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## S corporations and the “two-year” rule

by Neil E. Harl, Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University, Ames, Iowa. Member of the Iowa Bar, 515-294-6354, harl@iastate.edu

When Subchapter S of the Internal Revenue Code was enacted in 1958, the income tax rates were significantly different than in 2012. In 1958, the top corporate federal income tax rate was 52 percent and the top individual rate was 91 percent. The S corporation concept gained popularity among small businesses and currently ranks as the most popular corporate structure in the United States.

Notwithstanding its popularity, the S corporation concept still embraces problem areas, perhaps the most notable of which is the fact that some S corporations pay unreasonably low salaries, reducing payroll taxes as earnings are removed as corporate distributions rather than wages and salaries. Another problem area is the ownership of S corporation stock by entities other than individuals. This article focuses on one of those problems, the “two-year” rule for S corporation stock ownership by some types of trusts after the death of an individual beneficiary.

### Trusts permitted as shareholders

As originally enacted, Subchapter S limited eligible shareholders to those in a domestic corporation . . . which does not – (2) have as a shareholder a person (other than an estate) which is not an individual.” Over the years, that simple rule has been amended to allow certain trusts to be permitted shareholders –

- A grantor trust (technically a trust under subpart E of Part I of subchapter J of Chapter 1 of the Internal Revenue Code) which is treated “. . . as owned by an individual who is a citizen or resident of the United States” immediately before the death of the deemed owner . . . and which continues in existence after such death, but only for the 2-year period beginning on the day of the deemed owner’s death”

- A testamentary trust as transferee of stock under a will, “. . . but only for the 2-year period beginning on the day on which such stock is transferred to it”
- A voting trust
- An electing small business trust
- For Subchapter S banks and depositary institutions, a trust which constitutes an individual retirement account including a Roth IRA until October 22, 2004
- A qualified Subchapter S trust with only one beneficiary
- Wholly owned subsidiaries

It is important to note that the first two categories – grantor trusts and testamentary trusts – are limited by the “two-year” rule – grantor trusts (for two years after death) and testamentary trusts (two years after the stock is transferred to the trust).

### The “two-year” rule

The statute is clear as to the post-death period during which S corporation stock can be held by grantor trusts and testamentary trusts, although the provisions are not identical in terms of the period after death the stock can be held by the respective trusts. Both provisions use the term “but only for the 2-year period.” However, some have argued that the term during which trust ownership is allowed can extend beyond the two-year limit by invoking I.R.C. § 641. Regulations issued under that Code section state—

“The period of administration or settlement [of an estate] is the period actually required by the administrator or executor to perform the ordinary duties of administration. . . whether the period is longer or shorter than the period specified under the

S corporations and the "two-year" rule, continued from page 3

applicable local law for the settlement of estates. . . If the administration of an estate is unreasonably prolonged, the estate is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all of the duties of administration."

One question is whether the I.R.C. § 641 regulations trump the very specific language of I.R.C. § 1361(c)(2)(A) and have relevance to how long S corporation stock can be held after death in a grantor trust or testamentary trust. The regulations under I.R.C. § 641 were proposed and adopted in 1956, before the enactment of Subchapter S of the Internal Revenue Code, and neither section makes reference to the other provision. However, the I.R.C. § 1361 regulations do refer to I.R.C. § 641.

The regulations under I.R.C. § 1361(c)(2)(B) are ambiguous. Those regulations state that a grantor trust that continues in existence after the death of the deemed owner is an eligible shareholder ". . . but only for the 2-year period beginning on

the day of the deemed owner's death." The regulation goes on to state ". . . a trust is considered to continue in existence if the trust continues to hold the stock pursuant to the terms of the will or trust agreement, or if the trust continues to hold the stock during a period reasonably necessary to wind up the affairs of the trust." [Id.] Yet the preceding sentence from the regulations merely states that the trust ". . . is considered to continue in existence" ... "if the trust continues to own stock, not that the shareholder is a permissible shareholder of an S corporation." The fact that the regulations under I.R.C. § 1361 seemingly contradict the statute raises a question as to the validity of the regulations.

The consequences of violating the requirements of I.R.C. § 1361(c)(2)(A) can be severe – the S election is terminated inasmuch as the corporation ceases to be a "small business corporation." Therefore, the prudent course would appear to be to follow the statutory language – do not allow trust ownership (grantor trusts and testamentary trusts) to continue beyond the two-year period.



### Evaluation and selection of job candidates

by Melissa O'Rourke, farm & agribusiness management specialist, 712-737-4230, morourke@iastate.edu

Significant time and energy goes into the employee recruitment and interview process. The farm employer has invested effort in various stages such as: (1) analyzing labor needs; (2) writing position descriptions and recruiting candidates, and (3) scheduling and conducting well-planned interviews. When the interview process is complete, the employer will check references, evaluate the candidates, and hopefully extend a job offer.

The process of evaluating the candidates following the interview and reference-checking stage should

be given the same attention as other steps in the employment process. Ideally, the recruitment and interview steps have yielded several candidates from which to choose. It is important to reflect on the candidates and take the time to make a good selection. Farmers know the investment necessary to hire and train employees.

First, go back to the position description and review the necessary qualifications for the job. Assess how well each candidate meets the basic qualifications and rank them on this basis.