

Trusts as S corporation shareholders

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S CORPORATIONS

An S corporation structure is an advantageous option for many companies; however, business owners must ensure that they comply with the mandates of the Internal Revenue Code (IRC) and Treasury regulations to avoid losing their status as an S corporation. These mandates include a 100-shareholder limit, and each shareholder must qualify as an eligible S corporation shareholder. Eligible shareholders include individuals who are U.S. residents or citizens, as well as estates of decedents or individuals in a Title 11 (bankruptcy) case (Sec. 1361(b)). Nonresident aliens are prohibited from holding S corporation stock, except as discussed below for electing small business trusts (ESBTs). Generally, a trust cannot hold stock of an S corporation; however, grantor trusts, testamentary trusts, voting trusts, ESBTs, and qualified Subchapter S trusts (QSSTs) are permissible S corporation shareholders (Sec. 1361(c)(2)).

Grantor trusts

In a grantor trust, the grantor (also known as the settlor or trustor) retains certain powers to control and direct the income and/or assets of the trust. For income tax purposes, a grantor trust is a disregarded entity, such that the income, deductions, and credits are reported on the grantor's individual income tax return (Sec. 671).

For a grantor trust to qualify as an eligible shareholder of an S corporation, the grantor (or a trust beneficiary if Sec. 678 applies) must be the deemed owner of the *entire* trust. The deemed owner of the wholly owned grantor trust must be a U.S. citizen or resident. If the deemed owner of the wholly owned grantor trust dies, the trust continues to qualify as a permissible shareholder for two years following the date of death ("nongrantor administrative trust") (Sec. 1361(c)(2) (A)(ii)). However, if the trustee of a qualified revocable trust and the executor of the estate submit a Sec. 645 election, the trust will be treated as part of the estate, and the estate will qualify to hold S corporation stock for the duration of the election period. A qualified revocable trust is "any trust (or portion thereof) which was treated under section 676 as owned by the decedent of the estate . . . by reason of a power in the grantor (determined without regard to section 672(e))" (Sec. 645(b)(1)). Unlike ESBTs and QSSTs, no election is necessary for a grantor trust to be an eligible shareholder of an S corporation.

Testamentary trusts

A testamentary trust is "[a] trust with respect to stock transferred to it pursuant to the terms of a will" (Sec. 1361(c) (2)(A)(iii)). Although the estate is the shareholder of the stock following the death of the original owner, a testamentary trust that receives S corporation shares from the estate is a permissible shareholder for a period of two years following the transfer of the S corporation stock

to the trust. Upon the expiration of the two-year period, the testamentary trust becomes an ineligible shareholder, unless the trust qualifies as an eligible shareholder under another provision of the IRC.

Voting trusts

A voting trust is “[a] trust created primarily to exercise the voting power of stock transferred to it” (Sec. 1361(c)(2)(A)(iv)). To qualify as an eligible shareholder of an S corporation, the voting trust must arise from a written agreement that (1) delegates the right to vote to one or more trustees; (2) requires payment of all distributions from the stock of the corporation to the beneficial owners of such stock; (3) requires title and possession of the stock to be delivered to the beneficial owners upon trust termination; and (4) terminates on or before a specific date or event pursuant to the terms of the trust or state law (Regs. Sec. 1.1361-1(h)(1)(v)). Additionally, the beneficiaries (as determined under the grantor trust rules) are treated as the owners of their respective portions of the trust pursuant to the grantor trust rules.

ESBTs

A trustee may elect to treat a trust as an ESBT. The ESBT election generally must be filed within two months and 16 days of the date the S corporation stock is transferred to the trust. However, if the trust holds C corporation stock and the corporation makes an S election that is to be effective as of the first day of the tax year in which it is made, the ESBT election must be made within two months and 16 days of the date the S election is effective (Regs. Secs. 1.1361-1(m)(2)(iii) and 1.1361-1(j)(6)(iii)). Regardless of the number of S corporations whose stock is owned by the ESBT, only one election is required (unless the S corporations file at different service centers).

To qualify as an ESBT, the permissible beneficiaries of the trust generally are limited to individuals, estates, and charitable entities. Certain government entities also may qualify as permissible beneficiaries but only if the entity holds a contingent interest in the ESBT (i.e., a government entity may not be a potential current beneficiary of an ESBT) (Sec. 1361(e)). A trust is precluded from qualifying as an ESBT if any interest in the trust has been acquired by purchase (Sec. 1361(e)(1)(A)(ii)). Further, QSSTs (discussed below), tax-exempt trusts, and charitable remainder trusts are ineligible to be treated as ESBTs (Sec. 1361(e)(1)(B)). For purposes of the 100-shareholder limitation applicable to S corporations, each potential current beneficiary of an ESBT is treated as a shareholder. Under the law known as the Tax Cuts and Jobs Act, P.L. 115-97, nonresident aliens are permissible beneficiaries of an ESBT and will not impair the ESBT’s eligibility as an S corporation shareholder.

For purposes of taxation, an ESBT is bifurcated into an S portion and a non-S portion (Regs. Sec. 1.641(c)-1(a)). Income attributable to the S portion of the ESBT is taxed to the trust and is subject to tax on its ordinary income at the highest marginal rate applicable to trusts and net capital gains at the maximum capital gains rate. To the extent that one portion of an ESBT is deemed to be owned by a grantor, the grantor trust rules apply; in that case, it is permissible for a partial grantor trust to file an ESBT election, but the grantor portion will be taxed under the rules generally applicable to grantor trusts and not as part of the S portion. If a nonresident alien is a potential current beneficiary, the grantor trust rules do not apply, and the trust is taxed under the regular ESBT rules.

QSSTs

A QSST is a trust with a *single* income beneficiary who makes an election (which can only be revoked with IRS consent) to be treated as the deemed owner (Sec. 1361(d)(3)). As such, the Code generally applies the grantor trust rules to a duly formed QSST, in which the current income beneficiary is treated as the shareholder. However, upon disposition of the S corporation stock by the QSST, the trust will be treated as the owner, and any gain or loss recognized on the disposition will belong to the trust and not to the income beneficiary (Regs. Sec. 1.1361-1(j)(8)). A QSST cannot distribute any portion of the trust corpus to anyone other than the current income beneficiary during the beneficiary's lifetime. All current trust accounting income must be distributed annually to the current income beneficiary. Additionally, the income interest of the current income beneficiary ceases upon the earlier of the beneficiary's death or the termination of the QSST. Should the QSST terminate during the life of the current income beneficiary, all the QSST assets must be distributed to the beneficiary. The income beneficiary (rather than the trustee) of the trust makes the QSST election. *Separate* elections are required for each S corporation whose stock is held by the trust.

Ensuring compliance to preserve S election

Wholly owned grantor trusts, nongrantor administrative trusts, testamentary trusts, voting trusts, ESBTs, and QSSTs qualify as eligible shareholders of S corporation stock. If these trusts fail to comply with the respective Code provisions and regulations, the S corporation election for the underlying entity will terminate unless relief is pursued under Sec. 1362(f) for an inadvertent termination. Therefore, the individuals responsible for the aforementioned trusts should monitor trust status to ensure compliance, thereby preserving the S election for the underlying corporation.

Editor Notes

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