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Sentinel Trust

Together, families prosper℠

OnWatch

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AWKWARD BEDFELLOWS

Corporations, Trusts and Estate Planning

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I'll bet you didn't know that state legislators created LLCs (limited liability companies) in the 1990s because planning for S corporation shareholders is perilous and restrictive. Well, that's a slight exaggeration, but it is true that tax planners breathed a sigh of relief when LLCs appeared and the IRS ruled that they are treated as partnerships (not as corporations).

Due to their flexibility, LLCs became the go-to entity for privately held business and investment activities. S corporations still exist and, sadly, planning for their owners remains subject to numerous constraints including:

- S corporations may have only one class of stock.
- There are restrictions on who/what may own S corporation stock.
- A change of ownership (even due to death) may require tax elections that must be timely filed.

Violating any of these traps results in what polite company calls an "inadvertent termination." In fact, it is capital punishment…your S corporation election is summarily terminated. The company becomes subject to corporate income taxes and shareholders are taxed on dividend distributions — a double-tax Armageddon.

About Sentinel Trust Company

Sentinel Trust Company, LBA is an independent wealth management firm and multi-family office that provides comprehensive wealth and succession planning, fiduciary, investment management, philanthropic, and family office services to a select group of affluent families and their closely held entities and foundations. Founded in 1997 as the successor to two 40-plus-year-old single-family offices, Sentinel Trust currently serves more than 30 multi-generational families nationwide and is responsible for approximately $5.5 billion in assets as of December 31, 2022.

Learn more at
www.sentineltrust.com.

SALE-TO-DEFECTIVE TRUST STRATEGY

This wealth transfer strategy involves the senior generation making a gift to a trust and then selling appreciated assets to it, typically in exchange for a promissory note bearing interest at the applicable federal rate. The trust is structured to be a grantor trust for income tax purposes, but not to be includible in the grantor's estate at death.

Advantages include:

1. Gain is not triggered by the sale;
2. All subsequent income and appreciation in excess of the interest on the note escapes estate taxation; and
3. The grantor pays the income tax on the trust's income, which economically is a gift each year, but one that does not use gift exclusions or exemptions. The S corporation distributes enough earnings to pay taxes, but the trustee owes none, so he can use the trust's share of the "tax" distribution to prepay principal on the promissory note, thereby providing the grantor with the funds to pay the tax.

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Single-Class-of-Stock Limitation

Estate planning requires determining 1) what to transfer and 2) to whom you should transfer it. For S corporation shareholders, what to transfer seems "easy" since S corporations may have only one class of stock. Consequently, senior-generation owners typically stop after giving 49% of the stock to the kids. But, they can be more generous since S corporations can have more than one class of stock as long as the only difference between the classes is voting rights. So, you can recapitalize to create, say, 99 nonvoting shares and 1 voting share. That allows you to give away up to 99% of the equity while retaining voting control.

Oddly, the IRS can assert that things not labeled "stock" per se should be treated as stock thereby, you guessed it, busting your S election. Examples of these assertions in family businesses include:

- Excessive compensation to a senior generation shareholder could be considered an equity-like dividend associated with share ownership making his or her stock "different" from the kids' shares.
- Debt to a shareholder could be recharacterized as equivalent to preferred stock.

Yikes!

Ownership Limitations

Partnerships, corporations and LLCs may not own S corporation stock. Permitted shareholders include individuals (other than nonresident aliens and zombies), voting trusts, certain charities, certain retirement plans, and three types of trusts discussed below.

This means that a disgruntled (or bumbling) owner can bust your S election simply by transferring one share to a nonpermitted owner, like an LLC. A shareholder agreement that restricts election-terminating transfers is a necessity.

The first permitted trust is a wholly "grantor" trust. Such a trust is treated as the alter ego of the grantor, meaning it is taxed on all of the trust's income. Some wealth-transfer techniques work fine, for a while, with S corporation stock in grantor trusts including:

- The much-touted grantor retained annuity trust (GRAT). (See the April 2020 issue of Sentinel OnWatch for details.)
- The sexy "sale-to-defective-trust" technique, which purrs like a finely-tuned Ferrari when funded with stock of a highly profitable S corporation. (See side box for description of this technique.)

However, at some point (like the end of the GRAT annuity term or two years after the grantor's death), these trusts cease to be grantor trusts. To avoid capital punishment, the continuing trust must remain grantor (not possible for a deceased grantor turned zombie), convert to another form of permitted trust (which may require an election to be filed) or the stock must be distributed to a permitted owner.

QSST

The second permitted trust is the "Qualified Subchapter S Trust." Unfortunately, QSSTs are abysmal from a family standpoint. In its infinite wisdom, Congress decided that these trusts must distribute all of their income annually. It doesn't matter whether your kid is a valedictorian or lacks success, the income must be distributed. Furthermore, a QSST can have only one beneficiary. A newborn child or grandchild can't share in a previously-created QSST. They're left out in the cold. It's a statutory version of tough love.

Importantly, the QSST beneficiary must timely elect to be treated as the owner of the trust for income tax purposes. That means trust income is taxable to the beneficiary, so he knows share of S corporation income, which naturally leads to the age-old question, "Why don't I get all of my share of the business' income, Dad?"

ESBTs – A Family Planning Aid

The "Electing Small Business Trust" (ESBT) overcomes most QSST deficiencies. It can accumulate income and can have multiple beneficiaries, including future-born kids and grandkids. The trustee can have discretion to distribute disproportionately among the beneficiaries (e.g., distribute more to the special-needs grandchild and less to his or her less-trusted parent).

Unfortunately, the ESBT must pay the top individual tax rates on its share of S corporation income and on gain from selling the S corporation stock. Therefore, families with lower-bracket members, may be disadvantaged by using ESBTs. As a major boon to family business secrecy, the ESBT need not inform its beneficiaries about their shares of S corporation income. (I merely report and pass no judgment.) Very importantly, an election must be timely filed by the ESBT trustee or, surprise, your S election is history.

Potential Death Debacles

An estate can own S corporation stock, but only during administration. Revocable trusts (which typically act as testamentary substitutes) qualify for two years after death, unless the trustee elects to be treated as part of the estate, which allows it to qualify during the administration period. A trust that receives S stock under the terms of a will qualifies for two years after the stock is transferred to it.

Your testamentary documents should assure continued ownership by eligible shareholders and that any ESBT/QSST elections are timely made to avoid busting the S election. For example:

- The classic QTIP trust used to get a marital deduction for assets passing to a surviving spouse at death is unlikely to qualify as an S corporation shareholder (for more than two years after funding) unless it is structured and an election is filed to be treated as either an ESBT or a QSST.
- The family (aka bypass or credit-shelter) trust that is funded with the estate tax exemption amount typically must timely file an ESBT election.

Basis Dysfunction

Assets included in an estate receive a step up (or down) in basis to fair market value (FMV) at the date of death. So, a deceased shareholder's stock basis is adjusted to FMV.

Suppose you own 100% of the stock of an S corporation worth $10 million. You die in 2023 and your estate receives a new stock basis of $10 million. Assume that the corporation then sells its assets generating a $9 million gain that is taxable to your estate (or heirs). Partnerships and LLCs don't have this problem because they can elect to step-up the decedent's share of the underlying assets, thereby eliminating the sale gain.

In 2024, the corporation liquidates and distributes the $10 million cash. Your estate has stock basis of $19 million (the stepped-up basis of $10 million plus the $9 million of gain on the asset sale). The liquidation is treated as a sale of the stock, which generates a $9 million capital loss. However, because estates and heirs cannot carry back capital losses, they are screwed. To avoid this problem, the liquidation needs to occur in the same year as the asset sale so that the liquidation loss can offset the asset-sale gain.

Conversion Aversion

Converting an S corporation to an LLC or partnership is treated as 1) a sale by the corporation of its assets (with the resulting gain taxed to the shareholders and adding to their stock basis) and 2) a liquidation of the corporation (with the shareholders being treated as selling their stock, albeit with their basis increased for the asset-sale gain). Sound familiar? The magnitude of the resulting tax typically nixes the idea. However, a conversion after death can work great (at least for the decedent) because the deemed asset sale and liquidation occur in same year, allowing the asset-sale gain (other than any ordinary income due to depreciation recapture, inventory profit, etc.) to be offset by the liquidation loss. But, if there are other (still living) shareholders, they may nix the deal because they didn't get a basis step-up.

S corporations create additional complexities and pose potential traps for the unwary. Particular attention must be paid during estate planning to avoid transferring shares to nonqualified owners and to make timely elections necessitated by trust ownership. ■

Decoding MEDICARE

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Wealthy individuals have the same rights to Medicare coverage as the general population, but they often have differing perspectives of the choices available within the Medicare umbrella.

Medicare is the federal health insurance program for people aged 65 or older, certain younger disabled people and those with end-stage renal disease. Medicare is divided into parts:

Part A covers hospital services and is free if you or your spouse have 10 years of work history and paid Medicare payroll taxes during those years. If you aren't eligible for premium-free Part A, you may be able to buy it by paying a premium of up to $506 a month in 2023. Part A provides coverage nationwide without any restrictions on hospital selection.

Part B covers doctor visits and other medically necessary services. It has a standard monthly premium of $164.90 in 2023. However, if your modified adjustment gross income exceeds $97,000 for individuals (or $194,000 for married couples), you must pay an additional "income-related monthly adjustment amount" (IRMAA) of up to $560.50 per month. Part B also provides coverage nationwide with no restriction on your choice of doctor or specialist.

Part D covers prescription medicines, but not all plans cover all medications. So, finding a plan that covers your specific prescriptions is likely the most important selection factor. The plans are offered by insurance companies that can change their drug coverage and premiums each year, so reselecting a Part D plan should be an annual ritual during the October 15 and December 7 enrollment period. Like Part B, there is a monthly IRMAA of up to $76.40.

Medicare Supplement Insurance

Medigap plans cover certain "gaps" in Medicare Parts A and B coverage, meaning they may pay all or part of Medicare's deductibles, copays and some noncovered costs. For example, Medicare Part A pays 80% of hospital costs; Medigap plans pay the remaining 20%. Medicare permits insurance companies to offer some 10 highly standardized plans (labeled Plans A through N). The gaps covered vary by Plan. For example, Plan A covers 100% of Medicare's Part B copay, but none of Part B's annual deductible, while Plan C covers both. Monthly premiums vary by Plan, but there is no IRMAA. Changing Plans or insurers is not guaranteed and may require a medical exam, so be very thoughtful in your initial selection.

Additional Medigap considerations include:

- People with significant medical expenses may save substantially in excess of the Medigap premium with a Plan that covers the full 20% copay.
- Some Plans significantly reduce administrative burden by minimizing both your copays and deductible. Once you reach your deductible, virtually "everything" is handled among the service provider, Medicare, and the insurance company. It's refreshing to just walk out the door!
- Coverage is nationwide and services are not limited to a doctor or hospital network
- Some Plans offer foreign travel coverage of 80% of emergency care expenses with a lifetime limit of $50,000. Heath care outside the U.S. often is quite cheap due to socialized medicine, so this coverage might not be particularly important to wealthy people. The potentially huge cost not covered by Medigap involves medical evacuation (returning you to a hospital of your choice in the U.S.), so we recommend that clients consider adding a specialized policy for that purpose (e.g., Medjet).

Medicare Advantage (Part C) is a one-stop shop which bundles all Medicare and related coverages. Some plans include vision, dental, and hearing coverage and some advertise extremely low or no premiums (although you must pay the IRMAAs). While these plans may sound like a no-brainer, we normally don't recommend them to our ultra-wealthy clients because they impose doctor and hospital network restrictions, limit access to specialists without referrals, charge higher out-of-pocket costs for out-of-network providers and offer limited coverage outside of the plan's geographic service area. Our clients tend to prefer unrestricted access to physicians and hospitals and are willing to pay somewhat more for that privilege. Furthermore, our clients typically self-insure for vision, dental, and hearing because these plans offer very modest (and capped) benefits.

We take an individualized approach to addressing Medicare solutions for clients. Do-it-yourselfers should visit Medicare.gov for powerful tools to compare Part D and Medigap (as well as Advantage) plans. As always, the devil is in the details.

Helping Teenagers BUILD CREDIT

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Wealthy parents often overlook the importance of building their teenagers' credit because, frankly, they don't need credit. However, a lack of credit history can hinder the kids' ability to access credit later when they need a credit card, an automobile loan or a mortgage for their first house.

There are several ways to help a teenager establish a good credit history, which will provide substantial benefits as they transition to independent adulthood.

Children aged 13 and older can check their credit history at annualcreditreport.com for free. This platform aggregates reports from the three prominent credit bureaus, namely Experian, Equifax, and TransUnion, providing the opportunity to determine whether a credit report exists for the child. If so, you can review it for accuracy and to ensure the history is clean. You should resolve any issues as soon as possible.

The process can be educational. The first step in developing a credit history is to open checking and savings accounts. Doing so fosters discussions about budgeting and savings. Most banks have accounts targeted towards teenagers and will require a parent to be a joint owner of the account. As a joint owner, you will be able to monitor and manage the account; however, you will be responsible if it is overdrawn.

The next step is a discussion with your child about credit. The discussion can include the benefits of a budget and having a good credit score, what goes into maintaining a good credit score, and the importance of keeping personal information secure. You then can consider a student credit card or a secured (by cash deposit) credit card. These cards typically have low limits and often require a parent to co-sign. You should ensure that the credit card you select reports payment data to the three major credit bureaus.

Addressing credit with your child at a young age can help set them up for success as they become adults. A good credit history can provide a lifetime of benefits including lower insurance rates, lower interest rates and higher credit limits. ■

Sentinel Trust Company is a family-owned, multi-family office focusing on the unique needs of affluent families and their closely held companies and foundations. Sentinel Trust provides advice on investment, tax, and estate strategies, serves as corporate trustee, and provides lifestyle services with a personal touch.

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Founded in 1997 as the successor to two established, investment-focused single family offices, Sentinel Trust offers the stability of an institutional firm, the entrepreneurial spirit of a young firm, the personal feel of a family office, and the in-house technical skills of independent planning and investment management firms.

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