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PHILANTHROPISTS: ESTATE PLANNING

Estate Planning Tools for Small Business Owners

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Electing Small Business Trusts and Qualified Subchapter S Trusts

One of the many challenges of owning a small business is first determining the appropriate tax classification of the business. When an individual owns a business entity that is classified, either entirely or partially, as an S corporation, it is important to seek the guidance of an experienced estate planning attorney and tax advisor when planning for your death. Depending on your estate planning goals, the advice provided by these professionals may be very different from the advice given to another business owner.

For example, upon your death,

- Do you intend to pass on your business as an ongoing business entity that will produce income for your spouse or loved ones, or charitable beneficiaries?
- Is it important that the business continue to operate for years after your death to provide employment for your employees?
- Or would you prefer to sell the company to the other owners in exchange for cash, which can easily be distributed among your beneficiaries or donated to different philanthropic causes?
- Alternatively, do you intend to simply have the business shut down and have the assets sold?
- Is it important to you that your beneficiaries be protected from lawsuits, divorce, or bankruptcy once they receive their inheritances?

As you can see, there are various different scenarios that should be considered by a business owner when it comes to estate planning with a viable business. And because of certain federal laws, your estate planning must carefully address a business that is taxed as an S corporation.

What is an S corporation?

The Internal Revenue Service (IRS) describes S corporations as "corporations that elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes." This election is allowed under § 1362 of subchapter S of the Internal Revenue Code (I.R.C.), which is where S corporations get their name. Unlike a C corporation, which is first taxed on profits when earned and then taxed again to the shareholders when those profits are distributed, an S corporation offers the tax advantage of being able to pass income to the shareholders without first being taxed at the corporate level. The shareholders report their share of the S corporation's profits and losses on their individual tax returns and are assessed tax at their individual income tax rates.

Under the Internal Revenue Code, an entity must meet the following criteria to qualify for taxation as an S corporation:

- It is incorporated within the United States.
- It has only one class of stock.
- It does not have more than one hundred shareholders.
- The entity's shareholders are individuals, specific types of trusts and estates, or certain tax-exempt organizations. Partnerships, certain corporations, and nonresident aliens cannot be shareholders of an S corporation.
- It is not one of the types of corporations ineligible for S corporation taxation, such as certain financial institutions, insurance companies, and domestic international sales corporations.

What types of trusts can own stock in an S corporation?

As stated above, only specific types of trusts may be shareholders of an S corporation. The three most common types of trusts used to hold S corporation stock or membership interests are a grantor trust, a qualified subchapter S trust (QSST), and an electing small business trust (ESBT). (A voting trust may also be used but is beyond the scope of this article.)

Grantor Trust

In general, a grantor trust is a trust in which the grantor (also called the trustmaker) retains certain powers over the trust, which causes the trust income to be taxable to the grantor. The commonly used revocable living trust is one type of grantor trust. Because of some of the disadvantages of QSSTs and ESBTs (discussed below), a grantor trust is often the preferred type of trust for owning an S corporation. However, grantor trusts (as well as testamentary trusts) may generally hold S corporation stock for only two years after the death of the grantor, at which point the trust must either qualify as a QSST or ESBT or distribute the stock to an eligible shareholder. Otherwise, the corporation's S election will terminate.

QSST

A trust may qualify as a QSST if it meets several criteria:

- The trust has only one current beneficiary who is a US citizen or resident.
- All trust income is distributed to that sole beneficiary.
- The income beneficiary files an election with the IRS.

A QSST may work well in many circumstances; however, its requirements can also be unfavorable in certain situations. For example, the requirement that there is only one current beneficiary means that the beneficiary's children cannot also be beneficiaries of the trust. In addition, the requirement that all income is distributed to the beneficiary means that the income must be distributed regardless of the beneficiary's need, potential taxable estate, or troubling behavior. Further, that distributed income would be exposed to the beneficiary's creditors, lawsuits, and divorcing spouse. Some practitioners create multiple trusts to isolate subchapter S stock in a trust that meets the criteria and allow other assets to be held in a trust with different terms.

ESBT

In general, a trust may qualify as an ESBT if it meets the following criteria:

- The trustee of the trust files an election with the IRS within a certain time frame.
- The beneficiaries of the trust are all permissible beneficiaries under the Internal Revenue Code

Advantages of an ESBT are that they are not subject to the single beneficiary and mandatory distribution requirements of a QSST. In addition, because of certain phaseout deduction limitations that apply to individuals but do not apply to an ESBT, holding S corporation stock in an ESBT could result in income tax savings. However, the general rule is that all of an ESBT's income is taxed at the highest federal income tax rate, so if not all trust beneficiaries are in the highest tax bracket themselves, the overall tax could be higher when using an ESBT to hold S corporation stock. If the trust beneficiaries are not in the highest income tax bracket, some practitioners use careful drafting to cause the beneficiaries to be treated as grantors or owners under I.R.C. § 678, which takes precedence over the regulations governing ESBT income taxation.

When dealing with S corporation stock, it is essential to follow the S corporation requirements to ensure that the corporation's S election does not terminate and result in disastrous tax consequences. If you currently own shares of stock in a business being taxed as an S corporation, it's time to start forming a plan about what will happen to your business at your passing. Your loved ones and employees will thank you.