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# **S-Corp Trusts in Estate Planning: Drafting Grantor, Testamentary, Qualified Sub S and Electing Small Business Trusts**

Navigating Interest Expense and NII Issues and Overcoming Challenges to Maintain Tax Attributes

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TUESDAY, JULY 29, 2014

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

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# Some S-Corporation Estate Planning and Estate Administration Issues

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# The S-Election

- (i) no more than 100 shareholders,
- (ii) all shareholders are
  - individuals (other than nonresident aliens or, in most cases, their spouses),
  - decedents' estates, bankruptcy estates,
  - certain limited kinds of trusts,
  - certain charities, or
  - the corporation's stock may be 100% owned by another S-corporation
- (iii) there is only one class of stock.
  - As long as the economics are the same (such as rights to dividends or liquidating distributions), there may be different classes varying only as to voting rights.

# Use of Trusts, generally

- More restrictive than with LLCs
- Forced to fit the plan to the best available trust type
- Failure to plan properly can destroy the S-election
- Often will have agreements among shareholders to restrict transactions jeopardizing the election

# Types of available trusts

- a voting trust
- a grantor trust
- a trust with a deemed owner other than the grantor
- a will recipient trust, that is, a testamentary trust receiving the stock pursuant to the will
- certain tax-exempt trusts such as for qualified plans or for certain charities
- a qualified subchapter S trust or QSST
- an electing small business trust or ESBT



# Nonelective Trusts

- Voting trust: may be useful in establishing management control over the corporation
- Grantor trusts: trusts where some significant power is reserved by the grantor (or the grantor's spouse)
  - the grantor is taxed on the trust's income

# Useful Grantor Trust Types

- revocable estate planning trusts
- “defective” irrevocable trusts intentionally created to have one or more of the proscribed powers in the grantor; deemed owner trusts are treated similarly
- grantor-retained annuity trusts or grantor-retained unitrusts (GRATs and GRUTs)
  - charitable remainder trusts, however, cannot be grantor trusts and still qualify

# Grantor trust effects

- Holding periods for non elective trusts
  - grantor trusts may continue to hold the S-corp stock for up to two years after the death of deemed owner, the grantor.
  - A will recipient trust only qualifies as a shareholder for two years beginning on the day the stock is transferred to it from the estate.
  - If a decedent's estate is unreasonably prolonged, the estate is deemed terminated after the expiration of a reasonable period for administration. The estate is then treated as a trust.

# Grantor Trust Effects, cont'd

- Results if not distributed timely
  - If trust is not disposed of prior to end of the two-year period, the S election will be disqualified.
  - May timely elect a form of elective trust to maintain S election
- The estate of the grantor (deemed owner) will be treated as the stockholder prior to distribution.

# Elective Trusts

- QSST or ESBT trusts require the filing of special elections
- QSST is, essentially, a single beneficiary trust
  - marital trusts
  - minor gift trusts
  - charitable remainder trusts
  - Other trusts for single beneficiaries

# QSST Qualification

- actually distribute income to only one current income beneficiary, or be required to distribute to but one beneficiary
- income beneficiary must be a U.S. Citizen or resident
- during the life of the current income beneficiary, there will be but one current income beneficiary (separate shares can work)

## QSST Qualification, cont'd

- must require any principal distributed during the current income beneficiary's lifetime must only go to that beneficiary
- income interest terminates on the earlier of death or the termination of the trust
- distribution of the entire trust to the current beneficiary if the trust terminates while the current income beneficiary is alive

# QSST Election

- Current income **beneficiary** must timely elect QSST treatment, generally within two months and 16 days after the stock is transferred to the trust, or after the S election is effective if the S election is made while the trust holds the stock
  - separate QSST **election is required for each S-corp** held by the trust
  - continues in effect for successive beneficiaries, unless the beneficiary affirmatively refuses consent
  - current income beneficiary may unilaterally terminate the S election by refusing consent; other shareholders cannot (solve by agreement)



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# ESBT

- ESBT is a multiple beneficiary trust
- may sprinkle or accumulate income
  - credit-shelter trusts
  - grantor trusts with multiple beneficiaries which continue after the death of the grantor

# ESBT Qualification

- only individuals, estates, or certain charities as beneficiaries
  - Beneficiaries include present, reversionary, or remainder beneficiaries
  - other trusts are looked through and their beneficiaries are treated as the beneficiaries
  - potential recipients under an exercise of a power of appointment are not treated as beneficiaries (for this purpose) until exercised
  - nonresident aliens are permitted as eligible, but *not* as potential current beneficiaries (see below)
  - No tax exempt trusts or CRATs or CRUTs

## ESBT Qualification, cont'd

- No interest in the trust may be acquired by purchase
- The **trustee** must elect ESBT treatment, generally two months and 16 days after the stock is transferred to the ESBT
  - Only **one election per trust** is needed unless different IRS service centers are involved
  - If it is a grantor trust, the deemed owner must consent (e.g., an irrevocable grantor trust)
  - ESBT may convert to a QSST
    - otherwise, the election is irrevocable and protective elections are not allowable

# ESBT effects

- Each “potential current beneficiary” is treated as a shareholder for the 100 shareholder limit
  - if none, the trust itself is the shareholder for this
- A “potential current beneficiary” is any person who at any time during the period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust
  - unexercised powers of appointment may be disregarded
  - the time to dispose of stock after an ineligible shareholder becomes a potential current beneficiary is one year
  - if shares become separate shares, each income beneficiary can make an election to revoke the ESBT election for the separate share for that beneficiary and treat it as a QSST

## ESBT Effects, con'd

- There are three portions with differing tax treatment:
  - a grantor portion,
  - a nongrantor portion, which in turn is subdivided into
    - a non-S portion and
    - an S portion
- The grantor portion is the part treated as owned by a grantor or deemed owner under the grantor trust rules,
  - this portion is taxed to such grantor or deemed owner
  - it may include both S-corp stock or other assets

## ESBT Effects, cont'd

- non-S portion is the portion of the assets, other than S-corp stock, not treated as a grantor portion
  - treated as a separate trust using normal trust tax rules
  - dividends from the S-corp and interest on the sale of S-corp stock are includible in income of this separate trust

# ESBT Effects, cont'd

- S portion is the portion consisting of S-corp stock not treated as a grantor portion, treated as a separate trust
  - takes into account specified items ("S portion items") aggregated from all S-corps of which it owns stock
  - Except for capital gains, these items are taxed at the highest trust marginal rates, with no exemption for alternative minimum tax purposes, and are not included in income by any beneficiary, but are included in the overall actual trust's distributable net income (DNI), but are not deductible from it.
  - Disadvantage in keeping out of beneficiary lower brackets
  - Highest trust tax bracket other than capital gain
- The taxation of distributions stays the same for the overall actual trust, so that the DNI of the trust would follow a distribution to the beneficiary and be taxed to the beneficiary with a corresponding deduction for the *non-S* portion



# ESBT Effects, Con'd

- IRC 641(c): The only items of income, loss, deduction, or credit to be taken into account [by the ESBT] are the following:
  - (i) The items required to be taken into account under section 1366.
  - (ii) Any gain or loss from the disposition of stock in an S corporation.
  - (iii) To the extent provided in regulations, State or local income taxes or administrative expenses to the extent allocable to items described in clauses (i) and (ii).
  - (iv) Any interest expense paid or accrued on indebtedness incurred to acquire stock in an S corporation.
- No deduction or credit shall be allowed for any amount not described in this paragraph, and no item described in this paragraph shall be apportioned to any beneficiary.

# ESBT Effects, charitable contributions

- If an S corporation makes charitable donations, a pro rata share passes through to the ESBT and the share is treated as contributed by the S portion, subject to deduction limitations.
- If the ESBT donates S stock to charity, neither the S portion nor the non-S portion gets a deduction.

# Planning Considerations

- Personal Representatives need to consider distributions to qualifying stock holders and not keeping estate open so long as to be treated as a trust
- Trustees need to consider ESBT election
  - Can save the S election and provide family flexibility, but at the cost of bad tax results and much complexity
- Beneficiaries need to consider QSST election
  - Better tax results, less family flexibility

# Planning Considerations, cont'd

- All shareholders need to consider shareholder agreements
  - To maintain the election (e.g., no disqualifying shareholders)
  - Assure only proper trusts (or none at all) are shareholders
  - Assure fair distribution policies, treatment on sale of stock (e.g., book closing).
- Planners need to consider whether other forms of organization are superior overall; important factors include:
  - Step up basis at death (inside and outside basis),
  - special allocations and classes of interest,
  - any kind of trust can be used,
  - charging order creditor protection,
  - charitable planning,
  - possible modest self employment tax saving with S-corp., passive income,
  - state taxation

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# Planning for S Corp. Trusts and the NII Surtax

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**PRESENTED BY: Louis Vlahos**

Tuesday, July 29<sup>th</sup>, 2014

## S Corps.

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- S. corps. v. LLCs: S corps. suffer from a number of deficiencies.
- Many S corps. out there, though.
- Many C corps. that probably should be S corps.
- S corp. advantage over C corp. on sale of assets.
- S corp. advantage over C corp. on Section 1411 surtax.

## S Corp. and Section 1411

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- Portfolio-type income; e.g., C corp. dividends; sale/redemption of C corp. stock – subject to tax without regard to shareholder’s participation in business.
- S corp. shareholder that materially participates in business may avoid the surtax.
- S corp. shareholder that does not so participate: taxable on Section 1366 share of income; Section 1368 gain on distribution in respect of stock; Section 302(b) redemption and 1001 sale of stock.



## Post-Death Planning and Inter-vivos Trusts

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- Planning point for estate of deceased shareholder of S corp.
- Section 1014 basis step-up for stock (no inside basis adjustment as for an LLC under Section 754).
- Sale of assets; Section 1366 gain flow-through; Section 1367 basis adjustment.
- Liquidation of S corp. in year of asset sale; create offsetting loss.
- E.g., PLR 9218019.
- Section 2036 and non-taxable estates – bring trust into gross estate for basis step-up.

## Section 1411 Overview

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- 2013 brought increased OI rate (39.6%), increased capital gain rate (20%), and 3.8% surtax on NII. P.L. 112-240; P.L. 111-152, respectively.
- NII includes: interest, dividend, royalty, rent, etc.; IRC 1411(c)(1); Reg. 1.1411-4(a).
- Importantly: it also includes income from a T/B that is passive as to the taxpayer, and gain from the disposition of property unless held in a non-passive T/B. IRC 1411(c)(1)(A)(iii); Reg. 1.1411-4(a)(1)(iii).

## S Corp. Income and NII

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- Passive T/B – look to Section 469 rules. IRC 1411(c)(2)(A); Reg. 1.1411-5.
- S. corp.: passive v. non-passive determination is made at shareholder level. IRC 1411(c)(2)(A); Reg. 1.1411-4(b)(2)(i); Reg. 1.1411-4(c); Reg. 1.1411-4(d)(4).
- Sale of S Corp. stock: include gain in NII to extent of gain that would be taken into account on sale of corp.'s assets. Reg. 1.1411-4(d)(4); Prop. Reg. 1.1411-7.

## NII Thresholds

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- Individual TPs: surtax imposed on lesser of (a) NII for the year, or (b) excess of modified AGI for the year over “threshold amount” (\$200,000 for single TP). IRC 1411(b)(1).
- Trust: surtax imposed on lesser of (a) undistributed NII for the year, or (b) excess of (i) trust’s AGI over (ii) dollar amount for highest trust bracket (\$12,150 for 2014). IRC 1411(a)(2). Note the difference.

## Trust NII

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- Undistributed NII is reduced by NII included in distributions to beneficiaries that are deductible under Section 651 or Section 661. Reg. 1.1411-3(e).
- Beneficiaries deemed to receive proportionate taxable amount of each item of DNI (ratio of distribution amount to DNI amount).
- Same proportionate amount of trust's NII. Reg. 1.1411-4(e).
- Limited application to most S corp. trusts, as we will see.

## Trust Planning for NII -- in General

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- Consider threshold at which surtax applies for individual beneficiaries vs. trust.
- Incentive for trust to make distributions -- get income to a beneficiary who has less income, or who is below the threshold.
- Distribute income-producing property?
- Remember grantor's purpose for the trust, and the dispositive scheme - tax tail should not wag the dog.

## S Corp. and Material Participation

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- IRC 1366 pass-through – includes share of corp.’s NII.
- Is the S corp. engaged in T/B?
- Passive or not? Determined at shareholder level.  
Reg. 1.1411-4(b)(2).
- Does shareholder materially participate? Reg. 1.1411-5.
- Look to IRC 469: “regular, continuous and substantial”
- May vary from shareholder to shareholder – we’ll come back to this.

## Trust as S corp. Shareholder: possible NII “events”

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- Non-passive status determination is made at trust-level.
- IRC 1366 allocation (income or gain); 1368 distribution; 1001 stock sale.
- Less obvious scenarios: IRC 302(b), 338(h)(10), 336(e).
- Plan in advance for the surtax.
- Adjust shareholder’s level of authority/participation; shift equity to lower-income family members; use other investments to offset NII.



## Material Participation by Trusts

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- IRC 1411 points us to IRC 469's rules.
- Recent Regulations under IRC 1411 failed to elaborate. See T.D. 9644.
- IRS punted: said the issue is best addressed in IRC 469 Regulations.
- Regulations project in the works?

## Existing Guidance as to Trust Participation?

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- Some IRS rulings and two Court decisions – that’s all folks.
- Practically speaking, the absence of much authority has not been an issue.
- If a trust has not had losses, characterization did not make a difference in most cases.
- That changed with 2013 and the IRC 1411 NII surtax.

- Passive vs. non-passive character must now be considered.
- Interests in a family business are often transferred in trust (e.g., to protect against spendthrifts, creditors, spouse, etc.)
- If S corp. is not engaged in T/B, the tax applies.
- If S corp. is engaged in T/B, surtax applies if trust does not materially participate in T/B.

- Apply Section 469 rules to trust – but how?
- Several factors to consider, including: type of trust, tax elections made in respect of the trust, trustee's participation in the T/B, grantor's participation, beneficiary's participation.

## Material Participation

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- IRC 469(h): a taxpayer materially participates if involved in operations of the T/B on a “regular, continuous and substantial basis”
- Individuals: Regulation 1.469-5T provides several alternative tests (e.g., 500 hours per year)
- Applied to each business activity of the S corp.
- Grouping activities may help.

## Section 469 and Trusts

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- Trusts are subject to the 469 material participation rules. IRC 469(a)(2).
- Not clear how the material participation rules apply to trusts.
- Reg. 1.469-5T(g): “reserved” as to trusts.
- Rely on the base test: “regular, . . .” ?

## Trust Material Participation in an S corp.? Who “owns” the stock?

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- Grantor Trust – shares are deemed owned by grantor. IRC 671; IRC 1361(c).
- Trust’s share of S corp. income is taxed to grantor. Regulation 1.1361-1(h)(3).
- Same applies for IRC 1411 surtax. Regulation 1.1411-3(b)(1).
- Material participation is determined at grantor-level.
- Many business owners use grantor trusts to leverage their gifts. Rev. Rul. 2004-64.

## QSST

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- Treated as a grantor trust, with the beneficiary as the deemed owner. Reg. 1.1361-1(j)(8); Sec. 678.
- Applies for pass-through of distributive share of S corp. income; not for sale of S corp. stock
- Material participation by trust – determined at beneficiary-level. FSA 200106018.



## ESBT

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- Character of income is determined and taxed at trust level. Reg. 1.1361-1(h)(3)(ii); Reg. 1.1361-1(m); IRC. 641(c); Reg. 1.641(c)-1.
- Material participation is determined at the trust level (not the beneficiary or grantor).

## Former grantor trust or testamentary trust

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- The S corp.'s income flows through to the trust as a s/h. Reg. 1.1361-1(h)(3)(ii).
- The character of the income carries through to the beneficiary where the trust distributes DNI. Sec. 662(b).
- If the trust is passive as to the S corp.'s T/B, then the income is passive as to the beneficiary, apparently without regard to the beneficiary's personal involvement.

- Note that a former grantor trust, a testamentary trust, and a former QSST (beneficiary died) may be S corp. shareholders for only two years.
- Their “material participation” status may also change, depending upon whether they can make a QSST or ESBT election.

## QSST – sale of stock

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- Reg. 1.1361-1(j)(8): the trust – not the beneficiary – is taxed on the gain from the sale of S corp. stock
- Application to IRC 1411 surtax?
- Prop. Reg. 1.1411-7(a)(4)(C) tests material participation at the trust-level for purposes of characterizing the gain as passive or not

## How to determine material participation?

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- In the case of a grantor trust, the test is applied to the grantor-owner. If the grantor is active, so is the trust's income
- The same is true as to the beneficiary of a QSST who is treated as the owner of the trust under Sec. 678.
- Other S corp. trusts? More difficult issue.

## Authorities re Trust Participation

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- Code and Regs are silent
- Senate Report to '86 Act (No. 99-313): does trustee materially participate?
- Mattie Carter Trust, 256 F. Supp. 2d 536 (N.D. Tex. 2003)
- Trust operated business using employees and agents
- IRS: only activities of trustees are relevant, and only in their capacity as such.
- Court disagreed with IRS.

- Court: look to trustees, plus agents and employees of trust
- Who conducted business on behalf of trust?
- Those activities, in the aggregate, were regular, continuous and substantial.
- IRS has not acquiesced to Carter.

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## IRS's Position

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- IRS continues to argue that material participation for a non-grantor trust is determined only by reference to activities of trustee as such
- Points to S. Rep. No. 99- 313, at 735 (1986)
- TAM 200733023
- PLR 201029014
- CCA 201244017

- TAM 201317010
- S Corp.; one trustee was president of Qsub (a disregarded entity); was also the only other shareholder of the S corp. parent.
- As trustee, this individual was responsible only for the voting or selling of the trust's S corp. shares
- Was not granted other discretionary power over the trust assets or with respect to the operation or management of the trust.
- The other trustee was not involved in the business.

- IRS: the time spent as an officer of the Qsub corp. did not count toward the trust's material participation
- The special trustee could not differentiate the time spent in the various capacities
- In any event, the special trustee was not vested with discretionary power to act on behalf of the trust
- No material participation by trust.

## Aragona Trust, 142 T.C. No. 9 (2014)

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- Trust argued that its activities were not passive
- It owned properties directly and through its wholly-owned (disregarded) LLC
- Three of six trustees were employed full-time by LLC; two of these trustees personally owned minority interests in the properties
- LLC also had non-trustee employees

- Taxpayer: trust qualifies as real estate professional – IRC 469(c)(7) exception to passive loss rules
- IRS: trust cannot perform “personal” services
- Court: trustee managed assets for the beneficiaries of the trust
- Under state law, the trustees were not relieved of fiduciary duties by acting through a business entity owned by the trust

- Court rejected IRS position that employee-owner-trustees acted for themselves, not for the trust and its beneficiaries
- Their combined interest was a minority and was never greater than the trust's
- Their interests as owners were compatible with trust's

## Future of Aragona case

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- Not clear if IRS will appeal
- Parties have not yet agreed to tax calculation
- Time extended to July 30
- Once court enters its decision, 90 days for IRS to appeal. T.C. Rule 190; Sec. 7483

## Post-Aragona?

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- Will IRS appeal? Nonacquiescence?
- Will Regs be forthcoming under Sec. 469?
- Under the court's decision, the work in the business performed by individual trustees should count toward the trust's material participation
- Selection of the trustee, therefore, may be an important consideration; e.g. should the trustee be employed in the S corp?



## Open Items

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- A lot of questions remain unanswered
- Court did not rule as to the activities of the non-trustee employees (of the LLC)
- Would it make a difference if the trustees were employed by of an S corp., rather than by a disregarded entity?
- Must at least one-half the trustee be active participants (as in Aragona)?
- What if the trustees personally owned a majority interest?

# Planning

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- In general, trust will want its business income to be active
- The active S corp. shareholder can create a grantor trust
- The owner's participation should cause the income to be nonpassive
- Several ways to achieve grantor trust status without inclusion in gross estate; see, e.g., PLR 9543050 (Sec. 674), PLR 9525032 (Sec. 675)
- Beware of Administration proposals to better “coordinate” the income and transfer tax rules for grantor trusts (2015 budget proposal)

- QSST vs ESBT – consider beneficiary’s participation in the S corporation
- Consider granting Sec. 678 withdrawal power to beneficiary? Beware lapse and gift under Sec. 2514.

- Non-grantor trust or ESBT – selection of trustee may impact application of surtax
- Consider someone who is active in S corporation's business
- At least one-half of trustees should be active
- They should not personally own a majority of the corporation
- Remember: If ESBT is subject to the surtax, it cannot use distributions to beneficiaries to reduce its surtax

- Given its recent posture, IRS is not likely to agree that a non-grantor trust materially participates unless the trustee is active as such
- Trustee should take affirmative action toward achieving such status
- If participation in multiple capacities, instrument should not excuse trustee from fiduciary responsibility
- Consider a “special trustee” whose responsibility is limited to the business – give that trustee decision-making authority (see 2013 TAM)

- Again: Don't let tax tail wag the dog
- Keep the surtax in perspective – it's not the end of the world
- Be mindful of grantor's dispositive plan
- The above choices may have other consequences (tax and other)

- Remember: Burden is on the taxpayer
- Maintain accurate and contemporaneous records of trustee participation
- Bound to see more litigation in this area



# Thank You.

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