

Subchapter S Stock in Trust Special Considerations

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Trusts can be an effective component of the wealth transfer strategy of closely held business owners. Transfers of corporate shares to a properly structured trust can enable the owner to reduce the number of shares includible in his or her estate (along with the future appreciation on those shares) while shifting income among family members. In addition, the valuation of such shares for transfer tax purposes often takes into account lack of marketability and/or minority interest valuation discounts.

Complementing the above transfer tax advantages are the controls that trusts enable business owners to establish over transferred stock. The intended donees may be minors who cannot legally hold title or young adults not yet ready for outright ownership. In either case, a carefully selected Trustee will provide the owner with more confidence of competent stewardship. Trusts also permit the owner to control ultimate disposition of the stock; for example, to lineal descendants rather than in-laws.

Trusts established to hold subchapter S stock must, however, be carefully structured in order to maintain the company's S corporation election under Internal Revenue Code ("IRC") §1362.

I. Trusts that Qualify as S Stock Shareholders

There are only three types of trusts which qualify as permitted shareholders of an "S Corporation" (a small business corporation satisfying all of the requirements of

IRC §1361 and which makes an IRC §1362(a) election):

A. Grantor Trusts are permitted S stock shareholders pursuant to IRC §1361(c)(2)(A)(i).

1. A trust is deemed a grantor trust if the grantor is treated as the owner for income tax purposes under IRC §§673-677, or treated as owned by an individual other than the grantor under IRC §678.

B. Qualified Subchapter S Trusts ("QSST"s) are permitted S stock shareholders pursuant to IRC §1361(d). A trust is a QSST if it meets all of the following requirements:

1. The trust has a single income beneficiary who is a U.S. citizen or resident.
2. All of the trust income is required to be distributed currently.
3. Any trust principal distributed during the income beneficiary's life must be distributed to him or her.
4. The beneficiary's income interest terminates upon the earlier of the beneficiary's death or the trust's termination.
5. If the trust terminates during the beneficiary's lifetime, all of the trust assets must be distributed to the beneficiary.
6. The income beneficiary must make a timely election to have the QSST rules apply to the trust.

C. Electing Small Business Trusts ("ESBT"s) are permitted S stock share-

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holders pursuant to IRC §1361(e). A trust is an ESBT if it meets the following requirements:

1. All beneficiaries, including present, remainder and reversionary interests are individuals, estates or charitable entities.
2. No interest in the trust is acquired by purchase.
3. The Trustee makes a timely election to have the ESBT rules apply to the trust.

Income taxation of ESBTs are governed by special rules under IRC §641 and the regulations thereunder, which provide that for federal income tax purposes, an ESBT consists of an S portion, a non-S portion, and, if an ESBT election is made for a grantor trust, a grantor trust portion. Among other things, these rules require that with the exception of capital gains, the income of the S portion of an ESBT is taxed at the highest marginal rate for trusts, Reg., §1.641(c)-1(e)(1).

Accordingly, the ESBT may provide more planning flexibility than a QSST, but carries a substantial risk of a higher income tax cost.

II. Planning Considerations for Clients Owning S Stock

An essential goal in implementing planning for an owner of S stock is to avoid creating any disposition that will inadvertently terminate the company's S election. At a minimum then, the following issues should be considered:

A. Determine whether a shareholders agreement exists that will require the stock to be redeemed or offered for sale upon the death of the client.

B. Should the S stock pass pursuant to a specific bequest because the client intends that a particular beneficiary or trust is to receive the stock?

C. If the S stock will not pass to a specific beneficiary, the executor should be given authority to enter into agreements with the other shareholders of the company.

D. If the S stock is to be distributed to a trust, the trust must qualify as an S stock shareholder. Many commonly employed estate planning trusts (such as a sprinkle credit shelter trust) will not qualify, or will qualify only as an ESBT, which can carry significant and unintended income tax consequences.

There may be opportunities during an estate administration to convert non-qualifying trusts into eligible S stock shareholders through disclaimers. Alternatively, the inadvertent termination of S corporation status may be avoided by a Trustee's distribution of S stock to the trust beneficiaries.

III. Post Mortem Income Tax Planning For Estates or Trusts Owning S stock

A. Trusts and estates holding S stock will have distributable net income ("DNI") regardless of whether the company makes distributions. The DNI will remain with the trust or estate and be subject to compressed income tax rates (35% on income in excess of \$9,550) if distributions are not made to the beneficiaries. Income tax savings may be achieved by distributing income (and with it the tax consequences) to beneficiaries with lower marginal tax rates.

B. Beginning with the day following the decedent's date of death, S corporation income attributable to S stock in decedent's estate will be reported on the estate's income tax return. Income tax deferral may be possible with a careful fiscal year selection by the fiduciary.

1. If estate administration is expected to take more than a year, selecting a fiscal year that ends after the close of the first

calendar year of the decedent's death may allow the deferral of income reporting and payment. For example, if the DNI of the estate is going to be distributed to the beneficiaries, selecting a fiscal year ending January 31 for the first fiscal year (provided the decedent did not die in January) would defer the reporting of the income since the estate would pass through the income in the next calendar year. This means the beneficiaries, if individuals, would have until April 15 of the following year to pay tax on this income.

2. If decedent's death is late in the calendar year, the fiduciary may want to consider a calendar year in order to isolate S stock income on the first short calendar year return of the estate.

3. If a revocable trust is involved, the fiduciary should consider an IRC §645 election to treat the trust for income tax purposes as a part of the estate (including the opportunity for the selection of a fiscal year.)

C. The fiduciary should also consider the implications of opting out of the per-share, per-day basis of allocating S stock income. The corporation may, with shareholder consent, create a separate taxable year from the decedent's date of death through the end of the corporation's tax year; Reg., §1377-1(b)(4). This is a significant opportunity in certain circumstances:

Assume decedent dies on December 1 owning 50% of S stock. If the corporation incurs a loss later in the month, substantially all of the loss would be reported on the decedent's final return where it may be lost. However, if an IRC §1377 election is made, the loss would be reported by the estate. The estate can carry forward the loss if it is not fully utilized in the current tax year.

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IV. The Distinction Between Accounting Income and Taxable Income can be Significant

DNI determines tax consequences to the beneficiary and is based on accounting income distributed pursuant to the governing instrument or local law. In several circumstances, the difference between fiduciary accounting and taxable income can have important consequences:

A. Assume a trust receives an S corporation K-1 showing taxable income of \$100,000, but the corporation distributes only \$40,000 to the trust. If the trust does not have additional assets to distribute, \$60,000 of taxable income will be trapped in the compressed rates at the trust level (assuming the trust is not an ESBT).

B. Assume an S corporation has minimal income but makes a large distribution of cash from a non-taxable sale of assets. Is this accounting income to the trust even though it is not taxable income? The answer to this question will be of critical importance to both the income and principal beneficiaries of the trust.

Our clients' planning needs often dictate the use of trusts. While the planning for clients who own closely-held businesses may create additional complexity and challenges, an understanding of the rules described above will permit you to accommodate your business owner clients' planning goals even where they require trust arrangements for their Subchapter S stock.

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