S Corporation Planning

Many closely held businesses are formed as corporations. In order to avoid the negative income tax aspects of corporations (*i.e.*, corporate profits distributed to shareholders in the form of dividends generally are subject to income tax at both the corporate and shareholder levels), the shareholders typically elect for the corporation to be taxed under subchapter S of the Code. Corporations electing to be taxed under subchapter S have become known as "S corporations." S corporations receive favorable tax status under subchapter S, which allows the corporation to be treated as a conduit, much like a partnership, through which the corporation's income and losses flow to the shareholders on a current basis (thereby avoiding the corporate level tax that applies to regular corporations). Nevertheless, to achieve this tax benefit, there are a number of requirements that the corporation and its shareholders must satisfy.

Eligibility for S Corporation Status

In general, to qualify for S corporation status, the corporation must not be an "ineligible corporation" as defined in IRC § 1361(b)(2) and must satisfy the following criteria provided in IRC § 1361(b)(1):

1. Domestic Corporation. First, the corporation must be a domestic corporation that is incorporated in the United States.

2. Limit on the Number of Shareholders. Second, the corporation may not have more than 100 shareholders. IRC § 1361(b)(1)(a). For purposes of the shareholder limit, a husband and wife (and their estates) are considered as one shareholder (see IRC § 1361(c)(1)), while individuals (other than a husband and wife) who hold stock as tenants in common or as joint tenants are each considered a separate shareholder for purposes of applying this rule (see Treas. Reg. § 1.1361-1(e)(2)).

For tax years beginning after 2004, Section 1361(c) is amended to allow a family to elect to be treated as one shareholder. Members of a family are defined as the common ancestor, lineal descendants of the common ancestor, and the spouses (or former spouses) of such lineal descendants or common ancestor. The amended provision also incorporates the expansive definition of a family member in Section 152(b)(2). A family member includes a legally adopted child, a child who is a member of an individual's household, if placed with such individual by an authorized placement agency for legal adoption, or a foster child. The provision does not limit the number of families that can each elect to be treated as one shareholder. Thus, it is possible for an S corporation to have far in excess of 100 shareholders.

An individual will not be considered a common ancestor if, as of the later of December 31, 2004 or the time that the S election is made, that individual is more than six generations removed from the youngest generation of shareholders who would, but for this restriction, be a member of the family. Spouses and former spouses are considered to be in the same generation as the individual to whom the spouse is or was married.

The election can be made by any member of the family. Once the election is made, it remains in effect until terminated, as will be provided in regulations to be issued. There is no requirement that any minimum number of family members consent this election.

In conjunction with this election, Section 1362(f) is amended to qualify family elections for relief for inadvertent or invalid elections or terminations. This Section gives specific authority to the Treasury to provide relief where a family election is invalid and results in an invalid S election, or a family election is inadvertently terminated, thereby terminating the S election.

The family election applies only for purposes of determining the number of shareholders - each family member must be otherwise eligible to be an S corporation shareholder. The IRS has announced that it will issue future guidance regarding the S Corporation family shareholder election. Notice 2005-91, 2005-51 I.R.B. 1164.

3. Shareholder Restrictions. Third, all shareholders must be individuals and either U.S. citizens or resident aliens. There are, however, a number of important exceptions to the "individual" rule that allow the following entities to hold S corporation stock: (1) a deceased shareholder's estate; (2) a bankrupt shareholder's estate; (3) a qualified subchapter S trust ("QSST"); (4) an electing small business trust ("ESBT"); (5) voting trusts; and (6) specified tax-exempt organizations. The exceptions for estates, QSSTs and ESBTs are extremely important from an estate planning perspective and are, therefore, discussed in greater detail below.

4. One Class of Stock. Fourth, an S corporation may not have more than one class of stock outstanding. Nevertheless, for purposes of this rule, voting rights are disregarded. Thus, an S corporation may issue both voting and non-voting stock (*see* Treas. Reg. § 1.1361-1(l)(1)).

Estates as S Corporation Shareholders

Although, generally, all shareholders of an S corporation must be individuals, there is an important exception for an estate and certain types of trusts.

Although a deceased shareholder's estate is a permitted shareholder (see IRC § 1361(b)(1)(B)), prolonging the administration of an estate may cause the estate to terminate and become a trust that may not be a permitted shareholder (*see Old Va. Brick Co. v. Comm'r*, 44 T.C. 724 (1965), *aff'd*, 367 F.2d 276 (4th Cir. 1966)). For purposes of applying the S corporation rules, the estate, rather than the beneficiaries of the estate, is considered to be the S corporation shareholder.

> **EXAMPLE:** X Corporation, an S corporation, has 100 shareholders, including P. P dies and, at P's death, P's stock is then held by P's estate. P's estate has five beneficiaries. Because the

estate, rather than the beneficiaries, is deemed to be X Corporation's shareholder, X Corporation will not violate the 100 shareholder limit under the S corporation rules.

Trusts as S Corporation Shareholders

Although, generally, all shareholders of an S corporation must be individuals, there is an important exception for an estate and certain types of trusts. IRC § 1361(c)(2) authorizes the following types of trusts to be S corporation shareholders:

1. Grantor Trusts. A trust, all of which is treated under IRC §§ 671 through 678 as owned by an individual (whether or not the grantor) who is a citizen or resident of the United States, is permitted to hold S corporation stock. In addition, after the death of the deemed owner, the trust may continue as a permitted S corporation shareholder for up to two years after the date of the deemed owner's death.

➔ **Planning Point:** The grantor trust must be treated as owned by one individual to satisfy this rule and he or she must be treated as owning both the income and principal of the trust under the grantor trust rules (*see* Treas. Reg. § 1.1361-1(h)(1)(i)).

For purposes of applying the S corporation rules, (i) the individual who is the deemed owner for income tax purposes is considered to be the S corporation shareholder (rather than the trust), and, upon his or her death, if the trust continues to hold the S corporation stock, his or her estate will be considered the shareholder (for up to two years after the decedent's death).

EXAMPLE: X Corporation, an S corporation, has 100 shareholders, including Trust. Trust is a grantor trust for income tax purposes and P is Trust's deemed owner. P is X Corporation's shareholder for purposes of applying the S corporation rules. At P's death, if Trust continues to hold X Corporation stock, P's estate will be X Corporation's shareholder for purposes of applying the S corporation rules. Nevertheless, two years and one day after P's death, Trust will no longer be a permitted shareholder, unless Trust is either a grantor trust, a QSST or an ESBT (in which case the Trust will have a new deemed shareholder for purposes of applying the S corporation rules).

2. Testamentary Trusts. A trust that receives S corporation stock pursuant to the terms of a will may hold such stock for up to two years, beginning on the day of the deemed owner's death. For purposes of applying the S corporation rules, the estate of the testator is regarded as the shareholder. On the first day after the expiration of the two-year period, the general prohibition against trusts as shareholders of S corporation stock applies.

EXAMPLE: X Corporation, an S corporation, has 100

shareholders, including P. P dies and pursuant to P's will, X Corporation stock is transferred to Trust. Trust has six beneficiaries. Because P's estate, rather than the beneficiaries of Trust, is deemed to be X Corporation's shareholder, X Corporation will not violate the 100 shareholder limit under the S corporation rules. Nevertheless, two years and one day after P's death, Trust will no longer be a permitted shareholder, unless Trust is either a grantor trust, a QSST or an ESBT (in which case the Trust will have a new deemed shareholder for purposes of applying the S corporation rules).

3. Voting Trusts. A trust created to exercise the voting power of S corporation stock transferred to it will be permitted to hold S corporation stock if several conditions are satisfied. First, the beneficial owners of the stock must be regarded as the owners of their respective portions of the trust under the grantor trust rules of IRC §§ 671 through 678. Second, the trust must have been created pursuant to a written trust agreement entered into by the shareholders that (1) delegates to one or more trustees the right to vote, (2) requires all distributions with respect to the stock of the corporation held by the trust to be paid to, or on behalf of, the beneficial owners of that stock, (3) requires title and possession of that stock to be delivered to those beneficial owners upon termination of the trust, and (4) terminates, under its terms or by state law, on or before a specific date or event.

When a voting trust satisfies the above conditions, each beneficiary of the voting trust is regarded as a shareholder. Accordingly, each member of the voting trust will count in identifying the number of shareholders of the S corporation, and each member must be a permitted S corporation shareholder (*e.g.*, a U.S. citizen or resident alien).

4. Electing Small Business Trusts. A trust that qualifies as an ESBT may hold stock in an S corporation. In the case of an ESBT, each potential current beneficiary of the trust is regarded as a shareholder for purposes of applying the S corporation rules, unless for any period no potential current beneficiary exists, in which case the trust will be treated as the shareholder. Current beneficiaries include every person that may or will receive a distribution of principal or income from the trust (*see* IRC § 1361(e)(2)). Thus, each potential current beneficiary (i) will be counted toward the 100 shareholder limit and (ii) must be a permitted S corporation shareholder.

5. Qualified Subchapter S Trusts. A QSST is regarded as a grantor trust for purposes of IRC § 1361(c)(2)(A)(i) and, thus, is an eligible S corporation shareholder, provided the beneficiary makes a proper election (*see* IRC § 1361(d)). Only the current income beneficiary is treated as an S corporation shareholder, which, in comparison to the ESBT, simplifies the determination as to whether the shareholder is a permitted S corporation shareholder and in determining if the corporation satisfies the 100 shareholder limit.