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**Take-Away:** Holding S corporation stock in a non-grantor Trust is possible, but also a challenge considering the rules under the Tax Code that must be followed for the Trust to hold the S stock.

**Background:** It is difficult to hold S corporation stock in a non-grantor Trust. An S corporation is a domestic corporation that does not have: (i) more than 100 shareholders; (ii) an ineligible person as a shareholder; (iii) a nonresident alien as a shareholder; and (iv) more than one class of stock. [IRC 1361(b)(1).] It is a pass-through entity where all income, deductions, and credits flow through the entity to its shareholders on a pro rata basis.

**Trust as S Shareholder:** A *grantor* Trust is permitted to be a shareholder in an S corporation so long as the trust grantor/settlor is eligible to be an S shareholder. [IRC 1361(c).] Non-grantor Trusts are generally not eligible to be shareholders of an S corporation unless they are expressly permitted to do so under the Tax Code. [IRC 1361(c)(2).] Two options exist for a non-grantor Trust to be eligible to be an S corporation shareholder: (i) Qualify as a subchapter S Trust (QSST); or (ii) Qualify as an electing small business Trust (EBST.) Qualifying under either of these two options presents practical difficulties; qualifying under either option may also frustrate the settlor's purpose for their Trust.

**QSST:** To qualify as a qualified subchapter S Trust (QSST) the Trust must provide that there is only one (1) beneficiary as to income and principal, and that income must be distributed to that beneficiary each year. [IRC 1361(d)(3).] The trust beneficiary must elect to be treated as the owner of the portion of the Trust that holds the S stock [IRC 1361(d)(1)(B) and (d)(2)]. The trust beneficiary must be treated as the *owner* of the Trust for the portion of the Trust that relates to the S corporation stock under IRC 678. Consequently, the non-

grantor Trust treatment is negated with respect to any S corporation stock if the Trust is to qualify as a QSST. If the settlor of the Trust wants their trustee to have the flexibility to accumulate income within the Trust, that will not be possible under the QSST rules.

**EBST:** To qualify as an electing small business trust (EBST), the requirements are more flexible than a QSST, e.g., income may be accumulated by the trustee, but with some expensive tax trade-offs. The trustee, not the beneficiaries, makes the EBST election under the Tax Code. An eligible EBST permits multiple current trust beneficiaries, as opposed to just one beneficiary under the QSST rule. However, the income tax consequences of an EBST are likely to be much higher. [IRC 1361(e).] The potentially higher income tax burden of an EBST is attributable to specific rules [IRC 641(c)] which treat the portion of the EBST that holds the S corporate stock as a separate Trust and applies special modifications to the applicable general fiduciary income tax rules. Those special modification rules include the following:

- (i) The income that results from the separate portion of the EBST that holds the S corporation stock will be subject to the *highest marginal federal income tax rate* [IRC 1361(c)(2)(A);]
- (ii) Only those items of income, loss, deduction, and credit are permissible under IRC 1361 applicable to S corporations and gain or loss from the sale of the S corporation stock [IRC 1316(c)(2)(C) ((i)-(ii));]
- (iii) State or local income taxes and administration expenses are deductible only to the extent that such taxes and expenses are directly related to the income generated by or gain from the sale of the S corporation stock [IRC 1361(c)(2)(C)(iii);] and
- (iv) The exemption amount for purposes of the alternative minimum tax is set at zero. [IRC 1361(c)(2)(B).]

**Conclusion:** The upshot of the QSST and EBST rules is that the income taxes due on the income or gain that results from the portion of a non-grantor Trust that holds S corporation stock will be higher than if such S corporation stock was held in a *grantor* Trust. While the EBST rules are more flexible, permitting

more than one beneficiary and the trustee's ability to accumulate income distributed from the S corporation, it is much more complex to administer an EBST.