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ABILITY TO TRANSFER "S" CORPORATION STOCK TO INTER VIVOS TRUSTS

(Business Advisory No. 10)

Over the years, we have found that many of our clients elect to transfer their shares of "S" corporation stock to trusts as part of their estate planning. In doing so, it is important to ensure that the transfer does not terminate the "S" tax election of the corporation to the detriment of all of its shareholders and that upon death, the trust continues to qualify as a shareholder or the stock within the trust is distributed to individual beneficiaries. Normally,

- Transfers of "S" corporation stock through grantor inter vivos, revocable trusts do not undermine the corporation's "S" tax election with state and federal taxing authorities. (I.R.C. § 1361(c)(2)(A)(i); Regs. § 1.1361-1(h)(1)(i).)
- A previously qualified grantor trust remains an eligible shareholder within an "S" corporation for a two (2) year period from the date of the grantor's death, whereupon the trust must qualify as a QSST trust or the stock must be distributed to individual beneficiaries.
- There are specific requirements for qualifying the inter vivos trust as a shareholder in a corporation with "S" tax status. Otherwise, the "S" tax election is terminated for all of the corporation's shareholders.

This Advisory is neither exhaustive nor tailored to your specific situation. You should discuss your personal situation with us or with your own attorney. Our representation is only undertaken through a written engagement letter and not by the mere distribution of this Advisory.

"S" Tax Elections by Corporations. The "S" tax election for a California corporation must be made with the state and federal taxing authorities. Basically, it allows the corporation (and its 100 or fewer shareholders) to be taxed as a partnership for tax purposes. Gains and losses "flow through" to the shareholders. In California, however, there is an additional franchise tax of \$800 and 1.5% of taxable income. California Rev. & Tax Code § 23802(b). For closely held

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corporations, the "S" election, in spite of California's franchise tax, may still be the best tax alternative, although limited liability company status has become available (limited liability companies are fully treated as partnerships for federal and California taxes but have California franchise taxes based on gross revenues which are normally higher than the franchise taxes for a similar "S" corporation).

"S" Corporation Shareholders. An "S" election cannot be made by a corporation that has more than 100 shareholders, has as a shareholder a "person" who is not an individual (other than an estate during administration and certain trusts), has a nonresident alien as a shareholder, or has more than one class of stock. I.R.C. § 1361(b)(1). Further, the S corporation cannot own more than 80% of the stock of another corporation. I.R.C. § 1504(a)(1) and (2). If the shareholders (all of them) do not fall within this category at any time, then the "S" election is lost and the corporation, sometimes retroactively, is determined by the taxing authorities to be a "C" corporation. If "S" tax planning is employed, a change to a "C" corporation tax status can be problematic as there is double taxation (at the corporate and shareholder levels) which is especially difficult upon termination of the corporation or sale of its assets if there is an appreciated asset (the General Utilities doctrine was replaced by provisions in the Tax Reform Act of 1986).

"S" Election Agreement. Because of these tax ramifications, we normally suggest that the "S" corporation and its shareholders execute an "S" Election Agreement. This agreement guarantees the "S" tax status to each shareholder by the other shareholders and corporation unless all affected shareholders agree to a tax status change. The agreement also penalizes any shareholder causing the loss of the "S" tax status by making that person responsible for all taxes, penalties, etc., of the other shareholders and corporation for termination of the "S" tax status, levied by the IRS and Franchise Tax Board.

Inter Vivos Trust as a Qualified "S" Corporation Shareholder. When assets such as stock in an "S" corporation are transferred into an inter vivos trust, it is important to insure that each of the following requirements are met:

- (1) Any shareholders' agreement (including an "S" election agreement) should be revised prior to the transfer to specify the permissible transfers of stock to include transfers to the type of trust desired (I.R.C. §§ 673-678, 1361);

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- (2) The trust instrument should provide that the trust can be a holder of stock in an "S" corporation, or the trust instrument should be revised prior to the transfer;
- (3) The trust receiving the transfer should be revocable;
- (4) The trust can be an "S" corporation shareholder if it is owned by one individual (whether the grantor or another);
- (5) The trust should be a grantor trust. The income should be taxed to a grantor under I.R.C. § 677. The trust should be a grantor trust rather than a GRUT or GRAT which does not automatically qualify as an "S" corporation shareholder unless the trust instrument provides that grantor is taxed on all of the income earned by the trust (i.e., by making the trust a wholly grantor trust for income tax purposes). If the trust is a GRUT, GRAT, Section 678 or QSST (Qualified Subchapter "S" Trust), the trust can be revised to allow the trust to qualify to be an "S" corporation shareholder.

If we are not accomplishing your estate planning (as we do for most of our clients), we look forward to reviewing your trust before it is finalized to ensure the transfers of your "S" corporation stock will not terminate the corporation's "S" tax status. No changes should be made in your corporation's stock arrangements.

Disqualification Upon Death. Upon your death, your grantor inter vivos, revocable trust normally becomes irrevocable. Within two (2) years of your death, your trust will disqualify the "S" tax status of your corporation unless one of the following occurs:

- Your trust qualifies as a QSST trust (Qualified Subchapter "S" Trust); or
- The stock within the trust is transferred to individual beneficiaries.

While two (2) years is a long time, the beneficiaries of your trust and the shareholders of your corporation should be notified of the foregoing concerns upon death so appropriate actions

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are undertaken to qualify the trust or trust activities are undertaken to distribute the stock within two years.

This is a short summary of the interplay of corporation, estate and tax law as it applies to the holding of "S" corporation stock by inter vivos, revocable grantor trusts. In contemplating such a trust, transfer or other corporate or estate planning, it is important to seek the assistance of an attorney.

As always, you should be sure that additional legislation has not been enacted or court decisions rendered, that would change the above advisements. This Advisory is neither exhaustive nor is it tailored to your specific situation. You should discuss your individual situation with us or your own attorney. We look forward to being of assistance to you.

S. Timothy Buynak
Business and Tax Attorney

Enc: Sample Provisions

This Advisory is one of a series of business and tax advisories prepared by the attorneys at Buynak, Fauver, Archbald & Spray, LLP. Should you have further questions regarding the information provided in this Advisory, please contact the author listed above.

Buynak, Fauver, Archbald & Spray, LLP provides business legal services to individuals, business entities and nonprofit organizations from entity formation and start up, through day-to-day operations and exit strategies.

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Attachment: Sample Provisions

ARTICLE SEVEN
TRUSTEE

7.1. Remaining Settlor to Act as Sole Trustee on Death or Incapacity of Other Settlor. If, while both settlors are acting as cotrustees, either settlor dies, becomes incapacitated, or is otherwise unable or unwilling to continue to act as a cotrustee, the other settlor thereafter shall be sole trustee, with full power to continue the trust administration.

7.2. Successor Trustees. If the office of trustee becomes vacant, by reason of death, incapacity, or any other reason, then the following individuals in the following order of priority, shall be successor trustee:

First, _____, and _____, jointly, or the survivor(s) of them; and

Second, _____.

If all of the above individuals are unwilling or unable to serve as successor trustee, a new trustee or cotrustees shall be appointed by the court.

7.3. Power to Nominate Co or Successor Trustee. Any individual trustee shall have the power to appoint a cotrustee or successor trustee.

7.4. Definition of Trustee. Reference in this instrument to "the trustee" shall be deemed a reference to whoever is serving as trustee or cotrustees, and shall include alternate or successor trustees or cotrustees, unless the context requires otherwise.

7.5. Waiver of Bond. No bond or undertaking shall be required of any individual who serves as a trustee under this instrument.

7.6. Compensation of Individual Trustees. Each individual who is a trustee under this instrument shall be entitled to reasonable compensation for services rendered, payable without court order. Each corporate trustee under this instrument shall be entitled to compensation in accordance with its established compensation schedule for services rendered, payable without court order.

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7.7. Procedure for Resignation. Any trustee may resign at any time, without giving a reason for the resignation, by giving written notice, at least thirty (30) days before the time the resignation is to take effect, to the settlors, if living, to any other trustee then acting, to any persons authorized to designate a successor trustee, to all trust beneficiaries known to the trustee (or, in the case of a minor beneficiary, to the parent or guardian of that beneficiary) and to the successor trustee. A resignation shall be effective on written acceptance of the trust by the successor trustee.

7.8. General Powers of Trustee. To carry out the purposes of the trusts created under this instrument, the trustee shall have all of the powers enumerated in this trust instrument and all powers now or hereafter conferred on trustees under California law.

7.9. Power to Retain Trust Property. The trustee shall have the power to retain property received into the trust at its inception or later added to the trust, as long as the trustee considers that retention in the best interests of the trust or in furtherance of the goals of the settlors in creating the trust, as determined from this trust instrument, but subject to the standards of the prudent investor rule as set forth in the California Uniform Prudent Investor Act, as amended from time to time.

7.10. Trustee's Power to Invest Property. Subject to the standards of the prudent investor rule as stated in the California Uniform Prudent Investor Act, as amended from time to time, the trustee shall have the power to invest and manage the trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust.

7.11. Powers Regarding Subchapter S Stock. If at any time the trust estate includes shares of stock in any corporations that have elected to be governed by the provisions of Subchapter S of Chapter 1 of Subtitle A of the Internal Revenue Code (IRC Section 1361 et seq., or any successor sections), then notwithstanding any other provision of this instrument, the trustee shall at all times manage those shares, and administer the trust estate, in a manner that will maintain the S corporation status. To satisfy this obligation, but without limiting the discretion of the trustee to take any action to protect the S corporation status, the trustee shall act as follows:

- (a) Allocation or Distribution to Permitted Shareholders. The trustee shall allocate or distribute shares of S corporation stock only to those trusts or those beneficiaries that are permitted to be shareholders of an S corporation.

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- (b) Qualified Subchapter S Trust Provisions. If shares of S corporation stock are allocated to any trust created under this instrument and that trust does not otherwise qualify as a permitted shareholder under Internal Revenue Code Section 1361, or any successor section, then notwithstanding any other provision of this instrument, that trust (or any portion of that trust containing S corporation stock) shall be administered so as to ensure that it is a Qualified Subchapter S Trust (QSST), an Electing Small Business Trust (ESBT), or some other form of trust that qualifies as a permitted shareholder under Internal Revenue Code Section 1361, or any successor section. The S corporation stock in each such trust shall be held in separate share trusts (within the meaning of Internal Revenue Code Section 663(c), or any successor section) for each beneficiary; and all other property in each trust shall be held in a separate trust, which shall continue to be administered in accordance with the terms of this instrument. With respect to the separate share trusts holding S corporation stock, the trustee shall make distributions of income and principal, and otherwise administer the trusts, to ensure that those trusts do not become ineligible shareholders of an S corporation. To the extent that the terms of this instrument are inconsistent with those separate share trusts qualifying as permitted shareholders of an S corporation, those terms shall be disregarded.
- (c) Other Trustee Administrative Powers. The trustee shall have the power (1) to enter into agreements with other shareholders or with the corporation relating to transfers of S corporation stock or the management of the corporation; and (2) to allocate amounts received, and the tax on undistributed income, between income and principal. During the administration of a trust holding S corporation stock, the trustee may allocate tax deductions and credits arising from ownership of S corporation stock between income and principal. In making those allocations, the trustee shall consider that the beneficiary consider that the beneficiary is to have the enjoyment of the property at least equal to that ordinarily associated with an income interest.
- (d) Beneficiary Agreement. The trustee shall not distribute any S corporation stock to any beneficiary unless, prior to that distribution, the beneficiary enters into a written agreement with the S corporation stating the following: (1) that the beneficiary will consent to any election to qualify the corporation as an S corporation; (2) that the beneficiary will not

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interfere with the S corporation maintaining its S corporation status; (3) that the beneficiary will not transfer the S corporation stock to any transferee who does not agree to execute a similar consent; (4) that the beneficiary will not transfer the stock in a manner that will cause a termination of S corporation status under the then applicable federal and state tax law and regulations; and (5) that the beneficiary will join in any attempt to obtain a waiver from the Internal Revenue Service of a terminating event on the grounds of inadvertence if S corporation status is inadvertently terminated and the S corporation or any shareholder desires that S corporation status should continue.

- (e) Certificate to Bear Legend. If the trustee receives any shares of S corporation stock whose stock certificates bear a legend stating that the transfer, pledge, assignment, hypothecation, or other disposition of the stock is subject to the terms set forth in the preceding subsection, then the stock certificates shall also bear that legend when the trustee distributes those shares of S corporation stock to a beneficiary.

- (f) No Disqualification of Marital Deduction. Any grant of power or discretion to the trustee under this section shall be void to the extent that grant would cause the estate of the deceased settlor to lose all or part of the federal estate tax marital deduction, and in the event of an irreconcilable conflict between qualification of a trust as a permitted shareholder of an S corporation and qualification of that trust for the federal estate tax marital deduction, all of the S corporation's stock otherwise passing to that trust shall be distributed outright to the surviving settlor.

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