

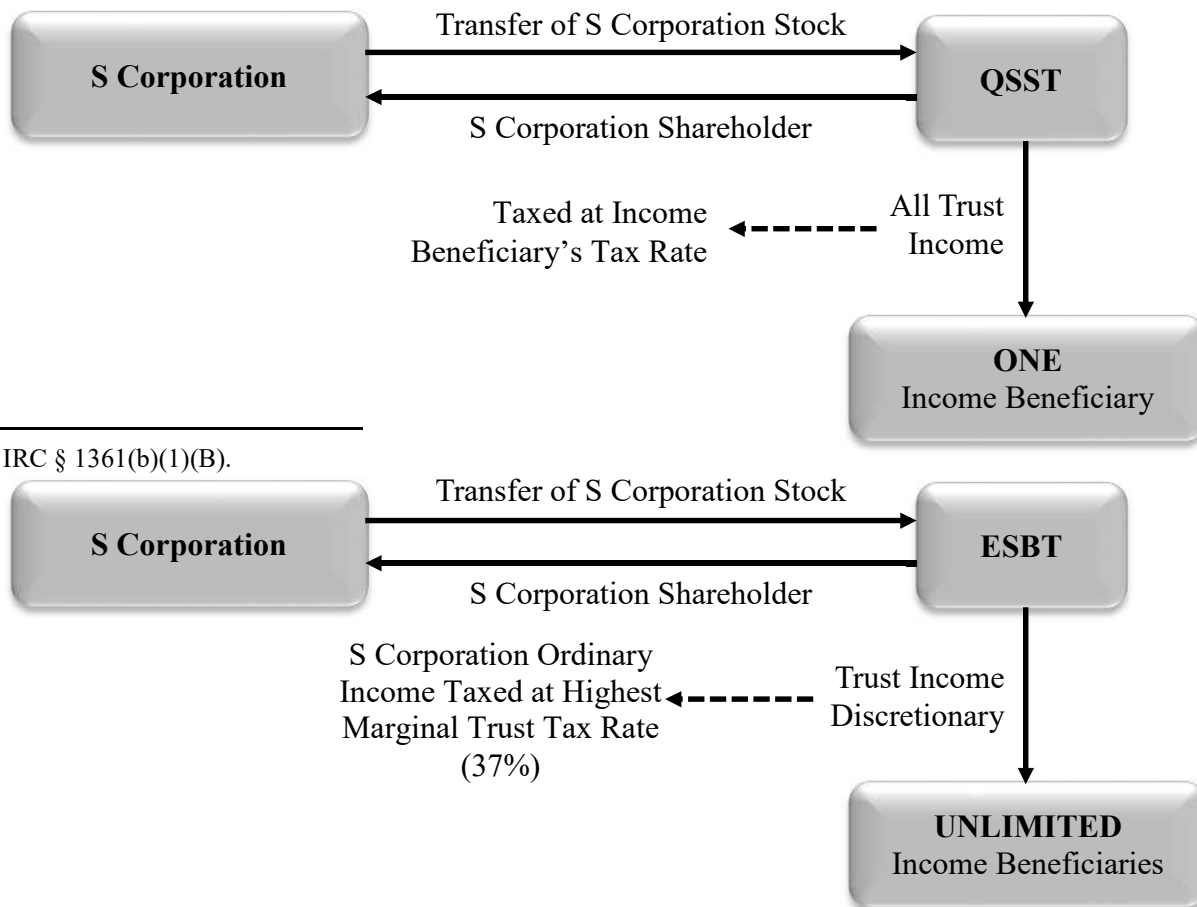
## #4: Trusts as S Corporation Shareholders: ESBT vs. QSST

A corporation does not qualify as an S corporation if it has an ineligible shareholder. Eligible shareholders include only individuals, a decedent's estate, the estate of an individual in bankruptcy, certain tax-exempt organizations and certain trusts.<sup>12</sup> Eligible trusts include (1) grantor trusts, (2) IRC § 678 trusts, (3) qualified subchapter S trusts (QSSTs), (4) electing small business trusts (ESBTs), (5) certain testamentary trusts, and (6) voting trusts.<sup>13</sup> Taxpayers who wish to hold S corporation stock in a trust must frequently choose between a QSST and an ESBT. Perhaps the most common situation is one in which an individual held S corporation stock in a grantor trust, but grantor trust status terminated when the grantor died. The trust continues to be a qualified S corporation shareholder for two years after the grantor's death, but after that, the estate must choose between making the trust a QSST or an ESBT.

Important differences between the two often make the decision a difficult one. Overall, the main issue is: Would you rather have more restrictions (a QSST) or, in most cases, more taxes (an ESBT)? This tradeoff is shown in the following chart.

	<b>QSST</b>	<b>ESBT</b>
Trust Income Distribution	All trust income must be distributed	Discretionary
Trust Corpus	Must be distributed to the income beneficiary	No restriction on corpus distributions
Number of Current Income Beneficiaries	One (US citizen or resident)	Unlimited (only individuals other than nonresident aliens, estates, and charities)
Taxable Income	Passes through to the income beneficiary and is taxed at the beneficiary's tax rate	S corporation's income is recognized at the trust level and taxed at a flat rate equal to the highest marginal rate for trusts
Election	Made by the income beneficiary	Made by the trustee

<sup>13</sup> IRC § 1361(c)(2).



<sup>12</sup> IRC § 1361(b)(1)(B).

Since a QSST may only have one current income beneficiary, if you want to transfer stock to multiple beneficiaries, i.e., your children, you would need to set up a separate QSST for each beneficiary. While there can only be one income beneficiary, a QSST may designate successor beneficiaries. With an ESBT, you can set up one trust that includes all of the income beneficiaries. However, note that any ESBT designated beneficiaries must be an individual, estate or charity eligible to own S corporation stock. Additionally, the beneficiaries must not have acquired their beneficial interest through purchase.

Furthermore, with a QSST, all trust income must be distributed annually. With an ESBT, the trustee has discretion as to how much of the trust income is distributed and to whom the trust income is distributed. Therefore, with an ESBT, income can be left in the trust to accumulate.

With a QSST, the trust corpus must be distributed only to the income beneficiary during that beneficiary's life or on termination of the trust if prior to the death of the income beneficiary. However, after the beneficiary's death there is no restriction on corpus distributions. This is always the case with an ESBT – no restrictions on corpus distributions. Therefore, the trustee has discretion as to when and to whom distributions of trust corpus will be made. These factors give an ESBT much more flexibility for estate planning purposes.

On the other hand, a QSST generally has better income tax consequences. A QSST is treated as an IRC § 678 trust owned by the trust beneficiary. Thus, trust income passes through to the income beneficiary and is taxed at that individual's current tax rate. Note, however, that all income of the trust is reported by the beneficiary, including the trust's share of S corporation income, even if the S corporation does not make a distribution to the trust. With an ESBT, the trust's income from the S corporation is recognized at the trust level and taxed at the highest marginal rate for trusts, which in 2022 is 37%. Because S corporation income is taxed at the trust level, there is no tax at the beneficiary level when income is distributed. Any other sources of trust income (i.e., anything other than S corporation income) are subject to the normal tax rules for trusts. The 37% ESBT rate is generally higher than the individual rate applicable to a QSST beneficiary.

As for eligibility to hold S corporation stock, with a QSST, the duration of eligibility depends on whether the income beneficiary dies prior to the end of the term of the trust. If the trust term ends during the beneficiary's life, the stock will be distributed to that person and the S corporation election will continue for at least as long as that person holds the stock. If, however, the beneficiary dies before the end of the trust term and there is no designated successor beneficiary, the trust remains an eligible S corporation shareholder during the two-year period beginning on the date of the beneficiary's death. Lastly, if a successor beneficiary has been designated, then the S corporation election continues unless the successor beneficiary affirmatively refuses to consent to the original QSST election. On the other hand, with an ESBT, the trust is an eligible shareholder until the ESBT election is terminated or until a person or trust that is ineligible to hold S corporation stock becomes a beneficiary.

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