

VIDEO TRANSCRIPT: Demystifying S-Corporation Trusts

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Bruce Van Vreede:

Good morning! Mark we are back with more discussion about trusts with Mark Kassens, who leads Brady Ware's Estates, Gifts, and Trusts practice. I'm Bruce Van Vreede, Director of Marketing. This is our sixth video where we're covering trusts, and we have one more that will cover the estate planning process. Mark, why don't you kick us off on what's going on with trust for shareholders of Corporations?

Mark Kassens:

Sure, hi Bruce! All right. Today we're going to talk about sub-chapter S corporations. Those are great options for pass-through entities, usually a much better advantage income-tax-wise for the shareholders because the pass-through income avoids the double tax of normal Corporations. So these are really good on startups and small businesses and such. Sub-chapter S corporations have limitations on who and what can be shareholders.

First, you have to be an individual, and an individual who is a US citizen or a legal resident. They also allow Charities 501c3s and some qualified retirement plans like ESOPs, for instance, and those are becoming more and more popular. And then single member LLCs are allowed to be owned as long as or be owners as long as they're also owned by that first bullet point, which is the individual who is a US citizen or a legal resident of the United States. Then there are also trusts that are allowed, so there are certain types of trusts: grantor trust, qualified sub chapter S trust, and then electing small business trusts.

Bruce Van Vreede:

I think that that's where we're going to focus our conversation, on that last bullet.

Mark Kassens:

The first one there is the easiest one, and that's the grantor trust, and we've covered those in previous videos. What we're talking about here for grantor trusts that are allowed to be shareholders is it's disregarded for income tax purposes, so the set lore is usually the grantor is considered the owner of that and for income tax purposes everything just hits their individual income tax return. Now that's an easy one the uh the other ones um oh a few examples of these slat um a spousal lifetime access trust or a intentionally defective grantor trust.

And then your revocable trust and the qualified sub-chapter S trust is allowed. And that has basically the same thing as a grantor trust, but there are some nuances in here. So qualified sub chapter S trust--all it has to allow in the actual plan in the actual trust document that during the lifetime of the income beneficiary that there's only one beneficiary and that one beneficiary is a US citizen or a US resident. It

has to allow that any Corpus that is distributed during the life of that beneficiary is only distributed to that one beneficiary. So again, this this kind of sounds like a grantor trust, meaning you've you got that one person involved in there. And that's exactly what they're trying to carve out here. Second, the income interest of that current income beneficiary in the trust terminates on the earlier of the beneficiary's death or the termination of the trust. And last, if it terminates during the beneficiary's life, that trust distributes all the assets to that beneficiary.

Meaning the trust isn't there anymore, everything's distributed out, and then it becomes owned by that beneficiary. So the beneficiary makes an election to be treated as that deemed donor for an income tax purposes, and it's for the portion of the trust assets consisting of the S Corporation trust. And then it has to also allow for all of that income being distributed or required to be distributed to that one individual.

And then we have that Electing Small Business Trust. In this one, the beneficiary doesn't make the election; the trustee makes the election. And what happens then is that the trust becomes the taxpayer. What we're trying to do on an S corporation is they don't want to pass through, pass through, pass through; they want to go right to that individual, right to that shareholder so it's easier tracking. We don't want layers and layers and layers of these individuals or trusts whatever.

So the trustee makes the election that the trust is the taxpayer. And from then on the electing small business trust (ESBT) kind of splits up into two trusts. So that S corporation income activity and distributions is taxed directly to the trust; it's carved out, and then you can have--you know--other assets in that trust like any other trust: just regular investments or whatever. That income can be distributed to beneficiaries. The S corporation income stays in the trust--taxed to the trust anyway--and then the other income can be pushed out to the beneficiaries if distributions are made.

But the S corporation income is not eligible for a deduction of distribution so it's all taxed in the corporation. Now the disadvantage of this—it's easy—is that trust income tax rates are really compressed, so you're in the 37% bracket, which is the highest individual taxation. You're in that highest income tax bracket in the trust's income tax reporting after \$14,450. So you just have a little bit of S Corporation income, and you're already paying 37% of that or the trust is paying 37% of that. On top of that the thresholds for computing the net investment income tax come into play.

Bruce Van Vreede:

When it comes to elections how are these trusts...how do you make these elections, and there are a lot of nuances to these things...of course, but are there any top-level implications or things folks need to worry about?

Mark Kassens:

Yeah, sure. Like big picture I'm not going to talk to what exactly has to be in the in the election statements, and these election statements are--like I said--either filed by the trustee or filed by the beneficiary. And it



depends on what kind of trust you have Grantor trusts are automatic; you don't have to do that. But the other two, they do have to have election statements filed with the IRS. And those have to be filed with the IRS within two and a half months of the effective date. So if you don't get that in in a timely manner you really risk the S election for the corporation and for all those other shareholders because you have a trust that's a shareholder that's not eligible to be a shareholder unless you make the election telling the IRS that this trust is going to be shareholder.

So there really are limitations on these trusts. You have to jump through all the hoops that you're required to jump through, and without these elections, it could just be disastrous for everyone involved. The IRS has seen plenty of these issues try to be resolved through private letter rulings and such over the last 20-30 years, and they would file or they would release Rev Procs (Revenue Procedures) to show people how to kind of get out of the late elections and basically plead mercy on the IRS and say, "We didn't really mean to neglect this can we have our election statement considered timely."

So the IRS released in 2013 Rev Proc 2013-30, and that grants relief for all kinds of late filing election C or late filing entities. That Rev Proc really consolidates a bunch of different Revenue Procedures that the IRS had in place before that under one citation and outlines the late filing requirements for S Corps in general, for qualified subsidiaries, Q Subs, and then the QSSTs, and the ESBTs.

So if you're late, there still may be hope, but you better follow the Rev Proc 2013-30, and if that doesn't work, then a private letter ruling may be necessary, and those can get really expensive. There's a lot of time involved, and those are basically almost like a court document; it's a legal document that you send into the IRS and say, "Hey, here's my facts, here's what we did, can we have relief," and then the IRS charges an astronomical fee for those because they have to have individuals look at them--professionals, lawyers, and all the their experts look at these--PLRs to make sure that they're not going to run afoul of their own Internal Revenue Gov.

Bruce Van Vreede:

Okay. So get it done right the first time, right? Talk to you. Well thanks Mark. Thanks for walking us through that, and thanks for all the effort in giving some good information throughout the previous videos we've done.

Mark thank you very much, and we will re-convene for another video talking about the estate planning process. If you have questions about S Corporation Trusts, please reach out to Mark Kassens at mkassens@bradyware.com.