What Types of Trusts Are Permitted Shareholders of an S Corporation?

> *If a trust that holds stock of an S corporation does not meet all the applicable S corporation trust rules, not only will the trust be ineligible to hold S stock but the corporation's S election will terminate.*

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S corporations are the most common types of corporate tax filings, representing 3.5 million corporations as of 2004. [1] For tax years beginning after 12/31/04, an S corporation can have up to 100 shareholders but is allowed only certain types of shareholders. [2] Eligible shareholders consist of U.S. citizen or resident individuals, estates (including bankruptcy estates), certain tax-exempt organizations, and certain types of domestic trusts. [3]

Because only certain kinds of domestic trusts with certain trust terms may hold S corporation stock, practitioners must carefully evaluate whether a particular trust is allowed to hold S stock. Further, in certain circumstances, after a trust is initially determined to be permitted to hold S corporation stock, it will be necessary to annually monitor that a trust continues to meet the Subchapter S trust rules. If a trust that holds S stock fails to qualify as a permitted trust or later ceases to qualify, the ineligibility of the trust causes the corporation's S election to terminate. This article describes the types of trusts that are permitted to hold S corporation stock and some of the pitfalls that frequently give rise to inadvertent terminations or invalid elections.

A trust is eligible to hold S corporation stock if it is a Subpart E trust (“grantor trust”), a testamentary trust, a voting trust, a qualified Subchapter S trust (“QSST”), or an electing small business trust (“ESBT”).

Grantor trusts

Only certain types of grantor trusts are allowed to hold S stock. Section 1361(c)(2)(A)(i) permits a trust to hold S corporation stock if it is a trust all of which is treated (under Subpart E of part I of Subchapter J) as owned by an individual who is a U.S. citizen or resident. It is the type of trust that contains certain powers that cause all the ordinary income and income allocable to corpus [4] to be deemed to be owned for federal income tax purposes by one person who created the trust (the “grantor”) or by a beneficiary of the trust, if Section 678 applies. Such a trust will be a permitted S corporation trust without having to make a special election.

Spouses are treated as one if they both are U.S. citizens or residents. [5] Therefore, a permitted S corporation grantor trust includes a typical revocable trust established by a husband and wife, the terms of which cause the spouses to be treated as the deemed owners of all the ordinary income and income allocable to corpus for federal tax purposes. But, in order for a trust to qualify as a permitted grantor trust under Section 1361(c)(2)(A)(i), the trust must not have more than one person who is treated as a deemed owner of the trust for federal income tax purposes. Such trust will not qualify unless it otherwise qualifies under another Code section and the requisite election is made.

For example, suppose that the settlor is treated as the owner for federal income tax purposes of a trust that includes a power for a beneficiary to withdraw contributions (i.e., a Crummey power). If there is a gift subject to the withdrawal power and the power is released, the power holder will also be treated as an owner of the portion of the trust that is subject to the power of withdrawal. In such case, there would be more than one deemed owner of the trust, making the trust ineligible to be a permitted S corporation trust under Section 1361(c)(2)(A)(i).

Types of S corporation grantor trusts. Certain types of grantor trusts that hold S corporation stock are established for estate planning purposes. These trusts are typically drafted to qualify as wholly owned grantor trusts for federal income tax purposes but as trusts excludable from the grantor's gross estate for federal estate tax purposes. Typical grantor trusts used for estate planning purposes include grantor retained annuity trusts (“GRATs”) or intentionally defective irrevocable grantor trusts (“IDITs”).

It is important that these trusts not be partial grantor trusts or have questionable grantor trust status. If a grantor trust does not definitely qualify as a Subpart E trust so that all the income or income allocable to corpus is deemed owned by the grantor (or another person pursuant to Section 678), the trust will cease to be an eligible shareholder, unless the trust otherwise qualifies as another type of trust permitted to be an S shareholder and any necessary elections are timely made.

Care must be taken in choosing the trust provisions that are used to create a wholly owned grantor trust. The type of Subpart E power that may be troubling if it is the sole power that purports to make a trust a grantor trust is the power to reacquire or substitute trust property in a non-fiduciary capacity by any non-adverse party without the consent of any person in a fiduciary capacity, prescribed by Section 675(4)(C). Reg. 1.675-1(b)(4) provides that if a power is not exercisable by a person as a trustee, the determination of whether the power is exercisable in a fiduciary or a non-fiduciary capacity depends on the terms of the trust and the circumstances surrounding its creation and administration. Accordingly, the IRS has indicated in numerous private letter rulings that it will refuse to rule on whether this type of power makes a trust a grantor trust. [6] (If the trust is in a community property state, the decedent's estate is the shareholder only of the portion of the stock included in the estate, not the surviving spouse's portion.)

Given the possibility that a facts and circumstances determination may result in such a trust not being a grantor trust, the more conservative approach is either to include another Subpart E power in the trust or to make an ESBT election for such trust if the trust is eligible to make this election. Including more than one Subpart E power in the terms of a trust or making an ESBT election will safeguard the corporation's status as an S corporation.

A beneficiary withdrawal power trust or as commonly referred to as the Crummey power trust is another grantor trust format that is commonly used to qualify trust contributions for the gift tax annual exclusion. Specifically, the trust grants the trust beneficiary a right to withdraw contributions made to the trust for a certain period of time. Where such Crummey powers are employed, problems often arise for a trust established before the corporation made the S election or for a trust previously funded with other assets prior to its receipt of a transfer of S stock.

For instance, if the terms of the trust provide that the initial contribution will not be subject to the withdrawal power, the initial contribution to the trust cannot be part of any grantor portion over which a withdrawal power holder is treated as the deemed owner under Section 678, thus precluding the possibility of the trust being a wholly owned grantor trust. Similarly, if a contribution exceeds the applicable gift tax annual exclusion amount, the amount in excess of the withdrawal amount may not be included in any grantor portion, again precluding the trust from being a wholly owned grantor trust. Another troubling type of withdrawal power is one that allows the transferor to decide on the amount, if any, that may be withdrawn. A determination would have to be made that no trust contributor ever restricted a beneficiary's withdrawal power. Absent such a determination, the trust would again be determined not to be a wholly grantor trust. In all these cases, the trust will cease to be an eligible S shareholder unless the trust otherwise qualifies as another type of trust permitted to be an S shareholder, and any necessary elections are timely made.

Death of a grantor. If a permitted grantor trust ceases to be a grantor trust because of the death of the deemed owner, the trust will continue to be treated as a qualified S corporation shareholder for two years. After the expiration of the two-year period, the trust will cease to be an eligible S shareholder unless the trust otherwise qualifies as another type of trust permitted to be an S shareholder, and any necessary elections are timely made or the trustee distributes the S corporation stock to a person eligible to be an S shareholder. Conversely, if a grantor trust ceases to be a grantor trust because the deemed owner relinquishes powers that cause the trust to be treated as a grantor trust, the trust will cease to be an eligible S shareholder unless the trust otherwise qualifies as another type of trust permitted to be an S shareholder and any necessary elections are timely made.

If a revocable trust is a qualified revocable trust as defined under Section 645, the trustee of the trust and the executrix of the estate can decide to make a Section 645 election. As a function of the Section 645 election, the qualified revocable trust is treated as part of the estate and loses its identity as a separate trust during the Section 645 election period. This characterization of the trust as part of the estate extends to the Subchapter S shareholder requirements of Section 1361(b)(1). The estate will be allowed to hold the S stock for the entire period of the Section 645 election. Reg. 1.1361-1(h)(1)(iv)(B) provides that if, under the terms of a qualified revocable trust for which a Section 645 election has been made, S corporation stock is actually transferred or deemed distributed at the end of the Section 645 period to a subsequent trust, the subsequent trust will be a permitted testamentary trust for Subchapter S purposes for a period of two years from the date of the actual or deemed transfer.

Testamentary trusts

The estate of the owner is treated as the shareholder for all federal tax purposes, starting on the day of the deemed owner's death. Section 1361(c)(2)(A)(iii) defines a testamentary trust as a domestic trust that receives S stock under the terms of a will. Such a trust is a permitted S corporation trust up to two years after the executrix transfers stock from the estate to the trust. At the expiration of the two-year period, the trust will cease to be an eligible S shareholder unless the trust otherwise qualifies as another type of trust permitted to be an S shareholder and any necessary elections are timely made.

Voting trusts

Section 1361(c)(2)(A)(iv) and Reg. 1.1361-1(h)(1)(v) define a voting trust as a trust created primarily to exercise voting power over S corporation stock. To qualify as a permitted trust, the beneficial owners must be treated as the owners of their respective portions of the trust under Subpart E. In addition, the trust must have been created pursuant to a written trust agreement entered into by the shareholders that (1) delegates to one or more trustees the right to vote; (2) requires all distributions with respect to the stock of the corporation held by the trust to be paid to, or on behalf of, the beneficial owners of that stock; (3) requires title and possession of that stock to be delivered to those beneficial owners of that stock upon termination of the trust; and (4) terminates, under its terms or by state law, on or before a specific date or event. Each beneficial owner of the stock is treated as a shareholder with respect to his or her proportionate share of stock held by the trust.

Qualified Subchapter S trusts

Congress first allowed qualified Subchapter S trusts under the Economic Recovery Act of 1981. [7] A QSST is a trust, the terms of which require that (1) during the lifetime of the current income beneficiary, there can be only one income beneficiary; (2) distributions of principal during the current income beneficiary's lifetime can be made only to that beneficiary; (3) the current income beneficiary's income interest must terminate at the earlier of the current income beneficiary's death or the termination of the trust; and (4) if the trust terminates during the current income beneficiary's lifetime, all trust assets must be distributed to the current income beneficiary.

The terms of the trust must satisfy these requirements from the date that the QSST election is made or from the effective date of the QSST election, whichever is earlier, throughout the entire period of the trust's existence or until it has disposed of its S stock, whichever is earlier. [8]

A trust that has multiple beneficiaries can meet the QSST single beneficiary requirement if each beneficiary has a separate and independent share of the trust, each of which is treated as a separate trust for federal income tax purposes. [9] A husband and wife who are both income beneficiaries of a QSST will be treated as a single beneficiary if they are U.S. citizens or residents and they file a joint income tax return. [10]

In addition to the above requirements, all of the trust's accounting income must either be required by the terms of the trust instrument to be distributed, or actually be distributed, to the income beneficiary at least annually. [11] Trust accounting income, in addition to the income generated by any other assets owned by the trust, generally includes distributions from the S corporation but does not include the trust's pro rata share of the S corporation's income, loss, deduction, or credit. [12]

The trustee must distribute trust accounting income directly to the beneficiary or to a custodial account for the benefit of a minor beneficiary. [13] The income cannot be distributed to another trust for the benefit of the beneficiary. (In a private letter ruling, the IRS created a limited exception to this rule, allowing income from a QSST to be distributed to a special disability trust where the QSST beneficiary was incapacitated and thus unable to receive distributions directly. [14])

The income beneficiary of a QSST is treated as a Section 678(a) deemed owner only with respect to the S stock held by the trust as to which the income beneficiary made a QSST election. [15] As with a grantor trust, the income beneficiary (rather than the trust itself) is treated as the S shareholder. [16]

QSST election. For a trust to be treated as a QSST, the trust's current income beneficiary must make a timely election ("QSST election") with the IRS service center where the corporation files its tax return. [17] If the income beneficiary is under a legal disability, that person's legal guardian may make the QSST election on the income beneficiary's behalf. [18] By making the QSST election, the income beneficiary acknowledges and agrees to be treated as a Section 678 owner of only the S stock held by the trust even though the trust by its terms may not be a Section 678 trust. The income beneficiary must make a separate QSST election for each S corporation whose stock is held by the trust. [19]

If the trust holds C corporation stock before the corporation makes an election to be an S corporation, the trust is the shareholder and all shareholders of a corporation that intend to be an S corporation must be eligible to hold S stock as of the effective date or filing date of the S election, whichever is first. The QSST election must be timely made to be effective. The income beneficiary must make a QSST election within two months and 15 days from the effective date of the S election. [20] If a person transfers S stock to a trust, the income beneficiary must make a QSST election within 15 days and two months from the date the stock was transferred to the trust. [21] Similarly, a QSST election must be made within 15 days and two months from the date that (1) a grantor trust ceases being a grantor trust and satisfies the QSST requirements and (2) the end of the two-year period for a testamentary trust. [22]

If a corporation's S election terminates or is invalid because of a late QSST election, the corporation and the trust may request relief for an inadvertent termination or an invalid election using a simplified method under Rev. Proc. 2003-43, [23] if applicable, or under Section 1362(f) through a private letter ruling request. [24]

A "protective QSST election" can be made in certain circumstances. If the current income beneficiary (or beneficiaries who are husband and wife, if both are U.S. citizens or residents and file a joint income tax return) of a trust is treated as the deemed owner of all or part of the trust under Section 678 of the grantor trust rules, such beneficiary (or beneficiaries) may make a QSST election, so long as the trust otherwise qualifies as a QSST. [25] However, a protective QSST election may not be made—even if the trust otherwise qualifies as a QSST—if the grantor of the trust (who is not the current income beneficiary) is treated as the deemed owner under the grantor trust rules.

The QSST election may be revoked only with the consent of the IRS. [26] The IRS will not grant the request for a revocation when one of its purposes is the avoidance of federal income taxes or when the taxable year is closed. [27]

Death of the QSST income beneficiary. If the income beneficiary of a QSST dies and the trust continues in existence and continues to hold S corporation stock but no longer qualifies as a QSST, a grantor trust, or an ESBT, then the estate of the income beneficiary is treated as the shareholder for eligibility purposes for two years from the date of death. [28] During this same period, the trust is treated as the shareholder for federal tax purposes under Sections 1366, 1367, and 1368. [29]

If, when the income beneficiary of a QSST dies, the trust provides for a successive income beneficiary, the successive income beneficiary of a QSST is treated as consenting to the original QSST election. [30] If there are multiple successive income beneficiaries, each beneficiary would have to have a separate share under the trust in order for the trust to continue to be a qualified QSST. A successive income beneficiary can affirmatively refuse to consent to the QSST election within two months and 15 days of becoming the income beneficiary. [31] Moreover, the term “successive income beneficiaries” does not include any beneficiary of a new trust (as defined under local law) that is created upon the death of the current income beneficiary of a QSST. [32] If such a new trust is created, the beneficiary of that new trust would be required to make a new QSST election (provided the new trust otherwise qualifies as a QSST).

QSST tax reporting. The income beneficiary of the QSST is treated as the shareholder and must report all the tax items attributable to the S corporation stock held by the trust. [33] A Form 1041 must be filed for a QSST, as provided by Reg. 1.671-4(b)(6)(iii). If the trust holds assets other than S corporation stock, the tax attributes related to the assets of the trust other than the S stock are subject to the non-grantor Subchapter J rules unless the terms of the trust result in the trust being, in fact, a grantor trust and thereby subjecting the grantor to the Subpart E reporting rules. [34] If the trust is a non-grantor trust and holds assets other than S corporation stock, the trustee must file a Form 1041 that will not be blank but will include the tax items attributable to the other non-S corporation stock assets in the trust. Because a QSST must distribute its trust accounting income annually, the computation of which—as indicated above—must include S corporation distributions, it would be unusual to encounter a QSST that would be subject to an income tax liability on its Form 1041. One instance in which the trust may have a tax liability is if the trust also holds a partnership interest and no other assets and the partnership does not make any distributions and the trust has no other trust accounting income. In such situation, the trust would have phantom taxable income from the partnership.

QSST stock disposition. Generally, if the QSST sells the S corporation stock, the QSST itself is taxed on the gain or loss on the sale. [35] For transfers made after 12/31/04, a QSST income beneficiary may treat the disposition of stock by the QSST as a disposition by the beneficiary, not the trust, for purposes of the at-risk and passive activity rules. [36]

QSST estate planning. For estate planning purposes, a settlor may, for any number of reasons, establish a QSST for the benefit of an heir other than grantor's spouse. Alternatively, a settlor may set up (1) a testamentary QSST that qualifies for the marital deduction (qualified terminable interest property trusts (QTIP trusts) by definition qualify as QSSTs), or (2) a QSST for the benefit of a minor which qualifies for the annual gift tax exclusion.

QSST disadvantages. A possible disadvantage of a QSST is the requirement that all trust accounting income must be distributed currently. The tax items attributable to the S corporation stock held by a trust are not considered trust accounting income under most state laws. Nevertheless, many state laws provide that cash distributions from an S corporation are allocated to trust accounting income. While distributions of cash from the S corporation are generally helpful because the income beneficiary (and any successor income beneficiary) is taxed on the pro rata share of S corporation income attributable to the stock held by the trust, such distributions can prove problematic when the trust has cash needs that do not give rise to a tax deduction—e.g., required debt service. Whenever any of these issues become too problematic, the trustee and the income beneficiary can convert the QSST to an ESBT if certain conditions are met. [37]

Electing small business trusts

The requirements for an electing small business trust are not as restrictive as those for a QSST. For example, an ESBT can have multiple beneficiaries, and the trust income can be accumulated and sprinkled among the multiple beneficiaries. As provided by Section 1361(e), a trust is eligible to be an ESBT if it is a domestic trust and all beneficiaries are individuals, estates, or certain types of charitable organizations. No beneficiary can acquire a trust interest by purchase, and the trustee must make a timely election under Section 1361(e). In addition, the trust cannot be a QSST that holds stock in a corporation that is subject to the QSST election, an exempt trust, or a charitable remainder trust. However, a charitable lead annuity trust may qualify as an ESBT.

Potential current beneficiary. A concept that applies only to an ESBT is the concept of a potential current beneficiary ("PCB"). With respect to any period, a PCB is any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. Therefore, a person who solely owns a future or contingent trust interest will not be treated as a PCB until the future event occurs. [38] For example, a person who holds a trust interest that does not vest until after the death of another person is not a PCB. For taxable years beginning after 2004, a person who could receive a trust distribution pursuant to a power of appointment is not considered a PCB until the power is exercised.

The significance of a PCB is that the PCB is treated as a shareholder for purposes of determining the number of "eligible" S shareholders and whether the shareholder eligibility rules are met under Section 1361(b) . Hence, a non-resident alien who may be a potential current recipient, in any period, of trust income or principal will disqualify the trust as an S shareholder and will terminate the S election. If the number of PCBs causes the number of shareholders to exceed the allowable number of shareholders, [39] the trust will not qualify as an ESBT, causing the termination of the corporation's S election. If all or a portion of an ESBT is treated as owned by a person under Subpart E, such owner is a PCB in addition to other trust beneficiaries meeting the PCB definition. [40]

If an ESBT disposes of all the S corporation stock, then any person treated as a PCB will not be treated as a PCB one year before the disposition. [41] (For tax years beginning before 2005, the trust has 60 days to dispose of the stock before a beneficiary is treated as a PCB.) Accordingly, if an ESBT disposes of all the S corporation stock, the ESBT's PCBs generally will not include anyone who became a PCB within the one-year period ending on the date of disposition.

For instance, suppose that a non-resident alien became a PCB at mid-year. If the trustee disposed of all the S corporation stock before year-end, the non-resident alien would not be considered a PCB for that year, the trust would not be an ineligible S shareholder, and the corporation's S election would not terminate. If a person who is not qualified to be an S corporation owner becomes a beneficiary of a trust that has a valid ESBT election in effect, the trust has a one-year period in which to dispose of all its S corporation stock. If the trust does not dispose of the stock within this one-year window, the corporation's S status will terminate.

ESBT election. Unlike a QSST, as to which the beneficiary must make the QSST election, the ESBT election is made by the trustee of the ESBT. However, the trustee must make the ESBT election within the same time constraints imposed on a QSST election in order for the election to be timely. [42] If the trust holds stock in more than one S corporation, the trustee needs to make just one election.

The election applies to the taxable year for which the election is made and all subsequent years unless it is revoked with the consent of the IRS. [43] If the election is being revoked because the trust wishes to convert to a QSST, the IRS will automatically consent if certain requirements are met. [44] Upon the termination of an ESBT, the S corporation stock must be immediately transferred to another qualified S shareholder. If the stock is transferred to a trust that is qualified to be a QSST, the trust's beneficiary must make a timely QSST election (within two months and 15 days after the trust becomes a shareholder), or the corporation's S status will terminate.

If a corporation's S election terminates or is invalid because of a late ESBT election, the corporation and the trust may request relief for an inadvertent termination or invalid election under a simplified method described in Rev. Proc. 2003-43, if applicable, or under Section 1362(f) through a private letter ruling request. [45]

Tax treatment. An ESBT is treated as two separate share trusts for tax purposes: an S portion that consists of all the S corporation stock, and a non-S portion that consists of all other trust assets. [46] An ESBT that is a partial grantor trust can have three portions: the grantor portion, a non-grantor S portion, and a non-grantor non-S portion. However, only the non-grantor S portion of the trust is treated as the shareholder for purposes of taxable income, basis, and distributions under Sections 1366, 1367, and 1368. Any grantor portion of an ESBT continues to be treated as the shareholder for that portion and subject to the grantor tax rules under Subpart E of the Code. [47]

Taxation of S portion. The S portion of an ESBT is taxed as a separate trust, the tax attributes of which cannot be merged or commingled with the tax items of the non-S portion. The S portion takes into account the items of income, deductions, gains, losses, and credits reported to it on its S corporation Schedule K-1. [48] The S portion's pro rata share of the S corporation's tax items will generally be calculated for any shareholder on a per-share, per-day basis as provided under Section 1377(a)(1) unless an election to close the tax year has been made.

If state and local income taxes and administrative expenses relate to both the S portion and the non-S portion, these items must be allocated on a reasonable basis. [49] Distributions to a trust beneficiary from either the S portion or the non-S portion are includable in the beneficiary's gross income only to the extent of the distributable net income ("DNI") of the non-S portion. [50] Accordingly, only the non-S portion will report any income distribution deduction. The items of income, deduction, loss, and credit on the S portion are excluded for purposes of determining DNI.

The S portion will be allowed a charitable deduction only to the extent of the S portion's pro rata share of charitable contributions made from the S corporation's gross income. [51] Only cash contributions by the S corporation are deductible by the S portion. Contributions of property are not made "from gross income" and therefore fail the requirements of Section 642(c). [52]

The Section 681 limitations regarding unrelated business income also apply to determine whether the contribution is deductible by the S portion. That is, no Section 642(c) deduction is permitted for that portion of the contribution that is allocable to what would have been unrelated net business income if the trust had been a Section 501(c)(3) tax-exempt organization. [53] The charitable contribution is deductible by the S portion only in the year that it is an item required to be taken into account by the trust under Section 1366.

The S portion will be taxed at the highest individual rate on all ordinary income. [54] The S portion will also be taxed on any gain or loss on the S corporation stock if the trust disposes of the stock. [55] Capital gains will be taxed at individual rates, but no deduction is allowed for capital losses that exceed capital gains. Similar to the loss limitations for individual shareholders, any operating losses may be limited by the S portion's basis in S corporation stock, the at-risk rules, and the passive loss rules. If operating losses are not limited, the NOL may be carried to other years and deducted against other income of the S portion. [56]

The S portion's stock basis will be adjusted in the same manner as an individual shareholder's stock basis so that it will be increased by income and decreased by deductions and distributions. [57] If the trustee distributes any S corporation stock to a beneficiary, the beneficiary will take the stock at a carryover basis (its adjusted basis). Distributions to the trust from the S corporation in excess of the S portion's stock basis will be taxed to the S portion as capital gain. [58]

If the S portion holds the stock of more than one S corporation, the S portion must aggregate income items and gain or loss for all its S stock investments for purposes of determining the S portion's taxable income. [59] The S portion is allowed to deduct state and local income tax and administrative expenses that are either (1) directly related to the S portion or (2) allocated to the S portion on a reasonable basis. [60] For example, state income taxes imposed on the ESBT as a whole must be allocated between the S portion and the non-S portion.

If the trustee sells or disposes of any S corporation stock on the installment method, the income recognized under this method is taken into account by the S portion. [61] However, any interest recognized on the installment obligation is taken into account by the non-S portion. [62] Most distressing is that interest paid by the trust on money borrowed to purchase stock in any S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion. [63] In addition, this interest is not deductible by the non-S portion. [64] The AMT exemption amount of the S portion is zero. [65]

Taxation of the non-S portion. All of the non-S income is taxed to the non-S portion. The taxable income of the non-S portion is determined by taking into account all items of income, deduction, and credit except those properly reflected in the S portion. [66] The non-S portion is taxed as a regular complex trust and may consist of several separate shares for purposes of computing DNI and the income distribution deduction. [67] The non-S portion is taxed on any dividends received from the S corporation that are paid from its C corporation earnings and profit account. [68] The trust will receive a Form 1099-DIV for these amounts.

The non-S portion is allowed to deduct all state and local taxes, administrative expenses, and other expenses directly related to the income from the other assets or allocated to the non-S portion on a reasonable basis. [69] The non-S portion deducts the trust's personal exemption.

If income from the sale or disposition of any S corporation stock is reported by the trust on the installment method, the interest on the installment obligation is includable in the gross income of the non-S portion. [70] The recognized income on this installment obligation is included in the gross income of the S portion.

The non-S portion is entitled to claim a charitable contribution deduction only to the extent of gross income of the non-S portion and then only if permitted by the trust instrument. [71] However, unlike for the S portion, contributions made after the close of the taxable year may possibly be treated as being made during the year if certain conditions are met and the necessary election is made.

If the non-S portion has DNI and the trustee makes a distribution from the S portion of the trust, the distribution will carry out DNI to the extent of the DNI of the non-S portion even though the S portion cannot have any DNI.

Once the ESBT election terminates or is revoked, the special taxation rules no longer apply. If, upon termination or revocation of the ESBT election, the S portion has a net operating loss ("NOL"), a capital loss, or deductions in excess of income, then any such loss, carryover, or excess deductions will be allowed as a deduction to the now non-ESBT trust, if the trust continues, or to the beneficiaries succeeding to the property of the trust if the ESBT terminates.

Differences between QSSTs and ESBTs

While an ESBT may convert to a QSST [72] and a QSST may convert to an ESBT, [73] an ESBT election imposes fewer significant constraints on the trust's dispositive provisions. Specifically, unlike a QSST, an ESBT can have multiple current beneficiaries, and income can be accumulated or distributed among the beneficiaries in any manner. The principal disadvantage is the possibility that the income tax liability imposed on the S corporation tax attributes reported in the S portion may be higher than the resulting liability under a QSST because the S corporation income of an ESBT is taxed at the highest marginal income tax rate whereas the S income of a QSST is taxed at the income beneficiary's marginal income tax rate—which might be lower.

If the sole current income beneficiary of a QSST dies during the term of the trust and the trust terminates as a result of the death, there is a two-year grace period to transfer the shares to a new qualified S corporation shareholder. With the termination of an ESBT, the shares must immediately be transferred to a new qualified S corporation shareholder. If that new shareholder is a trust qualified to be a QSST or an ESBT, the QSST election must be made within two months and 15 days after the transfer.

A trap for the unwary exists with ESBTs because each potential current beneficiary of an ESBT is treated as a shareholder for purposes of both the limitation on the number of shareholders and the shareholder eligibility rules. Furthermore, this number is not static. If a new person enters the class of potential current beneficiaries, that new person would be counted as an additional shareholder unless he or she is already a shareholder. This could inadvertently cause the 100-shareholder limit to be exceeded unless such person is included in the six-generation family exception. No such risk exists with a QSST, which can have only a single current beneficiary. [74]

The taxation of an ESBT is different from, and more complicated than, the taxation of a QSST. An ESBT will have at least two portions: an S portion consisting of the S stock, and a non-S portion consisting of all property excluding any S stock. An ESBT may also have also a grantor portion. Different tax rules apply to each portion of an ESBT.

Conclusion

Because S corporations are closely held, they are frequently the subject of estate planning that inevitably involves the need to establish trusts to hold the S stock. The types of trusts that are permitted to hold S corporation stock under Subchapter S are limited, and the eligibility and operational rules are extensive and unique.

If a trust that holds S stock does not meet all the applicable S corporation trust rules, not only will the trust be ineligible to hold S stock but the corporation's S election will terminate. Unfortunately, missteps are easily made, and inadvertent terminations and invalid elections frequently occur. Although there is no substitute for knowledgeable and careful advisors who know how to navigate the Subchapter S rules, there is some comfort in existing tax policy that permits inadvertent terminations of the S election or invalid elections to be corrected if certain conditions are met.

PRACTICE NOTES

In certain circumstances, after a trust is initially determined to be permitted to hold S corporation stock, it will be necessary to annually monitor that a trust continues to meet the Subchapter S trust rules.

1

Filing Characteristics and Examination Results for Partnerships and S Corporations, Treasury Inspector General for Tax Administration (8/28/06), Reference number: 2006-30-114.

2

Section 1361(b)(1)(A).

3

Sections 1361(b)(1)(B), 1361(b)(1)(C), and 1361(c)(6).

4

The Preamble to the final Regulations (TD 8600) provides insight into what is meant by "a trust all of which." Before 1995, proposed Regulations defined a Subpart E trust as a trust all of which (income and corpus) is treated (under Subpart E of part I of Subchapter J) as owned by an individual who is a citizen or resident of the United States. The final Regulations adopted a different position and tracked the language of the statute. The Preamble to the final Regulations provides that a trust is *a permitted shareholder if the grantor or another person includes in computing taxable income and credits all of the trust's items of income, deductions, and credits against tax under the rules in Reg. 1.671-3.* For this requirement to be met, a grantor or another person must be treated as the owner with respect to *ordinary income and income allocable to corpus*.

5

Reg. 1.1361-1(e)(2) and Reg. 1.1361-1(k), Example 1.

6

Ltr. Ruls. 200434012, 200022048, and 200022018.

7

Pub. L. No. 97-34.

8

9

Reg. 1.1361-1(j)(3).

10

Reg. 1.1361-1(j)(2).

11

Section 1361(d)(3)(B) and Reg. 1.1361-1(j)(1)(i).

12

Id.

13

Reg. 1.1361-1(e)(1).
14

Only the person who requested the private letter ruling may rely on the ruling.
15

Reg. 1.1361-1(j)(7)(i).
16

Id.
17

Reg. 1.1361-1(j)(6)(ii).
18

Reg. 1.1361-1(j)(6)(i).
19

Id.
20

Reg. 1.1361-1(j)(6)(iii)(B).
21

Reg. 1.1361-1(j)(6)(iii)(A).
22

Regs.1.1361-1(j)(6)(iii)(C) and 1.1361-1(j)(6)(iii)(D).
23

2004-1 CB 998.
24

Reg. 1.1361-1(j)(6)(iii)(E).
25

Reg. 1.1361-1(j)(6)(iv).
26

Reg. 1.1361-1(j)(11).
27

Id.
28

Reg. 1.1361-1(j)(7)(ii).
29

Id.
30

Reg. 1.1361-1(j)(9)(i).
31

Reg. 1.1361-1(j)(10).
32

Reg. 1.1361-1(j)(9).
33

Reg. 1.1361-1(j)(7).
34

Reg. 1.1361-1(j)(8).
35

Id.
36

Section 1361(d)(1)(C).
37

Reg. 1.1361-1(j)(12).
38

Regs. 1.1361-1(m)(4)(i) and 1.1361-1(m)(4)(v).
39

For taxable years beginning after 2004, an S corporation can have up to 100 shareholders. Moreover, if a PCB or an income beneficiary of a QSST is a member of six generations of a family, the family can choose to be treated as one shareholder for purposes of the limit on the number of shareholders, as provided by Notice 2005-91,

2005-51 IRB 1164.
40

Reg. 1.1361-1(m)(4)(ii). Furthermore, a grantor trust may make an ESBT election.
41

Section 1361(e)((2).
42

Reg. 1.1361-1(m)(2).
43

Reg. 1.1361-1(m)(6).
44

Reg. 1.1361-1(m)(7).
45

Reg. 1.1361-1(j)(6)(iii)(E).
46

Reg. 1.641(c)-1(a).
47

Reg. 1.641(c)-1(c).
48

Regs. 1.641(c)-1(d)(1) and 1.641(c)-1(d)(2).
49

Reg. 1.641(c)-1(d)(4)(i).
50

Reg. 1.641(c)-1(i).
51

Reg. 1.641(c)-1(d)(2)(ii).
52

Id. and Preamble to TD 8994.
53

Id.
54

Reg. 1.641(c)-1(e)(1).
55

Reg. 1.641(c)-1(d)(3)(i).
56

Reg. 1.1366-2(a)(4).
57

Reg. 1.641(c)-1(f).
58

Reg. 1.641(c)-1(d)(3)(iii).
59

Reg. 1.641(c)-1(d)(2)(iii).
60

Reg. 1.641(c)-1(d)(4)(i).
61

Reg. 1.641(c)-1(d)(3)(ii) .
62

Reg. 1.641(c)-1(g)(3).
63

Reg. 1.641(c)-1(d)(4)(ii).
64

Id.
65

Reg. 1.641(c)-1(d)(2)(i).
66

Reg. 1.641(c)-1(g)(1).
67

[68] *Id.*

[69] Reg. 1.641(c)-1(g)(2).

[70] Reg. 1.641(c)-1(h).

[71] Reg. 1.641(c)-1(g)(3).

[72] Reg. 1.641(c)-1(g)(4).

[73] Reg. 1.1361-1(m)(7).

[74] Reg. 1.1361-1(j)(12).

The legislative history for Section 1361(c)(1)(B) indicates that members of a family may be treated as one shareholder, for purposes of determining the number of shareholders for the "family election," whether a family member holds stock directly or is treated as a shareholder by reason of being a beneficiary of an ESBT or a QSST. Ways and Means Committee, Issues Managers' Statement on the Conference Committee Report (H.Rep't 108-755) or H.R. 4520, the American Jobs Creation Act of 2004, Pub. L. 108-357 (10/7/04). Thus, the income beneficiary of a QSST and the potential current beneficiaries of an ESBT may be included in a "family election."