MEMORANDUM

TO: S Corporation Clients of Barber Emerson, L.C.

FROM: Barber Emerson, L.C.

DATE: April 20, 2004

RE: Trusts as S Corporation Shareholders

The Internal Revenue Code strictly limits who may own shares of a small business corporation ("S Corporation"). The initial regulations governing the formation of S Corporations required that only individuals (as opposed to corporations, partnerships or trusts) were permitted to hold shares of S Corporation stock. The current version of Subchapter S, however, provides that certain trusts are permitted to own the shares of an S Corporation, including qualified subchapter S trusts ("QSSTs") and electing small business trusts ("ESBTs"). This memorandum briefly discusses the requirements for QSSTs and ESBTs.

Qualified Subchapter S Trusts

A QSST is defined as a trust that contains the following restrictions: (1) during the life of the current income beneficiary, there is only one income beneficiary of the trust; (2) any trust assets distributed during the life of the beneficiary must only be distributed to this beneficiary; (3) the income interest of the current income beneficiary must terminate upon the earlier of the termination of the trust or the beneficiary's death; and (4) upon the termination of the trust during the life of the income beneficiary, the trust must distribute all of its assets to such beneficiary. Additionally, all of the income distributed, or required to be distributed, by the trust must be made to only one individual that is a citizen or resident of the United States. The beneficiary, or his or her legal representative, must file an election with the IRS in order to be considered a QSST.

Electing Small Business Trusts

For the taxable years after 1996, an electing small business trust is permitted to hold stock in an S Corporation. An ESBT is defined as a trust that: (1) does not have as a beneficiary any person other than an individual, an estate or certain charitable organizations; (2) was not acquired, in whole or in part, by purchase; and (3) makes an election with the IRS to be treated as an ESBT. The term "purchase" means any acquisition if the tax basis of the property acquired is determined under Section 1012 of the Internal Revenue Code. Certain trusts are not, however, eligible to make the ESBT election. These include a QSST that has made the election described above, tax exempt trusts, and charitable remainder annuity trusts and charitable remainder unitrusts. Generally, charitable remainder trusts and charitable remainder unitrusts are trusts that must pay non-charitable beneficiaries a certain percentage of the trust annually. Although an ESBT is an eligible S Corporation shareholder, the trust beneficiaries will be taxed for federal income tax purposes at the highest tax rate imposed under the Internal Revenue Code. That rate is currently 35%.

Because an S Corporation's status as a small business corprroration may be jeopardized if an ineligible trust holds stock in that corporation, the corporation must be vigilant in monitoring whether any shareholder has established a trust that could result in the loss of the S Corporation election. Although a revocable or living trust during the lifetime of the grantor of the trust generally would not create a problem, upon the death of the grantor the continuation of the trust or the division of the trust into several new trusts may create problems. For example, certain trusts for minor children or incapacitated persons might easily fail the QSST or ESBT test. A trust that is intended to be a so-called "bypass," or "credit shelter," trust may also fail to qualify if improperly drafted. Other common estate planning and tax planning trust arrangements may also create S Corporation problems.

If your corporation does not have a Shareholders' Agreement requiring the shareholders to transfer their stock only to trusts that would be eligible S Corporation shareholders, a shareholder might transfer his or her shares to an ineligible trust and the corporation would probably not be in a position to deny the ineligible trust the right to become a shareholder. Consequently, the corporation's S Corporation status would be at risk. Your shareholders should regularly be reminded of these issues and urged to consult with their tax advisors with respect to their planning to ensure that any trust they might create would not adversely affect the corporation's S status.