

## **Know the Shareholder Rules Before Gifting S Corporation Stock**

Historically constrained by a number of rules and requirements, S corporations found some relief in 1996 from the Small Business Job Protection Act. Nevertheless, if you'd like to make a gift of S corporation stock, be aware that many restrictions under which S corporations must still operate may affect your transaction. To make the most of your gifts of S corporation stock, be sure you understand rules related to shareholders and the stock itself.

### **Number of Shareholders**

Under the 1996 Act, an S corporation can have as many as 75 shareholders. Prior law allowed only 35 shareholders. The number limitation usually is not a problem for those wishing to elect S corporation status, except for family businesses with a large number of family members. Typically, the patriarch or matriarch of the family that primarily owns a business creates through his or her estate plan a separate trust for each child and grandchild, and this is where the number of shareholders may cause a problem.

This type of arrangement can be effective only if you plan it carefully. The Internal Revenue Code contains several rules for determining the number of shareholders. For example, a husband and wife are treated as one shareholder. Conversely, beneficiaries of a qualifying trust that contains several separate shares will be treated as separate shareholders.

### **Types of Shareholders**

An S corporation can have only certain types of shareholders. In general, these are U.S. citizens and resident individuals, certain types of trusts and estates, certain tax exempt organizations and employee stock ownership plans (ESOPs):

**Trusts.** The tax law allows an S corporation to have a trust as a shareholder as long as the trust is:

- A grantor trust,
- A qualified subchapter S trust (QSST), or
- An electing small business trust (ESBT).

For income tax purposes, a grantor trust is treated as owned entirely by one person. Usually, but not always, this is the person funding the trust.

To qualify as a QSST, a trust must meet several qualifications:

- The trust must have only one income beneficiary,
- All trust principal distributed during the beneficiary's life must be made to that beneficiary, and
- The trust must distribute its assets to that beneficiary if it terminates during the beneficiary's life.

An ESBT can have more than one type of beneficiary. Beneficiaries can be an individual, an estate or a certain type of charitable organization. A charitable remainder trust, or any other trust exempt from income tax, cannot be an ESBT.

***Tax Exempt Organizations.*** Before Jan. 1, 1998, a transfer of stock to a tax exempt organization known as a 501(c)(3) charity would have terminated a corporation's S status, but now, a 501(c)(3) charity may be an S corporation shareholder.

All S corporation income allocated to a charity, including dividends and interest, is taxable to the charity. This type of income is referred to as unrelated business taxable income (UBTI). Income from the S corporation is taxed to the charity at corporate rates, currently as high as 35%. In contrast, if a tax exempt organization owns stock in a publicly traded company, the charity is not taxed on the dividends and interest received from the stock because that income is not treated as UBTI.

The charity will realize UBTI when it sells S corporation stock at a gain. As a result of UBTI issues, the value of the S corporation stock to the charity is diminished. In other words, if you want to donate S corporation stock, consider that a portion of your gift's value will be eaten away by the tax the charity will owe when it sells the stock. This might thwart your charitable endeavor.

Also be aware of the types of assets held by the S corporation when evaluating whether to make a gift to a charity. The amount of the charitable deduction will be reduced if you make a charitable contribution of S corporation stock and the corporation holds appreciated inventory or unrealized receivables.

***ESOPs.*** As of Jan. 1, 1998, an ESOP may own stock in an S corporation. This type of qualified plan allows employees to acquire stock in the company.

## **Shareholder Agreements**

The shareholders of many S corporations are bound by shareholder agreements designed to prevent the transfer of S corporation shares to unrelated parties. These agreements also prevent the termination of S status by the transfer of the shares to disqualified persons. Before transferring S corporation stock, always check the terms of any existing shareholder agreement to ensure that the transfer will be respected. Most shareholder agreements declare as void any purported transfer to an ineligible S corporation shareholder.

## **Type of Stock**

An S corporation can have only one class of stock. This means that all shares of stock must provide the shareholders with identical rights when the S corporation makes distributions, both during operations and in liquidation. While the corporation can have voting and nonvoting shares, it may not have preferred shares.

## **Help Your Estate**

To ensure that gifting S corporation stock enhances your overall estate plan, make sure you transfer it to an eligible shareholder, and remind the shareholder to consult any effective shareholder agreements. Also, consider the tax effects to the transferee -- you don't want your gift to become a burden. With a

thorough understanding of S corporation rules and proper planning, gifting S corporation stock can satisfy both your tax needs.