who pays tax on the in-

come attributable to those shares. Eustice & Kuntz, FEDERAL INCOME TAXATION OF S CORPORATIONS (RIA) at ¶¶ 3.03[7], 3.03[9] (4th Ed. 2001 and Supp. March 2011). When S corp shares are held in trust, the general rules for who pays the tax are found in Treas. Reg. § 1.1361-1(h)(3).

S corp *before* but not *after* the trust distribution, that taxpayer's suspended losses disappear.²

In a 1993 private letter ruling involving a proposed “defective grantor trust” arrangement, the Service concluded that Dad could use his suspended losses after he set up the defective grantor trust, because Dad would still be deemed the shareholder for purposes of Section 1366.³

Let’s get back to our example of the trust with the Section 645 election. The trust is treated as the shareholder

for pass-through purposes. When the trust transfers all of its shares to the beneficiaries, the suspended losses will disappear, because the trust does not retain any shares of the S corp. Tax-wise, when all of the S corporation shares move from the trust to the beneficiaries, the shares effectively “shed” the suspended losses. The good news is that under the right circumstances Section 645 trusts can hold S corp shares for a long time. All other things being equal, it might make sense to keep the trust in place (for example, by using Section 6166 to pay the estate tax) until the S corp generates profits sufficient to absorb the suspended losses.

When a surviving spouse with a QTIP trust elects QSST status to allow the QTIP trust to hold S corp stock, the beneficiary/surviving spouse is treated as the shareholder for all S corp purposes. If some or all of the S corp shares are transferred from the QTIP trust to the surviving spouse (for example, in an exchange with the survivor’s trust for other assets so that the surviving spouse can eventually gift the shares), the suspended losses should remain in place (at least until the gift). This is because the surviving spouse is treated as the shareholder for S corporation purposes *both* before *and* after the transfer from the QTIP/QSST trust. When the surviving spouse dies and the shares are dis-

² Re-acquiring shares will not resuscitate the suspended losses. The suspended losses do not follow the shares at the death of the shareholder or if the shares are gifted or sold. If the shares are transferred between spouses or at their divorce, the losses are allocated between them. The suspended losses generally follow the shares through corporate reorganizations. See generally Eustice & Kuntz at ¶ 9.05 fns 280-286; see also S. Starr and H. Sobol, S CORPORATIONS: OPERATIONS, Tax Mgmt. Port. (BNA) (No. 731 at fn 722 (2d ed. 2012).

³ LTR 93-35-028, June 4, 1993. It would be nice to have revenue rulings addressing distributions from other types of trust, but I did not find any.

tributed to the children, her suspended losses will disappear.

Here is a chart that shows when losses suspended for lack of basis will disappear at some typical transitions:

S corp shares are transferred:		Effect on losses suspended for lack of basis
From (deemed shareholder)	To (deemed shareholder)	
Individual	Grantor trust (grantor) ⁴	Losses continue to be suspended
	Estate of decedent (estate)	Losses disappear
	Testamentary trust (trust)	Losses disappear
Grantor trust of husband and wife (husband and wife)	Survivor's trust at death of first spouse (surviving spouse)	If the S corporation shares were community property at death, the spouse's losses continue to be suspended
	Administrative trust at death of a spouse (trust)	Losses disappear
Administrative trust created at death or testamentary trust (trust)	QTIP/QSST (surviving spouse)	Losses disappear
	Credit shelter trust/ESBuT (ESBuT)	Losses disappear

⁴ This is the 1993 private letter ruling transaction. This would include an ESBuT that is a grantor trust with respect to its "S portion." See Treasury Reg. § 1.641(c)-1 (ESBuT as grantor trust; "S portion" defined).

S corp shares are transferred:		Effect on losses suspended for lack of basis
From (deemed shareholder)	To (deemed shareholder)	
QTIP/QSST (surviving spouse)	Survivor's trust (surviving spouse)	Losses continue to be suspended
	Administrative trust at death of a spouse (trust)	Losses disappear
	Credit shelter trust/ESBuT (trust)	Losses disappear
Credit shelter trust/ESBuT (ESBuT)	Children	Losses disappear

There is no rule that allows suspended losses to be used by the beneficiaries. Contrast the specific rule of Section 642(h) that allows net operating loss carryforwards and capital loss carryforwards to be used by the residuary beneficiaries.

Note that S corp shares can never be held in a foreign trust.

If there is sufficient basis to absorb a loss, the loss is next tested for

the “at risk” and passive activity limitations, in that order. Temp. Treas. Reg. § 1.469-2T(d)(6)(i).

I would be pleased to discuss with you ways to protect suspended losses and the valuable S corporation status.

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