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Estate Planning with S Corporation Stock

S corporations have long been the business entity of choice for many Oregon companies. With the passage of Measure 67 and the resulting increased tax on C corporations, S corporation elections in Oregon will likely increase.

In the estate planning realm, there are many opportunities to pass stock in S corporations from one generation to the next in a tax advantageous way, but it is important to keep in mind certain limitations and restrictions when working with S corporations.

The tax code puts various restrictions on the number and types of shareholders an S corporation may have. Only three types of trusts may hold S corporation shares: grantor trusts, qualified sub-chapter S trusts (QSST), and electing small business trusts (ESBT). Estates are also permitted S corporation shareholders for a reasonable period of administration.

Whether engaged in simple planning with a revocable living trust or testamentary trust or complex planning such as selling a business interest to an intentionally defective grantor trust, estate planners need to be aware of the S corporation rules at every step in the process to ensure that an estate or business succession plan does not inadvertently terminate the business's S election. The purpose of this article is to review the types of trusts and estates that can hold S corporation shares and discuss briefly some of the estate planning opportunities and pitfalls involving S corporations.

Eligible Shareholders

The following are eligible S corporation shareholders in the estate planning context.

Grantor Trusts. A "grantor trust" is a trust that is deemed to be owned by an individual grantor or beneficiary under IRC §§ 671-679. A grantor trust may be an S corporation shareholder. IRC § 1361(c)(2)(A)(i). The deemed owner of the trust is treated under IRC § 1361(c)(2)(B)(i) as the shareholder for purposes of the eligibility rules. As a result, the individual grantor or beneficiary must be a U.S. citizen or resident.

Revocable Trusts Within Two Years of Death. If the entire corpus of a revocable trust is includible in the settlor's taxable estate, then the revocable trust remains an eligible shareholder for up to two years following the settlor's death. Once the eligibility period expires, the trust is treated as the shareholder (provided that the trust did not previously distribute the stock). Treas Reg § 1.1361-1(h)(1)(ii). Whether the corporation's election continues depends on whether the trust is an eligible shareholder at that time (e.g., a qualified subchapter S trust or an electing small business trust).

Testamentary Trusts Within Two Years of Receipt. A testamentary trust can qualify as an S corporation shareholder for a period of up to two years beginning on the date that it received the S corporation stock from the decedent's estate pursuant to the terms of a will. IRC § 1361(c)(2)(A)(iii). As with revocable trusts, a testamentary trust may

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continue as a permitted shareholder after the end of the two-year period by becoming an ESBT or an electing QSST. *See* Treas Reg § 1.1361-1(h)(3)(i)(D)).

The estate is not, however, treated as the shareholder for purposes of reporting the income (or loss) of the S corporation. The trust and/or its beneficiaries report any income or loss passed through from the corporation. Treas Reg § 1.1361-1(h)(3)(ii).

Estates. An estate is an eligible shareholder of an S corporation. IRC § 1361(b)(1)(B). Generally, an estate may remain an eligible shareholder for a reasonable period of time to conduct the administration of the estate. An estate cannot remain in existence and remain an eligible shareholder indefinitely. *See, e.g.*, Old Va. Brick Co. v. Comm'r, 367 F2d 276 (4th Cir 1966).

Qualified Sub-Chapter S Trusts. A qualified sub-chapter S trust with respect to which a beneficiary makes an *election* shall be treated as a grantor trust as described in IRC §§ 1361(c)(2)(A)(i) and 1361(d). The election can be made up to two and a half months after the trust becomes a shareholder or two and a half months after the beginning of the first taxable year in which the S corporation election is to be effective. IRC § 1361(d)(2).

Presently, automatic relief for late QSST elections may be granted under Revenue Procedure 2003-43, which provides a simplified procedure for QSSTs (as well as S corporations, ESBTs, and qualified subchapter S subsidiaries or "QSubs") to obtain relief from late elections. If the trust cannot obtain relief because it cannot meet the requirements of Rev Proc 2003-43, the QSST's only recourse is to request a private letter ruling.

To qualify as a QSST, the terms of the trust must require that (i) during the life of the current income beneficiary, there will only be one income beneficiary of the trust (thus, a spray or sprinkle trust for multiple beneficiaries cannot qualify); (ii) corpus distributions during the current income beneficiary's life can be made only to that beneficiary; (iii) the current income beneficiary's income interest must terminate on the earlier of the current beneficiary's death or the termination of the trust; and (iv) if the trust terminates during the current income beneficiary's life, the trust's assets are all distributed to the current income beneficiary.

In addition, IRC § 1361(d)(3)(B) requires that all the trust's income (as defined under IRC § 643(b)) must be either distributed or required to be distributed currently to only one individual who is a citizen or resident of the United States. Although a QSST by definition can have only one current income beneficiary, it is possible to have multiple beneficiaries provided that the trust creates separate shares for each beneficiary.

A final word of warning on QSSTs: The trust must be eligible *and* the election must be properly made in accordance with these rules. Under IRC § 1362(d)(4), an ineligible shareholder will terminate a corporation's S status. Although sometimes an ineligible shareholder can hold S corporation stock momentarily, *see, e.g.,* Rev Rul 72-320, a drafter should be careful to make sure the trust, as drafted, qualifies as a QSST or other trust eligible to own S corporation stock.

Electing Small Business Trusts. A trust is eligible to become an electing small business trust if no interest in the trust was acquired by purchase and all of its beneficiaries are individuals, estates, or charitable organizations. IRC § 1361(e)(1)(A). The following trusts are not eligible to be ESBTs: (i) a QSST with respect to which an election under Section 1361(d)(2) is in effect; (ii) a trust exempt from tax under subtitle A; and (iii) any charitable remainder annuity trust or charitable remainder unitrust. IRC § 1361(e)(1)(B). The ESBT trustee must file the ESBT election within the time requirements prescribed for QSST elections.

An ESBT is treated as two separate trusts for purposes of determining its income tax liability. Treas Reg § 1.641(c)-1. The two separate trusts are referred to as the "S portion" and the "non-S portion." The S portion is that portion of the trust that consists of S corporation stock and is not a grantor trust. The tax on the S portion is determined by reference to the general rules for the taxation of trusts but with certain modifications provided in Section 641(c), including the requirement that the S portion is subject to the highest trust rate of tax.

Tax-Exempt Organizations. An organization described in IRC §§ 401(a) (pension, profit-sharing, and stock bonus plans) or 501(c)(3) (charitable organizations) that is exempt from tax under IRC § 501(a) is eligible to be a shareholder in an S corporation. IRC §§ 1361(b)(1)(B), 1361(c)(6). The two classes of Section 501(c)(3) charitable organizations—public charities and private foundations—are primarily distinguished by the degree of public involvement in the charities. Public charities receive a greater portion of support from public sources and have greater interaction with the public, whereas private foundations receive the bulk of their support from a primary donor and investment income, and are typically controlled by single families or small groups of individuals.

To ensure that private foundations employ their resources for charitable purposes and do not misuse them, restrictions and various excise taxes are imposed on private foundations to compensate for their lack of public accountability. Due to these restrictions and excise taxes, private foundations may not be the best shareholders for S corporation stock.

Voting Trusts. A trust created primarily to exercise the voting power of stock transferred to it may be a shareholder of an S corporation. IRC § 1361(c)(2)(A)(iv). Treasury Regulation § 1.1361-1(h)(1)(v) provides guidance in structuring a qualified voting trust under the S corporation rules.

Planning Considerations and Opportunities

Revocable Living Trust. Many estate planning clients elect to use a revocable living trust instead of a will as the main document in their estate plan. This can be a useful technique to help avoid

probate, but if the client owns stock in an S corporation, a drafter needs to be mindful of that asset while preparing the documents.

A revocable living trust can hold S corporation shares while the settlor is living because it is a grantor trust. It also can hold S corporate shares for two years following the death of the settlor without a QSST or an ESBT election. However, following that two-year period, the revocable trust ceases to be an eligible shareholder in its own right and will need to qualify to be an S corporation shareholder in some other way.

When administering a revocable trust following the death of the grantor, lawyers need to docket that two-year date to ensure that either all S corporation shares are distributed from the administrative trust or that the administrative trust qualifies as an S corporation shareholder by making a QSST or ESBT election. Ideally a revocable trust is distributed fully within two years of the settlor's death, but that timing is not always possible. As a practice tip, if a revocable trust (i.e., a grantor trust under IRC § 676 during the settlor's lifetime) makes a § 645 election to be taxed as part of the decedent's estate, then a testamentary trust (i.e., the Administrative Trust) that receives S corporation stock from such trust is an eligible S corporation shareholder for the duration of the § 645 election (i.e., until distribution of the Administrative Trust to the beneficiaries or further sub-trusts). *See* T.D. 9078, 68 Fed. Reg. 42251 (July 17, 2003).

When drafting a revocable trust that creates additional trusts that will be funded upon the settlor's death, a drafter needs to ensure that the additional trusts will not inadvertently cause the termination of the S election for any company owned by the trustee. Either the trusts need to qualify to be S corporation shareholders or the revocable living trust or the company's shareholder agreement needs to provide a method for the trustee to sell the S corporation shares or have them redeemed by the company.

For the standard marital deduction tax plan, a qualified terminable interest property ("QTIP") trust will most likely qualify for a QSST election if drafted properly. The beneficiary must be sure to make that election timely. Not all standard credit shelter trusts (e.g., trusts with discretionary distributions) will necessarily qualify for QSST or ESBT elections, so the drafter needs to ensure that the terms of the credit shelter trust will qualify for such an election should the credit shelter trust need to hold S corporation shares.

When drafting trusts that will be eligible to hold S corporation shares upon the settlor's death, a drafter may create separate shares within those trusts that will hold the S corporation shares and will be eligible for QSST or ESBT elections. The remaining shares of the trust may have terms more flexible than those allowed for QSSTs or ESBTs.

If a revocable living trust provides that some or all of the residue of the trust estate will pass to charity, the drafter should determine whether a distribution of any S corporation shares could be made to a private foundation. Private foundations owning S corporation shares can be problematic due to the excise tax on excess business holdings under IRC § 4943. Additionally, a private foundation may be taxed currently, without a corresponding tax distribution, on income allocated to it by an S corporation pursuant to the unrelated business taxable income ("UBTI") rules under IRC § 511.

Wills. When drafting wills, a drafter needs to take the same care as with revocable trusts to ensure that any testamentary trusts will qualify as S corporation shareholders if they will continue for more than two years following funding.

Irrevocable Trust Funded During Life (Non-Grantor Trust). An irrevocable trust that is not a grantor trust must qualify for ESBT or QSST election from the outset. The election must be made within two and a half months of when the trustee receives the S corporation shares, but the trust must qualify as an S corporation shareholder from the day the trustee receives such shares.

To maximize flexibility in trust distribution provisions, the drafter may elect to create separate trusts to hold S corporation assets and other assets or may elect to create separate shares within one trust agreement. The separates shares within one trust agreement will be accounted for as if they were separate trusts, but the client will have the convenience of one trust agreement. The non-ESBT or non-QSST elected shares may have distribution provisions that are more flexible than the elected shares.

Irrevocable Trust Funded During Life (Grantor Trusts). An irrevocable trust that is a grantor trust during the settlor's lifetime (or until the settlor releases all grantor trust powers) may have more flexible terms during the period that it is a grantor trust than after grantor trust status terminates. Powerful estate planning techniques, such as sales to intentionally defective grantor trusts, use grantor trusts that might continue to exist after the grantor has passed away or released grantor trust powers. In such cases, the drafter needs to ensure that the trust will qualify as an S corporation shareholder immediately upon the termination of grantor trust status.

A drafter should use caution when the irrevocable trust has Crummey withdrawal rights because certain types of Crummey withdrawal rights could cause the trust to be treated as having two grantors. *See* Rev. Rul 81-6, Treas. Reg § 1.671-3(a)(3). A trust with two grantors will not qualify as an eligible S-Corporation shareholder, because IRC § 1361(c)(2)(A)(i) requires that a permissible grantor trust is one where "all of which" is treated as owned by an individual (emphasis added). In various private letter rulings, the IRS has concluded that a trust with Crummey withdrawal rights can qualify as a grantor trust eligible to hold S corporation stock. To qualify, the trust document must allow the beneficiary the right to withdraw, from corpus, all contributions. The lapse of that withdrawal right, combined with the beneficiary's income interest, will cause the beneficiary to be treated as the owner of all trust property under the grantor trust

rules. *See, i.e.*, PLRs 200147044, 9625031. However, where a beneficiary has only a discretionary income interest in trust, or a Crummey withdrawal power over only corpus (and not income), the exception to the two-grantor treatment that is provided in IRC § 678(b) may not apply to the trust. Either way, the only commentary from the IRS permitting Crummey trusts as S-corporation shareholders is in the form of private letter rulings, which cannot be relied upon as mandatory authority. Given that Revenue Ruling 81-6 interprets a Crummey trust as having dual-grantor status, the client should decide whether having a Crummey trust for the benefit of obtaining annual exclusions for gifting purposes outweighs the potential risk of a lost S-election.

Like the options for continuing trusts created pursuant to a revocable living trust, a grantor trust that holds S corporation stock can create separate trust shares to hold that S corporation stock upon the termination of the grantor trust status. Those separate shares must qualify for QSST or ESBT election. Shares of the trust that hold non-S corporation stock may continue to have more flexible terms. The QSST or ESBT elections must be made timely, but the trust shares that qualify for the election must so qualify immediately upon the termination of grantor trust status.

QSST vs. ESBT. A qualified subchapter S trust must have only one income beneficiary. If any trust principal is distributed from the QSST during the term of that income interest, it must be distributed to that income beneficiary. All income must be distributed annually to the income beneficiary. These distribution requirements are much more strict than those for ESBTs.

Electing small business trusts may have multiple income beneficiaries so long as all such beneficiaries are individuals, estates, or certain charities. No beneficiary may purchase its interest in the ESBT. An ESBT may distribute income annually or retain some or all trust income. These more flexible distribution terms can make ESBTs more appealing than QSSTs, but the differing income tax treatment often make QSSTs the better choice.

Because all QSST income must be distributed to the sole income beneficiary at least annually, all income is reported by that individual beneficiary. The beneficiary pays the income tax attributable to the S corporation shares in the QSST at the individual's income tax rate. That is not the case for ESBTs. Income tax attributable to the S corporation shares in an ESBT will be paid by the ESBT at its income tax rates, *regardless of whether that income is distributed to the ESBT beneficiaries.* Because trusts reach the highest income tax rates at levels of income much lower than individuals, this can cause an ESBT to generate significantly higher income tax liabilities than would a QSST.

Conclusions

A drafter must be careful when drafting and planning estates that contain stock in S corporations. Two primary traps are transferring S corporation stock to ineligible shareholders and failing to make necessary elections, for example, QSST or ESBT election. If a trust is to receive S corporation stock, the provisions of the trust must qualify under, and the appropriate elections must be made in accordance with, IRC § 1362. Failure to draft revocable or testamentary trusts with these rules in mind may lead to an inadvertent termination of the corporation's S election upon the death of the grantor. Additionally, failure to make the appropriate post-mortem elections may lead to an inadvertent termination.

With the likely increase in S corporation election in Oregon, estate planners are going to face planning for S corporation owners more and more. Taking a few precautions to ensure that the documents are drafted properly can save not only time and expense for fixing problems after the death of a settlor or testator, but also potentially great expense as a result of an inadvertent S election termination.

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Pinnacle of the Pantheon Award

At the Estate Planning and Administration Section's June CLE, Jonathan Levy presented Warren Deras with the Section's first-ever Pinnacle of the Pantheon Award. The Executive Committee of the Section created the award to honor Warren for his many years of service to the Section. Warren has assisted with legislative reform over the course of his career and in recent years has been a frequent contributor to the Section's listserv, providing detailed and thoughtful analysis of almost every question posted.

Tax Procedure Issues for Estates and Trusts

Both federal and Oregon law allow a fiduciary to request that the statute of limitations regarding tax issues associated with a decedent's estate be shortened by means of a prompt assessment, or that the fiduciary be released from personal liability for tax. This article discusses those procedures, along with the procedure to be followed to obtain income tax refunds payable to a decedent, and recent developments regarding notice concerning fiduciary relationships.

In this discussion, fiduciary liability should be distinguished from transferee liability. A fiduciary is personally liable if the fiduciary distributes assets without paying taxes or making adequate provision for taxes. Transferee liability is imposed on a beneficiary who has received assets from an estate or trust that did not pay or make provision for taxes. A fiduciary who is also a beneficiary will be exposed to both fiduciary liability and transferee liability. Fiduciary liability and transferee liability are imposed by a combination of federal and state law. In particular, federal law relies to a large extent on various state laws to aid in the imposition of fiduciary liability and transferee liability.

This article is based in part on an earlier article by two of my partners: Philip N. Jones & Peter J. Duffy, *New Rules Apply to Oregon Income Tax Issues in Estate Administration*, Oregon Estate Planning & Admin. Section Newsletter (Mar. 1996).

Form 56 Notice Concerning Fiduciary Relationship

Fiduciaries, such as a personal representative or a trustee, are required to give the IRS written notice of the fiduciary relationship so that future notices from the IRS will be sent to the fiduciary, not to the decedent. Form 56 (Notice Concerning Fiduciary Relationship) or Form 56 F (where the fiduciary is a financial institution) can be used for this purpose. In the past, a Form 56 has usually not been filed when an Estate Tax Return (Form 706) is filed, on the theory that all of the required information is contained in the Form 706. Recently, however, the IRS has been requiring the filing of a Form 56, even in cases where the IRS closing letter for the estate has already been issued. As a result, a Form 56 should be filed with every federal estate tax return. For most taxpayers, the Form 56 should be completed to include personal income tax returns (perhaps going back three years), the estate tax return, and fiduciary income tax returns (perhaps going forward a few years).

Decedent's Individual Income Tax

Federal Income Tax

The normal federal statute of limitations for income tax liability is three years from the date a return was filed, plus one additional year for transferee liability. IRC §§ 6501(a), 6901(c). The statutory period is extended to six years if more than 25% of gross income was omitted, and the period is unlimited if the return was false or fraudulent, or if no return was filed. IRC § 6501(c), (e).

A personal representative of an estate can make two elections to limit exposure to possible federal income tax liability resulting from the individual income tax returns of the decedent:

Request for Prompt Assessment. A personal representative may file a Form 4810 under IRC § 6501(d) to elect to require the IRS to assess individual income taxes within 18 months following the election. This same form can be used to require that fiduciary income tax and gift taxes be assessed within the same time period. After the 18-month period has expired, tax assessments are no longer allowed.

Release from Personal Liability. Under IRC § 6905(a), a fiduciary may file a Form 5495 to limit the personal liability of the personal representative for taxes asserted within nine months after the form is filed. This form is limited to estates and may not be filed by a trustee. Although the personal liability of the personal representative will be limited by filing this form, transferee liability is not limited. As a result, if the personal representative is also a beneficiary, the effect of this election will be limited. Treas Reg § 301.6905-1(a).

Oregon Income Tax

Oregon has adopted a three-year statute of limitations for income tax returns, similar to the federal three-year rule. ORS 314.410, 314.310(4). The Oregon limitations period is extended to five years if 25% or more of gross income was omitted and is unlimited if the return was false or fraudulent, or if no return was filed. ORS 314.410(2), (4)(a).

As under federal law, Oregon law permits fiduciaries to make two elections to limit exposure to possible federal income tax liability resulting from the individual income tax returns of the decedent:

*Request for Prompt Assessmen*t. ORS 316.387 provides a procedure for cutting off potential income tax liabilities arising out of individual and fiduciary returns. If a fiduciary files an Oregon Form 150-101-151, the Department of Revenue may issue a deficiency notice no later than 18 months after receipt of the form. The election applies only to individual and fiduciary income tax returns filed "during the period of administration"; returns filed by the decedent during the decedent's lifetime do not receive the benefit of the shortened period. The election applies to both the decedent's individual returns and the fiduciary income tax returns of an estate or trust. (Although Oregon Form 150-101-151 is somewhat ambiguous, the statute refers to both personal representatives and trustees.) The form recites that

copies of all relevant returns should be attached to the form, in addition to being listed on the form. If the form is filed, no reply will be sent by the Department of Revenue.

If the election is made, any deficiency notice issued after 18 months is invalid, with the following exceptions:

- Omission of 25% or more of income, in which case a deficiency notice may be issued within five years after the return was filed;
- A false or fraudulent return, or no return was filed, in which case no limitations period applies;
- If a federal change is made, a deficiency notice can be issued within one year after the Department of Revenue is notified (by the IRS or by the taxpayer) of the federal change. The one-year period does not shorten any of the longer periods described above.

If the election is made, both fiduciary and transferee liability will end after 18 months, with the exceptions noted above. For returns for which no election was made, however, both fiduciary and transferee liability will continue for the normal limitations period (generally three years for fiduciary liability and one year thereafter for transferee liability).

Release from Personal Liability. Oregon law also permits a personal representative to request a release from personal liability for the decedent's individual returns, but not for fiduciary income tax liability. ORS 316.387(4). The request must be made in writing. The same form described above is used for this purpose. See Oregon Form 150-101-151. If no notice of deficiency is received within nine months after making the request, the fiduciary is relieved of any personal liability, except to the extent estate assets are still in the hands of the fiduciary. Although this release does not affect transferee liability, the request is still beneficial to corporate fiduciaries and other non-beneficiary fiduciaries because they will have no liability after nine months, assuming they have not retained any assets.

The shortened time periods described above will not limit the joint and several liability of the surviving spouse for any returns filed jointly with the decedent. This liability would continue to exist as to the surviving spouse for the normal limitations period.

Because the shortened period for assessment of Oregon tax does not apply if a federal adjustment is made, practitioners will want to consider filing both the Oregon election and the federal election at the same time, so the shortened periods of assessment will be the same. Many practitioners, however, routinely do not make any of these elections, perhaps assuming that the risk of audit and assessment is low. ORS 316.387(3).

Fiduciary Income Tax

Federal Fiduciary Income Tax

Request for Prompt Assessment. A personal representative may file a Form 4810 under IRC § 6501(d) to elect to require the IRS to assess fiduciary income taxes within 18 months following the election. This same form can be used to require that individual income taxes and gift taxes be assessed within the same time period.

Oregon Fiduciary Income Tax

Request for Prompt Assessment. As discussed above, ORS 316.387 provides a procedure for cutting off potential Oregon income tax liabilities arising out of individual and fiduciary returns. The manner and effect of this election are discussed above.

Despite the possibly low risk, perhaps the most significant effect of these rules for fiduciaries is that liability of unpaid taxes cannot be eliminated entirely. Personal liability for some taxes can be eliminated after nine months, and others will be released after an 18-month waiting period, but it is not possible to close an estate or terminate a trust without some federal or Oregon income tax liability remaining a possibility. At the time of final distributions, and possibly upon partial distributions, fiduciaries may wish to obtain indemnifications from the distributees concerning any unpaid income taxes, perhaps as part of the distribution receipts.

Estate and Inheritance Tax

The statutes described above apply to the decedent's individual income tax returns and the post-mortem fiduciary income tax returns of an estate or trust. They do not apply to federal estate taxes or Oregon inheritance taxes.

Estate Tax

IRC § 2204(a) provides that an executor of an estate may request a release from personal liability from federal estate tax. If such a release is requested, the IRS must notify the executor of any additional estate tax due, and after that amount is paid the executor will be released from personal liability. The IRS must issue the notice within nine months after the request is made. If the personal representative pays that tax, then the personal representative will be released from personal liability. If no response is received from the IRS within the nine-month period, then the executor is released from personal liability for any deficiency thereafter determined. This request is made by including the following sentence in the cover letter transmitting the estate tax return to the IRS:

> In accordance with the provisions of Section 2204 of the Internal Revenue Code, I hereby make application for prompt determination of the amount of federal estate tax due and discharge from personal liability related to the enclosed tax return.

Unlike IRC § 6501(d), this statute does not shorten the period for assessments. It also does not release the estate tax lien on estate assets. However, requests under IRC § 2204 are rarely made, because the IRS typically sends a closing letter within six to eight months after a federal estate tax return is filed. Although a closing letter is not a legally binding commitment that

the estate tax liability of the estate or trust will not be adjusted, such adjustments following the issuance of a closing letter are exceedingly rare. As a result, most personal representatives simply rely on the closing letter as an indication that assets may be distributed with little risk of a liability for estate taxes arising subsequently. However, the closing letter is not a formal release, and thus is not as safe as a § 2204 release.

Even if a request is made to release personal liability for estate taxes, that release will have little effect if the fiduciary is also a beneficiary, because the estate tax lien on the assets will still apply to the assets received by the beneficiaries, including the assets received by the fiduciary as a beneficiary.

Fiduciaries other than executors (such as trustees) may make a similar request under IRC § 2204(b), but the request will result in a release from personal liability only if the executor of the estate has obtained a release under § 2204(a). As a result, if a decedent dies with a revocable trust and no probate is conducted, then the trustee of the trust cannot obtain a release from liability under either § 2204(a) or § 2204(b). The release of the trustee will take place upon the release of the executor or, if later, within six months after the trustee's application is filed. The application must include a copy of the trust instrument, a description of the property transferred from the decedent or his or her estate, and any other information that would be relevant to a determination of the trustee's tax liability. For more information, see IRC § 2204 and the regulations thereunder.

Inheritance Tax

Pursuant to ORS 118.265, personal representatives and trustees may request a prompt determination of the Oregon inheritance tax and seek a release of the fiduciary's personal liability for the tax from the Department of Revenue. These two requests may be made by filing Oregon Form 150-103-005. Upon receipt of the request, the department is required to notify the fiduciary of the amount of tax due. That notice of tax due is required to be given "[a]s soon as possible, and in any event within 18 months of the application." ORS 118.265(1)(a). After the payment of any tax specified in the notice, the fiduciary "shall be" discharged from personal liability, and the department will send the fiduciary a receipt or release to that effect. ORS 118.265(2). Administrative rules will be adopted to describe this procedure in more detail. ORS 118.265(3). A special version of the 18-month rule is provided in the unusual circumstance that an estate makes a request for a release before the return is filed. ORS 118.265(1)(b).

This procedure became effective on January 1, 2010, but it is not limited to returns filed after that date. As a result, any estate may file a request for release on or after January 1, 2010, including estates that have filed returns previously.

The ability to request a release for a previously filed return presents an issue brought about by the Oregon tax amnesty program, which ran from October 1, 2009, to November 19, 2009. Under that program, ORS 314.469, an estate could apply for "amnesty" and then file a past-due return or an amended return and pay past-due taxes for an inheritance tax return originally due before January 1, 2008. If certain other conditions are met, the Department of Revenue will waive all penalties and half of the interest that would otherwise apply.

However, as an "incentive" for taxpayers to participate in the amnesty program, if a taxpayer decides to not participate in the program (or was simply unaware of the program) but later is found to owe tax on a return that would have been eligible for the amnesty program, then that taxpayer will be subject to an additional penalty of 25% of the tax due, in addition to all of the previously due penalties and interest, with no reduction under the amnesty program. For example, if in 2010 an estate requests a release for an inheritance tax return that was originally timely filed in 2007, and that request for release causes the department to review the return, and the department determines that additional tax is due, the department could assert an additional 25% penalty for failure to have participated in the amnesty program. As a result, estates may wish to review their situations carefully before requesting a release for returns due before January 1, 2008. Those estates may prefer to simply allow the statute of limitations to expire. See below regarding the Oregon statute of limitations on the collection of inheritance tax.

ORS 118.265 does not repeal ORS 118.250, which requires that the Department of Revenue issue receipts for inheritance tax paid. As a result, the department will presumably continue to issue the same receipts that it has been issuing for the last several years.

It is important to note what this statute does not do. It releases the personal representative from personal liability, but it does not release the beneficiaries. If the fiduciary is also a beneficiary, that person's potential liability will continue. Although the statute does not so state, the Request for Discharge form published by the Department of Revenue indicates that the discharge is not effective to the extent that the fiduciary remains in possession or control of estate assets. Beneficiaries remain liable to the extent of assets received by them, ORS 118.270, and the statute of limitations on collecting tax from them is not limited by this statute. As a practical matter, however, a release of the fiduciary will likely serve as an indication that the Department of Revenue has examined the return and does not intend to seek any additional taxes. But it might possibly (although unlikely) mean that the department feels it will be able to collect any additional tax from the beneficiaries. Fiduciaries remain responsible to notify the Department of Revenue within 90 days, either through an audit or an amended return, in the event of a change in the federal tax liability. *See* ORS 118.100; Form IT-1 instructions at 2. The 90-day period is not statutory, nor does it appear in the regulations; it appears only in the Form IT-1 instructions.

ORS 118.265 also corrects a flaw in prior Oregon law, which inadvertently did not impose any statute of limitations on the collection of inheritance tax by the Department of Revenue or on the claiming of refunds by estates. The statute imposes a three-

year statute of limitations on deficiencies. It does so by adopting the three-year income tax statute of limitations on deficiencies, which is ORS 314.410. With regard to refunds, ORS 118.227 adopts the income tax statute on refunds, ORS 314.415, which imposes a period equal to the latter of three years from when the return was filed or two years from when tax was paid, whichever is later, within which to file a refund claim. These statutes are similar to the corresponding federal statutes. Although the Oregon income tax deficiency statute extends the period to five years if 25% or more of gross income was omitted from the return, and the federal estate tax statute extends the statutory period to six years if the estate omitted more than 25% of its assets, the inheritance statute makes no mention of a 25% omission from the gross estate, so presumably the extended five-year period (or six-year period) does not apply to the inheritance tax.

The statute of limitations on deficiencies does not begin running until a return is filed.

ORS 118.265 became effective on September 28, 2009. However, it appears to apply to all inheritance tax returns, including those filed in the past.

Obtaining a Refund for a Deceased Taxpayer

Often a family member or a fiduciary will need to obtain an income tax refund on behalf of deceased taxpayer. An income tax return showing a refund due constitutes both a tax return and a refund claim. Such a return should be filed to obtain a refund, even if a return is not otherwise required to be filed. In some cases, the decedent will have already filed his or her return (and refund claim) before death. In other cases, your client will need to file the return after the date of death. The procedure to be followed depends on who your client is.

Surviving Spouse Filing a Joint Return

Federal. If no personal representative has been appointed before the due date of the income tax return, a surviving spouse can file a joint income tax return with the decedent and claim a refund on that return. If a personal representative has been appointed, a surviving spouse and the personal representative can file a joint return for the decedent and the surviving spouse. The personal representative should attach to the return a copy of his or her letters testamentary or other evidence of court appointment. See Form 1310 instructions (Statement of Person Claiming Refund Due a Deceased Taxpayer); IRS Publication 559.

If the surviving spouse has received a refund check in joint name with the deceased spouse, the surviving spouse can return the check to the IRS along with Form 1310 to request that a new check be issued in the sole name of the surviving spouse. *See* Form 1310 instructions.

Oregon. As with the federal return, the instructions to Oregon Form 40 provide that a surviving spouse can file a joint return with a deceased spouse if no personal representative has been appointed. If a personal representative has been appointed, the personal representative and the surviving spouse should both sign the joint return. If the surviving spouse has received a refund check in joint name with the deceased spouse, the surviving spouse can return the check to the Department of Revenue along with Oregon Form 243 to request that a new check be issued in the sole name of the surviving spouse. *See* Oregon Form 243 instructions.

Court-Appointed Personal Representative Filing for an Unmarried Decedent

Federal. A court-appointed personal representative filing a decedent's original federal income tax return can claim a refund by attaching to the return a copy of his or her letters testamentary or other evidence of court appointment. However, a personal representative filing an amended return (Form 1040X) or a Claim for Refund (Form 843) is required to file a Form 1310 with the return. The Form 843 is rarely used; a Form 1040X is usually used instead of a Form 843.

A refund check received by a personal representative in the name of a decedent who filed an income tax return before his or her death but died before receiving the refund can be deposited into the estate's checking account. Because a probate is open, the check need not be returned to the IRS.

Oregon. A personal representative or affiant under a small estate affidavit can file an Oregon income tax return for a single decedent or a joint return with the surviving spouse of a married decedent. A refund check issued in the name of the decedent can be cashed by the personal representative or affiant. If a check made payable to the decedent is received after a probate has been closed, the surviving spouse, trustee, or other family member can return the check to the Department of Revenue along with Oregon Form 243 to have the check reissued in the proper name. See Oregon Form 243 instructions.

Trustee or Non-Spouse Family Member

Federal. Form 1310 can be used to obtain a refund where there is no surviving spouse or court-appointed personal representative. Thus, a trustee or non-spouse family member can obtain a refund by attaching to the decedent's final income tax return a Form 1310 and a copy of the decedent's death certificate. (If a personal representative has been appointed, only the personal representative can obtain a refund.)

Neither Form 1310 nor its instructions indicate that it can be used by a non-spouse, non-personal representative to return a refund check issued in the name of a decedent. However, if the only alternative is a probate or a small estate affidavit, consider returning the check with a completed Form 1310 and a request that the check be reissued.

It is important to note that a Form 1310 is not a refund claim. A refund claim (either an original return showing a refund due or an amended return showing a refund due) must be filed in all cases where a refund is due. Form 1310 is merely a mechanism to arrange for the check to be made payable to the correct person.

Oregon. A trustee or family member can file Oregon Form 243, together with Oregon Form 40, to obtain a refund when there is no surviving spouse (who will file a joint return) or court-appointed personal representative. A family member can also use Form 243 to obtain the reissuance of a refund check payable to the decedent. However, a trustee who receives a check made payable to a decedent is required to wait at least six months from the date of death before the trustee can file a Form 243 and request that the check be reissued. The apparent reason for requiring a six-month delay for a trustee is that the instructions to Form 243 state that a trustee should be able to cash a check issued in the name of the decedent. Unfortunately, this is not true. A trustee, unlike a personal representative, cannot cash checks made payable to a decedent. As a result, the six-month requirement seems unnecessary.

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The Trustee's Duty of Expeditious Distribution Under the Oregon Uniform Trust Code

Probate administration attorneys understand, at a fundamental level, that a court-appointed personal representative has a statutory duty to administer the probate estate efficiently and without undue delay. The duty is statutory, after all: "A personal representative is a fiduciary who is under a general duty to and shall collect the income from property of the estate in the possession of the personal representative and preserve, settle and distribute the estate in accordance with the terms of the will and ORS chapters 111, 112, 113, 114, 115, 116 and 117 as expeditiously and with as little sacrifice of value as is reasonable under the circumstances." ORS 114.265.

However, even three years after the effective date of Oregon's version of the Uniform Trust Code, some practitioners seem unaware that the trustee of an ordinary will substitute revocable living trust has the same duty of expeditious distribution upon the death of its settlor. That duty is codified at ORS 130.730(2): "Upon the occurrence of an event terminating or partially terminating a trust, the trustee shall proceed expeditiously to distribute the trust property to the persons entitled to the property. The trustee may retain a reasonable reserve for the payment of debts, expenses and taxes." The duty to distribute is a fiduciary duty. ORS 130.720(2). In the absence of the structure created by the strict timelines of the probate code, including ORS 115.005's four-month period after publication for filing claims, administrative attorneys and individual trustees sometimes find themselves behaving as if there are no rules, or even guidelines, about when and how a trustee must distribute trust assets to its ultimate beneficiaries.

This behavior probably flows from a misunderstanding of the word "termination," which is a term of art in the Uniform Trust Code and in trust administration generally. Individual trustees especially may equate "termination" with "final distribution" and believe that a trust terminates only when the trustee performs his or her last act. In fact, the death of the settlor of a will substitute revocable living trust is an event "terminating or partially terminating" that trust. The Restatement makes it clear:

> [T]he "termination date" of a trust means the time at which it becomes the duty of the trustee to wind up administration of the trust. This time ordinarily arrives at the expiration of the period for which the trust was created ***, not at the time when distribution is actually accomplished. Thus, for example, the termination date of a trust for L for life, remainder to R, arrives upon L's death ***.

Restatement (Third) of Trusts § 89 cmt a (2007); *see also A. Scott & W. Ascher*, *5 Scott and Ascher on Trusts* § 36.1 (5th ed 2008) (*citing* Restatement (Third) of Trusts § 89); *Lowery v. Evonuk*, 95 Or App 98, 101 (1989).

Thus, the "termination" of a revocable living trust takes place when its settlor dies. All of the necessary post-death administration that follows, including the marshaling and consolidation of assets, the payment of claims, and the determination and payment of tax liabilities, constitutes "winding up." The broad powers of the trustee, set forth generally at ORS 130.720 and specifically at ORS 130.725, change upon termination. At that point, the trustee is directed to "exercise the powers appropriate to wind up the administration of the trust and distribute the trust property to the persons entitled to the property." ORS 130.725(26). The official comment to ORS 130.725(26) reinforces that "even though the trust has terminated, the trustee retains the powers necessary to wind up the administration of the trust and distribute the remaining trust property." Valerie J. Vollmar, *The Oregon Uniform Trust Code and Comments*, 42 Willamette L Rev 187, 376 (2006). Read together with ORS 130.730(2)'s explicit allowance of a "reasonable reserve for the payment of debts, expenses and taxes," the statute strongly suggests that, unlike an ordinary probate administration, the administration of a will substitute revocable living trust should include early partial distribution as the rule, rather than the exception. In other words, as early in post-death administration as possible, the trustee should estimate a reasonable reserve and distribute the balance of the trust corpus. There are sound practical reasons beyond the statute's mandate for the trustee to do exactly that.

For example, distribution of a beneficiary's full distributive share satisfies that beneficiary's interest in the trust; a fully satisfied beneficiary is no longer a permissible distributee as defined by ORS 130.010(10). Consequently, the beneficiary is no longer entitled to notice, trustees' reports, and the like. In particular, when a beneficiary is entitled only to a specific gift of personal property, or a small pecuniary gift, satisfying that beneficiary's interest early reduces the administrative demands on the trustee as well as providing closure to the beneficiary.

Perhaps a more important reason for distribution is the elimination of moral hazard for the trustee. A trustee who holds assets longer than necessary after a termination event faces the very real possibility that real property or securities will decline in value. The trustee is liable for such depreciation if he or she has unreasonably delayed liquidation or distribution of the assets. Restatement (Second) of Trusts § 345 cmt f (1987). Faced with the risk of liability to the beneficiaries because of such a decline, a trustee may continue to hold property and hope that the market will make up the losses, thereby reducing his or her exposure. A trustee who does so is engaging in speculative investment (a breach of the duty of prudent investment), is acting from a personal motive (a breach of the duty of loyalty), and is doing so in continued violation of the duty of expeditious distribution. The trustee will be in a much better position if he or she does not hold declining assets in the first place.

There is no hard and fast rule about what is "expeditious enough." A trustee who is historically familiar with the assets of the trust and the decedent's liabilities—for example, an adult child who has been managing her parent-settlor's affairs for years—may be able to estimate the liabilities of the trust, set a reasonable reserve, and distribute the bulk of a trust's assets immediately after the settlor's death. More complicated situations, including valuation issues in taxable estates, apportionment concerns, pending litigation, or unclear or incomplete funding, may require more administrative work before even partial distribution can take place. However, so long as the trust estate is patently solvent, such concerns should affect only the size of the reasonable reserve, not the timing of distributions.

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New Editor-in-Chief Announced

This issue of the Newsletter is Susan Gary's last issue as Editor-in-Chief. The Editorial Board has selected Sherry McConnell as the next editor. Sherry practiced estate planning for eight years, first as an associate and later as a partner, with Hershner Hunter, LLP in Eugene. Her duties with the Marine Corps Reserve sent her to Iraq for two years from 2003 – 2005. She then served for three years as the Clerk of Court for the United States District Court for the District of Oregon. Sherry now practices estate planning in McMinnville, Oregon. Comments about the newsletter and articles for the newsletter can be sent to Sherry.

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