

New Tax Law Keeps S Corporations All in the Family

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The American Jobs Creation Act of 2004 (AJCA) adds new rules to the Internal Revenue Code which make the use of *S* corporations more attractive than in the past. Many of our closely-held business clients prefer to use *S* corporations to save on taxes.

S corporations are popular because conducting business in corporate form provides creditor protection (limited personal liability if the corporation is properly organized, capitalized and operated) and a *single* level of income tax on net profits.

Since 1996, an *S* corporation can have as many as 75 shareholders. Under the AJCA, the maximum number of shareholders is increased to 100 (effective for *S* corporation taxable years beginning after December 31, 2004). While most *S* corporations actually have 10 or fewer shareholders, the new rules may be helpful to companies looking to raise capital (provided the investors otherwise qualify as *S* corporation shareholders). There are planning opportunities available to exceed this number when necessary.

Even better, when counting to 100, all family members may elect (any family member can make the necessary filing which remains in effect until terminated) to be treated as one shareholder! All that is required is a common ancestor. The common ancestor may not be more than six generations removed from the youngest generation of shareholders who would be members of the family at the later of the time the *S* election is made or the effective date of the new rules. For

this purpose, S corporation stock held in a qualified subchapter S trust (*QSST*), such as a marital deduction trust (*QTIP*) under the typical revocable living trust of a married couple following the death of a spouse, or an electing small business trust (*ESBT*), such as a credit-shelter trust or Bypass Trust under such a living trust, can qualify. Also, spouses of shareholders or former shareholders are considered family members and are assigned to the same generation as the family member shareholder to whom she or he is (or was) married. Clarification is needed about the consequence upon the new rule of the estate of a deceased family member (other than a spouse) holding shares.

This new single-family rule will also be of great benefit to closely-held businesses seeking to continue as S corporations within a group of lineal descendants notwithstanding the expansion of that class as children, grandchildren and great-grandchildren are born or adopted or as marriages occur. Moreover, since family members occupy only one slot, key employees and managers may also participate through various incentive arrangements which we can design. However, the *Uniform Statutory Rule Against Perpetuities* (California Probate Code §21200 *et seq.*) may restrict the use of long-term or "dynasty" trusts (vesting or terminating after creation no later than 21 years after the death of an individual then alive or 90 years). Of course, appropriate shareholder and buy-sell agreements should be carefully crafted to deal with ownership of S corporation shares among the growing number of owners.