

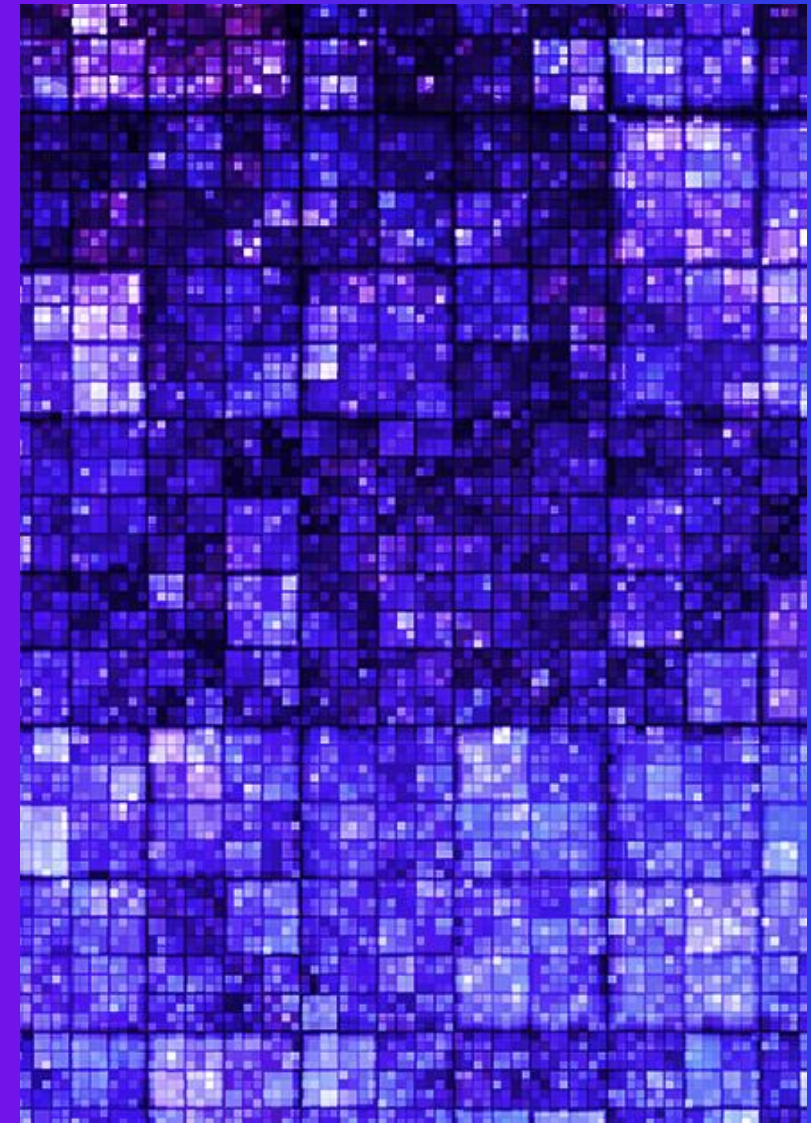


# Practical Implications with Using S Corporations in Estate Planning

September 17, 2024

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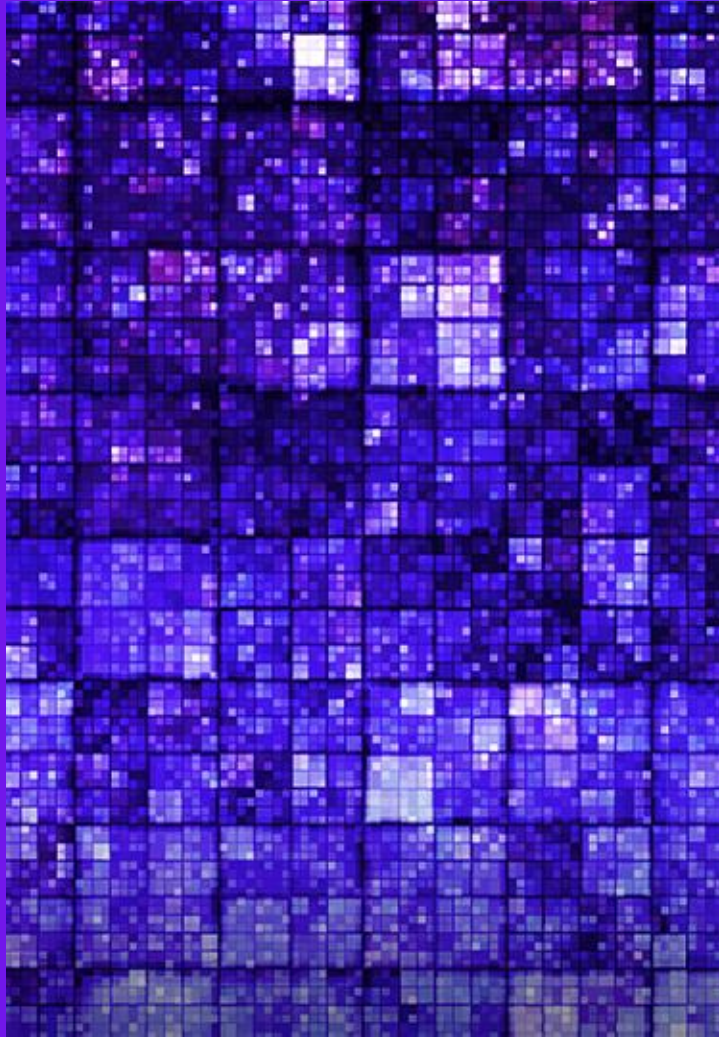
# Notices

The following information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

# Objectives

- Provide an understanding of different types of trusts eligible to hold S corporation shares, including grantor trusts, testamentary trusts, voting trusts, electing small business trusts (ESBTs) and qualified subchapter S trusts (QSSTs).
- Explain the distinct tax treatment of S corporations and partnerships, focusing on how these differences impact estate and income tax considerations.
- Illustrate practical considerations with utilizing S corporations as part of a taxpayer's comprehensive estate planning.



# Eligible Trusts / Grantor Trusts

# S Corporations

- An S corporation means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.
- A small business corporation means a domestic corporation that is not an ineligible corporation and which does not-
  - Have more than 100 shareholders,
  - Have as a shareholder a person (*other than an estate, a trust described in section 1361(c)(2), or an organization described in section 1361(c)(6)*) who is not an individual,
  - Have a nonresident alien as a shareholder, and
  - Have more than 1 class of stock.

# Eligible Trusts & Estates

## — Grantor trusts

- During lifetime of grantor
  - Grantor treated as shareholder
- Up to two years following grantor's death
  - Grantor's estate treated as shareholder

## — Testamentary trust for two years

- Estate of testator treated as shareholder

## — Decedent's estate

- Consider section 645 election with qualifying revocable trust

# Eligible Trusts & Estates (cont'd)

- Voting trust
  - Each beneficiary treated as a shareholder
- Qualified subchapter S trust (QSST)
  - Deemed owner treated as shareholder
- Electing small business trust (ESBT)
  - Unexercised powers of appointment ignored in determining potential current beneficiaries

# Grantor Trusts

- A grantor trust is a trust that is treated as owned by the grantor because of the retaining of “Grantor Powers”
- A grantor includes any person to the extent such person creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust (section 1.671-2(e)(1))
- The grantor must be an eligible shareholder because the grantor is treated as the owner of the S stock



# Grantor Trusts – Section 671 through 677

- Reversionary interests (section 673)
- Power to control beneficial enjoyment (section 674)
- Administrative powers (section 675)
- Power to revoke (section 676)
- Income for the benefit of the grantor (section 677)
- Grantor is treated as holding any power held by spouse

# Grantor Trusts – Administrative Powers

— Administrative powers are detailed in section 675. They include:

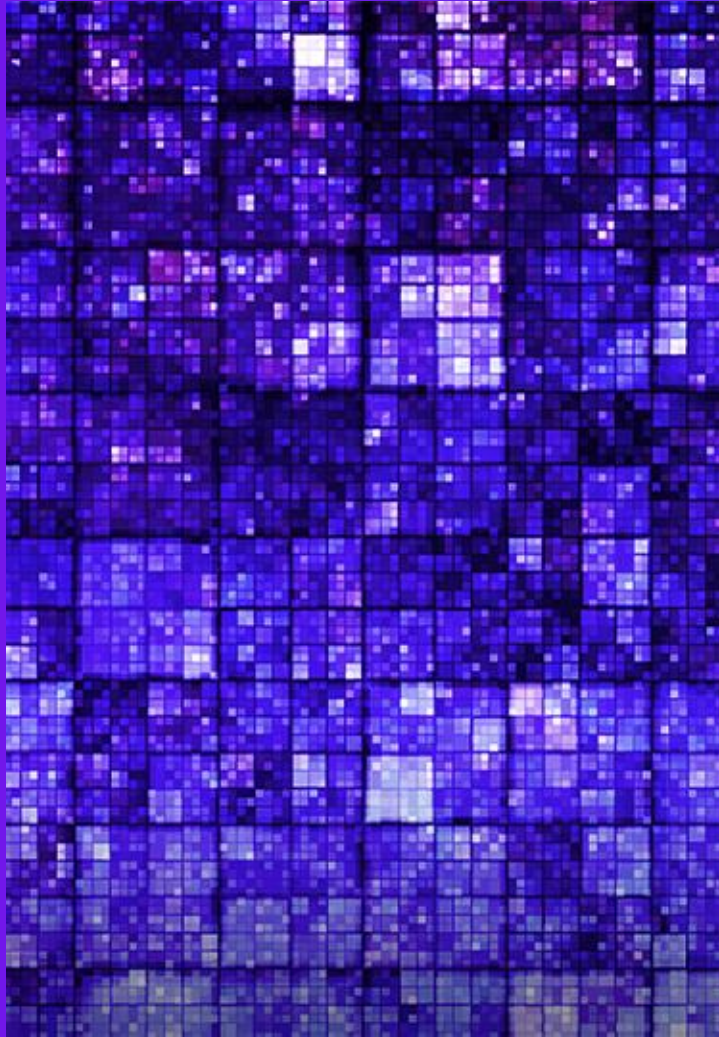
- The power to deal the corpus or income therefrom for less than adequate and full consideration.
- The power to borrow without adequate interest or security.
- Borrowing of the trust funds.
- General powers of administration.
  - Power to vote or direct the voting of stock or other securities of a corporation if the voting interest is significant.
  - Power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments if the voting interest is significant.
  - Power to reacquire the trust corpus by substituting other property of an equivalent value.

# Grantor Trusts – Section 678 Trusts

- A person other than the grantor is treated as the owner of a trust (Section 678 Trust) if that person:
  - Holds a power exercisable solely by holder to vest corpus or income of trust in self or
  - Previously partially released or modified such power and retains one or more “Grantor Powers” (sections 671 through 677)

# Grantor Trusts – Section 678 Trusts

- Generally eligible to be an S shareholder if –
  - One individual other than the grantor is treated as the owner of all of the Trust.
    - e.g., beneficiary who has unrestricted right to withdraw corpus
    - Husband and wife
    - *Crummey* powers
    - Power to withdraw only a portion of corpus?
  - **Deemed owner cannot be a nonresident alien**
  
  - ***Consider***
    - Husband and wife
    - Community property
    - Death of owner



# CCA 202352018

# Trust Modification - Gift from Beneficiaries?

- In year 1, donor establishes and funds an irrevocable trust for the benefit of their child and child's descendants.
  - Trustee may distribute income and principal to beneficiaries in trustee's "absolute discretion."
  - Donor retains a power which causes the trust to be treated as a grantor trust for income tax purposes.
  - Neither trust nor state law requires or provides authority for trustee to reimburse donor for income taxes related to trust income.
- In year 2, Trust petitions court to modify terms of the trust to allow for discretionary income tax reimbursement to donor.
  - Pursuant to state law, child and child's descendants consent to the modification.
  - Court grants the petition.

# Trust Modification is Gift from Beneficiaries

- In CCA 202352018, the IRS ruled that a judicial modification of an irrevocable grantor trust to give the trustee the discretionary power to reimburse the grantor for income taxes attributable to trust income would constitute a taxable gift by the beneficiaries.
- The IRS said this would be the outcome even if the beneficiaries had not affirmatively consented but rather merely had knowledge of the modification and failed to object (assuming a right to do so).
- This is a reversal of the position taken by the IRS in a 2016 PLR.
- Rev. Rul. 2004-64 held that there is no gift from the beneficiaries if a reimbursement power is included in the original governing instrument – but no consent or right to object aspect.

# Trust Modification is Gift from Beneficiaries

- Unclear how gift would be valued - would need to make assumptions about tax rates, amount of income, how often reimbursement power is exercised – and how the total gift would be allocated among discretionary beneficiaries (including those not yet born).
  - The CCA acknowledges valuation difficulty but cites Treas. Reg. section 25.2511-1(e) for the proposition that the gift would be the entire value of the trust if the parties cannot value what was gifted vs what was retained.
- Could be an IRS warning to taxpayers related to the prevalence of modifications/amendments to irrevocable trusts through decantings, non-judicial settlement agreements, changes in grantor status, etc.



# Trust Modification is Gift from Beneficiaries

- Planning in light of CCA:
  - If trust is modified to add beneficiaries or change beneficial interests, consider whether to file gift tax returns for beneficiaries to report gifts (even if taking position that the gift is worth 0 in order to get statute of limitations running).
  - Consider including reimbursement clause in original document – although actually using this power to reimburse the grantor is not ideal from an estate inclusion perspective.
  - Caution taxpayers against modifying/decanting irrevocable trusts – especially if the modifications includes adding beneficiaries or changing beneficial entitlements.



# Eligible Trusts – Testamentary Trusts, Voting Trusts, ESBTs, QSSTs, ESOPs

# Testamentary Trusts

## — Testamentary trusts

- If stock in an S corporation is transferred to a trust pursuant to the terms of the shareholder's will, the estate is treated as the shareholder (and is therefore eligible) for 2 years following the owner's death.
  - The trust must report all of the S corporation's income and losses as a shareholder, however, and is entitled to all distributions from the S corporation.
  - Therefore, the fact that the trust is not eligible to be the shareholder during that 2-year period does not terminate the S election.
- If (within the two-year window) the trust transfers stock to an eligible shareholder or is reformed so that the trust is eligible, the S election does not terminate.

# Voting Trusts

- A voting trust is an eligible shareholder
- Each beneficiary of the trust is considered to be a shareholder for purposes of the 100-shareholder limitation.
- A voting trust is created primarily to consolidate the voting power of certain shareholders
- Care must be taken if trustee of voting trust has powers other than power to vote the stock
- Trust must be represented by a written agreement that—
  - Delegates to one or more trustees the right to vote the stock held by the trust
  - Requires that all distributions with respect to the stock be paid to or for the beneficial owners of the stock
  - Requires title and possession of stock to be delivered to the beneficial owners upon termination of the trust, and
  - Terminates, under its terms or by state law, on or before a specific date or event.

# Qualification to be an ESBT

- An electing small business trust (ESBT) can be a complex trust that accumulates income, has multiple beneficiaries, and provides the authority to the trustee to make discretionary distributions of corpus and income and can be a shareholder of an S corporation if it qualifies and elects ESBT treatment.
- ESBTs pay tax at the trust level at the highest marginal individual rate of taxation.
- Each “potential current beneficiary” of the ESBT is treated as a shareholder of the S corporation for purposes of determining the number and qualification of shareholders.

# Qualification to be an ESBT

- For taxable years after 1996, a trust can qualify as an ESBT if the following conditions are satisfied:
  - The trust does not have a beneficiary other than an individual, an estate, an organization described in section 170(c)(2), (3), (4), or (5), or an organization described in section 170(c)(1) that holds a contingent interest in such trust and is not a potential current beneficiary.
  - No interest in the trust was acquired by purchase
  - Trust may not be a QSST, charitable remainder, or tax-exempt trust
  
- And an election to be an ESBT is timely filed

# Who are Beneficiaries of an ESBT?

- A beneficiary is generally any person who has a present, remainder, or reversionary interest in the trust.
  - A distributee trust is a trust that receives or may receive a distribution from an ESBT, whether rights to receive the distribution are fixed or contingent, immediate or deferred.
  - A distributee trust is not a beneficiary of an ESBT unless the trust is an organization described in section 170(c)(2) or (3).
  - Otherwise, the persons with a beneficial interest in the distributee trust are the beneficiaries of the ESBT.
  - A person in whose favor a power of appointment could be exercised is not a beneficiary of an ESBT until the power is exercised in favor of that person.

# Who are Potential Current Beneficiaries of an ESBT?

- For purposes of limits on shareholders, each Potential Current Beneficiary (PCB) of an ESBT is treated as a shareholder of the S corporation unless the ESBT has no PCBs. In that case, the ESBT is the shareholder.
- A PCB is any person (with respect to any period) who at any time during such period, is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the ESBT.
  - A person who holds solely a future interest in the trust is not a PCB
  - If a trust disposes of all of its S stock, a person who became a PCB during the year before the disposition is disregarded as a PCB of the S corporation during that year.



# Distributee Trusts of an ESBT

- If a distributee trust is not qualified to be a shareholder of an S corporation, the distributee trust is treated as the PCB and the S election terminates.
- If a distributee trust is qualified to be a shareholder of an S corporation, the persons who would be its PCBs if the distributee trust were an ESBT are treated as the PCBs of the ESBT.
- **EXCEPTION:** If the distributee trust is a testamentary trust or estate that qualifies as an S corporation shareholder, the estate or trust is treated as the PCB of the ESBT for the 2-year period during which it is a permitted shareholder.

# Charitable Donee as PCBs

- If trustee or other fiduciary has power (that is not a power of appointment) to make distributions to a class of charitable organizations that are qualified to be S shareholders (Qualified Charitable Power), the organizations are treated as one PCB until the organization receives a distribution from the trust.
- If the trust instrument identifies the charitable organizations to which distributions may be made, each charity is treated as a PCB.

# Taxation of an ESBT

- An ESBT is treated as consisting of the following portions:
  - **Grantor portion** – portion treated as owned by grantor
  - **S portion** – portion of trust that consists of S corporation stock and that is not treated as owned by the grantor or another person
  - **Non-S portion** – portion of trust that consists of all other assets of the trust.

# ESBT Election

- **When:** Within 2 1/2 months of
  - Trust becoming shareholder or
  - Beginning of first S corporation tax year
- **Who:** Fiduciary (trustee)
- Effect of ESBT election
  - ESBT reports the flow-through income
  - ESBT is taxed at the highest marginal individual rate
  - Each PCB is counted for the 100 shareholder limit (unless exception applies; e.g. Qualified Charitable Power or Family Shareholder)
  - Generally only one ESBT election needed even if trust owns stock in multiple S corporations (unless those S corporations file in multiple IRS Service Centers – all relevant Service Centers must be alerted).

# ESBT Election Statement

— ESBT election statement must include:

- Name, address, and TIN of trust, PCBs and corporation
- Identification of election as an ESBT election under section 1361(e)(3)
- Date on which trust first owned stock in each S corporation
- Date on which election is to be effective (not earlier than 2 months and 15 days before date election filed)
- If the trust includes a Qualified Charitable Power, statement that the power is included in the trust instrument
- Required representations:
  - Trust meets requirements to be an ESBT
  - All PCBs are eligible to be shareholders of an S corporation

# Trap for the Unwary

- §1361(c)(2)(B)(v) treats each potential current beneficiary of an ESBT as a shareholder
- A potential current beneficiary is a person who at any time is entitled to or, at the discretion of any person, may receive, a distribution from the principal or income of the trust – determined without regard to any power of appointment to the extent such power remains unexercised.

# Planning Issues

Summary of options - Grantor or Section 678 trust, ESBT or QSST

- What can settlor do for his descendants?
- What about settlor's spouse?
- Can the trust be structured so that the trustee has discretion to distribute income and corpus?
- Who can be the trustee?
- How can settlor assure that his share of the S corporation inures to the benefit of his children and grandchildren even though they are not involved in management of the corporation?

# Qualified Subchapter S Trust (QSST)

## Eligibility Requirements - Summary

- A QSST must have a single income beneficiary during the lifetime of the beneficiary
- A QSST must make current distributions of all income (as defined in section 643(b)) to the income beneficiary
- Terms of an eligible QSST trust must satisfy certain requirements
- The income beneficiary must elect to treat the trust as a QSST



# QSST – Single Income Beneficiary

- A QSST can have only one income beneficiary
  - If the trust can be divided, a substantially separate and independent share of a trust within the meaning of section 663(b)) can be treated as a separate trust
  - In that case, each beneficiary is considered sole income beneficiary for their “separate” trust.
  
- A QSST is treated as a section 678 trust (treated as a grantor trust)
  
- **NOTE**
  - Husband and wife who file a joint return qualify as a single person
  - A trust that provides for multiple beneficiaries after death of income beneficiary does not disqualify the QSST

# QSST – Income Distribution Requirement

- A QSST must make current distributions of all income to the income beneficiary
  - Income for this purpose is “trust accounting income” as defined in section 643(b).
  - Does not include flow-through items of the S corporation
  - Does include distributions from the S corporation
  
- Not necessary that trust instrument require that all income be distributed annually; the requirement is that the income actually *be* distributed annually
  - Election under section 663(b) – consider distribution made in first 65 days of taxable year as made on last day of preceding year
  
- If trust is discretionary, trustee must have authority to distribute all income annually

# QSST – Trust Instrument

## The QSST instrument must--

- Require that during lifetime of income beneficiary any corpus can be distributed only to the income beneficiary
- Require that income interest will terminate on earlier of beneficiary's death or termination of trust
- Require that upon termination of trust during the life of income beneficiary, trust will distribute all assets to the income beneficiary

**NOTE:** Trust document cannot be retroactively changed to qualify as a QSST

# Avoiding Traps for the Unwary QSST

- To qualify as a QSST, the trust document should preclude even the possibility of the QSST eligibility requirements (stated on the prior slide) not being met.
  - For example, if the terms of the trust are silent with respect to corpus distributions, and distributions of corpus to a person other than the current income beneficiary are permitted under local law during the life of the current income beneficiary, then the terms of the trust do not preclude the possibility that corpus may be distributed to a person other than the current income beneficiary and, therefore, the trust is not a QSST.
- See Treasury Regulation 1.1361-1(j)(1)(iii).

# Making the QSST Election

- **When:** Within 2 ½ months of
  - Trust becoming shareholder or
  - Beginning of first S corp. tax year
  
- **Who:** Beneficiary (or legal representative / parent), who is treated as owner of the share of the trust that consists of S corporation stock
  - NB – Grantor Trusts and QSST elections
    - If beneficiary is treated as owner of grantor trust, beneficiary can make QSST election
    - If grantor is treated as owner of grantor trust, beneficiary cannot make QSST election
  
- **Where:** Form 2553 or separate statement filed with service center

# QSST Election

- Generally irrevocable
- Separate QSST elections must be made for each S corporation whose stock is owned by the trust
- If several QSSTs own shares of the same S corporation, each trust must file a separate QSST election even if the trusts share the same beneficiary

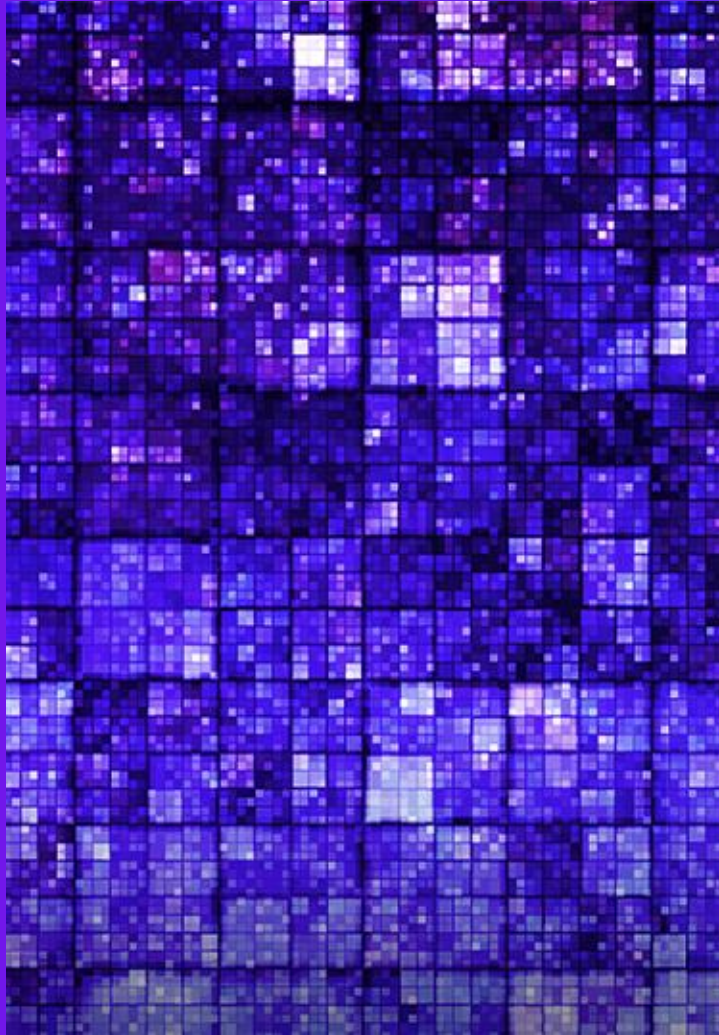
# Eligible Exempt Organization Shareholders

- An organization described in §401(a) –
  - E.g. an ESOP or other retirement plan
  - Treated as a single shareholder
  
- An organization described in §501(c)(3)
  - Charitable deduction may be available
  - UBTI considerations
  - Treated as a single shareholder

# ESOP

- An employee stock ownership plan (ESOP) can own S Corporation stock.
- An ESOP is counted as a single shareholder for the 100-shareholder limit, regardless of the number of ESOP participants.





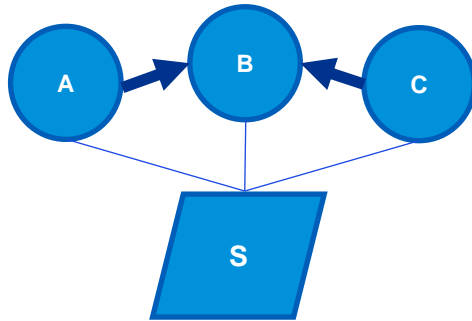
# Structuring & Buy / Sell Considerations

# Other Approaches to Control

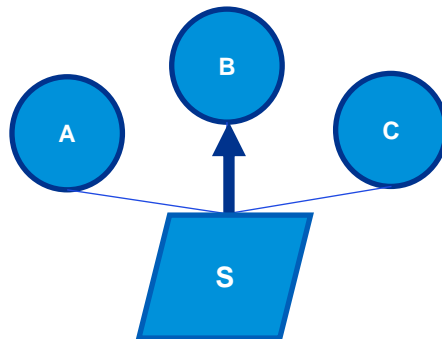
- Recapitalize into voting and nonvoting stock
  - Stock can have different voting rights without becoming a second class of stock.
  - Bill can retain all voting stock and transfer nonvoting stock to trusts.
- Irrevocable proxy
- Shareholders agreements

# Life Insurance as Liquidity for Buy / Sell Agreements

## Cross-Purchase



## Redemption / Liquidation



The two main types of buy / sell agreements are cross purchase and redemption:

– **Cross purchase:**

- The purchasers under a cross purchase are generally the other owners.
- Each purchaser acquires part or all of the seller's interest in the company.

– **Redemption:**

- The purchaser in a redemption is the entity.
- The owner is, in effect, selling his interest. back to the company, and his interest is retired.

– **Hybrid:**

- Some combination of the above.

# Life Insurance Included in Estate Tax Value of Corporation Without Offset for Redemption Obligation

In *Connelly v. United States*, the 8th Circuit Court of Appeals considered the estate tax value of shares in closely held corporation and concluded that:

- The buy-sell agreement did not fix the estate tax value because it did not satisfy the section 2703 or case law requirements - no fixed or determinable price
  - The value of the corporation included life insurance proceeds used to fund the purchase of the decedent's shares in accordance with the corporation's obligation to do so under the buy-sell agreement
  - There was no reduction in the value of the corporation attributable to the contractual obligation to purchase the decedent's shares
- The 11th Circuit Court of Appeals had allowed the obligation to offset the proceeds in *Estate of Blount v. Commissioner*.
  - The U.S. Supreme Court granted the *Connelly* estate's petition for writ of certiorari in December.

# Life Insurance Included in Estate Tax Value of Corporation Without Offset for Redemption Obligation

The redemption obligation should arguably not reduce the value of the entity

- The redemption obligation is a liability of the corporation because it is a contractual obligation.
- However, the redemption liability simultaneously reduces shareholder equity in an amount equal to the redemption obligation.
- The buy-sell agreement transforms the decedent's interest from that of a residual equity owner to that of a contract creditor.
- And the value of the corporation remains the same after accounting for that adjustment.
- In essence, the company does owe the estate the value of the deceased shareholder's shares – but they only owe that amount one time – to the estate as a creditor rather than as both a creditor and a shareholder.
- Structuring and funding buy-sell agreements can be very complicated – careful consideration should be given to section 2703 and cases like *Connelly* in connection with this effort

# Life Insurance Included in Estate Tax Value of Corporation Without Offset for Redemption Obligation

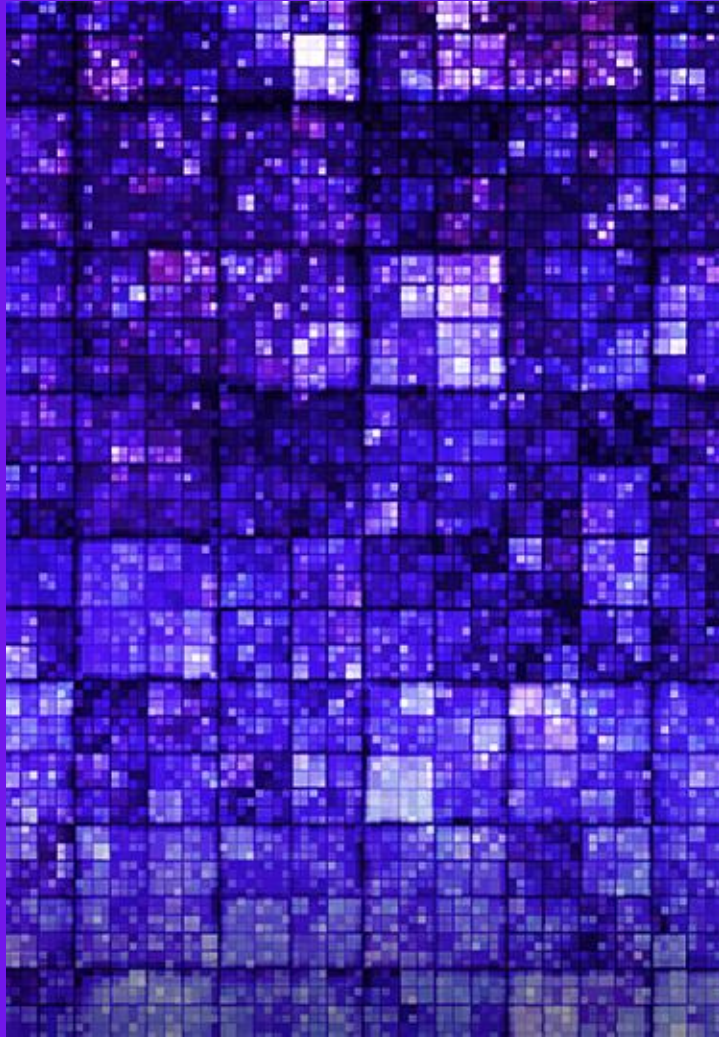
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# Life Insurance Included in Estate Tax Value of Corporation Without Offset for Redemption Obligation

Supreme Court Decision

- In a 9-0 decision, the Supreme Court agreed with the IRS on that fact that the value of life insurance death benefit proceeds for a decedent owner of the entity - which were paid to the entity in cash - must be included in the underlying stock value at the date of death of the decedent (or at least his proportionate share, through his ownership of the entity).



# Fixing Problems



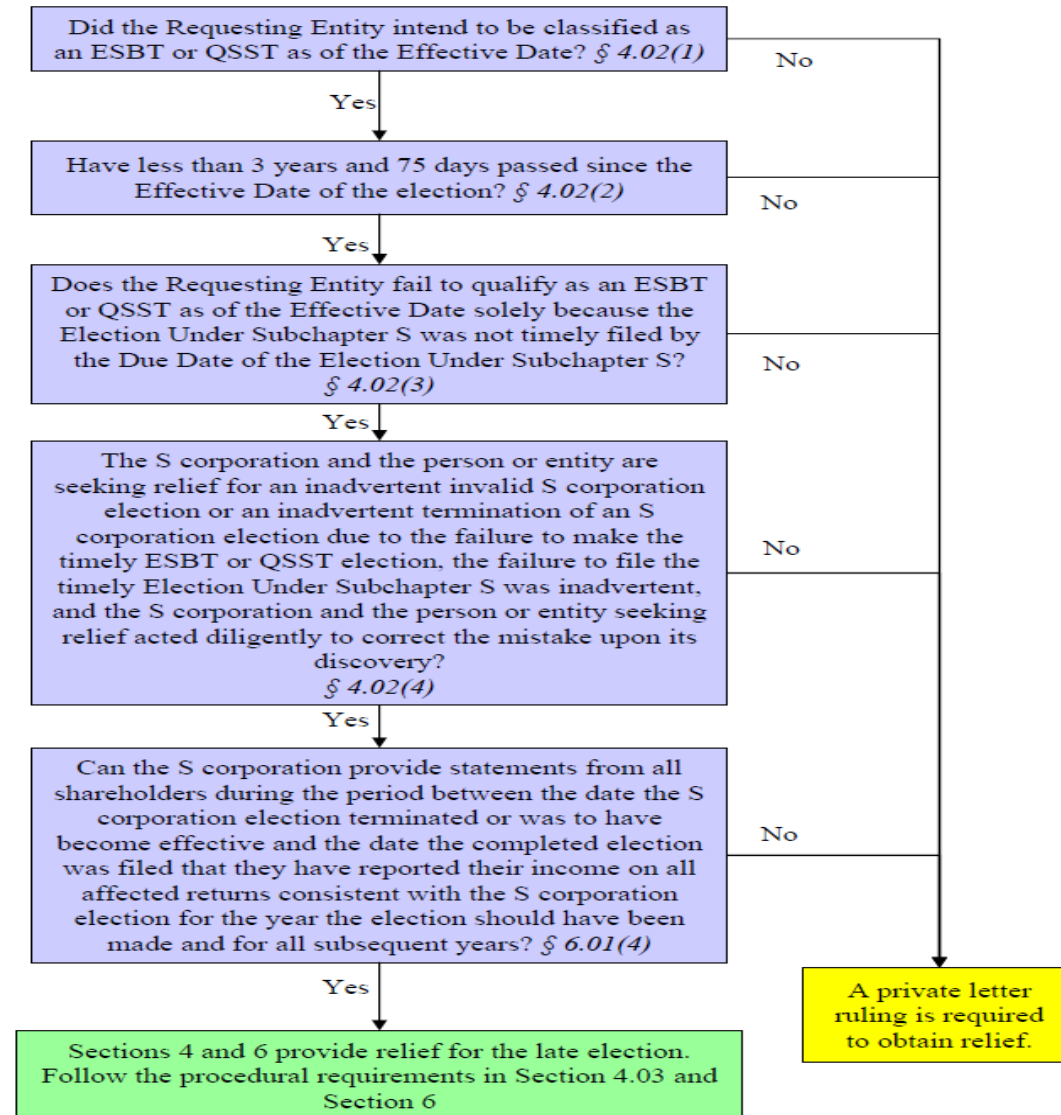
# Fixing Problems

- Late QSST / ESBT Election
  - Rev. Proc. 2013-30
  - Section 1362(f) – PLR Request

# Rev. Proc. 2013-30

This revenue procedure modifies and supersedes Rev. Proc. 2003-43, 2001 C.B. 998, Rev. Proc. 2004-48, 2004-2 C.B. 172, and Rev. Proc. 2007-62, 2007-2 C.B. 786 for taxpayers making late S corporation, ESBT, QSST, QSub and late corporate classification elections (intended to take effect at the same time as the S corp election).

## Relief for Late QSST & ESBT Elections



# Q&A



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