11

ESTATE PLANNING ISSUES FOR S CORPORATIONS

TURNEY P. BER
C. CARTER RU
Wyatt, Tarrant & Combs, L
Louisville, Kentu

I. [11.1] Overview .....

II. [11.2] Drafting Trusts to Own S Corporation Stock .....

A. [11.3] *Crummey* Trust .....
B. [11.4] Section 2503(c) Trust .....
C. [11.5] Charitable Remainder Trusts .....
D. [11.6] Charitable Lead Trusts .....
E. [11.7] Grantor Retained Annuity Trusts ("GRAT") .....
F. [11.8] Lifetime QTIP Trusts .....
G. [11.9] Testamentary QTIP Trusts .....
H. [11.10] Exemption Equivalent Trusts .....
I. [11.11] Trusts for Issue .....
J. [11.12] Trust Division for Exemption Equivalent Trust and Trusts for Issue .....

III. [11.13] Advisory Committees .....

IV. [11.14] Allocation of Business Interests Among Family Members .....

I. [11.1] Overview

These materials will discuss drafting trusts to hold S corporation s drafting with advisory committees, and drafting to allocate business inte among family members. To the extent that an estate plan includes par ships or limited liability companies, no special drafting is typically requ However, specific drafting is required to ensure that an S corporation's s is preserved through the estate planning process.

II. [11.2] Drafting Trusts to Own S Corporation Stock

Under the Internal Revenue Code, only certain kinds of trust permitted S corporation shareholders. IRC § 1361(c)-(d). IRC § 1361((A) provides that the following trusts (other than foreign trusts, whic not permitted) are permitted as shareholders [annotations in brackets pr non-exhaustive "real world" examples]:

(i) A trust all of which is treated...as owned by an individual who is a citizen or resident of the United States [*e.g.*, a grantor trust]. IRC § 1361(c)(2)(A)(i).

(ii) A trust which was described in [IRC § 1361(c)(2)(A)(i)] immediately before the death of the deemed owner and which continues in existence after such death, but only for the 2-year period beginning on the day of the deemed owner's death [*e.g.*, a revocable trust included in a decedent's taxable estate under IRC § 2038]. IRC § 1361(c)(2)(A)(ii).

(iii) A trust with respect to stock transferred to it pursuant to the terms of a will, but only for the 2-year period beginning on the day on which such stock is transferred to it [*e.g.*, a revocable trust pursuant to a "pour-over" estate plan, or a trust that is the object of a testamentary power of appointment]. IRC § 1361(c)(2)(A)(iii).

(iv) A trust created primarily to exercise the voting power of stock transferred to it [*e.g.*, a voting trust] IRC § 1361(c)(2)(A)(iv).

(v) An electing small business trust ("ESBT"). IRC § 1361(c)(2)(A)(v).

Among the permitted trusts listed above, some, such as revocable trusts and voting trusts, are used for non-tax reasons. Others, such as grantor trusts and ESBTs are used in income tax and transfer tax planning.

Shareholder eligibility results under IRC § 1361 are not uniform; outcomes vary widely depending on the precise manner in which S corporation shares are owned at the decedent's death. For instance, a revocable trust or trust established by Will may hold S corporation stock for 2 years after the stock is transferred to it, but an estate may hold S corporation stock for the period of reasonable administration (which, in the event an election has been made under § 6166, may last for the entire 15 year period). Rev. Rul. 76-23, 1976-1 CB 264; *see also,* PLR 200226031; PLR 7951131. Overall, however, shareholder eligibility requirements under IRC § 1361 make it necessary for S corporation stock to be disposed of shortly after an owner's death, unless the stock will pass to individual(s) or a trust that is a permitted long-term owner (*e.g.*, a qualified subchapter S trust ("QSST") or an ESBT).

IRC § 1361(d)(3) describes the attributes of a *qualified subchapter S trust*:

> (3) Qualified Subchapter S Trust. For purposes of this subsection, the term qualified subchapter S trust means a trust:
>
> (A) the terms of which require that:
>
> (i) during the life of the current income beneficiary there shall be only 1 income beneficiary of the trust,
>
> (ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary,
>
> (iii) 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
>
> (iv) 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, and
>
> (B) all of the income (within the meaning of section 643(b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States.

A substantially separate and independent share of a trust withi
meaning of § 663(c) shall be treated as a separate trust for purposes o
subsection and subsection (c).

Section 1361(e) sets forth the requirements of an *electing s*
business trust:

> (e) Electing small business trust defined
>
> (1) Electing small business trust
>
> For purposes of this section-
>
> (A) In general
>
> Except as provided in subparagraph (B), the term "electing small business trust" means any trust if –
>
> (i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in paragraph (2), (3), (4), or (5) of section 170c, or (IV) an organization described in section 170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary,
>
> (ii) no interest in such trust was acquired by purchase, and
>
> (iii) an election under this subsection applies to such trust.
>
> (B) Certain trusts not eligible
>
> The term "electing small business trust:" shall not include:
>
> (i) any qualified subchapter S trust (as defined in subsection (d)(3)) if an election under subsection (d)(2) applies to any corporation the stock of which is held by such trust,
>
> (ii) any trust exempt from tax under this subtitle, and
>
> (iii) any charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)).

(C) Purchase

For purposes of subparagraph (A), the term "purchase" means any acquisition if the basis of the property acquired is determined under section 1012.

(2) Potential current beneficiary

For purposes of this section, the term "potential current beneficiary" means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust (determined without regard to any power of appointment to the extent such power remains unexercised at the end of such period). If a trust disposes of all of the stock which it holds in a S corporation, then, with respect to such corporation, the term "potential current beneficiary" does not include any person who first met the requirements of the preceding sentence during the 1-year period ending on the date of such disposition.

(3) Election

An election under this subsection shall be made by the trustee. Any such election shall apply to the taxable year of the trust for which made and all subsequent taxable years of such trust unless revoked with the consent of the Secretary.

(4) Cross reference

For special treatment of electing small business trusts, see section 641(c).

Section 641 deals with the income tax treatment of an ESBT. Although an ESBT has one taxpayer identification number and files one tax return, the portion of an ESBT that consists of S corporation stock is treated as one trust and the portion consisting of all other assets is treated as another trust. Either or both portions may be taxed as a grantor trust under the normal grantor trust rules of subchapter J. The S portion, if not a grantor trust, is taxed under § 1366 – generally rules similar to the normal trust rules using

the highest marginal trust rate. The non S portion may be one or more sl (under § 663(c)) and is taxed under the normal trust rules. Distributions the S or non S portion reduce the income of the *non S portion*, only, bu below zero. Further charitable contributions will not reduce the income c S portion. No protective ESBT election may be made (in contrast to QS with respect to which protective elections may be made).

In general, three kinds of trusts may be S corporation shareho over a long period of time: the wholly grantor trust, the qualified subch S trust (the "QSST"), and the electing small business trust ("ESBT"). D ent kinds of estate planning trusts either qualify or must be made to qu as one of these trusts in order to preserve the S corporation election. In instances ESBT status is least desirable because of the high income tax

Relief is available for late QSST elections or ESBT electio certain circumstances. *See, e.g.*, Rev. Proc. 2003-43, 2003-23 I.R.B. The IRS will not normally issue private letter rulings in cases for which provided an an automatic approval procedure or administrative procedu an S corporation to obtain relief for late S corporation, qualified subchap subsidiary, qualified subchapter S trust, or electing small business trust tions. Rev. Proc. 2008-3, § 4.01(42), 2008-1 I.R.B. 110.

A. [11.3] *Crummey* Trust

Crummey trusts typically have multiple beneficiaries, each with drawal rights and income and principal interests. Accordingly, a *Cru* trust presents several complications in holding S corporation stock. A sta *Crummey* trust will not qualify as a QSST, because there is more tha income and principal beneficiary and the trust will not necessarily term when any particular beneficiary dies. On the other hand, a *Crummey* which has only one beneficiary – one person with a withdrawal right, rights to income and principal – until the beneficiary's death will quali a QSST. One example of such a *Crummey* trust would be a *Crummey* which is established for a grandchild for purposes of qualifying the trust f direct skip annual exclusion for generation skipping tax purposes as pro in IRC § 2642(c)(2).

Under certain circumstances a *Crummey* trust may be a grantor Typically, that requires giving the grantor a power as described in IRC to ensure that the trust is a wholly grantor trust. The most commonly power is the power of the grantor under IRC § 675(4)(C) to substitute of equivalent value in a non-fiduciary capacity. Care, however, must be because the Internal Revenue Service's current position is that whether s power can be exercised in a non-fiduciary capacity is a facts and circumst analysis. *See* PLR 9437002 and PLR 9437023; *see also,* PLR 2008480

If the trust owns life insurance on the life of the grantor or the grantor's spouse, the trust may be a grantor trust under IRC § 677(a)(3). Some commentators, however, believe that the trust would be a grantor trust only in part. The fact that the income and principal of the trust may be paid to or for the benefit of the grantor's spouse would make the *Crummey* trust a grantor trust, under IRC § 677(a)(1), but for the presence of the withdrawal rights in the other beneficiaries. The Service's position is that the withdrawal rights convert the *Crummey* trust into a grantor trust with respect to each person having a power of withdrawal. *See* PLR 8142061, PLR 8521060, and PLR 8805032.

An open issue is whether the provisions of IRC § 671 through IRC § 677, which apply to tax the trust to the "real" grantor, trump the provisions of IRC § 678, which applies to tax the trust to a donee with a withdrawal right.

Another issue which must be considered in drafting the *Crummey* trust is the presence of a divorce provision. In many instances the spouse who has benefits in a *Crummey* trust will cease to be a beneficiary upon divorce. Such a provision will cause the trust to fail to qualify as a QSST. On the other hand, the presence of a broad *inter vivos* power of appointment will prohibit an ESBT election.

B. [11.4] Section 2503(c) Trust

A properly drafted trust qualifying for the annual exclusion under IRC § 2503(c) will normally qualify as a QSST.

C. [11.5] Charitable Remainder Trusts

A charitable remainder trust may not, by regulation, be a grantor trust, Treas. Reg. § 1.671-1(d). Further, a charitable remainder trust may not qualify as a QSST, because no one receives all of the income of the trust (charitable remainder trusts are either unitrusts, which pay a set percentage of the trust assets each year to the noncharitable recipient, or annuity trusts). A charitable remainder trust may not be an ESBT. IRC § 1361(e)(1)(B)(iii).

A popular use of the charitable remainder trust is to enable closely-held stock to be sold without recognizing capital gains (because a charitable remainder trust is not subject to the capital gains tax). This technique is effective only for C corporations. A charitable remainder trust may not be used to sell or redeem S corporation stock.

D. [11.6] Charitable Lead Trusts

Many charitable lead trusts are drafted as grantor trusts, and lead trusts may hold S corporation stock. ESBT status is typically not a tive for a charitable lead trust.

E. [11.7] Grantor Retained Annuity Trusts ("GRAT")

A GRAT is typically drafted to be a grantor trust, either beca specific power is given to the grantor to make the GRAT a grantor trust a power under IRC § 675(4)(c) power to substitute assets in a non-fidu capacity as discussed above), or because the grantor has a reversion i trust assets which causes the trust to be a grantor trust under IRC § 673(a reversion is the grantor's right to receive the GRAT assets back if the gr dies within the GRAT term).

S corporation stock is a very popular asset to put into a GRAT, be the earnings of the S corporation may be used to make the GRAT payr before the earnings are reduced by income taxes. Many S corporations pre-tax earnings of 15% to 25% which may almost always be used to GRAT payments. This enables the entire value of the S corporation removed from the grantor's estate within a relatively few years (*e.g.,* 10 years). The technique is particularly effective when combined with capitalization to produce voting and nonvoting stock. The nonvoting s appropriately discounted, is transferred to the GRAT.

A variation on this technique is to convert a C corporation to corporation in connection with the recapitalization into voting and nonv stock, before transferring the nonvoting stock to the GRAT. As long as C payments can be made without selling built-in gain assets for ten years the C-to-S conversion, double-level taxation of net unrealized built-in from the period the corporation was a C corporation under IRC § 1374(a be avoided. IRC § 1374; *see also,* Treas. Reg. § 1.1374-1.

F. [11.8] Lifetime QTIP Trusts

In order for basic marital deduction/equivalent exemption pla to be effective, it is necessary for each spouse to have at least $3,500,0 such spouse's individual name. In some instances, one spouse has most assets of the couple and does not want to transfer $3,500,000 worth of a to the other spouse's name. That could be because it is a second mar because the transferee spouse is a spendthrift, or for other reasons. In instances a lifetime QTIP trust may be helpful.

The transferor spouse may create a trust which provides for the transferee spouse to receive the income from the trust for life. The trust may also provide for the transferee spouse to receive discretionary principal encroachments or can allow encroachments only under certain circumstances (*e.g.,* the transferee spouse has not remarried). The transferor spouse may make a QTIP election under IRC § 2523(f), which will cause the trust assets to be included in the transferee spouse's estate if the transferee spouse dies first. Those assets may return to the transferor spouse in the form of a trust which will not be included in the transferor spouse's estate. The effect of the trust is to transfer assets into the transferee spouse's name without providing the transferee spouse with much, or any, control over the assets.

A lifetime QTIP trust must be qualified as a grantor trust while the grantor is living (it cannot be a QSST) but after the grantor's death may be a QSST. Treas. Reg. § 1.1361-1(j)(4) provides the applicable rules:

> (4) *Qualified terminable interest property trust.* If property, including S corporation stock, or stock of a corporation that intends to make an S election, is transferred to a trust and an election is made to treat all or a portion of the transferred property as qualified terminable interest property (QTIP) under section 2056(b)(7), the income beneficiary may make the QSST election if the trust meets the requirements set out in paragraph (j)(1)(i) and (ii) of this section. However, if property is transferred to a QTIP trust under section 2523(f), the income beneficiary may not make a QSST election even if the trust meets the requirements set forth in paragraph (j)(1)(ii) of this section because the grantor would be treated as the owner of the income portion of the trust under section 677. In addition, if property is transferred to a QTIP trust under section 2523(f), the trust does not qualify as a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section (a qualified subpart E trust), unless under the terms of the QTIP trust, the grantor is treated as the owner of the entire trust under sections 671 to 677. If the grantor ceases to be the income beneficiary's spouse, the trust may qualify as a QSST if it otherwise satisfies the requirements under paragraphs (j)(1)(i) and (ii) of this section.

This is a significant trap for the unwary. Because a testamentary QTIP trust qualifies as a QSST [if the QTIP trust meets the requirements of Treas. Reg. §1.1361-1(j)(4(1)(i)-(ii)], many practitioners suppose, to their peril, that

a QTIP created during lifetime also qualifies as a QSST. In such instance ESBT election may be required to preserve the S election.

G. [11.9] Testamentary QTIP Trusts

A QTIP trust created upon the death of a spouse will qualify QSST as discussed above [if the QTIP trust meets the requirements of T Reg. §1.1361-1(j)(4(1)(i)-(ii)].

H. [11.10] Exemption Equivalent Trusts

A trust which is established to be for the benefit of the survi spouse and the issue of the deceased spouse [*e.g.*, a "credit shelter" or " B" trust] must be drafted specifically to qualify as a QSST. Typically the is established for the benefit of not only the surviving spouse but also the viving issue, with the trustee being given discretion to distribute income principal among them in accordance with the standards specified in the A trust drafted in such manner may qualify as an ESBT.

In order for a credit shelter trust to be a QSST, the surviving sp must receive all of the income of the trust and must be the sole principal eficiary (of course the spouse need not receive any principal, but no one must either while the spouse is living). The rights of the surviving spou receive principal may be cut off in the event the surviving spouse rema but no one else may be substituted as a principal beneficiary, and, of co the surviving spouse's right to income may not be cut off.

I. [11.11] Trusts for Issue

A trust for the benefit of a child and a child's issue will not qu as a QSST, and instead must be redrafted to have the child as the mand recipient of income and the sole potential beneficiary of principal. The ibility of a so-called spray trust for a child and the child's issue is incompa with the S election, absent ESBT treatment.

J. [11.12] Trust Division for Exemption Equivalent Trust and T for Issue

If some but not all of the assets of an exemption equivalent tru a trust for issue will consist of S corporation shares, and it is undesirab give up the spray provisions except to the extent required, S corporation could be allocated to a special qualifying trust, while other assets are allo to a more typical trust.

With respect to an exemption equivalent (credit shelter) trust, called Fund B here, an example of such an allocation and the parallel trusts would be for one item, here Item 6, to provide for assets other than S corporation stock and for the next item, here Item 6A, to provide for the S corporation stock:

ITEM 6
Administration of Fund B

6.1 If Fund B holds S corporation stock, such stock will be held and administered as a separate trust as provided in Item 6A herein, as Fund B-1. The remaining assets of Fund B will be held and administered as provided in this Item 6.

6.2 Trustee will distribute to or for the benefit of my Spouse and my issue so much of the net income of Fund B as Trustee deems advisable to provide for their health, education (including education beyond the undergraduate level), maintenance and support. Primary consideration will be given to the needs of my Spouse. Undistributed income will be periodically added to principal. Unequal distributions of income will not be taken into account in the final distribution of assets.

Drafter: Insert after Fund B income provision if desired.

6.3 My Spouse has the right each year, by written notice to Trustee, to withdraw specific assets from the principal of Fund B, the value of which does not exceed 5% of the market value of the principal of Fund B on December 31 of the year of withdrawal. This right to withdraw is noncumulative.

6._ Trustee will distribute from the principal of Fund B (even to its complete exhaustion) such amounts as Trustee deems advisable to provide for the health, education (including education beyond the undergraduate level), maintenance and support of my Spouse and my issue. Primary consideration will be given to the needs of my Spouse but my Spouse's taxable estate will be considered when making distributions from Fund B for my Spouse's benefit. Distributions from principal will be based on an individual's needs and unequal distributions will not be taken into account in the final distribution of assets.

Drafter: Spouse's special Testamentary Power of Appointment a descendants

6._ My Spouse may appoint, by specifically referring to this power in my Spouse's Will, part or all of the assets of Fund B among my issue in such proportions and in such manner, outright or in trust or otherwise, as my Spouse determines. Regardless of other provisions to the contrary, my Spouse may, at any time and by written notice to Trustee, relinquish this power in whole or in part.

6._ If my Spouse remarries, my Spouse will not benefit from income or principal of Fund B and will not be entitled to exercise any withdrawal right during the time my Spouse is married. During the time of my Spouse's marriage Fund B will be administered for the exclusive benefit of my issue. My Spouse will again be a beneficiary of Fund B during any subsequent times when my Spouse is unmarried and under the same terms as if my Spouse never remarried.

6._ If my Spouse remarries, Fund B will be administered as if my Spouse were deceased.

Drafter: Always use 1 of the following 3 paragraphs. Add the "unappointed" before the word "assets" in line 1 of wha you select if spouse has a special Testamentary Pow Appointment.

Drafter: This gives you separate shares for each descendant.

Drafter: Variation A.

6._ Upon my Spouse's death, the remaining assets of Fund B and property transferred to it from any source will be divided among my then living issue, per stirpes, and held or distributed as provided herein.

Drafter: This gives you separate shares for children and a single s for descendants of a deceased child.

Drafter: Variation B.

6._ Upon my Spouse's death, the remaining assets of Fund B and property transferred to it from any source will be divided, in equal shares, one for each then living child of mine and one for each deceased child with issue then living, and held or distributed as provided herein.

Drafter: *This gives you 1 share F/B/O all descendants. This is not the best election for GST purposes.*

Drafter: *Variation C.*

6._ Upon my Spouse's death, the remaining assets of Fund B and property transferred to it from any source will be held in trust for the benefit of my then living issue as provided herein.

ITEM 6A
Administration of Fund B-1

6A.1 Trustee will distribute to or for the benefit of my Spouse the net income of Fund B-1 in quarterly or more frequent installments.

6A.2 Trustee will distribute from the principal of Fund B-1 (even to its complete exhaustion) such amounts as Trustee deems advisable to provide for the health, education (including education beyond the undergraduate level), maintenance and support of my Spouse.

6A._ My Spouse may appoint, by specifically referring to this power in my Spouse's Will, part or all of the assets of Fund B among my issue in such proportions and in such manner, outright or in trust or otherwise, as my Spouse determines. Regardless of other provisions to the contrary, my Spouse may, at any time and by written notice to Trustee, relinquish this power in whole or in part.

6A._ If my Spouse remarries, my Spouse will not benefit from principal of Fund B-1 and will not be entitled to exercise any withdrawal right during the time my Spouse is married. My Spouse will again be a principal beneficiary of Fund B-1 during any subsequent times when my Spouse is unmarried and under the same terms as if my Spouse never remarried.

Drafter: *Always use 1 of the following 3 paragraphs. Add the word "unappointed" before the word "assets" in line 1 of whatever you select if spouse has a special Testamentary Power of Appointment.*

Warning: *Variation B creates non-qualifying S corporation shareholders at the grandchild level, and Variation C creates a non-qualifying trust immediately.*

Drafter: This gives you separate shares for each descendant.

Drafter: Variation A.

6A._ Upon my Spouse's death, the remaining assets of Fund B-1 and property transferred to it from any source will be divided among my then living issue, per stirpes, and held or distributed as provided herein.

Drafter: This gives you separate shares for children and a single s for descendants of a deceased child.

Drafter: Variation B.

6A._ Upon my Spouse's death, the remaining assets of Fund B-1 and property transferred to it from any source will be divided, in equal shares, one for each then living child of mine and one for each deceased child with issue then living, and held or distributed as provided herein.

Drafter: This gives you 1 share F/B/O all descendants. This is no best election for GST purposes.

Drafter: Variation C.

6A._ Upon my Spouse's death, the remaining assets of Fund B-1 and property transferred to it from any source will be held in trust for the benefit of my then living issue as provided herein.

With respect to a trust for issue, an example of such an allocatio the parallel trusts would be:

ITEM 7

Trusts for the Primary Benefit of My Children

Drafter: Child's trust terminating at age[s] ____.

Drafter: Variation A or B.

7.1 Each share set aside for a living child of mine will be held by Trustee as follows. If such share holds S corporation stock, such stock will be held and administered as a separate trust as provided in Item 7A herein. The remaining assets will be held and administered as provided in this Item 7.

7.2 Until such child becomes 21 years old, Trustee will distribute to or use so much of the net income of the trust, as Trustee deems advisable for such child's health, education, maintenance and support. Undistributed income will be added to principal. After such child becomes 21 years old, the net income of the trust will be distributed to or for the benefit of such child in quarterly or more convenient installments. Trustee will distribute from the principal of the trust such amounts as Trustee deems advisable to provide for the health, education (including education beyond the undergraduate level), maintenance and support of such child and such child's descendants. Distributions will be based on an individual's needs and unequal distributions will not be taken into account in the final distribution of assets.

Drafter: Child's 5% withdrawal right if desired.

7.3 After attaining age ___, my child has the right each year, by written notice to Trustee, to withdraw specific assets from the principal of my child's trust, the value of which does not exceed 5% of the market value of the principal of the trust on December 31 of the year of withdrawal. This right to withdraw is noncumulative.

Drafter: Use next paragraph if assets might be subject to a GST if child dies before termination of trust.

7.4 My child may appoint, by specifically referring to this power in my child's Will, the assets held in my child's trust that would incur a generation skipping tax at my child's death to my child's estate, to the creditors of the estate, or to any person or entity. To the extent such power is not effectively exercised the assets of the trust will be administered as otherwise provided herein. Unless my child directs otherwise by specific reference to this paragraph, Trustee will pay directly, or to the Personal Representative of my child's estate, the amount of incremental death taxes imposed on such estate by reason of any assets of this trust being included therein.

Drafter: Child's special Testamentary Power of Appointment.

Drafter: Review appointees for client's desires.

7.5 In addition, my child may appoint, by specifically referring to this power in my child's Will, part or all of the assets of this trust among my descendants, or, if

none, to any person or entity (but in all instances, excluding such child, such child's estate, such child's creditors and the creditors of such child's estate) in such proportions and in such manner, outright or in trust or otherwise, as my child determines. Regardless of other provisions to the contrary, my child may, at any time and by written notice to Trustee, relinquish this power in whole or in part.

Drafter: Use next 3 paragraphs when trust is to be distribute descendants of a child who dies before termination of his t Delete "unappointed" in line 2 of each option if the wo inappropriate.

7.6 All unappointed assets remaining in the trust upon such child's death will be distributed in fee and per stirpes to the child's then living descendants; but if there are none, to my then living descendants, per stirpes. Provided, however, if Trustee is then holding another trust under this instrument for the primary benefit of any such descendant, the descendants interest in this trust will be consolidated with such other trust and will be administered in accordance with this instrument.

7.7 Each share set aside for any descendants of my deceased children will be divided and distributed in fee and per stirpes to them.

7.8 Notwithstanding the above, if a beneficiary is not 21 years old when Trustee is directed to distribute to such beneficiary any portion of the principal of this trust, such portion will vest in such beneficiary. However, Trustee may withhold possession of it and hold it under the provisions of this instrument for such beneficiary until the beneficiary becomes 21 years old, at which time the remaining assets will be distributed to the beneficiary or to the beneficiary's estate if the beneficiary dies before age 21. In the meantime, Trustee will distribute to or for the benefit of the beneficiary as much net income and principal as Trustee deems advisable for the beneficiary's health, education, maintenance and support. Undistributed income will be added to principal.

ITEM 7A

Trusts for the Primary Benefit of My Children

Drafter: Child's trust terminating at age[s] ___.

Drafter: Variation A or B.

7A.1 The net income of the trust will be distributed to or for the benefit of such child in quarterly or more convenient installments. Trustee will distribute from the principal of the trust such amounts as Trustee deems advisable to provide for the health, education (including education beyond the undergraduate level), maintenance and support of such child.

Drafter: Use next paragraph if assets might be subject to a GST if child dies before termination of trust.

7A.2 My child may appoint, by specifically referring to this power in my child's Will, the assets held in my child's trust that would incur a generation skipping tax at my child's death to my child's estate, to the creditors of the estate, or to any person or entity. To the extent such power is not effectively exercised the assets of the trust will be administered as otherwise provided herein. Unless my child directs otherwise by specific reference to this paragraph, Trustee will pay directly, or to the Personal Representative of my child's estate, the amount of incremental death taxes imposed on such estate by reason of any assets of this trust being included therein.

Drafter: Child's special Testamentary Power of Appointment if desired.

Drafter: Review appointees for clients desires.

7A.3 In addition, my child may appoint, by specifically referring to this power in my child's Will, part or all of the assets of this trust among my descendants, or, if none, to any person or entity (but in all instances, excluding such child, such child's estate, such child's creditors and the creditors of such child's estate) in such proportions and in such manner, outright or in trust or otherwise, as my child determines. Regardless of other provisions to the contrary, my child may, at any time and by written notice to Trustee, relinquish this power in whole or in part.

Drafter: Use next 3 paragraphs when trust is to be distribute descendants of a child who dies before termination of his Delete "unappointed" in line 2 of each option if the wo inappropriate.

7A.4 All unappointed assets remaining in the trust upon such child's death will be distributed in fee and per stirpes to the child's then living descendants; but if there are none, to my then living descendants, per stirpes. Provided, however, if Trustee is then holding another trust under this instrument for the primary benefit of any such descendant, the descendant's interest in this trust will be consolidated with such other trust and will be administered in accordance with this instrument.

7A.5 Each share set aside for any descendants of my deceased children will be divided and distributed in fee and per stirpes to them.

7A.6 Notwithstanding the above, if a beneficiary is not 21 years old when Trustee is directed to distribute to such beneficiary any portion of the principal of this trust, such portion will vest in such beneficiary. However, Trustee may withhold possession of it and hold it under the provisions of this instrument for such beneficiary until the beneficiary becomes 21 years old, at which time the remaining assets will be distributed to the beneficiary or to the beneficiary's estate if the beneficiary dies before age 21. In the meantime, Trustee will distribute to or for the benefit of the beneficiary the net income of the trust and as much principal as Trustee deems advisable for the beneficiary's health, education, maintenance and support. Undistributed income will be added to principal.

In many instances it may be reasonable to believe that S corpor stock will need to be held in trust, even if none is present in the estate c client now. For this reason it may be desirable to use an S corporation savings clause. The intent of such a clause is to transform a trust that woul be a QSST into a trust which is a QSST. The cost of doing so is a dispos change in the estate plan: spray provisions become mandatory income d bution provisions with limits on the potential principal beneficiaries. S provision could be drafted as follows:

ARTICLE __

Administration of Trusts Owning Business Entities Taxed As S Corporations

__.1 Regardless of any provisions in this Agreement to the contrary, if any equity interest in any business entity (hereinafter simply referred to as "stock"): (A) which has in force an election to be treated as an S corporation pursuant to section 1361 of the Code; or (B) for which such an election is made while such stock is held by Trustee, would otherwise be held in any trust administered hereunder: (i) all of which is not treated as owned by me for federal income tax purposes, or for which Trustee has not made a valid election to be treated as an Electing Small Business Trust ("ESBT"), pursuant to section 1361(e) of the Code, that is then in effect; and (ii) which would not qualify to be treated, pursuant to section 1361(d) of the Code, as a Qualified Subchapter S Trust ("QSST"), then such stock will not be held in such trust, but instead will be held in a separate trust with provisions identical to those of such trust, except as provided below. It is my intention that such separate trust qualify to be treated as a QSST.

__.2 Any such separate trust will have provisions identical to the trust in which such stock would otherwise be held, except that: (A) all of the income of such trust (within the meaning of section 643(b) of the Code) will be distributed to the beneficiary of such trust (who will be called the "current income beneficiary" of the trust) at least annually; (B) no principal distributions may be made to, or for the benefit of, any person other than the current income beneficiary during the life of the current income beneficiary; (C) during the life of the current income beneficiary, no one will have any power to appoint any portion of the trust property to anyone other than the current income beneficiary; (D) the remarriage of the current income beneficiary will not result in any termination of the current income beneficiary's rights to receive trust income as defined above; (E) a single trust for multiple income beneficiaries in the same generation will be divided into separate shares, each of which will have only one current income beneficiary; and (F) if any other requirements are imposed on a trust by section 1361(d) of the Code in order to make such trust eligible for treatment as a QSST, such separate trust will meet those requirements.

__.3 A trust, prior to the separation provided for in the first paragraph of this Article, may have beneficiaries in multiple generations as potential current recipients of income and/or principal. In such case, the "current income beneficiary" of the separate trust will be the beneficiary in the oldest generation.

__.4 In addition, Trustee may make any elections or give consents which are required to achieve or maintain S corporation statu stock held in any trust administered herein.

III. [11.13] Advisory Committees

In many instances an advisory committee to the trustee is benef If a closely-held business, whether in corporate, partnership, or limit ability company form, is held in a trust having a corporate trustee, the tr may request that family members or other persons (attorneys, accoun business managers) be appointed to advise the trustee. However, that is much a matter of local practice and custom. Currently, the authors be that most of the corporate fiduciaries active in Kentucky prefer to ha advisory committee for closely-held business interests; however, in Fl the authors' experience has been the opposite with the corporate fiduc taking the position that the liability for operating the business is its alo it wants full authority.

An issue facing any advisor is the advisor's status. Kentucky is c the few states with clear law stating that an advisor is a fiduciary. *Gathr Trustee v. Gaut*, 124 S.W.2d 782 (Ky. 1939).

An advisory committee provision dealing with closely-held bus interests could be as follows:

ARTICLE _

Advisory Committee

__.1 During any time I am incapacitated or after my deat _____, _____ _____, and _____ are appoint the initial Advisory Committee ("Advisor") to Trustee. Provided, how my child may serve as an Advisor for a trust for such child's primary b under Article _____ upon reaching age _____ and may serve as sole Ad for such trust upon reaching age _____. No Advisor will be deemed to accepted such position until the Advisor gives written notice of accep to the then acting Trustee. Notwithstanding anything herein to the con Trustee will be subject to the powers and authority of Advisor as herei set forth.

A. Powers. Advisor has the following powers and authority:

(A.1) To advise Trustee with regard to general investment policy, but Trustee's decision will be controlling unless an Investment Advisor is appointed as provided herein.

[or]

(A.1) To advise Trustee, to approve or disapprove any investment recommendation made by Trustee, to direct Trustee with respect to general investment policy, to initiate action, and to direct Trustee concerning important matters pertaining to investments of any trust established hereunder, including, but not limited to, the borrowing of money, the lease, sale, investment, and reinvestment of any trust assets, the making of tax elections applicable to a trust, and the voting of stock.

(A.2) To approve, disapprove, or direct discretionary payments or accumulations of income or encroachments upon the principal of any trust established hereunder, subject to the standards herein set forth.

(A.3) To replace the then acting Trustee, or any successor Trustee, at any time and from time to time by giving notice to the then acting Trustee, with a Qualified Trustee. If Advisor is not in existence, the current income beneficiary in the oldest generation (or a majority of them if more than one) of each separate trust has the continuing right, by giving written notice to the then acting Trustee, to replace such Trustee or any successor Trustee with a Qualified Trustee. The duly appointed guardian of a minor or adult incapacitated beneficiary will act on behalf of such beneficiary. If there is no such guardian, then (1) with respect to a minor beneficiary, the parent who is my descendant may exercise the power or if such parent is deceased or incapacitated then the other parent may exercise the power; and (2) with respect to an adult incapacitated beneficiary, the attorney in fact may exercise the power. Notwithstanding anything herein to the contrary, a beneficiary acting pursuant to this paragraph other than as an Advisor on such beneficiary's own behalf is not subject to a fiduciary duty; but any duly appointed guardian, parent of a minor child, or attorney in fact acting on behalf of a beneficiary is subject to a fiduciary duty with regard to the beneficiary on whose behalf such individual is acting, regardless of whether such individual is also a beneficiary hereunder.

(A.4) To appoint an Investment Advisor to advise and direct Trustee regarding the investment of trust assets. Advisor may remove the Investment Advisor at any time and appoint a successor

Investment Advisor. Any such Investment Advisor will be registered the Securities Exchange Commission under the Investment Advisors of 1940, as amended. In the event that no successor is appointed, o Investment Advisor fails to serve as such, then Trustee will again bec responsible for the investment of trust assets (subject to any auth reserved to Advisor). Advisor will determine the amount of the Invest Advisor's fee, and inform Trustee of the fee determination, and the fee w payable from the trust as an administration expense. Trustee will be reli from liability resulting from actions taken pursuant to the directions o Investment Advisor. During the period an Investment Advisor is a hereunder, Trustee will act as a custodial trustee concerning the trust prop and will have no duty to supervise investments made or to make invest recommendations.

(A.5) To advise and direct Trustee with re to all decisions pertaining to any life insurance policies which may bec or are assets of any trust administered hereunder. Such power and auth extends to, but is not limited to: the selection of an insurance carri carriers; the selection of the type of life insurance; the method of pa premiums; the election to purchase riders to life insurance policies decision to make changes in existing policies (such as, but again not lir to, canceling a policy, borrowing cash values, applying for extended insurance, opting for reduced paid-up insurance, or exchanging a polic a replacement policy). Trustee has no duty regarding such policies exce follow the directions of Advisor.

(A.6) To enter into agreements with a Succ Trustee regarding the management of the trust assets which the Succ Trustee requires of similar trusts prior to agreeing to serve as Trustee.

(A.7) To direct Trustee with regard to all ortant decisions regarding an incorporated or unincorporated business e including, but not limited to, any corporation, partnership, limited lia company, joint venture, business trust, or sole proprietorship ("closely business") in which any trust owns an interest, including, but not limite the retention or sale of such closely held business interest; the manager lease, sale, exchange, investment, and reinvestment of the assets of closely-held business; lending to or borrowing from the closely-held bus or using it as collateral; the making of tax elections; the voting of s partnership units, and membership interests; and generally, to appro disapprove any recommendation made by Trustee regarding such clo held business.

B. Acts of Advisor. Unless otherwise pro herein, Advisor will act through a majority of its membership. Any a

taken by Advisor respecting any matter within its powers and authority will be communicated in writing to Trustee and Trustee will be conclusively bound thereby. If Trustee communicates in writing a proposed action to Advisor and it does not direct Trustee within 15 days, Trustee may take the proposed action without the necessity of further communication.

C. Successor Members. Unless otherwise provided herein, Advisor with respect to a trust established herein will be self-perpetuating for the duration of such trust. Successor members to those named or designated herein may be appointed by Advisor to serve when appointed, upon the occurrence of a future event, or on a specified date. If a successor member has not previously been appointed or designated when a member ceases to act then the remaining member or members will appoint a successor and Advisor will continue in this manner to perpetuate itself during the continuation of any trust established hereunder. A member of Advisor ceases to act when the member dies, resigns, becomes incapacitated, or fails to act for a period of 180 days. Advisor will inform Trustee of any successor member. No successor member will succeed to the liability of any former or currently serving members. If the situation ever occurs where there are no duly appointed and acting members of Advisor, Trustee will act alone for the duration of a trust or until Advisor again becomes active. In the alternative, Trustee may appoint a member or members of the Advisory Committee which will function with the same powers and authority as otherwise provided herein.

D. Compensation of Advisor. Trustee may pay members of Advisor reasonable compensation as may be agreed upon between Advisor and Trustee. Any compensation paid will be considered a cost of the administration of the trust with respect to which Advisor is serving.

E. Advisor Liability. No member of Advisor will at any time be held liable for any action taken or not taken (including any action taken or not taken in exercising a business judgment or in making payments to or for the benefit of any beneficiary) or for any loss or depreciation of value of any property in any trust created hereby, whether due to an error of judgment or otherwise, unless such member of Advisor has acted in bad faith. In the case of the delegation of any discretionary power hereunder, the member of Advisor so delegating will not be liable for the acts, omissions, or defaults of the agents, servants, or employees to whom the delegation is made. The member of Advisor will be entitled to recover from the trust assets (but only to the extent of the assets therein at the time a request for such recovery is made) for any and all losses, damages, expenses (including attorney fees), claims, lawsuits, or judgments incurred or suffered by such member of Advisor, whether individually or in a fiduciary capacity by virtue of, or in any way arising from, any action taken or not taken by, or allegedly taken or not taken by such member of Advisor; provided, however,

no member of Advisor will be entitled to recover any such amount if established by a final judgment of a court of competent jurisdiction that person was acting in bad faith at such time.

F. Relation of Advisor. Members of Advisor w all times act as and have the obligations of fiduciaries. Nevertheless, fa members, persons having a financial interest in a trust asset, and professio rendering services to this trust or any of its assets may be membe Advisor. In that regard, the fact that an individual is serving as a me of Advisor will not disqualify such individual from serving as a memb the board of directors and/or as an officer of any corporation the sto securities of which are held as part of any trust hereunder, and a me of Advisor may vote to cause such individual's election as a director a officer to any such corporation. In addition, the fact that an individual h in a personal capacity any interest in a closely-held business will not pre such individual from serving as a member of Advisor and will not pre such individual from participating in decisions regarding such closely- business. Further, with respect to any corporation (whether or not clo held) of which any stock or securities are held as part of any trust hereu or any closely-held business in which any trust owns an interest, a me of Advisor may serve in any capacity with such corporation or closely- business and receive reasonable compensation for such services and authorization will not be affected by the fact that such member of Ad holds in a personal capacity an interest in such corporation or closely- business. Moreover, the fact that an individual is serving as a memb Advisor will not prevent such individual from purchasing assets from trust (including, but not limited to, any interest in a closely-held busine the assets thereof); provided, however, such individual will not partic as a member of Advisor in determining whether such sale will be ma the price and terms thereof, and if there is no member of Advisor who i a party to a proposed transaction, Trustee will act alone with regard to transaction.

G. Trustee Liability. Trustee will incur no lia when acting at the direction of Advisor if Advisor is acting within its po and authority. Further, no party dealing with Trustee has any duty to deter if Trustee is acting at the direction of Advisor.

IV. [11.14] Allocation of Business Interests Among Family Members

In many instances it is desirable that business interests be alloca one or more family members and that other assets be allocated to other fa

members. In general it is better for those family members who are active in the business to have interests in the business, and for other family members to receive other assets.

Suppose that there are three children and one is to receive business assets and the other two are not. There are two ways to ensure the proper division of assets. One is for the business assets to be allocated to each child equally after the surviving parent's death. There would be a stock restriction and purchase agreement among the three, and all trusts for their benefit, which would require the one child to buy the interests from the other two children. The disadvantage of such an arrangement is that any shares which have been given away by the parents may have a tax basis which is less than the purchase price called for by the stock purchase agreement, thus causing the recognition of capital gain. The second way, which may be more favorable, is to allocate the business interests among the family members directly when creating shares for the children. This will be effective, of course, only to extent there are sufficient non-business assets.

One key issue is to create an appropriate definition of the business interests involved. Such a definition could be:

> _._ For purposes of this agreement, the term Business will include all shares of stock or other equity interests of any kind or nature in ABC Corporation, whether voting or non-voting, and any successor business entities thereto, including (but not limited to) corporations, partnerships, and limited liability companies, and any real estate which is leased to such entities and is used in connection with the business of such entities.

In some instances it may be desirable to exclude real estate from the definition because, for example, the real estate can be allocated to family members who are not in the business.

Another issue which must be considered (particularly in the context of equalizing the value distributed among a client's descendants) is the date of valuation of the business interests and other assets (*e.g.,* date of death values or date of distribution values). Using date of death values, typically tied to the value as agreed to by the Internal Revenue Service on the Form 706 after audit (if any), has the advantage of not requiring a revaluation after estate administration. However, if values have changed during administration then using date of death values may produce a different result than that intended.

A related issue is whether any discount for the size of the int allocated (*e.g.*, a minority interest) or for the lack of marketability of an i est will be taken. One way to value business assets is to exclude any discount. Such a clause would provide either that business interests wou valued taking into consideration the size and marketability of the interes that business interests would be valued by calculating the value of the bus as a whole and determining the pro rata value of the interest being transf without regard to any discount for lack of marketability or minority inte

A clause which would effectively allocate business interests to child could be drafted as follows:

> _._ When creating a share for _____[a child], Trustee will first allocate from the trust property to such share all interests in the Business to the extent reasonably possible. I recognize that all Business interests may not be able to be so allocated because the value of such interests may exceed the share set aside for _____; in that event Trustee will allocate any excess interests to the share set aside for_____ to the extent reasonably possible. When making any allocation hereunder Trustee will value all assets at the date of allocation, and such values will be computed for the interests to be allocated taking into consideration the size and marketability of the interest.