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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

TUESDAY, JULY 29, 2014

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

Today's faculty features:

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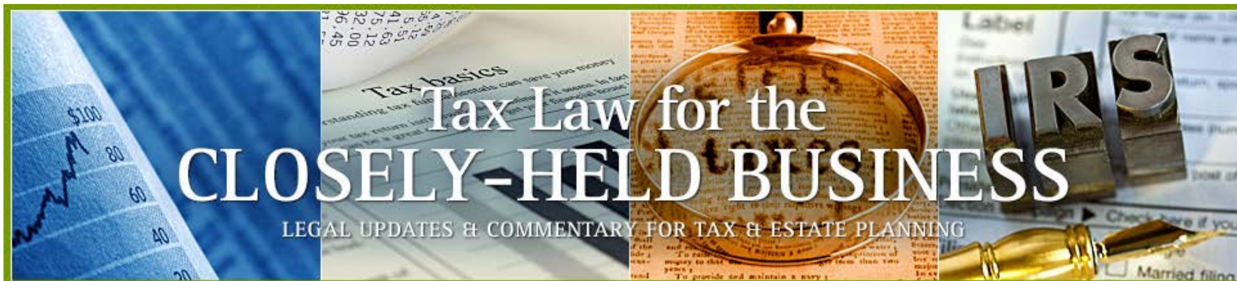

In S Corps We Trust

By Lou Vlahos on December 2, 2013

Posted in Federal Tax Issues

Earlier this year, the IRS issued Rev. Proc. 2013-30 to provide relief to corporations that have ceased to qualify as S corporations where the terminating event was not reasonably within the control of the corporation. In particular, the Rev. Proc. addresses late QSST and ESBT elections.

IRS
Department of the Treasury
Internal Revenue Service

The issuance of the Rev. Proc., which consolidates various relief provisions previously adopted by the IRS, points to the continuing difficulty that some taxpayers have in determining whether trusts to which shares of S corporation stock are transferred are permitted S corporation shareholders. This state of affairs may lead to some serious tax and economic consequences to taxpayers who are engaged in gift and estate planning with respect to their shares of S corporation stock.

The Internal Revenue Code limits the permitted shareholders of an S corporation to domestic individuals, estates, certain trusts, and certain exempt organizations. What follows is a brief description of the basic rules applicable to the ownership of S corporation stock by trusts.

Trusts that May Hold S Corp. Stock

Grantor Trusts

A grantor trust is a trust, all of which is treated, for tax purposes, as owned by an individual (typically the grantor) who is a citizen or resident of the United States.

Upon the death of the deemed owner of the grantor trust, if the trust was a grantor trust immediately before the death, and it continues in existence after the death, the trust may continue to hold S corporation stock, but only for the 2-year period beginning on the day of the deemed owner's death. In general, a trust is considered to continue in existence if the trust continues to hold the stock pursuant to the terms of the decedent's will or of the trust agreement.

Testamentary Trusts

A trust to which S corporation stock is transferred pursuant to the terms of a decedent's will, may hold S corporation stock, but only for the 2-year period beginning on the day the stock is transferred to the trust.

QSSTs

A QSST is a permitted S corporation shareholder if the beneficiary of the QSST makes an election under the Code. A QSST is defined as a trust that

1. distributes or is required to distribute all of its income to a citizen or resident of the United States,
2. has certain trust terms, including the requirement that there be only one income beneficiary,
3. does not distribute any portion of the trust corpus to anyone other than the current income beneficiary during the income beneficiary's lifetime, including the time at which the trust terminates, and
4. the income interest of the current income beneficiary ceases on the earlier of such beneficiary's death or the termination of the trust.

In the case of a QSST with respect to which a beneficiary makes an election, the beneficiary of the trust is treated, for purposes of the grantor trust rules, as the owner of that portion of the trust that consists of stock in an S corporation with respect to which the election is made.

A QSST election is made by signing and filing an election statement with the applicable IRS Service Center. The QSST election must be made within the 16-day-and-2-month period beginning on the day that the S corporation stock is transferred to the trust.

ESBTs

An ESBT is a permitted S corporation shareholder. It is defined as any trust where:

1. the trust does not have as a beneficiary any person other than an individual, an estate, or certain charitable organizations;
2. no interest in the trust was acquired by purchase; and
3. an election has been made with respect to the trust.

To qualify as an ESBT, the trustee of the trust must make an ESBT election by signing and filing an election statement with the applicable IRS Service Center. The ESBT election must be filed within the same time requirements prescribed for filing a QSST election.

Who is Treated as the Shareholder for Various Tax Purposes

For purposes of

1. qualification as a small business ("S") corporation and, in general, for purposes of
2. (i) the pass-through of items of S corporation income, loss, deduction, or credit, (ii) the adjustments to basis of shareholder's stock, and (iii) the treatment of distributions by an S corporation, the shareholder of S corporation stock held by a trust that is a permitted shareholder, is determined as follows:

(A) If stock is held by a **grantor trust**, the deemed owner of the trust is treated as the shareholder.

(B) If stock is held by a **trust that was a grantor trust immediately before the death of the deemed owner**, and the trust continues in existence after the death of the deemed owner, the estate of the deemed owner is generally treated as the shareholder as of the day of the deemed owner's death.

The estate ordinarily will cease to be treated as the shareholder upon the earlier of the transfer of the stock by the trust or the expiration of the 2-year period beginning on the day of the deemed owner's death.

If the trust qualifies and becomes an electing QSST, the beneficiary and not the estate is treated as the shareholder as of the effective date of the QSST election. If the trust qualifies and becomes an ESBT, the shareholders are determined under paragraph (E), below, as of the effective date of the ESBT election.

However, solely for purposes of applying the pass-through, basis and distribution rules, the trust is treated as the shareholder of S corporation stock held by the former grantor trust. If the trust continues to own the stock after the expiration of the 2-year period, the corporation's S election will terminate unless the trust is otherwise a permitted shareholder.

(C) If stock is held by an **electing QSST**, the income beneficiary who makes the QSST election, and is treated (for purposes of the grantor trust rules) as the owner of that portion of the trust that consists of the S corporation stock, is treated as the shareholder for purposes of the qualification, pass-through, basis and distribution rules; however, the beneficiary will not be treated as the owner of the S corporation stock in determining and attributing the income tax consequences of a disposition of the stock by the QSST.
If, upon the death of an income beneficiary, the trust continues in existence, continues to hold S corporation stock but no longer satisfies the QSST requirements, is not a grantor trust, and does not qualify as an ESBT, then, solely for purposes of the qualification rule, as of the date of the

income beneficiary's death, the estate of that income beneficiary is treated as the shareholder of the S corporation with respect to which the income beneficiary made the QSST election.

The estate ordinarily will cease to be treated as the shareholder for purposes of the S corporation qualification rule upon the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day of the income beneficiary's death.

During the period that the estate is treated as the shareholder for purposes of the qualification rule, the trust is nevertheless treated as the shareholder for purposes of the pass-through, basis and distribution rules.

If, after the 2-year period, the trust continues to hold S corporation stock and does not otherwise qualify as a permitted shareholder, the corporation's S election terminates.

(D) If stock is transferred or deemed distributed to a **testamentary**, the estate of the testator is treated as the shareholder until the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day that the stock is transferred or deemed distributed to the trust.

However, solely for purposes of applying the pass-through, basis and distribution rules, in the case of a testamentary trust, the trust is treated as the shareholder of the S corporation stock held by the trust. If the trust continues to own the stock after the expiration of the 2-year period, the corporation's S election will terminate unless the trust otherwise qualifies as a permitted shareholder.

If the trust qualifies and becomes an electing QSST, the beneficiary and not the estate is treated as the shareholder as of the effective date of the QSST election. If the trust qualifies and becomes an ESBT, the shareholders are determined under paragraph (E), below, as of the effective date of the ESBT election.

(E) If S corporation stock is held by an **ESBT**, each potential current beneficiary is treated as a shareholder. The trust itself, however, is treated as a separate taxpayer for purposes of the pass-through rules – the income does not flow-through to the beneficiaries; in addition, any gain from the disposition of the S corporation stock is taxable to the trust; the ESBT is not entitled to a deduction for distributions to its beneficiaries.

A trust cannot make a conditional ESBT election that would be effective only in the event the trust fails to meet the requirements for an otherwise eligible. If a trust attempts to make such a conditional ESBT election and it fails to otherwise qualify as an eligible S corporation shareholder, the S corporation election will terminate because the corporation will have an ineligible shareholder.

Estate – Or Is It A Trust?

An estate is an eligible S corporation shareholder. Upon the death of an S corporation shareholder, if the decedent's stock in the corporation is held by the executor of his estate for purposes of administration, the estate will become a shareholder as of the date of the decedent's death. This is true notwithstanding the fact that state law may provide that the legal title to the stock passes directly to the decedent's legatees or heirs.

However, an estate cannot remain in existence indefinitely. Indeed, under IRS regulations, an estate will be considered terminated if the period of administration is unduly prolonged. The period of administration of an estate is the period actually required by the executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests.

The IRS may contend that a corporation has ceased to qualify as an S corporation where one of its shareholders is, in effect, a testamentary trust, rather than an estate, where the executors have long since completed their duties as executors yet have continued to hold the stock (i.e., the estate has converted into a trust).

Conclusion

The forgoing discussion highlights the complexity of the rules governing the ownership and taxation of trusts that hold shares of stock in an S corporation. In light thereof, it is easy to appreciate how an S corporation may inadvertently lose its status by virtue of a trust's ceasing to qualify as a permitted shareholder. Thankfully, the IRS has provided some relief from such terminations, as in the form of Rev. Proc. 2013-30.

However, it also underlines the importance of having a well-drafted shareholders agreement, one that restricts the transfer of stock so as to preserve the corporation's S election and that ensures the cooperation of all the shareholders in preserving or reinstating the election.

http://www.taxlawforchb.com/2013/12/in-s-corps-we-trust/

S Corp Sales, Built-In Gain, and 2013

By Lou Vlahos on September 27, 2013

Posted in Federal Tax Issues

Last year saw many taxpayers selling appreciated assets. The primary reason for this activity was the imminent increase, in 2013, of the long term capital gain rate, and the imposition (in some cases) of a 3.8% tax on net investment income, both of which would impact sales of assets owned directly by individuals or by pass-through entities owned by such individuals, including S corporations.

Notwithstanding the foregoing tax rate increases, 2013 may be a good time for certain S corporations to consider a sale of assets.

Built-in Gain Tax

Unlike C corporations, S corporations generally pay no corporate-level tax. Instead, items of income and loss of an S corporation pass through to its shareholders. Each shareholder takes into account its share of these items on its individual income tax return. Thus, any gain recognized by an S corporation on the sale of assets is passed through and taxed to its shareholders.

There is an exception to this rule for asset sales by S corporations that were previously taxed as C corporations. Specifically, under Section 1374 of the Internal Revenue Code (the "Code"), a corporation level tax, at the highest marginal rate applicable to corporations (currently 35%), is imposed on that portion of an S corporation's gain that arose prior to the conversion of the C corporation to an S corporation (the "built-in gain" inherent in its assets at that time; "BIG") and that is recognized by the S corporation during a specified period of time following the conversion (the "recognition period").

The amount of corporate BIG tax imposed upon the S corporation is treated as a loss taken into account by the corporation's shareholders in computing their individual income tax. The character of the loss is based upon the character of the BIG giving rise to the tax; thus, the sale of an asset that produces a capital gain would generate a capital loss.

Assume, for example, that ACME Inc. was a C corporation with no liabilities and with the following assets on January 1, 2010:

Assets	Basis	FMV
Building & Equipment	$0	$2 MM
Goodwill	$0	$1 MM
Total Assets	$0	$3 MM

ACME made an S election effective January 1, 2010. The BIG inherent in its assets is $3MM. In 2013, ACME sells its assets to an unrelated third party for $3.5 MM. The sale occurs within ACME's recognition period. Of the $3.5 MM gain recognized, $3 MM represents BIG and is subject to corporate level tax at a 35% rate. Thus, ACME is liable for $1.05 MM of corporate income tax. Because ACME is an S corporation, the gain recognized passes through to its shareholders, who are also allocated a loss in the amount of the tax liability arising from the BIG. Thus, the shareholders are allocated $3.5 MM of gain and $1.05 MM of loss, they pay a 20% capital gain tax, and they net proceeds of $1.96 MM: sale proceeds ($3.5 MM) minus corporate tax ($1.05 MM) minus individual capital gains tax ($490K).

By comparison, if the asset sale had not been subject to the BIG tax, there would have been no corporate tax, the $3.5 MM of gain recognized by the corporation would have been taxed only to the shareholders (at 20%), and they would have retained $2.8 MM of the sale proceeds.

<u>Recognition Period & ATRA</u>

Given the economic impact of the BIG tax, shareholders have historically been reluctant to cause their S corporation to sell its assets during its recognition period.

Before 2009, this period was defined as the first ten taxable years that the S election was in effect. However, Congress temporarily reduced the recognition period to five tax years, and the

American Taxpayer Relief Act of 2012 (P.L. 112-240; "ATRA") extended the five-year period to include tax years beginning in 2013. Thus, with respect to any pre-conversion BIG, (for sales occurring in 2013) no tax will be imposed under Section 1374 if such sales occur after the fifth taxable year the S corporation election is in effect.

2013

In light of the foregoing, 2013 may be a good time for an S corporation that converted from C corporation status in 2007 or earlier to consider selling all or some of its assets.

As an illustration, assume ACME Inc. was a C corporation that elected to be taxed as an S corporation beginning on January 1, 2008. At that time, it had net unrealized BIG of $3 million. Prior to ATRA, if ACME had sold its assets in 2013 and recognized gain of at least $3 million, then the entire BIG would have been subject to corporate level federal income tax because the sale would have occurred within the ten-year recognition period.

Under ATRA, however, the recognition period is reduced to five years. Since ACME will have been an S corporation for five years at the end of 2012, its recognition period will end at that time, and any gain on the sale of its assets in 2013 will escape corporate level taxation, even if that gain is recognized and taxed after 2013 (during what would have been the 10-year recognition period before ATRA) under the installment method.

Notably, the ATRA provision that reduced the recognition period to 5 years expires at the end of 2013, and the ten-year recognition period is then reinstated. Thus, if ACME delays the sale of its assets to any time from 2014 through 2017, it will be subject to corporate tax on its BIG.

Conclusion

The foregoing is not to suggest that a pre-2008 S corporation with assets subject to the BIG tax should hurry to sell those assets only to capture the tax benefit afforded by ATRA before it expires. However, an S corporation that was otherwise contemplating a sale should consider the fact that the shortened recognition period expires at the end of 2013, thereby increasing the tax cost of a later sale.

This article originally appeared in the May 2013 of The Suffolk Lawyer.

http://www.taxlawforchb.com/2013/09/s-corp-sales-built-in-gain-and-2013/

Sale of Business Meets Investment Income Surtax

By Lou Vlahos on October 28, 2013

Posted in Federal Tax Issues

The owners of a business must consider many tax issues in connection with its sale. These include the structure of the transaction as a sale of assets or stock, the amount of gain arising from each structure, the character of the gain as ordinary or capital, and the resulting tax liability. From the foregoing, the owners may determine the net economic benefit inuring to them as a result of the sale. Owners will sometimes use this information in negotiating an increased purchase price, or some other form of "gross-up", to arrive at the after-tax figure for which they would be willing to sell the business.

New Surtax

After 2012, the tax cost of selling a business increased for higher-income taxpayers. In the case of individuals, the top rate for ordinary income increased to 39.6%, while the top long-term capital gain rate increased to 20%.

In addition, a new 3.8% surtax is imposed on an individual's net investment income ("NII") for the year. This tax presents another cost which must be considered in determining the net economic result of a sale.

The Deal

The impact of the surtax is best appreciated by reviewing a typical deal structure.

The sale of a business includes several components. First, is the sale of either equity or assets by the owners of the "target." In the case of an asset sale, the selling entity may then be liquidated. In either case, the consideration received usually includes money and/or notes. Owners who were active in the target may receive consulting/non-compete agreements from the buyer. Sometimes, these individuals own the property on which the business was conducted; as part of the transaction, they may lease or sell the property to the buyer.

NII: What Does It Include?

As it relates to the sale of a business, NII includes the net gain attributable to the disposition of property, other than property held in a trade or business which is not a passive activity as to the taxpayer. It also includes income from interest and rents, unless such income is derived in the ordinary course of a trade or business which is not a passive activity as to the taxpayer.

Do C Corps Escape the Surtax?

Since the tax only applies to the NII of individual taxpayers, the sale of assets by a C corporation does not trigger the tax. However, the distribution of the sale proceeds in liquidation of a shareholder's stock will trigger the tax.

In addition, the gain recognized on the sale of C corporation stock by an individual will also be subject to the tax.

Pass-Through Entities and "Material Participation"

Gain realized by an S corporation or partnership on a sale of assets is passed through and taxed to its owners. An owner's NII includes the gain attributable to the entity's sale of property held in a trade or business that is a passive activity as to the owner. The determination of whether the property sold was held in a trade or business that is a passive activity is made at the level of the individual owner, not at the entity level.

Thus, the determination of whether the surtax applies to a shareholder's allocable share of the gain from an S corporation's sale of assets depends upon whether the corporation held the assets for use in its business and whether that business was a passive activity as to the shareholder; i.e., whether the shareholder "materially participated" in the business.

A taxpayer is treated as materially participating in a business activity if the taxpayer is involved in the operations of the activity on "regular, continuous and substantial" basis.

If the business activity was passive as to the shareholder, then the shareholder's allocable share of the gain from the asset sale shall be subject to the surtax. However, if the business was not passive as to the shareholder, the gain is not subject to the tax, except to the extent it is derived from the sale of assets not used in the business. This may result in a situation where a passive shareholder is liable for the surtax on his share of the gain from an asset sale, while an active shareholder is not.

In the case of an equity sale, a sale of an ownership interest in a pass-through entity may result in NII subject to the surtax if the entity is engaged in a trade or business that is a passive activity with respect to the seller. In general, however, if the seller materially participated in the business, the gain recognized by him shall be subject to the surtax only to the extent of the gain which would have been treated as NII if the entity had sold all of its assets (including goodwill) for fair market value immediately before the sale of the interest.

Other NII

An owner's NII from the sale of a business will also include his share of interest income arising from the sale, including interest on an installment note or interest imputed on other deferred payments of purchase price, as well any gain recognized under the installment method on the receipt of the deferred payment.

Additionally, if the seller retains ownership of the real property on which the business operated, and leases that property to the buyer, the rental income will likely be subject to the surtax since the rental of real property is generally treated as a passive activity. This is especially true for property that requires little activity.

As for payments to be made to the owner under any consulting agreement, these will be subject to the 2.9% Medicare tax on self-employment income, and not the tax on NII. However, if this consulting income exceeds a certain threshold, the excess will be subject to an additional 0.9% Medicare tax.

Conclusion: Plan Ahead

The best time to plan for the sale of a business is well before the sale. This advice applies to the tax on NII. The surtax rules are complex, but the tax may be addressed, at least partially, in a number of ways; the owner's level of activity may be adjusted, the owner's equity may be shifted to lower-income family members, the owner's other investments may be used to offset NII. While some of the planning alternatives may carry an economic cost, it behooves the taxpayer to consider them since some combination thereof may help reduce the surtax.

http://www.taxlawforchb.com/2013/10/sale-of-business-meets-investment-income-surtax/