BUYNAK · FAUVER · ARCHBALD · SPRAY

ATTORNEYS

INADEQUATE ESTATE PLANNING CAN RESULT IN THE LOSS OF FAVORABLE "S" CORPORATION TAX STATUS

(Estate Planning Advisory No. 15)

To gain and maintain S corporation tax status,[1] a corporation must comply with certain requirements dictated by Federal and State tax laws and regulations. Often times, a corporation will inadvertently lose its S corporation status as a result of inadequate estate planning. This loss results in the corporation reverting to C corporation tax status,[2] with its unfavorable tax treatment for small, closely held corporations. The purpose of this Advisory is to summarize the S corporation tax requirements and provide common estate planning strategies to avoid the loss of favorable S tax treatment.

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.

Eligibility Requirements for S Corporations. In order for a corporation to have S corporation tax status, it must:

(1) Have 100 or less shareholders;

(2) Ensure that all shareholders are individuals, except certain estates, trusts and exempt organizations;

(3) Not have a nonresident alien as a shareholder (resident aliens qualify);

(4) Not have more than one class of stock (with certain exceptions);

(5) Not be an insurance company;

[1] See §1361-1379 Statutory references within this Advisory are to the Internal Revenue Code.
[2] See §301 et seq.

Buynak, Fauver, Archbald & Spray, LLP
820 State Street, 4th Floor | Santa Barbara, California 93101 | (805) 966-7000 tel
433 Alisal Road, Suite C | Solvang, California 93464 | (805) 688-8090
www.BFASLaw.com

(6) Not be a foreign corporation;

(7) Not be a domestic international sales corporation;

(8) Not have an IRC §936 election in effect (involving Puerto Rico and possession tax credit); and

(9) Timely file an election for S tax status (usually within 75 days of incorporation) with the State and Federal taxing authorities.

If any of these above requirements are not continually met, a corporation loses its S tax status. At first glance, it may seem as though it is easy to comply with the requirements. Frequently, however, in the course of a shareholder's estate planning, trusts are created without the forethought to include provisions allowing the trustee to amend the trust to ensure compliance with the S corporation tax status requirements.

Tax Consequences of Termination of S Corporation Tax Status. If any of the above-mentioned requirements for S corporation tax status are not met, the corporation's S tax status is immediately terminated and its tax year effectively ends on the day before the termination event. As a result of the termination, the corporation will be taxed as an S corporation up until the termination event and will be taxed as a C corporation for the rest of the corporation's fiscal year.

If a termination of S corporation tax status occurs, the shareholders and corporation lose the associated tax advantages and barring consent from the IRS,[3] will be unable to make another S corporation election for five years from the termination event. In the case of inadvertent termination, the IRS may disregard the termination if certain steps to remedy the problem are taken by the corporation and its shareholders with a reasonable time.[4]

Certain Trusts Can Be S Corporation Shareholders. It is quite popular for a shareholder undertaking estate planning to create a trust to hold his/her corporate stock. Three popular types of trusts that can be S corporation shareholders are (1) Grantor Trusts; (2) Qualified Subchapter S Trusts (QSST); and (3) Electing Small Business Trusts (ESBT).

1. Grantor Trust. A grantor trust is a trust where the grantor retains control over the income and/or principal; the grantor is therefore treated as the owner of the property and income for income tax purposes. For these trusts to be eligible S corporation shareholders, the grantor

[3] See §1362(g).
[4] See §1362(f).

must own all of the trust income and principal, with the grantor being a U.S. citizen or a resident of the United States.[5]

When a grantor trust is created to hold S corporation stock, it is important to consider what will become of the trust and the stock upon the death of the grantor. Tax provisions allow for a grantor trust, that continues in existence after the death of the grantor, to remain an eligible S corporation shareholder for two years from the death of the owner.[6] If, however, the trust is one that terminates after the death of the grantor, the trust becomes a successor trust, which is only eligible to be an S corporation shareholder for 60 days from the grantor's death.[7] Thus, after 60 days, the corporation's S tax status may be undermined by having an ineligible shareholder.

In order for a successor trust to continue its eligibility as an S corporation shareholder, it is often recommended that the successor trust acquire status as either a Qualifying Subchapter S Trusts (QSST) or Electing Small Business Trusts (ESBT) status. To achieve QSST or ESBT status, it is recommended that the trustee of the successor trust be authorized to satisfy the requirements of these trust arrangements upon the death of the grantor. To accomplish such a transition, the trust's trustee should be provided appropriate powers in the trust document, which is usual within Buynak Law's trust documents. The attachment sets forth the usual trust language.

*2. Qualifying Subchapter S Trusts (QSST***).** In order for a trust to qualify as a QSST, it must meet the following six requirements in its documentation and operation:[8]

(1) There may be only one income beneficiary of the trust.[9] (However, a QSST may have successive income beneficiaries as long as there is no more than one income beneficiary at any one time.[10])

(2) The trust may not distribute principal to anyone other than the income beneficiary.[11]

(3) The income beneficiary's interest must terminate at the earlier of (a) his or her death or (b) the termination of the trust.[12]

[5] See §§1361(c) and 673-678.
[6] See §1361(c)(2)(A)(ii).
[7] See id.
[8] Requirements listed in Tax Management Portfolio, 809 A-55.
[9] §1361(d)(3)(A)(i).
[10] Reg §1.1361-1(j)(1)(iii), (j)(9).
[11] §1361(d)(3)(A)(ii).
[12] §1361(d)(3)(A)(iii).

(4) If the trust terminates while the income beneficiary is alive, the assets held in the trust may be distributed only to the income beneficiary.[13]

(5) The trust must be required to distribute or must actually distribute currently (*i.e.*, at least annually) all income to one individual who is a United States citizen or resident.[14]

(6) The income beneficiary, or his or her legal representative, must elect to be treated as the deemed owner (§678(a)) of the portion of the trust consisting of the S corporation stock.[15]

If a trust meets all of the requirements listed above to become a valid QSST, the income beneficiary is required to make a QSST election within two months and 16 days of death for each corporation whose stock the trust is contemplated to hold.[16] The IRS has ruled that the first four requirements listed above must be set forth in the trust instrument and must be met even after the trust ceases to hold S corporation stock. This is not true of the fifth requirement.[17]

For QSSTs, the income beneficiary is deemed to be the S corporation shareholder, who is counted as one of the 100 authorized shareholders of the corporation. Should a grantor trust have multiple beneficiaries, it is possible to create several QSST trusts, provided that the foregoing requirements are met and the trust documents provide such authorization.

3. Electing Small Business Trusts (ESBT). The ESBT is somewhat more flexible than the QSST. The ESBT allows for multiple beneficiaries and the accumulation of income; however, it does not have the same tax advantages as a QSST.

The four requirements for becoming an ESBT are:

(1) The trust may not have beneficiaries other than individuals, estates, or certain specified charities, including public charities (§170(c)(2)), war veterans' organizations (§170(c)(3)), fraternal societies, orders, or associations (§170(c)(4)), and cemetery organizations (§170(c)(5)).

[13] §1361(d)(3)(A)(iv).
[14] §1361(d)(3)(B).
[15] §§1361(d)(1)(B), (d)(2).
[16] See Regs. §1.1361-1 (j)(6)(iii)(A).
[17] Rev Rul 89-55, 1989-1 Cum Bull 268 and PLR 9014008.

(2) No interest in the trust may be acquired by purchase.[18] (An interest is considered to have been purchased if its basis is determined under §1012. §1361(e)(1)(C).)

(3) The trustee must make the election to be treated as an ESBT.[19] In addition, because each potential current beneficiary of the ESBT is treated as a shareholder of the S corporation,[20] each individual must consent to the election to treat the corporation as an S corporation.[21] Failure to have all persons who are shareholders of the S corporation (in this case, all potential current beneficiaries of the ESBT) consent to the election invalidates the election. The IRS has authority, however, to waive the inadvertent invalidity of a qualified S corporation election.[22]

(4) The trust may not be a QSST, a tax-exempt trust, or a charitable remainder trust. (*i.e.*, a CRT).[23]

In order to elect to become an ESBT, a trustee must file a statement with the IRS within two months and 16 days of the transfer of the stock to the trust.[24]

Each potential beneficiary is treated as a shareholder of the S corporation, when beneficiaries include any person entitled to or who may receive a distribution. This definition could conceivably create a high number of shareholders depending on the language of the trust.

Since each beneficiary is considered a shareholder of the S corporation, it is important to consider how many potential beneficiaries exist in light of the 100-shareholder limit for S corporations. Often times, potential beneficiaries are overlooked and S tax status is unknowingly placed at risk.[25]

An additional consideration related to potential beneficiaries is the requirement that each shareholder of an S corporation be a U.S. citizen or resident. If any potential beneficiary of an

[18] §1361(e)(1)(A)(ii).
[19] §1361(e)(3). See Reg §1.1361-1(m)(2).
[20] Reg §§1.1361-1(h)(3)(i)(F), 1.1361-1(m)(4).
[21] §1362(a)(2); Reg §1.1362-6(b)(2)(iv).
[22] See §1362(f)(1)(A). Relief from late elections may be requested under Rev Proc 2003-43, 2003-1 Cum Bull 998.
[23] §1361(e)(1)(B)(ii)-(iii).
[24] See id.
[25] Current IRS Regulations have brought into question whether bypass trusts are viable ESBTs because the power of appointment may be construed by the IRS to take the number of S corporation shareholders over the limit of 100. Please consult your estate planning and/or tax attorney or us to determine whether your bypass trust may put your corporation's S tax status at risk.

ESBT trust is a nonresident alien, the corporation's S tax status is at risk.

The main drawback of ESBTs, as compared to QSSTs, is that they are not as tax-friendly.[26] For income taxes, ESBTs are effectively split into a corporate trust, which holds the S corporation stock, and a remainder trust, which holds the rest of the trust assets.[27] The corporate trust which holds S corporation stock is taxed at the highest individual rate, which is a burden for those shareholders who are not already in the highest tax bracket. If, however, all shareholders are already within the highest tax bracket, there is not a tax drawback to holding stock in an ESBT.

Solutions. Should you desire to protect and maintain the Subchapter S tax treatment of your corporation and to protect yourself as an individual shareholder, it is important to:

(1) Review all trusts before transferring your corporation's stock into them. The review should be for current and future compliance with S tax status requirements. A sample trust clause for future transition to a QSST or ESBT is attached.

(2) Have a shareholder agreement, which indemnifies you, your corporation, and other non-offending shareholders from the taxes and other damages through the failure of a shareholder who undermines the corporation's S tax status.

(3) Immediately supervise the disposition and transfer of stock of a deceased shareholder.

(4) Finally, if the S tax status of the corporation has been undermined by an ineligible shareholders, you should immediately contract your tax attorney as the Internal Revenue Service (IRS) and California Franchise Tax Board (FTB) can allow the reinstatement of the S tax status under certain circumstances provided that timely relief is requested and corrections made.

As always, you should be sure that additional legislation has not been enacted,[28] 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

[26] Please consult Buynak Law's Business or Estate Planning sections for a full explanation of the tax ramifications of ESBT's.
[27] See §641(c).
[28] Legislative proposals are currently pending; these proposals would liberalize some of the S corporation requirements and provide for more than one class of stock, a greater number of shareholders, etc.

S. Timothy Buynak
Business and Tax Attorney

Attachment: Sample Trust 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

A t t a c h m e n t
Sample Provisions

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:

1. 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.

2. 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.

3. 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 S 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 is to have the enjoyment of the property at least equal to that ordinarily associated with an income interest.

4. 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 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.

5. 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.

6. No Disqualification of Marital Deduction. Any grant of power or discretion to the trustee under this section shall be void to the extent that 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.