Trusts as Shareholders of S Corporations

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I. Introduction to Types of Trusts that Can Hold S Corporation Stock

Under Section 1361 of the Internal Revenue Code, the following types of trusts are permitted to be shareholders of S corporations:

- A trust that is a wholly-owned grantor trust (Section 1361(c)(2)(A)(i));
- A trust that was a wholly-owned grantor trust during the deemed owner’s lifetime for two years following the deemed owner’s death (Section 1361(c)(2)(A)(ii));
- A testamentary trust with respect to stock transferred to it under a will for the two-year period beginning on the day stock is transferred to such trust (Section 1361(c)(2)(A)(iii));
- A voting trust (Section 1361(c)(2)(A)(iv));
- A Qualified Subchapter S trust (“QSST”) (Section 1361(d)); and
- An electing small business trust (“ESBT”) (Section 1361(c)(2)(A)(v)).

The following summarizes the requirements that apply to each type of trust, who is considered the deemed shareholder for qualification purposes and some of the income tax implications of each type of trust.

A. Grantor Trusts

In order for a grantor trust to be an S corporation shareholder, the entire trust must be treated as owned under the grantor trust rules by a single individual who is a citizen or resident of the United States (a “U.S. person” for income tax purposes).\(^1\) This includes a grantor trust that is treated as wholly owned by a beneficiary under Section 678 of the Internal Revenue Code.\(^2\) The deemed owner is treated as the shareholder for purposes of determining whether the trust is a permissible shareholder of an S corporation and for income tax purposes.\(^3\)

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\(^1\) A married couple may be treated as one individual for these purposes. Treas. Reg. § 1.1361-1(c)(2) and Treas. Reg. § 1.1361-1(k)(1), Example 1.

\(^2\) See, e.g., Private Letter Ruling 201216034 (January 11, 2012); Private Letter Ruling 201039010 (October 1, 2010).

\(^3\) Section 1361(c)(2)(B)(i).
B. **Grantor Trusts for Two Years After the Deemed Owner’s Death**

A trust that would have been a permissible owner of S corporation stock during its deemed owner’s lifetime will qualify as an S corporation shareholder for two years after the deemed owner’s date of death.\(^4\) After that time, the trust may continue to qualify as an S corporation shareholder if it meets the requirements for and makes the election to be treated as an ESBT or QSST. The estate of the deemed owner is treated as the shareholder for purposes of determining whether the trust is a permissible shareholder of an S corporation.\(^5\) The trust is treated as the owner of the S corporation stock for income tax purposes.\(^6\)

C. **Testamentary Trusts for Two Years After Stock is Transferred from Decedent’s Estate**

The estate of the testator is treated as the shareholder for purposes of determining whether the trust is a permissible shareholder of an S corporation for two years after the date stock is transferred to the testamentary trust from an estate.\(^7\) The trust is treated as the owner for income tax purposes.\(^8\) Estates also qualify as S corporation shareholders without the two-year limitation; estates owning S corporation stock sometimes choose to delay distribution of S corporation stock for as long as possible within a reasonable period of administration to avoid triggering the two-year rule before a trust must make an ESBT or QSST election in order to maintain its S shareholder eligibility.

D. **Voting Trusts**

A voting trust is a trust created primarily to exercise voting power over S corporation stock. All beneficial owners must be U.S. persons who are treated as the owners under the grantor trust rules of their respective portions. 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.\(^9\) Each beneficial owner of the voting trust is treated as a shareholder for qualification and income tax purposes.\(^10\)

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\(^{4}\) Section 1361(c)(2)(A)(iii); see Treas. Reg. § 1.1361-1(h)(3)(i)(B) for special rules regarding grantor trusts in community property states.

\(^{5}\) Section 1361(c)(2)(B)(ii).


\(^{7}\) Section 1361(c)(2)(B)(iiii).


\(^{9}\) Treas. Reg. § 1.1361-1(h)(1)(v).

\(^{10}\) Section 1361(c)(2)(B)(iv); Treas. Reg. §
E. Qualified Subchapter S Trust

1. Requirements of a QSST

A QSST is a trust that only has one income beneficiary\(^{11}\) during such beneficiary’s lifetime.\(^{12}\) During any portion of the taxable year in which the trust owns S corporation stock, the terms of the trust must require that all income of the trust be distributed to the beneficiary or, if the terms of the trust do not so require, all income of the trust must actually be distributed to the beneficiary.\(^{13}\) During the income beneficiary’s lifetime, principal distributions may only be made to such beneficiary, and such beneficiary’s interest can only end upon the earlier of such beneficiary’s death or the termination of the trust. If the trust terminates during the beneficiary’s lifetime, all assets of the trust must be distributed to the beneficiary.\(^{14}\) The beneficiary must be a citizen or resident of the United States\(^ {15}\) and the beneficiary of the trust must elect to have the trust treated as a QSST.\(^ {16}\) The beneficiary of a QSST is treated as the shareholder for qualification purposes.\(^ {17}\)

2. Income Tax Implications of a QSST

Even if the trust is not a grantor trust with respect to assets other than stock in an S corporation, the trust will be treated as though the beneficiary is the owner of the portion of the trust owning S corporation stock under Section 678(a).\(^ {18}\) A successive income beneficiary is treated as having consented to the corporation’s S election unless such beneficiary affirmatively refuses to consent.\(^ {19}\)

F. Electing Small Business Trusts

1. Requirements of an ESBT

In order for a trust to qualify as an ESBT, all of its beneficiaries (which includes all individuals with a present, future or remainder interest in the trust) must be individuals,\(^ {20}\) estates, certain charitable organizations or other trusts that would qualify as S corporation shareholders if they held S corporation stock.\(^ {21}\) In addition, no interest in the trust can have been acquired by purchase.\(^ {22}\) The trustee must elect to be treated as an ESBT.\(^ {23}\) In addition, the trust cannot be

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\(^ {11}\) Under Treas. Reg. § 1.1361-1(j)(2)(i), a husband and wife are treated as one individual for these purposes.
\(^ {12}\) The trust must meet the requirement of having only one beneficiary at all times after the earlier of the date the QSST election is made and the effective date of the QSST election. See Treas. Reg. § 1.1361-1(j)(1)(iii).
\(^ {13}\) Section 1361(d)(3)(B); Treas. Reg. § 1.1361-1(j)(1)(i).
\(^ {14}\) Section 1361(d)(3)(A); Treas. Reg. § 1.1361-1(j)(1)(ii).
\(^ {15}\) Section 1361(d)(3)(B).
\(^ {16}\) Section 1361(d)(2).
\(^ {17}\) Section 1361(d)(1)(A) provides that a QSST is treated as a grantor trust owned by the beneficiary under Section 1361(c)(2)(A)(i) and Section 678(a).
\(^ {18}\) Id.
\(^ {19}\) Treas. Reg. § 1.1361-1(j)(9).
\(^ {20}\) A non-resident alien is a permissible future beneficiary of a trust but cannot be a potential current beneficiary. Treas. Reg. § 1.1361-1(m)(1)(D)(ii).
\(^ {21}\) Section 1361(e)(1)(A)(i).
\(^ {22}\) Section 1361(e)(1)(A)(ii).
\(^ {23}\) Section 1361(e)(1)(A)(iii).
a tax-exempt entity or charitable remainder trust or have made a QSST election, though the regulations do contain mechanisms for converting a QSST to an ESBT and vice versa.

2. Determining the Shareholder of an ESBT

All of the potential current beneficiaries are treated as the shareholders for qualification purposes. Potential current beneficiaries are all people who at any time during a particular time period are entitled to or may receive distributions from a trust (without regard to any exercise of a power of appointment that has not been exercised). This means that all of a trust’s potential current beneficiaries will count toward the shareholder limitation. However, following the Tax Cut and Jobs Act of 2017, non-resident aliens are now permitted to be potential current beneficiaries of an ESBT.

3. Income Tax Consequences of ESBT

The trust is the shareholder for income tax purposes. Section 641(c) provides that for income tax purposes, the portion of a trust holding S corporation stock will be treated as a separate trust for purposes of determining its income tax. There are several adjustments to the ordinary rules of trust taxation for the S portion of an ESBT under Section 641(c), which typically results in the S corporation income for an ESBT being taxed at the highest rate except for qualified dividends and capital gains. There is no distribution deduction for income from an S corporation that is distributed to the beneficiary. Any portion of an ESBT that does not hold S corporation stock is subject to the ordinary rules of fiduciary income tax.

If a grantor trust has made an S corporation election, the grantor trust taxation rules override the ESBT provisions. As a result of non-resident aliens now being permitted to be potential current beneficiaries of ESBTs, regulations have been issued to require that if a non-resident alien is a deemed owner of a grantor trust that has elected to be an ESBT, the S corporation income must be included in the S portion of the ESBT rather than being allocated to the non-resident alien under the grantor trust rules.

The Tax Cuts and Jobs Act of 2017 also implemented changes pursuant to which ESBTs determine their charitable contribution deduction under the rules applicable to individuals (including AGI limits) rather than the rules generally applicable to trusts. This will likely be

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24 Section 1361(e)(1)(B); Treas. Reg. § 1.1361-1(m)(1)(iv).
25 Treas. Reg. § 1.1361-1(j)(12) and (m)(7).
26 Section 1361(c)(2)(B)(v).
27 Section 1361(e)(2).
28 Treas. Reg. § 1.1361-1(m)(4)(i). Assuming a distributee trust is a potential current beneficiary, all of its current potential beneficiaries must be eligible shareholders and all of them will count for purposes of the 100-shareholder limitation. Section 1.1361-1(m)(4)(iv).
29 Section 1361(c)(2)(B)(v) now reads that “This clause shall not apply for purposes of subsection (b)(1)(C),” which is the prohibition against nonresident alien shareholders of S corporations.
31 Section 641(c)(2)(A).
32 Section 641(c)(2)(C) (flush language).
33 Treas. Reg. § 1.641(c)-1(c).
34 Treas. Reg. § 1.641(c)-1(b)(1)(ii) (“If… the deemed owner of the ESBT is [a NRA]… the items of income, deduction, and credit from that grantor portion must be reallocated from the grantor portion to the S portion…”).
favorable for many ESBTs, as it (1) eliminates the requirements that the charitable distribution be made from gross income and pursuant to the terms of the governing instrument and (2) permits a 5-year carryforward of excess charitable deductions. However, ESBTs will be subject to the AGI limit on deductions and required to comply with the same substantiation requirements as individuals.

Regulations clarify that ESBTs qualify for the Section 199A deduction. Each portion of the trust (ESBT, grantor and non-S portion) is to take into account the Section 199A deduction attributable to the assets in that portion, all portions are treated as a single trust for purposes of determining whether the taxable income of the ESBT exceeds the threshold amount.

II. Choosing Between an ESBT and a QSST

A. Advantages of an ESBT

- Can have more than one beneficiary, including a non-resident alien beneficiary.
- Does not require that all income tax is distributed to the beneficiary and generally permits more flexible terms.
- The trustee can make the election, which can be less cumbersome than having a beneficiary make the election and may make the election more likely to happen.
- If the beneficiary is in a high tax bracket, using an ESBT is likely tax-neutral to a QSST, though the impact of the 3.8% net investment income tax may change this in certain cases (depending on whether the trustee and/or the beneficiary actively participates in the business). If the beneficiary is in the highest tax bracket and resides in a high-income-tax state but the trust is taxed in a low- or no-tax state, there may be some benefit to having the income taxed to the ESBT. The burden to pay the taxes is with the trust, rather than with the individual beneficiary.
- An ESBT may be able to take advantage of the Section 199A deduction even if the individual beneficiary exceeds the taxable income threshold.
- Any trust that would qualify as a QSST will also qualify as an ESBT.

B. Advantages of a QSST

- If a beneficiary is not in the highest tax bracket, lower overall income tax likely will be paid on the S corporation income by utilizing a QSST.

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- If the beneficiary resides in a low or no-tax state and the trust is a resident in a state with high income taxes, there may be some overall tax benefits to having the trust taxes as a QSST. However, the burden to pay the taxes is with the individual beneficiary rather than with the trust.

- If the beneficiary materially participates in the business, the QSST can be beneficial to avoid the 3.8% net investment income tax. The Service’s arguments against trustee active participation have been in cases involving ESBTs rather than the active participation of deemed owners of a business held in a grantor trust or QSST.