

S Corporation Stock As an Estate Planning Tool

Recent Tax Law Changes Make S Status More Attractive

With the advent of limited liability companies, discussion about the merits of operating a business through an S corporation has abounded. This entity still remains viable, however. In fact, many shareholders can benefit from 1996 tax law changes that make estate planning with S corporation stock even easier.

More Control

Although an S corporation can have only one class of stock, it can issue voting and nonvoting stock. Therefore, a parent can retain control of the corporation through voting stock, even though that voting stock represents only 1% of the issued and outstanding shares. In addition, both voting and nonvoting stock can qualify for minority interest and lack of marketability valuation discounts. As a result, S corporation stock is a useful vehicle for making gifts.

Savings and Lifted Restrictions

Gifts of S corporation stock can qualify for the annual gift tax exclusion. And, S corporations are less likely to be subject to certain limitations the Internal Revenue Code (IRC) imposes on liquidation. The IRC requires an appraiser to disregard certain restrictions on liquidation in family controlled corporations and partnerships if those restrictions are more restrictive than provided for under state law. Thus, if state law allows a shareholder to liquidate his or her shares, being more restrictive in the document won't matter. Note that generally the default rule under state law is that a minority shareholder can't require the corporation to liquidate his or her interest in the corporation.

In addition, the 1996 law increases the maximum number of S shareholders from 35 to 75, expanding the usefulness of S corporations. In the estate and gift tax planning context, it's easier to reduce estate taxes and preserve family businesses because gifts of S corporation stock can be made to more family members.

New Qualifying Trust

Before the 1996 changes, only grantor trusts, voting trusts, certain testamentary trusts and qualified subchapter S trusts (QSSTs) could be S corporation shareholders. Now, electing small business trusts (ESBTs) can hold S corporation stock too. An ESBT cannot have anyone other than an individual, an estate or a charitable organization as a beneficiary nor any interest that was acquired by purchase. Unlike a QSST, an ESBT can have multiple beneficiaries. Each beneficiary is treated as a shareholder for the 75 shareholder rule.

One of the ESBT's quirks relates to taxation. The rules that generally apply to trusts do not apply to ESBTs. ESBT income attributable to S corporation stock is taxed at the highest individual income tax rate. Additionally, the personal exemption generally allowable for trusts (i.e., \$300 for a simple trust and \$100 for a complex trust) isn't permitted when calculating the income tax for S corporation income and loss. The income tax for the portion of the trust that does not hold S corporation stock is taxed without regard to any S corporation income or loss, any gain from the stock's disposition, state or local taxes, or administrative expenses attributable to S corporation stock.

While the ESBT election doesn't result in two taxable entities, calculating its federal income tax liability requires a two-step procedure:

1. Tax on the S corporation income, loss and stock disposition is calculated separately in accordance with the rules. That amount then gets added to the tax due on the trust's non-S corporation portion.
2. The distributable net income (DNI) calculation for the entire trust is made without regard to the S corporation income and loss or its stock disposition, gain or loss. DNI is the deduction from the trust's income to which the trust is entitled for distributions of income made to the trust beneficiaries during the year.

Let's look at an example. ABC Corp. is a calendar year S corporation. Brad owns 50% of the stock, and a trust established for Brad's children and grandchildren holds the other 50%. During 1998, the trust owns 5,000 shares of ABC stock and 10,000 shares of XYZ stock (a C corporation). The trust's 1998 K-1 (the form advising what amount should be reported as income on the beneficiary's tax return) from ABC shows \$100,000 of income, and its 1998 dividends from XYZ stock are \$10,000. If the trustee elects to treat the trust as an ESBT, the two-step procedure must be followed when computing its federal income-tax liability.

First, the \$100,000 of ABC income reported on the trusts' K-1 is taxed at 39.6%, as if the stock were held by a separate trust. Second, the \$10,000 of XYZ dividend income is taxed at the normal trust income tax rate without regard to ABC's income and may be offset by the deductions generally available to trusts. Let's assume that the trust distributes the \$100,000 of ABC income plus the \$10,000 received from XYZ stock to the trust beneficiaries. In computing the trust's DNI, the \$10,000 would be deducted from the trust's taxable income, but the \$100,000 wouldn't be included in the DNI nor be deducted as part of the DNI.

In spite of the potentially higher income tax, the flexibility of an ESBT can make it a more attractive alternative for high bracket taxpayers than the QSST. The ESBT can also serve well as an irrevocable life insurance trust that holds S corporation stock. The distributions can be used to fund insurance premiums rather than provide for the complicated Crummey withdrawal rights.

Final Planning Issues

These are just a few of the planning concepts that are available with S corporation stock. Careful consideration is required, however, for pre-mortem and post-mortem planning with the stock. If you would like assistance, please give us a call.