PacificCPE

COURSE
33252A

S Corporation Shareholders, Elections, and Filing Requirements

Not every trust or entity can hold S corporation stock — and the filing rules around elections and returns leave little room for error. This course explores which trusts qualify as S corporation shareholders and breaks down the procedural requirements for making a valid S election and filing the corporate return. If you work with closely held businesses or estate planning clients who have S corporation interests, the rules covered here are ones you'll use regularly.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize types of trusts that can be a shareholder of an S corporation.
- To recall the requirements of an S corporation election.
- To identify the requirements for filing Form 1120S.

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Publication Date: June 2026

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Chapter 1: TRUSTS THAT QUALIFY AS S CORPORATION SHAREHOLDERS

Chapter Objective

After completing this chapter, you should be able to:

- Recognize types of trusts that can be a shareholder of an S corporation.

301 SIX TYPES OF ELIGIBLE TRUSTS

Only the following six types of trusts are permitted to be S corporation shareholders. A discussion of each of the trusts and their unique qualifications follows in the paragraph number shown.

- Grantor trusts (302)
- Trusts owned by a beneficiary (Code Sec. 678 trusts) (303)
- Testamentary trusts (304)
- Voting trusts (305)
- Electing small business trusts (ESBTs) (306)
- Qualified subchapter S trusts (QSSTs) (307)

.01 Code Sec. 1411's Effect on Trust Operations

Code Sec. 1411 could impose taxation on a trust's income.

In adopting the final Code Sec. 1411 regulations, the Treasury Department and the IRS stated in TD 9644 (November 26, 2013) that the issue of "guidance on material participation of estates and trusts . . . would be addressed more appropriately in the section 469 regulations" and that this guidance "may be addressed in a separate guidance project issued under section 469 at a later date." Arguably, since the Treasury Department and the IRS state that the 469 regulations "more appropriately" apply to define material participation, the cases of Mattie K. Carter Trust and the Frank Aragona Trust (discussed at 301.02) should apply to determine trust and estate activity for purposes of Code Sec. 1411(c)(2).

.02 Material Participation of a Trustee for Purposes of Satisfying Code Secs. 469, 1411 and 56(b)

Code Sec. 469 prescribes for purposes of making an activity "active" rather than "passive" for purposes of deducting losses there has to be material participation. In the case of a trust, Mattie K. Carter Trust v. U.S., "material participation by a trustee of a testamentary trust engaged in a ranching business was determined by addressing the activities of the trust through its fiduciaries, employees, and agents,

and could not be decided by evaluating only the activities of the trustee. However, IRS Letter Ruling 201029014 (July 24, 2010) held that a trust may only have "active participation in a business for Code Sec. 469 purposes if only the trustee materially participates.

In the case of an S corporation trust, Technical Advice Memorandum 201317010 (April 26, 2013), a trustee of a complex trust was deemed not to actively participate in the management of an S corporation where the grantor of the trust actively ran the business. Thus, under Code Sec. 56(b)(2), the trust could not deduct research and experimental expenses in the year incurred for alternative minimum tax; rather they had to be amortized over ten years.

302 GRANTOR TRUSTS

.01 Qualifications of Grantor Trusts

A grantor trust is allowed to be a shareholder of an S corporation, provided that the grantor is:

- An individual,
- Not a nonresident alien, and
- Treated as owning all of the trust.

In addition, the grantor must also consent to the S election. A grantor trust does not have to qualify as an S corporation shareholder for its entire life—only for the period that it is to be a shareholder of an S corporation. Thus, a trust could be a qualifying S corporation grantor trust for the first 20 years of its life, then terminate (e.g., when the beneficiary turns 20), and then prescribe different provisions that would prevent the trust from qualifying as an S corporation shareholder (i.e., becoming an ineligible trust).

.02 Characteristics of a Grantor and Trust

A grantor of a grantor trust qualifying as an S corporation shareholder can:

- Retain the right to revoke the trust;
- Retain a reversionary power in the trust;
- Retain certain administrative rights normally designated to the trustee, such as the right to decide to distribute income or accumulate it for the grantor, the grantor's spouse, or both; and/or
- Control beneficial enjoyment of the corpus or income.

The fact that income and principal of the trust can be distributed to individuals other than the grantor (e.g., the grantor's children and grandchildren) does not prevent the trust from qualifying as an S corporation shareholder. Also, the trust may continue as a shareholder for up to two years after the grantor's death.

Tax Pointer

If the S corporation's shareholders' agreement does not provide for a distribution of funds to pay income taxes, the grantor may want to consider funding the trust with additional income-producing assets to pay taxes.

.03 Example of Grantor Trusts

Living trusts. A common example of a grantor trust is the revocable inter vivos trust or living trust, which is often used as an estate-planning device to minimize estate probate of assets.

303 TRUSTS OWNED BY A BENEFICIARY (CODE SEC. 678 TRUSTS)

.01 Qualifications of Trusts Owned by a Beneficiary

A trust owned by a beneficiary (a person other than the grantor) is allowed to be a shareholder of an S corporation, provided that the beneficiary is:

- An individual and
- Not a nonresident alien.

.02 Characteristics of a Beneficiary and Trust

A beneficiary of a trust who holds a Crummey power to withdraw the trust corpus is deemed the owner of the trust even if the beneficiary never exercises the withdrawal

power. Generally, the beneficial owner of the trust becomes the shareholder for receiving the taxable income of the S corporation; however, the trust is the legal owner of the stock and, therefore, receives the distributions from the S corporation.

At the death of the beneficiary/owner, the trust may continue as an S corporation shareholder for two years after the time the beneficiary's gross estate includes the entire corpus of the trust.

.03 Reasons for Code Sec. 678 Trusts

A Code Sec. 678 trust allows a donor gift-giving flexibility in that the donee (i.e., the beneficial owner) can elect or not elect to be an S corporation shareholder. Practically, this means that the donor is not "ruling from the grave." To illustrate, assume a parent establishes a Code Sec. 678 trust for a child and places C corporation stock in it. Under this scenario, the child can decide to elect S status.

Tax Pointer

A simple reading of Code Sec. 1361(c)(2)(A) indicates that a foreign trust cannot be a shareholder in an S corporation even if it is described in Code Sec. 678.

304 TESTAMENTARY TRUSTS

.01 Reasons for Testamentary Trusts

Frequently, an individual is very concerned that after his or her death the beneficiaries named in his or her will may not be able to handle their own affairs. Consequently, trusts called "testamentary trusts" are provided in the individual's will for such a situation. One primary reason for establishing a testamentary trust is to prevent a beneficiary from owning S corporation stock until such time as the decedent dictates in his or her will. This added control could be beneficial when a parent fears that a child receiving S corporation stock at the parent's death would not act responsibly (e.g., the child has a drug habit). Consequently, the parent may establish a testamentary trust for the S corporation stock so that the child will not receive the stock until he or she reaches an age which the grantor of the trust feels the child will have the maturity, wellness or ability to handle his or her own affairs.

Testamentary trusts are also used in second marriage situations through qualified terminal interest property (QTIP) trusts. Example 3-1 will illustrate.

Example 3-1

Gary Nemeth, a 100% owner of S corporation stock, divorced Helena, his wife of many years. In the divorce settlement, Gary was allowed to keep all the S corporation stock. Shortly after his divorce from Helena, Gary met Donna Dodds and married her. Gary was so much in love with Donna that he ignored his lawyer's advice and did not enter into a prenuptial agreement with Donna. At the time of Gary's marriage to Donna, Gary had only one asset in his estate, the S corporation stock. Shortly after his marriage to Donna, Gary came to his senses and realized that Donna could become a shareholder in the S corporation by electing against Gary's will if he did not make adequate provision for her in his will. To protect his children by his first marriage, Gary, in his will, establishes a QTIP trust for the S corporation stock that provides Donna the use of the stock's income during her life (from the principal), and at her death, the QTIP trust will terminate and all the S corporation stock will be given to Gary's children from his first marriage. Thus, Gary's children from his first marriage can operate the S corporation free of management control by Donna while Donna is living, and they will keep the stock ownership intact by receiving the stock at Donna's death.

In some states, Donna (in Example 3-1), notwithstanding the QTIP provisions, trust, etc., can still fight against Gary's will demanding one-third of the S corporation stock outright. Thus, Gary, at the time he drafts his will and until his death must keep a careful eye on state law to ensure that his plans for giving his entire stock to his children are not sabotaged. Donna, assuming she does not elect against the QTIP trust, could sue the QTIP trustee for corporate waste if she can establish that corporate excesses are occurring (e.g., the S corporation employs Gary's minor children and pays them exorbitant salaries).

.02 Characteristics of Testamentary Trusts

A trust that receives S corporation stock under a will can remain as an S corporation shareholder for up to two years, beginning on the day that the stock was transferred to it. Thereafter, unless the testamentary trust qualifies as a type of permitted S corporation trust (e.g., a qualified terminal interest property trust (QTIP Trust)), the S election will be lost. This time restriction on testamentary trusts severely limits estate planning, forcing a testamentary trustee to either sell and/or redeem the stock in a limited period of time or make a distribution to the beneficiaries of the stock, assuming they are all eligible shareholders.

Tax Pointer

When faced with a testamentary trust that will cause the S corporation to lose its S election, the corporation could redeem the trust's stock, converting the "tainted" stock in the trust to cash and/or notes. This would preserve the S corporation's status.

.03 Advantages of Testamentary Trusts

One advantage of transferring stock to a testamentary trust is that a sale can frequently be made from a trust without court approval, whereas sale of stock by an estate could require court approval.

305 VOTING TRUSTS

.01 Qualifications of Voting Trusts

The requirements a trust must meet to qualify as a voting trust are not clearly defined in Code Sec. 1361(c)(2)(A)(iv). However, below are a number of requirements provided in Reg. § 1.1361-1(h)(1)(v):

- The trust must be in writing.
- The trust must give right-to-vote stock to one or more trustees.
- All distributions must be for the benefit of the beneficial owners.
- The title and possession of the S corporation stock must vest in the beneficiaries at the end of the trust.
- The trust must terminate on or before a specific time period or event under its terms, or by state law.

.02 Characteristics of Voting Trusts

Voting trusts are defined by state law. Normally, their existence is only for ten years, subject to renewal. By definition, voting trusts can have multiple owners. Code Sec. 1361(c)(2)(B)(iv) prescribes that each beneficiary of a voting trust is a shareholder. Accordingly, each beneficiary should sign the Form 2553 consent form for an S election, and it would be advisable to have the trustee of the trust sign the form as well.