



Don't let S corporation stock throw you a curve

The S corporation remains one of the most popular entity choices for closely held businesses, combining limited personal liability with the advantages of pass-through tax treatment. From an estate planning perspective, however, S corporation stock can complicate matters.

S corporation restrictions

One of an S corporation's biggest advantages is that it avoids double taxation. Unlike a C corporation, whose earnings are taxed once at the corporate level and again when they're distributed to shareholders in the form of dividends, an S corporation pays no corporate tax (at least at the federal level). Earnings are passed through to the shareholders, who pay tax at their individual rates on their proportionate shares of corporate income.

To qualify for this tax treatment, an S corporation must meet several requirements. It can't have more than one class of stock, for example, or more than 100 shareholders. (For purposes of the 100-shareholder limit, family members – generally defined as descendants of a common ancestor and their spouses – would count as a single shareholder, so long as any one family member so elects.)

Eligible shareholders are limited to individuals who are U.S. citizens or residents, estates, certain tax-exempt organizations and certain domestic trusts. If S corporation stock is transferred to an ineligible shareholder, the company risks termination of its S election and loss of the tax benefits that go with it.

Eligible trusts

Many people use trusts to build flexibility into their estate plans, preserve their wealth for future generations and remove assets from their taxable estates without relinquishing all control. Five types of domestic trusts (foreign trusts don't qualify) are permitted to hold S corporation stock. Voting trusts are one type, but they have little relevance to estate planning. Here's a review of the pros and cons of the other four:

1. Grantor trust. This is a lifetime trust structured so that the grantor is the owner of the trust assets for income tax purposes. Grantor trusts play an important role in many estate plans. A grantor retained annuity trust (GRAT), for example, can transfer S corporation stock and other assets to family members at a minimal tax cost while continuing to receive some or all of the income.

One drawback of a grantor trust is that, to qualify as an S corporation shareholder, it can have only one deemed owner. This may limit the trust's ability to take advantage of techniques such as Crummey withdrawal powers to reduce or eliminate gift taxes on contributions.

When the grantor dies, the trust ceases to be a grantor trust. It will continue to qualify as an S corporation shareholder for two years, however, providing time to transfer the stock to an eligible shareholder or qualify the trust as a qualified Subchapter S trust (QSST) or an electing small business trust (ESBT).

2. Testamentary trust. A trust established by the terms of your will is eligible to hold S corporation stock for up to two years after the shareowner's death. To continue holding the stock after the two-year period, the trust must qualify as a QSST or ESBT.

3. QSST. To qualify as a QSST, a trust must meet several requirements, including distributing all of its current income to a single beneficiary who is a U.S. citizen or resident. Also, the beneficiary must file a timely QSST election with the IRS.

The primary disadvantage of the QSST is that it can't be used to benefit multiple beneficiaries or allow income to accumulate.

4. ESBT. A trust qualifies as an ESBT if all of its beneficiaries are individuals, estates or certain types of charities; no beneficiary purchases an interest; and the trustee files a timely ESBT election with the IRS.

An ESBT offers estate planning flexibility: The trust income can be accumulated or it can be sprinkled among many beneficiaries. A variety of trusts commonly used in estate planning can qualify, including credit shelter trusts and charitable lead trusts. The main disadvantage is that the trust's income is taxed at the highest marginal rate (currently 35%). (A QSST's income is taxed at the beneficiary's marginal rate, which is often lower.) This is neutralized in a situation where the individual already is paying tax at the highest rate. In such a case, whether the shares were held by the individual or the trust, the tax rate would be the same.

For S corporation purposes, each potential current beneficiary (PCB) is treated as a shareholder. A PCB is anyone who's entitled to distributions from the trust or who, at the discretion of any person, may receive a distribution. Under a 2004 tax law, however, PCBs don't include persons who might receive a distribution under an unexercised power of appointment.

It's critical to scrutinize the trust's terms to be sure that its PCBs don't include ineligible shareholders (such as nonresident aliens) or cause the S corporation to exceed the 100-shareholder limit. If that happens, the trust can avoid a termination of the corporation's S election by disposing of all of its S corporation stock within one year.

Review your options

If you own S corporation stock, review your estate plan and take steps to avoid transfers that would endanger the corporation's S status. Trusts such as QSSTs and ESBTs provide estate planning flexibility for S corporation shares, but they have drawbacks. Consult with your estate planning professional to learn more about your options.

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