



# WRMarketplace

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**TOPIC: Oh No, There Goes the S Corp – Reviewing Trust Eligibility to Hold S Corp Stock.**

**MARKET TREND:** Many clients continue to use S corporations as their entity of choice, especially with active family businesses.

**SYNOPSIS:** A federal election to treat a company as a subchapter S corporation (an “S Corp”) enables taxation of a small business corporation as a pass-through entity for federal income tax purposes, avoiding the dual taxation otherwise imposed on corporations and their shareholders. Legacy planning with S Corp stock offers the same lifetime and testamentary legacy planning opportunities provided by limited liability companies (“LLCs”) and limited partnerships (“LPs”), including through gifts and bequests, installment sales to grantor trusts, and grantor retained annuity trusts (“GRATs”). Only certain types of trusts are eligible to hold S Corp stock, however, and these trusts must comply with several technical requirements to avoid jeopardizing an S Corp election.

**TAKE AWAYS:** Given the popularity of the S Corp structure for closely-held businesses, legacy planning advisors should have familiarity with the types of trusts that

may hold S Corp stock without invalidating the S Corp status, as well as the associated election deadlines and other technical requirements necessary for a trust to continue as an S Corp shareholder. A well-designed legacy planning trust will include language that allows the trust to qualify as an S Corp shareholder even though it does not currently own S Corp stock.

Despite the prevalence of LLCs and LPs in business planning, so-called “**S Corps**” remain an attractive option for clients with active family businesses. Yet, legacy planning for ownership of S Corp stock through a trust requires an understanding of the types of trusts that can both hold S Corp stock without jeopardizing S Corp status and meet the client’s goals for business succession.

### **WHAT IS AN S CORP?**

Most corporations are taxed under subchapter C of the Internal Revenue Code (“**Code**”) as so-called “**C corporations**” and incur federal income tax on two levels: (1) the corporation pays tax on income it generates and (2) the shareholders pay tax on corporate dividends they receive at either ordinary income or qualified dividend tax rates. An S Corp, however, is a corporation where the shareholders have unanimously elected taxation as a pass-through entity pursuant to subchapter S of the Code. Like LLCs and LPs, S Corps pass corporate income, losses, deductions, and credits through to their shareholders, who then report and pay tax on the income at their personal income tax rates. The tax treatment of S Corps **eliminates the dual-level taxation** imposed on C corporations.

To make an S Corp election, the corporation must be a “small business corporation,”<sup>1</sup> meaning:

- The corporation **cannot have more than 100 shareholders**;
- All shareholders must be **individuals, estates of individuals, or certain types of trusts**;
- All shareholders must be **U.S. citizens or residents** (no non-resident aliens);
- The corporation can have **only one class of stock** (although that stock can be comprised of voting and non-voting shares);<sup>2</sup> and
- The corporation cannot be a financial institution, insurance company, or a current or former domestic international sales corporation.<sup>3</sup>

### **TRUSTS ELIGIBLE TO HOLD S CORP STOCK**

S Corps offer many of the same legacy planning advantages as LLCs and LPs, including creditor protection, pass-through treatment of income, the ability to place voting control in the hands of family members involved in the business, and the ability to restrict the transfer of shares. S Corp stock can be used with gifts, installment sales to grantor trusts, GRATs, and other types of lifetime and testamentary trust planning, provided that the types of trusts used qualify as eligible S Corp shareholders.

**Grantor Trusts.** A trust deemed owned by one individual who is a U.S. citizen or resident is a permissible shareholder for S Corp purposes.<sup>4</sup> Such trusts include revocable trusts and irrevocable trusts deemed to be owned by the grantor or a beneficiary for income tax purposes under the grantor trust rules found in Code §§ 671-679 (“**grantor trusts**”).<sup>5</sup> GRATs and grantor retained unitrusts also are permitted shareholders as long as the trusts are otherwise treated as a grantor trust. Yet, ***foreign trusts are not permissible shareholders even if the grantor is a U.S. citizen or resident.***<sup>6</sup> The deemed owner of the grantor trust is treated as the shareholder for purposes of the S Corp election.<sup>7</sup> Like other grantor trusts, income generated by the S Corp is reported by the deemed owner on his or her individual income tax returns.

**Estates & Grantor Trusts After the Grantor’s Death.** If an individual owns S Corp stock at death, ***the individual’s estate*** is a permissible owner of S Corp stock for a ***reasonable period*** of time required to administer the estate.<sup>8</sup> The estate is treated as the owner of the stock for eligibility purposes and pays tax on the estate’s share of corporate income.

Similarly, a grantor trust may continue to be an S Corp shareholder following the death of the grantor (and termination of grantor trust status), but only for two years.<sup>9</sup> The estate of the deemed owner of the grantor trust is treated as the shareholder for purposes of the S Corp election.<sup>10</sup> However, the trust or the beneficiaries will report and pay tax on the income generated by the S Corp. The trust can continue as a shareholder after the two-year period without jeopardizing the S Corp election only if it otherwise qualifies as an eligible shareholder at that time.

**Trusts Receiving Stock Pursuant to a Will.** A trust that receives S Corp stock pursuant to the terms of the owner’s Will also may hold the stock for two years beginning on the date the stock is transferred to the trust.<sup>11</sup>

*Example:* H, a U.S. citizen, owns all of the stock of HoldCo, an S Corp. H’s Will distributes all his stock in HoldCo to a trust for his son. H’s estate is a permissible shareholder for a reasonable period of time for administration. When the stock is distributed to the son’s trust, the trust also is a permissible shareholder of HoldCo stock for two years after the transfer to the trust.

S Corp income is reported by the trust or the beneficiaries. For the trust to continue as an eligible shareholder after the two-year period, it must otherwise qualify as an eligible shareholder (for example, as a QSST or ESBT, discussed below) at that time. If the trust is not then eligible, the S Corp status will be lost, and corporate income will be subject to dual taxation.

**Qualified Subchapter S Trusts (QSSTs).** For a non-grantor trust to hold S Corp stock, the trust must qualify as either a QSST or an electing small business trust. QSSTs generally offer more favorable tax treatment than electing small business trusts but

provide less flexibility with respect to the number of beneficiaries or accumulation of income.

*Qualifications.* To qualify for treatment as a QSST, the terms of the trust must provide that:

- There is only one beneficiary of the trust.
- The beneficiary must be a U.S. citizen or resident.
- During the beneficiary's lifetime, principal can only be distributed to the beneficiary.
- The beneficiary's interest in trust income terminates only upon the beneficiary's death or earlier termination of the trust.
- If the trust terminates during the beneficiary's lifetime, the trust must distribute all assets to the beneficiary.
- All the trust's income must be distributed, or be required to be distributed, currently to the beneficiary.<sup>12</sup>

*Example:* H, a U.S. citizen, transfers all his stock in HoldCo, an S Corp, to Trust X, a revocable trust (a grantor trust and permissible S Corp shareholder). After H's death, all the HoldCo stock passes to a lifetime trust benefiting H's son, also a U.S. citizen. As long as the trust meets the above requirements and a timely election is filed with the IRS to treat the trust as a QSST, the trust may continue to hold the S Corp stock without invalidating the S Corp election.

The beneficiary of the QSST is treated as the owner of the stock for purposes of the S Corp election. Marital deduction trusts (such as general power of appointment marital trusts and qualified terminable interest property trusts) generally will qualify for a QSST election, as will an irrevocable trust created for a minor under Code §2503(c) and trusts for a single beneficiary with mandatory distributions of income. Trusts that have more than one beneficiary, such as ***"pot" or sprinkle trusts, generally will not qualify for the QSST election***, although well-designed trusts should include savings provisions that allow the S Corp stock to be segregated into a separate share and held solely for the benefit of one beneficiary, allowing that share to qualify as a QSST as long as all of the other requirements are satisfied.<sup>13</sup>

*Tax Treatment.* As the deemed owner of the S Corp stock, the beneficiary pays the tax on the trust's share of corporate income at the beneficiary's individual income tax rate.

- ✓ ***Practice Point:*** The beneficiary is responsible for paying the tax on ***all the trust's share of corporate income***, even if retained by the corporation. A shareholders agreement, discussed below, can be used to ensure each shareholder receives at least the amount of income necessary to cover the shareholder's income tax liability.

*Election Requirements.* An election to treat a trust as a QSST must be **made by the beneficiary within 2 ½ months** after the transfer of stock to the trust. A **separate election is required for each S Corp** in which the trust has an interest.<sup>14</sup> Once made, the election is treated as being made by each successive beneficiary unless a beneficiary affirmatively refuses to consent,<sup>15</sup> potentially giving later beneficiaries the unilateral ability to invalidate the S Corp election for the entire corporation.

**Electing Small Business Trusts (ESBT).** A non-grantor trust also may hold S Corp stock if it is an ESBT.

*Qualification.* Generally any trust (other than a QSST, tax exempt trust, or charitable remainder trust) can qualify as an ESBT as long as:

- The trust only has individuals, estates of individuals, and/or certain charities as beneficiaries.
- No beneficiary's interest in the trust was acquired by purchase (this requirement does not prevent the trust from acquiring the S Corp stock by purchase).
- The trustee makes a timely election with the IRS to treat the trust as an ESBT.<sup>16</sup>

ESBTs are generally used when the trust is a “pot” or sprinkle trust for multiple beneficiaries. **Each potential current beneficiary** of the trust is treated as a shareholder for purposes of the S Corp election or, during any period of time that there is no potential current beneficiary, the trust is treated as the shareholder.<sup>17</sup>

*Example:* H, a U.S. citizen, makes a gift of HoldCo stock, an S Corp, to Trust X, an irrevocable non-grantor trust benefiting his children and their descendants, all of whom are U.S. citizens. None of the beneficiaries has acquired an interest in the trust by purchase. As long as the trust files a timely ESBT election with the IRS, the trust may hold the stock without invalidating the S Corp election.

*Tax Treatment.* With an ESBT, the trust reports and pays tax on the trust's share of S Corp income at the trust's income tax rate, even if the income is distributed to the beneficiaries. This can result in a higher effective tax rate since the trust reaches the highest income tax bracket with relatively little income.

*Election Requirements:* The ESBT election must be **made by the trustee** (rather than the beneficiaries) with the IRS within 2 ½ months after the transfer of stock to the trust.<sup>18</sup> Generally, the election applies for all S Corps in which the trust has an interest; unlike QSSTs, separate elections are not required.<sup>19</sup>

**QSST vs. ESBT:** While both the QSST and ESBT elections enable an otherwise ineligible trust to hold S Corp stock, differences in the impact of each election may favor one over the other. Trusts that require annual distributions of trust income, such as a marital deduction trust, or a trust for the benefit of one beneficiary, would fit into the

requirements for a QSST election and may result in a lower effective tax if the beneficiary is in a lower tax bracket. A so-called “BDIT” or beneficiary defective inheritor’s trust could either be treated as a grantor trust (as to the beneficiary) or qualify as a QSST.

An ESBT generally would be favored for trusts with multiple beneficiaries that do not designate a primary beneficiary, such as a “pot” trust for the collective benefit of the client’s children. An ESBT election also would be more appropriate where the client prefers to accumulate excess income (rather than forcing income distributions to the beneficiary or beneficiaries) or where the beneficiary is unwilling to make a QSST election or consent to the S Corp election.

The differences in the effect of the QSST and ESBT elections, illustrated in the below chart, must be analyzed in light of each client’s individual goals, needs, and circumstances to determine which election is appropriate for the client and his or her intended beneficiaries.

QSST	ESBT
Election is made by the beneficiary	Election is made by the trustee
Requires <b>beneficiary</b> consent to the S Corp election - each successive beneficiary may unilaterally revoke the election by refusing to consent	Requires <b>trustee</b> (not beneficiary) consent to the S Corp election
Separate QSST elections must be filed for each S Corp in which the trust holds an interest	Generally only one ESBT election is required, even if the trust owns stock in multiple S Corps
May have only one beneficiary	May have multiple beneficiaries
All income must be distributed currently	Income may be distributed or accumulated
Beneficiary reports and is taxed on all income at the beneficiary’s individual income tax rate	Trust reports and is taxed on income at trust’s income tax rate, even if distributed to beneficiaries
Only the current income beneficiary is counted as a shareholder for purposes of the S Corp election	Each potential current beneficiary is counted as a shareholder for purposes of the S Corp election and the limitation on the number of shareholders
On trust termination (at beneficiary’s death), a two-year grace period applies before the new owner or trust must qualify as an eligible S Corp shareholder	On trust termination, shares must immediately be transferred to a person who is an eligible S Corp shareholder

**Voting Trusts.** Voting trusts also are permissible shareholders for purposes of the S Corp election.<sup>20</sup> A voting trust is created primarily to vote the stock transferred to it, with voting authority granted to the trustees. Generally, only voting rights are transferred to the trust and each beneficiary retains his or her rights to dividends or distributions. Voting trusts can be used to consolidate voting control over ongoing management of the

company, resolve issues regarding limitations on irrevocable proxies, or to deal with a specific short-term corporate matter.

To qualify as a S Corp shareholder, the voting trust must be in writing, require that distributions from the S Corp be paid to the beneficiaries, require that the stock be returned to the original shareholders when the trust terminates, and set a date or event on which the trust terminates.<sup>21</sup> Each beneficiary of the voting trust is treated as an S Corp shareholder for purposes of the election and reports his or her share of S Corp income on his or her individual income tax returns.<sup>22</sup>

### ***THE NEED FOR A SHAREHOLDERS AGREEMENT***

In light of the many ways an S Corp election could be invalidated by future shareholders (whether trusts or individuals), legacy planning advisors should discuss establishing a shareholders agreement for the corporation with their clients. A shareholders agreement can define shareholders' rights and obligations with respect to the stock and the S Corp election, including restrictions on shareholders that may terminate S Corp status. Shareholder agreements also can require that the corporation distribute a minimum amount of income annually to cover each shareholder's income tax liability, even if no other income is distributed.

### ***TAKE AWAYS***

Given the popularity of the S Corp structure for closely-held businesses, legacy planning advisors should have familiarity with the types of trusts that may hold S Corp stock without invalidating the S Corp status, as well as the associated election deadlines and other technical requirements necessary for a trust to continue as a S Corp shareholder. A well-designed legacy planning trust will include language that allows the trust to qualify as an S Corp shareholder even though it does not currently own S Corp stock.

### ***DISCLAIMER***

**This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.**

### ***NOTES***

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<sup>1</sup> Code § 1361(b).

<sup>2</sup> Code § 1361(c)(4).

<sup>3</sup> Code § 1361(b).

<sup>4</sup> Code § 1361(c)(2)(A)(i).

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<sup>5</sup> A beneficiary can be the deemed owner of a trust if the beneficiary holds any of the powers listed in Code § 678, for example as with a beneficiary defective inheritor's trust, or BDIT.

<sup>6</sup> Code § 1361(c)(2)(A).

<sup>7</sup> Code § 1361(c)(2)(B)(i).

<sup>8</sup> Code § 1361(b)(1)(B); *see also*, *Old Va. Brick Co. V Commissioner*, 367 F.2d 276 (4th Cir. 1966).

<sup>9</sup> Code § 1361(c)(2)(A)(ii).

<sup>10</sup> Code § 1361(c)(2)(B)(ii).

<sup>11</sup> Code § 1361(c)(2)(A)(iii).

<sup>12</sup> Code § 1361(d)(3).

<sup>13</sup> *Id.*

<sup>14</sup> Code § 1361(d)(2)(B)(i).

<sup>15</sup> Code § 1361(d)(2)(B)(ii).

<sup>16</sup> Code § 1361(e)(1).

<sup>17</sup> Code § 1361(c)(2)(B)(v).

<sup>18</sup> Code § 1361(e)(3).

<sup>19</sup> Treas. Regs. § 1.1361-1(m)(2)(i).

<sup>20</sup> Code § 1361(c)(2)(A)(iv).

<sup>21</sup> Treas. Regs. § 1.1361-1(h)(1)(v).

<sup>22</sup> Code § 1361(c)(2)(B)(iv).