

Avoiding S Corporation I.E.D.'s

Including:

Qualified S Trusts
S Terminations
LLC Conversions
Shareholder Agreements
Community/Separate Property Issues

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GAO Report Zeros In On S Corps

- ▣ Released December 15, 2009
- ▣ S corps are very popular – in 2006:
 - 12.6% of businesses were S corps
 - 2nd most common entity type after sole prop.
 - \$3.5 trillion of assets and \$500 million of net income
- ▣ Most S corps are closely held:
 - 60% had a single shareholder
 - 89% had two or fewer shareholders
 - 94% had three or fewer shareholders

GAO Report Zeros In On S Corps

- ▣ High Noncompliance Level
 - 68% of S corp returns filed for 2003 and 2004 tax years misreported at least one item
 - ▣ The smaller the number of shareholders, the larger the number of return errors
 - ▣ Net income and Other Deductions were the most frequently misreported items
 - ▣ Distributions and Gross Sales contained largest errors
 - ▣ 13% of S corps pay inadequate wage compensation
 - ▣ S corps with fewest shareholders responsible for largest compensation underpayments

GAO Report Zeros In On S Corps

▣ Common Errors

- Pay lower wages but increase distributions
 - ▣ Reason – all wages are subject to all employment taxes while distributions are exempt from some
 - ▣ Proposed Solutions – base employment tax liability for all shareholders on net business income or on all types of payments made to active shareholders
- Shareholders using losses beyond allowable basis
 - ▣ Reason – offset S corp losses and deductions against other income
 - ▣ Proposed Solutions – require S corp to calculate and report each shareholder's basis on Schedule K-1

Congress Acts On GAO Report

- ▣ Congress Acts Quickly To Close Employment Tax Loophole
 - May, 2010 – House passed its version of “American Jobs and Closing Tax Loopholes Act of 2010”
 - The Senate is still working on its version
 - ▣ Senate Finance Chair Max Baucus has introduced a “second draft” of a substitute amendment to the Senate version which, among other things, revises the application of employment taxes on service professionals

Congress Acts on GAO Report

- ▣ Both the House and Senate versions prevent individuals engaged in certain professional services from avoiding employment taxes by routing their earnings through S corps
- ▣ Both become effective December 31, 2010
- ▣ General Operational Provision
 - A shareholder of a “disqualified S corp” who provides substantial services with respect to the “professional service business” conducted by the S corp shall take into account the shareholder’s pro rata share of *all* items of income and loss attributable to the business in determining the shareholder’s earnings subject to *self employment tax*

Congress Acts On GAO Report

- ▣ Covered “Professional Services Businesses”
 - Health
 - Law
 - Lobbying
 - Engineering
 - Architecture
 - Accounting
 - Actuarial Sciences
 - Performing Arts
 - Consulting
 - Athletics
 - Investment Advice or Management
 - Brokerage Services

Congress Acts on GAO Report

- ▣ House-passed bill – two types of “disqualified S corps”
 - An S corp is engaged in a “professional service business” that is principally based on the reputation and skill of 3 or fewer individuals; or
 - An S corp is a partner in a partnership engaged in a “professional service business” if substantially all of the activities of the S corp are performed in connection with the partnership
- ▣ Modified Senate substitute amendment only changes the first trigger:
 - First trigger would apply only if 80% or more of the “professional service income” of the S corp is attributable to the services of 3 or fewer owners of the S corp

S Corp Shareholder Eligibility Requirements

- ▣ No more than 100 shareholders at any one time
 - Husbands and wives together count as one
 - Members of a family together count as one
 - ▣ Common ancestor up to a maximum of six generations
 - Each joint owner (TIC or JT) counts as one
 - Shares held by a nominee, agent, guardian, or custodian are deemed owned by the persons for whom the stock is held
 - Executors, Trustees, and Beneficiaries – may be counter-intuitive as to who counts – we will address this later in the presentation

S Corp Shareholder Eligibility Requirements

- ▣ Types of Shareholders
 - Individuals – U.S. citizens or resident aliens
 - Charitable Organizations – qualified plans and charities exempt under 401(a) and 501(c)(3)
 - No corporations, partnerships, LLCs, or other entities unless:
 - ▣ Disregarded entity whose owners are eligible shareholders
 - ▣ Q-Sub 100% owned by another S corp

Estates as S Corp Shareholders

- ▣ A decedent's estate can be a shareholder
 - No requirement that executor file an election to continue the S status
 - Estate can hold S stock until the administration is complete for federal estate tax purposes, which can include the time period for making installment payments under 6161 or 6166
 - If probate administration continues after estate tax is paid and settled, the stock may be deemed held in a testamentary trust (which must independently qualify as a shareholder)

Trusts As S Corp Shareholders

- ▣ Only certain trusts can qualify as S corp shareholders
 - Qualified Subchapter S Trust (QSST)
 - Electing Small Business Trust (ESBT)
 - Grantor Trusts
 - Testamentary Trusts
 - Estate Planning Trusts

QSSTs As S Corp Shareholders

- ▣ Specific Requirements:
 - Domestic Trust – U.S. court has primary supervision over administration and U.S. fiduciaries control all substantial decisions
 - Only 1 CIB (who must be a qualified shareholder)
 - CIB's interest does not terminate prior to earlier of:
 - Termination of the trust and distribution of all assets to CIB
 - or the CIB's death
 - Income must be distributed at least annually to CIB
 - Principal distributed during the term must be to CIB

QSSTs As S Corp Shareholders

- ▣ Must Affirmatively Elect QSST Status
 - CIB (or legal rep. of CIB) must make the election
 - Trustee does not elect and is not required to consent
 - Separate election filed for each S corp in the QSST
 - Window for filing:
 - ▣ Existing S corp – 2 months and 16 days after trust becomes shareholder
 - ▣ New S Election – 2 months and 16 days after first taxable year in which S election is to be effective
 - Election is irrevocable unless IRS consents

QSST's As S Corp. Shareholders

- ▣ Effect of Election:
 - S corp stock is treated as held in a separate trust
 - ▣ CIB is treated as the owner of the portion of the trust consisting of the S corp stock
 - ▣ All income, deduction, and credit related to the S corp stock is reportable by CIB, regardless of whether it is actually distributed
 - All other assets of the trust will be accounted for and handled in the same manner as if the QSST election had not been made

ESBT As S Corp Shareholder

- ▣ Beneficiaries – is there an ineligible beneficiary
 - All beneficiaries must be individuals, estates, certain charitable organizations, or certain governmental organizations (no CRUTS or CRATS)
 - Beneficiary includes any person who has a present, remainder, or reversionary interest in the trust
 - Also includes the beneficiaries of a distributee trust
 - Does not include a person whose interest is so remote as to be negligible
 - Does not include a person in whose favor a power of appointment can be exercised (until actually exerc.)

ESBT As S Corp Shareholder

- ▣ Potential Current Beneficiaries – are there any ineligible PCBs or too many PCBs
 - PCB is any person who at any time is entitled to, or at the discretion of any person may receive, a distribution from principal or income of the trust
 - All PCBs are treated as shareholders
 - ▣ All PCBs must be eligible S corp shareholders
 - ▣ All PCBs count toward the 100 shareholder limit

ESBT As S Corp Shareholder

- ▣ Must Affirmatively Elect ESBT Status
 - Trustee (not the beneficiary or PCB) makes the election
 - Window for filing election:
 - ▣ Existing S Corp – 2 months and 16 days after trust becomes shareholder
 - ▣ New S Election – 2 months and 16 days after first taxable year in which S election is to be effective
 - Election is irrevocable unless IRS consents

ESBT As S Corp Shareholder

- ▣ Taxation of ESBT
 - The price for the relaxed qualification requirements (compared to the QSST) lies in the taxation of the ESBT's income
 - The ESBT is treated as two separate trusts:
 - ▣ Non-S Portion – is treated as a normal trust subject to traditional trust tax principles
 - ▣ S-Portion – the trust itself, not the beneficiaries, must pay tax on the income from the S corp at the highest trust tax rate (cap. gains are taxed at the appl. rates)

Grantor Trusts As S Corp Shareholders

- ▣ Administration during life of grantor
 - Trust must qualify as a “grantor trust” under IRC 671 – 678
 - Can be revocable or irrevocable
 - Grantor, during life, is considered the owner for both shareholder eligibility purposes, as well as income tax purposes

Grantor Trusts As S Corp Shareholders

- ▣ Administration upon death of grantor
 - Trust terminates at grantor's death – distributees become the new shareholders and must independently qualify
 - Trust continues after grantor's death - stock can be held for two-year period (as a testamentary trust)
 - ▣ *grantor's estate* is treated as the owner for purposes of the shareholder eligibility requirements
 - ▣ *the trust* is treated as the owner for income tax purposes
 - ▣ after the two-year period – the trust(s) will need to qualify as a QSST or ESBT or distribute the stock to otherwise qualified shareholders

Testamentary Trusts As S Corp Shareholders

- ▣ Permitted shareholder for two years
- ▣ Testator is the shareholder for the 100-shareholder limitation
- ▣ Trust and beneficiaries are taxed on the items of income, gain, loss, deduction, and credit attributable to the S corp, based on traditional trust tax principles
- ▣ After two-year period, the trust must qualify as a QSST or ESBT or distribute the stock

Estate Planning Trusts As S Corp Shareholders

- ▣ Bypass Trust
 - Typical bypass trust violates most QSST req.
 - ▣ Usually multiple income beneficiaries
 - ▣ Spouse has power to appoint trust property
 - Bypass will require specific drafting to qualify as QSST
 - ▣ Spouse should be sole beneficiary
 - ▣ All income distributed to spouse at least annually
 - ▣ If terminated during spouse's lifetime – assets should be distributed to spouse
 - ▣ If to continue after surviving spouse – must distribute stock outright or to separate trusts for children

Estate Planning Trusts As S Corp Shareholders

- ▣ QTIP Trust – requirements similar to QSST
 - Spouse entitled to income from the trust for life, payable at least annually
 - No person, including the spouse, may have a power to appoint any part of the property to any person other than the surviving spouse during his/her life
 - Requirement that upon termination of the trust during the spouse's life , the assets of the trust must be distributed to the spouse, can be included without busting the QTIP requirements
- ▣ Marital Deduction Trusts – can also be drafted to comply with the QSST requirements

Buy-Sell Agreements

- ▣ In addition to typical benefits, protecting S corp eligibility makes them critical
 - Prohibit direct transfers to ineligible shareholders
 - Prohibit two-step transfers via encumbrances
 - Deal with dispositions of stock by estates and trusts
 - Limit shareholder actions to terminate S election
 - Provide for conditions to terminate S status
 - Provide for tax distributions for phantom income
 - Provide for damages in the event of a termination

Conversions of S Corps

- ▣ Why convert from a corporation taxed as an S corp to an LLC taxed as a partnership
 - Outside-in liability protection – membership interests subject to a charging order
 - Shareholder limitations – no limits on the types or numbers
 - Second class of stock issues – no prohibition on a second class of stock

Conversions of S Corps

- ▣ Tax Consequences of S to Partnership Taxation
 - Step 1 – Deemed sale of all assets by Corp for FMV
 - ▣ FMV = willing buyer/willing seller determination, except FMV cannot be less than liabilities
 - ▣ Assets include goodwill, even if not booked for tax purposes
 - ▣ Gain/loss passes through to shareholders for tax purposes
 - ▣ If there is a gain, the shareholder's basis in his/her stock would likely be increased (which impacts Step 2)

Conversions of S Corps

- ▣ Tax Consequences of S to Partnership Taxation
 - Step 2 – Deemed liquidation of all assets by Corp in exchange for all stock of shareholders
 - ▣ Gain or loss based on the difference between:
 - The cash and “Net Fair Market Value” of property received
 - “Net Fair Market Value” is the amount a willing buyer would pay a willing seller, *less liabilities assumed by the shareholder*
 - ▣ If there are liabilities involved, they could trigger gain in Step 1 (increasing the basis in the stock) and, thus, trigger a corresponding loss in Step 2 (if basis is higher than net fair market value of assets)

Conversions of S Corps

- ▣ Tax Consequences of S to Partnership Taxation
 - Step 3 – Contribution of assets and liabilities to new partnership
 - ▣ No gain or loss upon contribution of assets to partnership
 - ▣ Basis in partnership/membership interest is equal to the basis of the property contributed
 - ▣ Contribution of liabilities may trigger gain
 - If a partner is relieved of any portion of a liability, then the amount from which the contributing partner is relieved is treated as a distribution of cash (which will trigger gain if it exceeds the member's basis in his partnership)

Second Class of Stock Issues

- ▣ Only entities with one class of stock are eligible to elect S status
 - An entity has only one class of stock if all interests confer identical rights to distribution and liquidation proceeds
 - Potential Triggers:
 - ▣ Reclassifying debt as equity
 - ▣ Issuance of call options, warrants, and similar instruments
 - ▣ Issuance of debt with convertibility features

Second Class of Stock Issues

- ▣ Debt vs. Equity
 - General test is highly subjective/fact intensive
 - ▣ “general principles of federal tax laws”
 - Straight Debt Safe Harbor :
 - ▣ In writing
 - ▣ Unconditional promise to pay a sum certain on a set date or on demand
 - ▣ Interest rate and payment dates are not contingent on borrower’s profits, discretion, or payment of dividends
 - ▣ Not convertible, directly or indirectly, into equity
 - ▣ Creditor is either (i) an individual, estate, or trust or (ii) a person (non-individual) actively and regularly engaged in the business of lending money

Second Class of Stock Issues

- ▣ Call Option/Warrant/Similar Instrument
 - General test is highly subjective/fact intensive
 - ▣ “substantial certainty” as to exercise and relation of strike price to FMV
 - Lender Safe Harbor:
 - ▣ Option will not constitute a second class of stock if issued to:
 - a person actively and regularly engaged in the business of lending money; and
 - in connection with a commercially reasonable loan

Second Class of Stock Issues

- ▣ Convertible Notes
 - ▣ Convertible debt is actually subject to two tests:
 - ▣ First, the debt vs. equity test, and
 - ▣ Second, the option test