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The M&A Tax Report

AUGUST 2011 VOLUME 20, NUMBER 1
The Monthly Review of Taxes, Trends & Techniques

S Corporation Planning for the Final Exit

By Christopher Karachale • Wood LLP • San Francisco

In many ways, S corporations hearken to the past, appearing like a relic in the bottom of the tax advisor tool chest. Decades ago, we did not have the various other passthrough entities that can now be formed, nor did we enjoy the relative ease with which such formation can take place. Who knew that someday we could just check the box!

In this light, the inherent limitations of S corporations make them less appealing and more of an also-ran. There are hurdles, exclusions and mechanical and basis problems not found by LLCs or partnerships. When compared with other choices of entities, the S corporation seems to offer little to recommend it.

The shortcomings of the S corporation in the M&A world are particularly salient. The limited ownership structure and the restriction of stock to U.S. shareholders make the entity particularly cumbersome, if not downright provincial. But are there instances in the M&A world in which an S corporation is advantageous?

While perhaps a bit macabre, there is one transaction that every taxpayer must contemplate at some point—namely, his own mortality. True, Subchapter S contains a number of unwieldy restrictions. Yet, at least in the estate planning area, S corporations can offer helpful tools to ease the pain of the final merger.

S Corporation Basics

Internal Revenue Code Section ("Code Sec.") 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under Code Sec. 1362(a) is in effect. Code Sec. 1361(b)(1) defines a "small business corporation" as a domestic corporation that is not an ineligible corporation and that *does not* have:

- more than 100 shareholders;
- as a shareholder a person (other than an estate, certain trusts and exempt organizations) who is not an individual;

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- a nonresident alien as a shareholder; and
- more than one class of stock.

Corporations ineligible to be organized as S corporations include banks (before 1997), insurance companies and domestic international sales corporations (DISCs). [Code Sec. 1361(b)(2).] Upon election by all of the shareholders, the small business corporation will be treated as an S corporation. [Code Sec. 1362(a).]

Trust Ownership of an S Corporation

Code Sec. 1361(c)(A) lists the six trusts that may serve as shareholders of an S corporation. The most significant of these are the qualified subchapter S trust (QSST) and the electing small business trust (ESBT). In order to qualify as a QSST, a trust must meet the following statutory requirements:

- The trust must have only one current income beneficiary.
- If distributions of trust principal are permitted during the lifetime of the income beneficiary, the trust's terms must permit such principal distributions only to such income beneficiary.
- The income interest of the current income beneficiary must be required to terminate on the earlier of such income beneficiary's death or the termination of the trust.
- The terms of the trust must provide that, upon termination of the trust during the life of the income beneficiary, all trust assets must be distributed to the income beneficiary.
- All trust income must be distributed to one individual who is a citizen or resident of the United States. [Code Sec. 1361(d)(3).]

Code Sec. 1361(e) provides that an ESBT means any trust if:

- such trust does not have as a beneficiary any person other than (1) an individual, (2) an estate, or (3) a charitable organization that holds a contingent interest in such trust and is not a potential current beneficiary;
- no interest in such trust was acquired by purchase; and
- the appropriate election is made by the trustee.

Code Sec. 1361 explicitly disallows certain trusts to function as ESBTs. In particular, QSSTs, tax-exempt trusts and certain charitable remainder trusts cannot be ESBTS. A grantor trust may elect to be an ESBT. For purposes of Code Sec. 1361, a "potential current beneficiary" is any person who is entitled to, or, at the discretion of any person, may receive a distribution from the principal or income of the ESBT. [Code Sec. 1361(e)(2).]

Electing Small Business Trusts in Action

The ESBT rules were enacted in 1996 under the Small Business Job Protection Act (H.R. 3448). Congress perceived the limitations on QSSTs that can only have a single income beneficiary. Therefore, Congress attempted to facilitate family financial planning by allowing a trust to hold S corporation stock *and* provide income to be distributed to (or accumulated for) a class of individuals. [*See* General Explanation of Tax Legislation Enacted in the 104th Congress, JSC 12-96 (Dec. 18, 1996).]

Only certain types of persons are permitted to be beneficiaries of the trust for the trust

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THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

to qualify as an ESBT and as a shareholder in a Subchapter S corporation. Once a trust makes the ESBT election, each potential current beneficiary of the trust is treated as a shareholder of the S corporation. Pursuant to the general rules of Code Sec. 1361(a), this number cannot exceed 100.

Thus, in a symbiotic relationship, the identity of the beneficiaries affects whether a trust can be an ESBT. Then too the identity and number of potential current beneficiaries affect whether the corporation can be an S corporation. The tax regime for ESBTs is complicated.

Essentially, the portion of the trust that consists of stock in one or more S corporations is treated as a separate trust for purposes of computing taxable income. Taxable income attributable to the trust as an S corporation shareholder is taxed at the highest individual rate to the ESBT. Since this income is not included in the distributable net income of the trust, it is not included in the beneficiaries' income.

Provided that the ESBT holds items other than S corporation stock, such items are disregarded. Distributions to beneficiaries from the S corporation portion or the non–S corporation portion (including distributions of the S corporation stock) are, to the extent of the distributable net income of the non–S corporation portion, deductible in determining the taxable income of the non–S corporation portion, and are includible in the gross income of the beneficiaries.

Planning Possibilities

So when the final merger comes, what are the advantages of establishing an ESBT? For individuals who own shares of S corporations, the ESBT is a viable means to transfer such equity either during their lifetime or at death. The grantor can define who the beneficiaries will be and the timing and amount of the distributions.

Since there can be multiple beneficiaries, the ESBT can effectively serve as the primary vehicle through which small business operate. Importantly, the election to become an ESBT is a separate step to qualification under Code Sec. 1361. Provided that the other requirements are met, a trust can elect ESBT status at some future point based on changes in assets or the whims of the grantor.

In this setting, interests in the trust must be obtained through gift or bequest. Still, nothing prevents the ESBT from purchasing *additional* S corporation shares to increase the holdings of the trust.

Conclusion

Despite the limitations on S corporations, Subchapter S offers significant resources. Especially in the family wealth transfer area, ESBTs can be the perfect entity to address the final M&A transaction each and every taxpayer will face.