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In this installment of Yadav's column (Tax) Matters of Life and Death, Yadav explores the challenges S corporations present for estate and succession planning.

IRS data from 2013 surprisingly revealed that S corporations are the most prevalent type of corporation in the United States.[1] In fact, over 70 percent of corporate income tax returns that year were filed by S corporations. Nontax reasons supporting the formation and use of S corporations include the ease of formation (with an S election for an LLC), protection of shareholder liability similar to that afforded by C corporations, and relative ease for compliance purposes. On the tax side, a primary advantage is that only the part of S corporation income paid out as salary to shareholders is subject to self-employment tax and payroll taxes, including taxes under the Federal Insurance Contributions Act and Medicare, as compared with potentially all of an LLC's or partnership's income. S corporations also qualify for passthrough entity elections that allow the entity to pay the income tax and provide credit to the shareholder.

From an estate planning and wealth transfer perspective, however, organizing as an S corporation may actually be trading short-term small gain for longer-term greater pain. This article explores the unique challenges presented by S corporations for estate and succession planning.

Capital, Management, and Succession Issues

S corporations have stringent restrictions on ownership, which is limited both in number (no more than 100 shareholders) and type (individuals, certain trusts, estates, and exempt organizations).[2] Further, individual owners must be U.S. citizens — that is, non-resident non-citizens cannot be shareholders,[3] and only limited types of trusts qualify.

This may not seem too onerous on its face, but in the longer term it makes it substantially more difficult to attract capital from third parties. Most sources of private capital — such as venture or private equity funds — are organized as partnerships, which are not allowed to be S corporation shareholders. So in reality, this form of ownership restricts how a business can grow by reducing its capital opportunities. Also noteworthy is that some benefits that apply to start-ups and are key attractors for venture capital, such as qualification of stock as qualified small business stock, are unavailable for S corporations.

Employee incentives are another practical issue. S corporations allow only a single class of stock (though it can be split into voting and

[1] IRS, "SOI Tax Stats — S Corporation Statistics" (last updated Dec. 5, 2023).

[2] IRC section 1361(b)(1).

[3] IRC section 1361(b)(1)(C).

nonvoting),[4] and employees who may be granted S corporation stock as equity compensation would be taxed at ordinary income rates in the year of grant. Further, since S corporations cannot be publicly traded (by virtue of shareholder number limitations), any grant would most certainly require contemporaneous valuation. This makes equity grants onerous for the employers, so it is unusual to see equity compensation even for high-performing employees in S corporations. In turn, this may disincentivize talent, and the company may lose high-performing employees to businesses that are organized to allow those incentives. For example, partnerships — and LLCs taxed as partnerships — allow profits interests that cause minimal or no income tax to a service provider upon grant[5] and allow a great degree of management control (and clawback, if needed), yet they allow high-performing service providers to participate in the upside of the business.

The issue of incentives is also not just for outside employees; it can easily encapsulate family members (especially younger generations) who may be more inclined to join and help grow a family business if they could participate in its upside.

And since multiple classes of stock are disallowed, S corporations also do not allow disproportionate distributions — meaning that tiered or threshold distributions become impossible, further complicating the structure's equitability. For example, in many businesses, distributions for various employees or investors are tiered to levels of company performance/target achievement to ensure that certain owners and investors are guaranteed a return before employee interests pay out. Also, partnerships with certain allocation models allow disproportionate distributions[6] even without different classes of ownership, providing even more flexibility about when and how much profit is actually distributed and to whom in any given year.

Trust Ownership Issues

Qualification Issues

Succession issues become even more pressing upon the death of a senior family member and subsequent transfer of the S corporation to junior family members. Assuming the decedent had a revocable trust as part of her estate plan, that trust (or at least the decedent's share of it) converts upon death to a non-grantor trust. Similarly, any irrevocable trusts that were treated as grantor trusts (such as "intentionally defective" grantor trusts or "IDGTs") also convert to non-grantor trusts upon the grantor's death.

IRC sections 1361(c)(2) and 1361(d) provide for seven types of trusts that are permitted as S corporation shareholders, none of which can be a foreign trust[7]:

- A trust treated in its entirety as owned for income tax purposes by an individual who is a citizen or resident of the United States. This covers revocable trusts and irrevocable trusts that are treated as grantor trusts under IRC sections 671-678.
- A trust that was described in clause (i) immediately before the death of the deemed owner and that continues to exist after that death, but only for the two-year period beginning on the day of the deemed owner's death. This provides a grace period for trusts that convert to non-grantor trusts upon the death of the owner.
- A trust regarding stock transferred to it under the terms of a will, but only for the two-year period beginning on the day when that stock is transferred to it. This provides a grace period for trusts that arise as part of estate administration under the terms of an individual's will.
- A trust created primarily to exercise the voting power of stock transferred to it.

[4] IRC sections 1361(b)(1)(D), 1361(c)(4).

[5] Rev. Rul. 93-27. *See*, *e.g.*, RSM, "Frequently Asked Questions About Profits Interests" (Apr. 2, 2024). Note that tax partnerships are technically prohibited from granting equity to Form W-2 employees. However, the various employment arrangements available for service providers have meant that most tax partnerships are able to structure around this prohibition and use equity as a performance incentive.

[6] The enormous flexibility provided to tax partnerships regarding their distribution regimes is limited primarily by the "substantial economic effect" rules found in the Treasury regulations promulgated under IRC section 704(b), which permit significant choice in economic arrangements among the partners so long as income is not manipulated purely to skew tax consequences.

[7] The first six categories are enumerated under IRC section 1361(c)(2) and the last one under IRC section 1361(d).

- An electing small business trust (ESBT), which is the most common type of non-grantor trust shareholder of S corporations, as discussed further below.
- A trust that constitutes an IRA (or Roth IRA), but only if it held stock in an S corporation as of a specific date and that corporation was a bank or depository institution holding company.
- A qualified subchapter S trust (QSST), the other type of non-grantor trust allowed to be an S corporation shareholder.

As this list indicates, upon the death of an S corporation individual shareholder (directly or through their revocable trust), there is a short grace period (see subparts (ii) and (iii)) before any trust that they were paying income tax on must qualify either as an ESBT or a QSST — or the S corporation status would be forsaken.

QSSTs are the more restrictive of the two options. To qualify as a QSST, a trust must meet several criteria:

a. only one income beneficiary of the trust can be a U.S. citizen or resident;
b. all trust income must be distributed currently to the one income beneficiary;
c. any corpus distributed during the lifetime of that income beneficiary can only be made to that person; and
d. the income interest terminates upon the death of the income beneficiary (or if earlier, upon the termination of the trust), and if the trust terminates before the death of the income beneficiary, all assets must be distributed to that beneficiary.[8]

Further, the beneficiary is treated as the owner for income tax purposes of that share of the trust that consists of S corporation stock,[9] and the first beneficiary must proactively elect into this regime.[10] Successive beneficiaries then have the election applied automatically to them[11] and must affirmatively opt out instead of opting in.

By contrast, ESBTs allow for multiple beneficiaries, which can be individuals, an estate, or EOs.[12] However, former QSSTs or charitable remainder trusts are not eligible to make the ESBT election.[13] An ESBT also requires an election, which must be made by the trustee and is irrevocable (except with the Treasury secretary's consent).[14] Most importantly, ESBTs can accumulate income — that is, there is no requirement for concurrent distribution of income to beneficiaries.

Besides the stringent requirements that come with the formation of a QSST or ESBT, including a narrow window for making elections by the trustee or beneficiary, traps exist for the unwary in continuing administration of these trusts. For example, an ESBT cannot have acquired S corporation stock by purchase,[15] so in years following a decedent shareholder's death and formation of trusts for beneficiaries, the family may be stuck with certain ownership even if the next generation would choose otherwise.

Reporting and Tax Liability Issues

Tax reporting, especially state income tax reporting with ESBTs, adds to the complexity of these trusts. QSSTs are somewhat straightforward and generally report as "simple" trusts — except for years when a distribution of corpus is made.[16]

The rules governing state income taxation of trusts add to the complexity. In California, for example, non-grantor trusts are taxed in a cascading fashion:

- *Determine all California-source income; that amount is fully taxable in California.*[17]
- *Apportion all non-California income based on the residence of fiduciaries.* When there are multiple fiduciaries, some California residents and some not, Rev. & Tax. Code section 17743 (and regulations thereunder) requires apportionment of non-California-

[8] IRC section 1361(3); Treas. reg. section 1.1361-1(j)(1).

[9] IRC section 1361(d)(1)(B).

[10] IRC section 1361(d)(2)(A).

[11] IRC section 1361(d)(2)(B)(ii).

[12] IRC section 1361(e)(1)(A)(i).

[13] IRC section 1361(e)(1)(B).

[14] IRC section 1361(e)(3).

[15] IRC section 1361(e)(1)(A)(ii).

[16] IRC section 651; Treas. reg. section 1.651(a)-1.

[17] This long-held position was recently confirmed in *Steuer v. Franchise Tax Board*, 51 Cal. App. 5th 417 (Cal. Ct. App. 2020), commonly referred to as the Paula Trust case.

source income based on the number of resident fiduciaries.

- *Apportion any remaining non-California income based on the residence of non-contingent beneficiaries.* A beneficiary has a contingent interest in a trust when the trustee holds sole and absolute discretion to distribute to the beneficiary.[18] In other words, a contingent beneficiary cannot compel the trustee to give him any portion of trust assets.[19] When the trustee's discretion is restricted or the beneficiary enjoys the ability to demand distributions, the interest would be non-contingent. Franchise Tax Board Legal Ruling No. 238 (Oct. 27, 1959) provides an example of the double bite at non-California-source income when there is at least one California resident fiduciary and one non-contingent beneficiary. It states that for a trust with non-California-source taxable income of $90,000, with three trustees (one of whom is a resident) and two non-contingent beneficiaries (one of whom is a resident), California can tax $60,000 of this income.
- *Calculate throwback taxes.* When a trust has only non-California fiduciaries and any California resident beneficiaries are contingent, income earned by that trust is not immediately taxable by the state. But when a distribution is made from that earned but untaxed income to a California resident beneficiary, the beneficiary is considered non-contingent up to the amount of that distribution, and it could be taxable in California at the time of distribution.[20] This is the lurking throwback tax. There are two factors for throwback tax to apply: First, there must be a distribution to a California resident beneficiary; and second, there must have been previously accumulated untaxed income starting when the contingent beneficiary became a California resident.[21]

Under the aforementioned rules, now imagine an ESBT in which the sole asset is stock in one S corporation. For federal tax purposes, IRC section 641(c) requires that the trust (ESBT) be liable for taxes on S corporation income, rather than the beneficiaries (that is, there is no deduction for distributable net income). California incorporates the rules of subchapter J, including ESBT rules with some modifications but that do not affect the tax liability aspects.[22] If the ESBT has no California resident fiduciaries or non-contingent beneficiaries, there will be no California tax. But if a distribution is made to a California resident beneficiary, the compliance would get more complicated:

- First and foremost, generally, the California resident beneficiary is liable for payment of taxes (whether on current-year income or arising because of the throwback tax); however, this rule would be overridden by the ESBT rules that would make the trust liable for taxes on any distribution to a resident beneficiary. This can create an issue for fiduciaries if there are non-California beneficiaries, because by making a distribution to a California beneficiary, the fiduciary is causing the other beneficiaries' shares to deplete since the ESBT must bear the tax liability.
- The second issue is the amount of income that would be taxable in California. Generally, again, the rule is that California taxes a beneficiary to the extent that it becomes non-contingent. One would think that the taxable amount should not change depending on the person who is liable, but there is no specific guidance on this point.
- If the distribution is of prior-year income, then under the throwback tax rules, again, the ESBT would be liable for California taxes even if it did not receive any income in that year. When thinking about making

[18] California FTB, TAM 2006-0002 (Feb. 17, 2006).

[19] *Id.*

[20] Cal. Rev. & Tax. Code section 17745(b).

[21] Cal. Rev. & Tax. Code section 17745(e) provides that a beneficiary is presumed to be a resident in California if she leaves within 12 months before the distribution and returns within 12 months after the distribution. Naomita Yadav, "Checking Out of Hotel California," *Tax Notes State*, July 18, 2022, p. 281.

[22] Cal. Rev. & Tax. Code sections 17331, 17331.5.

distributions to beneficiaries, fiduciaries who may believe they have already satisfied tax payments should keep this in mind.

Basis Step-Up Issues

As with a C corporation, upon the death of an individual S corporation shareholder, the step-up applies only to the basis in the shares of the S corporation, rather than the underlying assets.[23] This means that if the new shareholders (trusts or individuals who inherit from the decedent) want to sell the business, they must find a purchaser who desires to buy S corporation stock which, as discussed earlier, is a limited universe. Otherwise, a liquidation of the S corporation and subsequent sale of its assets may be necessary. The latter may not be feasible if the decedent wasn't the sole or majority owner, because the other shareholders would be subject to income tax upon the liquidation of the S corporation.[24]

In short, S corporations do not lend themselves well to estate or succession planning. Because these issues are inevitable, advisers should proactively discuss with their clients the reorganization options, like creating preferred partnerships under the S corporation. ■

[23]Herbert R. Fineburg and Charles A. McCauley III, "Avoiding an Adverse Tax Impact on Death of an S Corporation Shareholder," 40 *ABA Tax Times* 2 (2021).

[24]*Id.* As explained in the American Bar Association article, the liquidation of the S corporation is treated as a deemed sale of its assets, which results in a gain reported on Forms K-1 for the shareholders. While the estate will have an offsetting loss because of the basis step-up in the shares, the other shareholders will not have this offsetting loss. Further, to reiterate the allocation point raised earlier, in the S corporation context there is no method of specially allocating the S corporation's aggregate built-in gain entirely to one shareholder, and there also may not be an avenue for compensation of the other shareholders by the estate for their tax burden on the associated gain, without triggering additional income to those shareholders.