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WATCH YOUR STEP! RESTRICTIONS ON TRUSTS AS S CORPORATION SHAREHOLDERS

For as long as S Corporations have been around, there have been restrictions on the number and type of shareholders that may own S Corporation stock. The limit on the number of S Corporation shareholders was originally 10, but was expanded later to 35, then 75. Today, the limit on the number of S Corporation shareholders is no more than 100. Congress has maintained limits on the number of shareholders of Subchapter S corporations for several policy reasons over the years. First, Congress wanted to limit the expansion of the number of businesses that could qualify as Subchapter S Corporations as a way to help small businesses (by providing pass through treatment of corporate earnings) without dramatically eroding federal corporate income tax revenue. Moreover, Congress wanted to avoid larger corporations from being able to pass through losses to individual shareholders, which would further erode federal income tax collection.

Whatever the policy purpose behind the restriction on the number of shareholders, federal restrictions on the types of S Corporation shareholders are designed to ensure that the limit on the number of shareholders could not be easily bypassed through creative lawyering. Thus, the Small Business Investment Act of 1958 (the federal legislation that created the S Corporation) was infused with a strong bias against institutional shareholders. And that bias has carried through to today. Currently, federal law restricts the types of S Corporation shareholders to individuals and certain estates and trusts. Husband and wife are treated as a single shareholder, as are members of a family and their estates. Members of a family include common ancestors, six generations of lineal descendants, and spouses of common ancestors and lineal descendants.

Five types of trusts are also allowed to be S Corporation shareholders:

- Grantor trusts
- Testamentary trusts
- Qualified S Corporation trusts (QSST)
- Electing small business trusts
- Voting trusts

In general, the Internal Revenue Code restricts the kinds of trusts that can be S Corporation shareholders through requirements which require clear identification of the deemed shareholder(s), whose shares are held in the trust. The purpose of these provisions is to ensure the IRS can keep track of how many shareholders an S Corporation has, and enforce its 100 shareholder limit. Thus, in the case of a grantor trust, the grantor is deemed the shareholder. In the case of a testamentary trust, the estate is the shareholder. In the case of a voting, a QSST, or an electing small business trust, each beneficiary of the trust is considered a separate shareholder.

Changes in circumstances relating to S Corporation stock held by a trust can pose risks to a corporation's Subchapter S election, and must be scrutinized carefully. For example, a grantor trust remains qualified as an eligible S Corporation shareholder after the death of the grantor, but only for a period of two years from the date of the grantor's death. Similarly, S Corporation stock that passes into a testamentary trust by will is an eligible S Corporation shareholder for two years from the date the stock is transferred into the trust.

If there has been a change of circumstances related to S Corporation stock held in trust, it is in the best interests of all shareholders as well as the corporation to understand the status of the stock, and take steps to ensure that the stock ultimately is owned by an eligible S Corporation shareholder. Failure to do so could result in the termination of the Subchapter S election. There are remedies for inadvertent mistakes, but of course it is far preferable to ensure that such mistakes are avoided, and that S Corporation stock remains under the ownership of eligible shareholders.

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