S CORPORATIONS AND ESTATE PLANNING

GLENDALE ESTATE PLANNING COUNCIL

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This outline should be viewed only as a summary of the law and not as a substitute for legal or tax consultation in a particular case. Your comments would be appreciated and are invited.

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The Internal Revenue Service expected to receive 3.5 million S corporation returns for 2004, out of a total 6 million corporate returns. From 2004 to 2010, the IRS expects the number of S corporation returns to increase at 3.5% annually, while C corporation returns increase at less than 1% annually.[1]

1. AMERICAN JOB CREATION ACT OF 2004[2]

⇒ Maximum number of shareholders increased from 75 to 100.[3]

⇒ All members of a family can be treated as one shareholder for purposes of the 100-shareholder limit.[4] An affirmative election must be made by "any member of the family."[5] Family includes

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[1] Terry Manzi, National Office of Research Headquarters, IRS, *Projections of Returns That Will be Filed in Calendar Years 2004-2010*, page 3, August, 2003 (On IRS website at http://www.irs.gov/pub/irs-soi/04proj.pdf). The report anticipates 2.5 million partnership returns in 2004, with an annual rate of increase (3.7%) somewhat greater than the rate for S corporation returns.

[2] The one S corporation change in the Working Families Tax Relief Act of 2004 involves the post-termination transition period in Section 1377 and is not worth mentioning.

[3] I.R.C. § 1361(b)(1)(A). Treas. Reg. § 1.1361-1(e) has not been updated.

[4] I.R.C. § 1361(c)(1)(A)(ii).

[5] I.R.C. § 1361(c)(1)(D)(i). It is possible to terminate the election, but the IRS has not said how. I.R.C. § 1361(c)(1)(D)(ii).

six generations traced to a common ancestor, including the ancestor's lineal descendants and their spouses and former spouses.[6]

⇒ When a spouse transfers S corp shares to the other spouse, the losses suspended as a result of lack of sufficient basis will belong to the transferee.[7] The loss may remain blocked by the at-risk and passive activity rules. The statute appears to cover transfers of less than all of the transferors shares in the S corporation, but commentators have questioned this.

⇒ When a QSST sells S corporation stock, it is treated as a disposition by the beneficiary – and not by the trust – for purposes of the at-risk and passive loss rules.[8]

⇒ All potential current income beneficiaries are counted as shareholders and must be eligible S corporation shareholders. Under prior law, if a power of appointment in a trust was too broadly drawn, the trust would not qualify as an ESBuT. If the trust holds shares but does not qualify as an ESBuT, the S corporation election will terminate unless the shares are taken out of the trust within 60 days. Now unexercised powers of appointment are disregarded, so they do not cause this problem.[9] The 60-day period is also extended to one year.

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[6] I.R.C. § 1361(c)(1)(B). A husband and wife continue to be treated as one shareholder for counting purposes. I.R.C. § 1361(c)(1)(A)(i).

[7] I.R.C. § 1366(d)(2)(B). This is accomplished by treating the loss as incurred by the corporation in the year after the transfer.

[8] I.R.C. § 1361(D)(1)(C). See Treas. Reg. § 1.1361-1(j)(8), resolving whether the trust or the beneficiary recognizes the income when the trust sells S corporation shares. (The trust recognizes it. This avoids a deemed disposition of the installment obligation and allows the trust to use the installment method. See Section 2.7(b) below.) Why couldn't the regulation resolve the at risk and passive loss issues?

[9] I.R.C. § 1361(e)(2).

⇒ The IRS is authorized to grant relief for bad QSub elections and inadvertent QSub terminations.[10] The IRS is also authorized to require QSubs to file information returns.[11]

⇒ Odds and ends - Other new rules allow ESOPS to repay employer loans with S corporation distributions.[12] Banks that are S corporations can have shares held in an IRA, but other S corporations can't have IRAs as shareholders.[13] Some investment income of a bank S corporation is not treated as passive for purposes of the excess passive receipts rules.[14]

2. ELIGIBILITY ISSUES

2.1 Estates as shareholders

2.1(a) Estates can hold S corporation shares, without any limitation as to time.[15]

2.1(b) If the shares will be distributed from the estate to an ineligible trust, the ineligible trust has two years to dispose of the shares without terminating the S corporation status.[16]

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[10] I.R.C. § 1361(f). A "QSub" is a "qualified subchapter S subsidiary." I.R.C. § 1361(b)(3).

[11] I.R.C. § 1361(b)(3)(A).

[12] I.R.C. § 4975(f)(7).

[13] I.R.C. § 1361(c)(2)(A)(vi). Unless you represent banks, it's best to just forget about IRAs holding S corporation stock.

[14] I.R.C. § 1362(d)(3)(F).

[15] I.R.C. § 1361(b)(1)(B).

[16] The former 60-day period in which an ineligible trust must dispose of its S corporation stock was extended to two years after the trust acquires the shares. Effective for taxable years beginning after December 31, 1996. Small Business Tax Act § 1303, amending I.R.C. § 1361(c)(2)(A)(ii) and (iii).

2.1(c) A corporation that is an S corporation for federal purposes is also an S corporation for California tax purposes. When the federal election terminates, the California election terminates also. It does not matter whether the corporation is incorporated in California or qualified to do business in California. There is longer the possibility of being an S corporation for federal tax purposes and a C corporation for California tax purposes, or vice versa.[17]

2.1(d) The Service is empowered to validate **bad and late S corporation elections** and instructed to apply this power liberally. Effective for elections made for taxable years beginning after December 31, 1982.[18]

⇒ The IRS has published fairly liberal rules to permit late elections, including late QSST and ESBuT elections.[19] Another procedure applies when a spouse with a community property interest in the shares fails to sign the S corporation election.[20]

⇒ California has conformed, but the election cannot be made valid before January 1, 1997, when California adopted the federal S corporation rules.[21]

2.2 Living trusts (and their progeny) as shareholders

2.2(a) If the shares were in the name of the employee-shareholder before the trust was created, consider creating in the trust a special trust to hold closely-held stock. The other share-

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[17] Cal. Rev. & Tax. Code § 23801(a), (b), (e).

[18] Yes, 1982. I.R.C. § 1362(b) and (f).

[19] Rev. Proc. 2003-43, 2003-1 C.B. 998 (for elections up to 24 months late); Rev. Proc. 97-48, 1997-2 C.B. 521 (late S corporation elections).

[20] Rev. Proc. 2004-35, 2004-1 C.B. 1029.

[21] Cal. Rev. & Tax. Code § 23891(i).

holders will appreciate not having the non-employee spouse voting the shares.[22]

2.2(b) Grantor trusts can hold S corporation shares,[23] so the typical living trust qualifies during the lifetime of the trustor and for two years after death.[24]

2.2(c) At the death of the first spouse:

⇒ If the survivor's trust created after the first death is a grantor trust, it qualifies as an S corporation shareholder.[25]

⇒ A QTIP trust will qualify as a QSST – but it must make a timely QSST election.[26]

⇒ A credit shelter trust will often qualify as an electing small business trust or ESBuT – but it also must make a timely ESBuT election.[27]

2.3 Number of shareholders

2.3(a) Avoiding exceeding the 100-family limit is now less important as S corporation shares move through the second and third generations.

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[22] See Staley, *Living Trusts Hold Surprises for Owners of Closely-Held Businesses*, Business Law Update (Summer 2004), www.staleylaw.com on the Articles page.

[23] I.R.C. § 1361(c)(2)(A)(i). The grantor must be an eligible individual shareholder. *Id.*

[24] I.R.C. § 1361(c)(2)(A)(ii).

[25] Assuming the surviving spouse remains a U.S. citizen or resident alien.

[26] *See* footnote 40 at page 8.

[27] *See* Section 2.8 at page 9.

2.3(b) Holding the shares in ESBuTs is the best way to avoid exceeding this limit. The trust can specifically address the 100-family limit.

2.3(c) A buy-sell agreement and close-corporation status are the next best ways to avoid exceeding the limit – or to get inadvertent termination relief if the limit is accidentally exceeded!

⇒ The necessity of getting shareholder and spousal consents to changes to the buy-sell agreements makes them inferior to trusts.

2.4 Community property interests of nonresident aliens

If a nonresident alien has or acquires a current ownership (as opposed to survivorship) interest in shares, the corporation cannot be an S corporation.[28] This is a particular concern with shareholder-employees in California, where the non-employee spouse can acquire a **community property interest** in separate property shares to the extent that the employee-spouse is undercompensated for his or her efforts on behalf of the corporation.

2.5 Custodians

A custodian for the benefit of a minor is not treated as the shareholder for S corporation purposes.[29]

⇒ The minor must be an eligible shareholder, but the custodian need not be eligible.

⇒ The minor's parent or guardian must consent to the S election, and the consent of a custodian who is not the parent or legal guardian is not sufficient.[30]

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[28] Treas. Reg. § 1.1361-1(g)(1)(i).

[29] Treas. Reg. §1.1361-1(e)(1).

2.6 **Separate Trust Shares**

Separate trust shares under Section 663(c) are treated as separate trusts for S corporation purposes.[31]

2.7 **QSSTs**

If it meets the requirements of Section 1361(d) and makes a timely election, a QSST is treated as a grantor trust with respect to its S corporation stock. It must distribute all of its income annually to a single beneficiary, and if it distributes principal, it must be to that beneficiary and to no other. It cannot sprinkle or spray.

2.7(a) **QSST Elections**[32]

⇒ The election is made by the beneficiary.[33] A separate election must be made for each S corporation.[34]

⇒ Generally, the election must be made within two months and 15 days after the trust acquires the shares. For shares in a living trust prior to the death of the first spouse, or in the survivor's trust prior to the death of the surviving spouse, the election generally must be made within two years, two months and 15 days after the death.[35]

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[30] Rev. Rul. 68-227, 1968-1 C.B. 381; Rev. Rul. 66-116, 1966-1 C.B. 198. *See, e.g.,* PLR 94-47-022, August 23, 1994 (inadvertent termination relief), 91-21-027, May 24, 1991 (same).

[31] I.R.C. § 1361(d)(3) (flush language); Treas. Reg. § 1.1361-1(j)(3).

[32] Treas. Reg. § 1.1361-1(j)(6) (necessary information). For a C corporation making an S corporation election, there is a form of QSST election on the Form 2553.

[33] Treas. Reg. § 1.1361-1(j)(6)(ii).

[34] I.R.C. § 1361(d)(2)(B)(i).

[35] Treas. Reg. § 1.1361-1(j)(6)(ii)(C).

⇒ The final QSST regs permit protective QSST elections by beneficiaries in some situations.[36]

⇒ **Limited Inadvertent Termination Relief for QSST Elections**

If S status was lost solely because stock was transferred to a trust which would have been a QSST had the current income beneficiary so elected, the S election can be salvaged by a QSST election filed up to **two years** after the original due date.[37] This will save the corporation from the expense (including the user fee) of obtaining a ruling request for inadvertent termination relief.

2.7(b) When a QSST sells all of its S corporation stock, the Section 1361 regs treat the sale proceeds as taxable to the trust (which will have the sale proceeds in most cases), and not to the grantor, and confirm that the installment method is available.[38]

2.7(c) A trust that satisfies a **legal obligation** of a third party **to support** the single income beneficiary cannot be a QSST because it benefits more than one person.[39]

2.7(d) The regs include explicit rules about when **QTIP trusts** can be QSSTs.[40] A QTIP will *not* be treated as a QSST *unless* it makes a valid and timely QSST election.

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[36] Treas. Reg. § 1.1361-1(j)(6)(iv).

[37] Rev. Proc. 2003-43, 2003-23 I.R.B. 998 (also applies to late QSub and ESBuT elections).

[38] Treas. Reg. § 1.1361-1(j)(8). See fn. 8 above.

[39] Treas. Reg. § 1.1361-1(j)(2)(ii)(B).

[40] Treas. Reg. § 1.1361-1(j)(4).

2.7(e) Until 1996, reviewing a living trust involved tracing all the possible ways that shares could end up in a non-grantor trust, and then requiring all those trusts to either be QSSTs or requiring the trustee(s) to distribute the principal to a CUTMA custodian. Sometimes neither alternative fulfilled the clients' wishes.

⇒ It is still important to instruct the trustee to segregate S corporation stock into separate trusts, to take actions necessary to preserve the S corporation status, and to use promissory notes when necessary to equalize trusts that cannot hold S corporation stock.

⇒ If it becomes necessary to reform the trust to satisfy future S corporation laws, the court will look for language in the trust document that allows the court to find that the trustors would have wanted the court to reform the trust to preserve the S corporation status.

2.8 Electing Small Business Trusts ("ESBuTs")[41]

Since the 1996 Small Business Tax Act, S corporation shares have been permitted to be held by sprinkling trusts and trusts with "contingent" charitable beneficiaries.

2.8(a) The current beneficiaries will be treated as the shareholders for S corporation purposes (counting shareholders and allocating tax items). If there is no current beneficiary "for any period," the trust is treated as the shareholder.[42]

2.8(b) The trust does not qualify as an ESBuT if any interest in the trust was "acquired by purchase." It must have as beneficiaries only individuals and estates. Charities can hold contingent interests, but cannot be current income beneficiaries

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[41] This outline does not reflect the ESBuT regulations.

[42] I.R.C. § 1361(c)(2). *See* PLR 2005-22-003, February 15, 2005 (nonresident alien beneficiary with no current right to distributions did not prevent ESBuT status or S corporation election).

until tax years beginning after 1997.[43] A QSST cannot also be an ESBuT, nor can a charitable remainder trust, charitable lead trust or other tax-exempt trust be an ESBuT.[44]

2.8(c) The ESBuT is treated as a separate trust for trust tax accounting.[45] The ESBuT provisions of the Internal Revenue Code reflect an effort to avoid double taxation of the S corporation income (that is, at the shareholder and trust levels).

2.8(d) ESBuT Tips:

⇒ Diverting a beneficiary's income to an ESBuT reduces the itemized deduction cut-back because it reduces the beneficiary's AGI.

⇒ Each human is counted only once toward the 100-family limit, even if he/she holds stock both individually and as an ESBuT beneficiary.

⇒ The trustee makes the ESBuT election.[46] The consent of the beneficiaries is not required by the IRS, but the trustee might be well-advised to get it. If there is more than one trustee, look to state law to determine how many need to consent. Of course, you can't go wrong with unanimous consent by all the trustees.

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[43] I.R.C. § 1361(e)(1)(A). Charities are defined by reference to Section 170(c)(2), (3), (4) and (5), rather than by reference to Sections 401(a) and 501(c)(3), as in the eligible shareholder provision. This means that a charitable remainder trust can be a contingent beneficiary.

[44] I.R.C. § 1361(e)(1)(B).

[45] I.R.C. § 641(d).

[46] I.R.C. § 1361(e)(3).

2.9 GRATs

As a grantor trust, the GRAT is eligible to hold S corporation shares[47] – and a GRAT is an ideal way to capture a third discount (added to lack of control and lack of marketability) for S corporation shares.

2.10 Defective grantor trusts

Although the Service has some odd ideas about defective grantor trusts, there is no question that they are grantor trusts. As such, they are entitled to hold S corporation shares. If your clients are willing to take on the Internal Revenue Service, the defective grantor trust holding stock of a very profitable S corporation is a powerful estate planning technique.

2.11 Crummey trusts

In theory part of a Crummey trust is a grantor trust with respect to the beneficiaries, and the S corporation stock could be allocated to that part of the trust. The better approach is to be very conservative with the S corporation status, and to avoid S corporation stock in Crummey trusts.

2.12 Voting trust

Ignored for S corporation purposes.[48]

2.13 Bypass or credit shelter trust

Usually does not qualify as a QSST because it does not require current distributions to a single beneficiary. So must qualify as a ESBuT, if at all.

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47 *See* PLR 94-15-012, January 13, 1994.

48 I.R.C. § 1361(c)(2)(A)(iv); Treas. Reg. § 1.1361-1(h)(1)(v).

2.14 **Foreign Trust**

Does not qualify as an S corporation shareholder, even if the beneficiaries are eligible or the trust would otherwise be a QSST, voting trust or ESBuT.[49]

3. BUY-SELL AGREEMENTS

3.1 **Eligibility Protection**

A buy-sell agreement is by far the best way to protect the fragile S corporation status. The agreement can address transfers to ineligible shareholders as well as non-transfer problems: allocation among trusts as trustors die and beneficiaries reach target ages, change from resident alien to nonresident alien tax status, and change of residence from California.

Eligibility protection can be enhanced by electing close corporation status for corporate law purposes. The puts more teeth in the various restrictions.

The agreement can address whether the corporation will be required to make distributions to enable the shareholders to pay their taxes on the S corporation income. This issue also arises when the agreement provides for sales of stock paid for by promissory notes that are secured by pledges of the purchased shares; in that case, the pledge should allow the buyer to retain distributions to pay taxes.

3.2 **Redemptions before and after death**

3.2(a) Because a shareholder's basis in his or her S corporation shares is affected by the corporation's income, loss and distributions (as well as the shareholder's capital contributions and capitalized expenses associated with the shares and the corporation's excludable income and non-deductible ex-

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[49] Treas. Reg. 1.13611-1(h)(2)().

penses),[50] S corporation stock basis is much more volatile than C corporation stock basis.

3.2(b) The carry-over basis rule for gifts might not be a big problem if the gift is stock of an S corporation that has substantial undistributed income. In effect, the parents can pay the tax on the income, give the shares to the children, and permit the children to take the tax-free distributions. (For S corporations without C corporation e&p, the play is in the stock basis. For S corporations with undistributed C corporation e&p, the key rule is that the "accumulated adjustments account" is maintained at the corporate level,[51] so a shareholder can lose or give up his or her right to receive tax-free distributions.

3.2(c) When a shareholder dies, there will be a basis adjustment in his or her shares under Section 1014.

3.2(d) A redemption or sale *before* death will result in gain if Section 302 sale-or-exchange treatment applies, and might be partly tax-free and partly taxable if Sections 301 and 1368 apply. So for appreciated stock, a "bad" 302 redemption is best, and an outright sale is to be avoided.

3.2(e) A redemption or sale *after* death will *not* result in gain if Section 302 or 303 sale-or-exchange treatment applies, and might be partly tax-free and partly taxable if Sections 301 and 1368 apply. So for appreciated stock, a "good" 302 or 303 redemption or a taxable sale is best, and a "bad" 302 or 303 redemption is to be avoided.

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[50] I.R.C. § 1367.

[51] I.R.C. § 1368.

3.3 Cross-purchase vs. redemption agreements; life insurance proceeds

Bottom line: Do a cross-purchase to avoid the "disappearing basis" problem, even in an S corporation.

Bottom line: Have the shareholders hold the insurance on each others' lives to avoid the "disappearing basis" problem, even in an S corporation. How to avoid the jillion policies problem? "Live with it" is the best answer. "Use a partnership" is the distant second best, but no one has resolved all the theoretical and mechanical problems raised by the partnership.

3.4 Life insurance premiums and stock basis

The AICPA's S Corporation Tax Committee believes that there should be no adjustment to outside (share) basis when an S corporation pays premiums on a **level-premium whole life** policy or on a **variable universal life** policy. However, the Committee believes that the premiums for **one-year renewable term** life insurance should reduce the shareholders' basis in their shares.[52]

[End of outline.]

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[52] DAILY TAX REPORT (BNA) October 30, 1995 at G-4.