HARRANG/LONG/GARY/RUDNICK P.C.
ATTORNEYS & COUNSELORS AT LAW

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**Closely Held Business Alert**

# Estate Planning For S Corporations Owners

Operating as an S corporation is the favored choice of many closely held business owners eager to escape the double taxation associated with C corporations. However, it is important to note that making that choice will restrict the available estate planning options of the S corporation shareholders, both in terms of lifetime transfers and transfers at death, especially if the closely held business wishes to remain an S corporation.

Thus, careful planning is required to circumvent the traps that come with ownership of S corporation stock. Concerning succession planning, for instance, pitfalls may be avoided by transferring shares to trusts. When it comes to shareholder agreements, caution must be observed so that accidental terminations of the S Corporation election are avoided.

## Succession Planning

Gifts of business interests serve several purposes. All businesses require succession planning to provide an orderly transfer of ownership to future generations. For the business that is increasing in value, gifts have a "freezing" aspect as well, transferring future appreciation to the next generation. Since an S corporation distributes income directly to its shareholders, this income passes to the younger generation instead of accumulating in the taxable estates of senior shareholders.

However, parents are often reluctant to confer direct ownership to their children. They are concerned about giving their children a voice in business affairs disproportionate to their wisdom. In addition, if the beneficiary-recipient has creditor/liability issues (*i.e.*, divorce, IRS liens, etc.), it is realistic to assume that the S corporation stock may end up in unintended hands.

A preferred alternative to an outright gift is to employ a trust to serve as the gifting vehicle. If structured correctly, the trust can qualify as an eligible S corporation shareholder while providing a layer of asset protection to the beneficiaries. Depending on the trust terms, gifts of the stock made to the trust can also qualify for the annual gift tax exclusion.

An additional caveat with family succession involves situations where some, but not all, of your children become active in management of the S corporation. When stock is transferred to your children, whether outright or in trust, having some active

while others are not often creates resentment and sometimes leads to litigation. A buy-sell agreement should provide for the sale or redemption of the shares of any child who does not, by a certain age, become active in management.

**Transfer upon Death**

If no buy-sell arrangement exists upon the S corporation shareholder's death, stock held individually or as a tenant-in-common will be distributed as provided in the decedent's will (or revocable living trust). Thus, estate planning documents for an S corporation shareholder should ensure that the S election will not be jeopardized as a result of death. The will (or revocable living trust) should provide that the executor/personal representative has discretion to account for the needs of the beneficiaries while considering the impact of the distribution on the S corporation. Additionally, the executor/personal representative should possess the authority to enter into agreements with the other S corporation shareholders regarding elections, distributions, transfer restrictions, and other matters.

**Shareholder Agreements**

Care must be taken to avoid inadvertent terminations. New owners should not transfer stock to ineligible shareholders or take other actions which might be inconsistent with S corporation status. A shareholder agreement may solve some of these worries.

The threshold question is whether the estate of a deceased shareholder is to be bought out or continue as a shareholder. A buy-out is the easiest method from the standpoint of maintaining the S election. If the estate is to continue as a shareholder, the shareholder agreement must prohibit transfers to ineligible shareholders or to a number of shareholders which would cause the corporation, in total, to exceed the 100 shareholder limitation.

If a buy-out is contemplated, the question is whether there should be a redemption or a purchase by the surviving shareholders. On the whole, the tax consequences are the same. However, a purchase by shareholders may provide those shareholders with a valuable step-up in basis.

**Liquidity Issues**

If the deceased shareholder's interest in the S corporation exceeds thirty-five percent (35%) of the decedent's adjusted gross estate, that percentage of the total estate tax due may be deferred under the Internal Revenue Code ("IRC"). The IRC allows for installment payment of estate taxes with interest only payable for five years. Thereafter, the estate pays the tax equally over ten years with interest on the

outstanding balance. The make-up and valuation of estate assets should be reviewed periodically to assure qualification.

**Valuation**

Reduction of a decedent's estate tax often hinges on arriving at the lowest justifiable value for the S corporation. The valuation principles for an S corporation do not differ from those of a C corporation. For example, if a price-earnings multiple was being applied to net income, hypothetical federal, state, and local taxes should be factored in. The value should include the corporation's accumulated adjustments account ("AAA") and reflect its tax attributes. For state law purposes, the AAA is really only earned surplus. However, there are some advantages to the AAA since it has already been taxed as income to the decedent. Tax-free distributions can be made to the estate, and amounts equal to the AAA can be bequeathed to beneficiaries other than those who inherit the stock.

**Estate Administration Considerations**

When the assets of a decedent include the stock in an S corporation, the executor must consider many factors.. The executor must first determine whether it is prudent to retain the S election and if not, whether the executor has the power to terminate the S election. If termination is preferred, the executor must determine how and when the election can be terminated. There are also income tax considerations. When a shareholder dies in the middle of an S corporation tax year, the general rule is that profit or loss will be allocated on a per share-per day basis. However, if all shareholders agree, the corporation can determine income on a specific accounting as of date of death. It may be beneficial to get more income or loss on the shareholder's final return. This is possible with proper planning.

**HLGR's Closely Held Business Team**

If you own S corporation stock and are thinking about transferring it to your family members, the use of trusts could prove extremely useful from a risk mitigation and tax perspective. Satisfying the myriad of rules under subchapter S while minimizing your estate tax exposure is where we have expertise. If you have any questions, please contact our closely held business team leader, Randall L. Duncan, at 503-242-0000, or Jonathan Mishkin, LLM, at 503-242-0000, and we will be glad to assist you.