

Construction Lenders and Mechanics' Liens



Accounting for Success

Revocable Trusts Owning S Corporation Stock



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“What happens to a revocable trust when the grantor passes away?”

A revocable trust is an arrangement in which title to property is placed in the name of a trustee with the grantor retaining rights to reclaim the property during their lifetime. A revocable trust may help avoid probate, minimize potential will contest, provide flexibility, and reduce the administrative burden of the estate. Individuals who contribute their S corporation stock to a revocable trust should be very cautious. There are rules which limit the type of shareholder the S corporations can have. If an ineligible shareholder owns S corporation stock, the corporation could lose its “S” status and revert to being treated as a “C” corporation for federal income tax purposes. This could result in additional tax filings, more complicated accounting, and unfavorable tax consequences.

For federal income tax purposes, revocable trusts are treated as being one and the same as the grantor of a trust. A revocable trust’s tax information is often reported under the grantor’s social security number and therefore is included on the grantor’s Form 1040. Since a revocable trust is not treated as separate from the grantor, it is an eligible S corporation shareholder while the grantor is alive.

But what happens to a revocable trust when the grantor passes away? A new separate tax entity would be created on the grantor’s date of death and a separate trust tax return would then have to be filed. In general, trusts are not eligible shareholders of S corporations, so the creation of the new separate entity would cause the loss of the “S” status.

Estates are eligible shareholders of S corporations so the easiest way to avoid the loss of the “S” status in this situation

would be for the trustee to treat the revocable trust as part of the estate under IRC Sec. 645. The trust (now part of the estate) could be treated as an eligible shareholder of the S corporation for a period of two years after the grantor passes away.

If the trust’s ownership in the S corporation continues past the two-year mark, a Qualified Subchapter S Trust (QSST) election must be made for the trust to continue as an eligible shareholder. The election needs to be made within two years, two months, and sixteen days of the death of the grantor. To make the election, the following requirements must be met.

1. The trust can only have one income beneficiary.
2. All income is or is required to be distributed.
3. Any principal distributions must go to the income beneficiary.
4. The income beneficiary’s interest must terminate on the earlier of the beneficiary’s death or the trust’s termination.
5. No distribution by the trust can satisfy the grantor’s legal obligation to support the income beneficiary, which would violate items 1 and 3.

Making the QSST election can be easily overlooked so there needs to be proper consideration at the beginning whether stock of an S Corporation even needs to be retitled into a revocable trust. Please note that this article does not cover the Electing Small Business Trust, which may be an option for trusts that do not meet the above criteria.