# A Primer on Electing Small Business Trusts (ESBTs) and Qualified Subchapter S Trusts

Thursday, November 16, 2023

Take-Away: A Trust that holds S corporation stock is confronted with the decision to make either a *qualifying subchapter S trust* (QSST) election or an *electing small business trust* (ESBT) election. There dramatically different rules for each type of irrevocable trust that holds S corporation stock, and advantages and disadvantages to each.

Background: The LLC has emerged as the most popular legal entity of choice over the past 20 years for small business owners. LLCs are popular because there are no restrictions on- (i) the ownership of equity in an LLC; (ii) the number of LLC members it may have; (iii) the varying classes of economic interests that the LLC may issue to its members; and (iv) the LLC's ability to specially allocate items of income, gain, loss and deductions among its members. The LLC is treated as a *pass-through* entity for federal income tax purposes, meaning that the LLC does not pay an entity-level tax on its taxable income; rather, those tax items are passed through and reported by and taxed to the LLC's member.

Despite the popularity of LLCs, S corporations continue to be the most popular form of corporation, accounting for about 70% of the combined C and S corporation tax returns that are filed annually, even after the 2017 Tax Act imposed a flat 21% federal income tax rate on a C corporation's taxable income. Like the LLC, items of income, gain, loss and deductions are passed-through to the S shareholders, but they are passed-through strictly on a *pro rata* basis, i.e., without any special allocations among the shareholders. It is the annual pass-through of these tax items to the S shareholders that results in the need for a formal election of the trust to be taxed as either a *qualified subchapter S trust* (QSST) or an *electing small business trust* (ESBT.)

Small Business Corporation: The term *S corporation* means with respect to any taxable year a *small business corporation* for which an election is in effect for such year. [IRC 1361(a)(1)(A)(v).] The definitional requirements for a *small business corporation* include among other requirements that the corporation cannot have as a shareholder a person other than a U.S. individual, a domestic estate, or one of certain enumerated *domestic* trusts.[IRC 1361(c)(2)] or certain tax-exempt organizations. Both QSST and ESBTs may hold an interest in an *S corporation*.

QSST: A QSST may have only one (1) beneficiary who is treated as the owner of the S corporation stock that is held by the trust for which an election is made by the trust beneficiary. A perceived disadvantage of QSST election is that a QSST can have only one lifetime beneficiary and *all* of the ordinary income of the QSST must be distributed to its beneficiary currently, regardless of the beneficiary's actual need. [By analogy, think of a *conduit see-through* trust for retirement benefits that are paid to the estate planning trust.]

ESBT: As noted, irrevocable trusts that hold S corporate stock are subject to special rules that relate to, and implement, the *pro rata* pass-through tax rules that relate to S shareholders. One is an S corporation is held by an *electing small business trust* (or EBST) [IRC 1361(c)(2)(A)(v)]. Technically, an EBST is defined as a U.S. trust that: (a) that is not a qualifying subchapter S trust, or QSST; (b) a tax exempt trust, or a charitable remainder trust, or certain tax-exempt organizations; (c) no interest in which was acquired by purchase [Regulation 1.1361-1(m)(1)(iii)]; and (d) with respect to which an EBST election was made by the trustee and which remains in effect [IRC 1361(e).] Consequently, an ESBT can have multiple beneficiaries, and its terms will determine whether, and to what extent, the trust beneficiaries are treated as the owners of the trust's share of the S corporation stock that it owns. A downside to an ESBT election is that it may be impossible for cause all of the taxable income that is allocable to the ESBT's interest in the S corporation to be taxed to the trust's beneficiaries, rather than to the trust at the highest federal income tax rate. [By analogy, think of an *accumulation see-through* trust for retirement benefits that are paid to the estate planning trust.]

QSST and ESBT Comparison Summary: The main difference between an ESBT and a QSST is that an ESBT may have multiple beneficiaries and the ESBT does not have to distribute all of its income to its beneficiaries each year. With a QSST, the trustee , rather than the beneficiaries, makes the QSST election, and *all* income must be distributed to the sole trust beneficiary from the trust each year.

> ESBT: Compared to an ESBT, a QSST generally will carry significant tax disadvantages in light of its inflexibility. There can only be one lifetime QSST beneficiary, which means that the beneficiary's children cannot also be beneficiaries of the same trust (which is not the case with an ESBT.) All the *ordinary* income of a QSST must be distributed to its beneficiary currently, regardless of his or her need. This mandatory distribution obligation then could potentially cause unnecessary: (i) buildup of the QSST's beneficiary's taxable estate, compounded by the value of the QSST's share of the S corporation's undistributed income; (ii) exposure of the compounded value of the QSST's share of the S corporation's undistributed income to potential lawsuits against the QSST beneficiary (unlike an ESBT;) (iv) exposure of the compounded value of the QSST's share of the S corporation's undistributed income to potential marital rights of the QSST beneficiary's former spouse; and (v) finally, full access to the S corporation's undistributed income to an underage, spendthrift, or special-needs QSST beneficiary.

> QSST: The perceived advantages of a QSST over a ESBT are that it may be possible in some situations to cause all the taxable income allocable to an ESBT's interest in the S corporation to be taxed to the trust's beneficiaries by giving the beneficiaries the rights of withdrawal [IRC 678], but that access to trust assets might not be what the settlor wants. Moreover, only the *ordinary* income of the S corporation portion of an ESBT is withdrawable, though, if IRC 678 is used. If a portion of the taxable income of the S corporation is not distributed to the ESBT, e.g., a result of withholding working capital for other needs of the corporation, in effect that withheld income is allocable to trust corpus; if so, then, this retained taxable income of the S corporation will be taxed to the ESBT at the

highest federal income tax rate. If the settlor's family controls the S corporation, one possible workaround to this needed working capital situation would be for the S corporation to first distribute this portion of its *ordinary* income to the ESBT and then have the ESBT trustee voluntarily invest the same distributed amount back into the S corporation.

ESBT: While an ESBT is probably more flexible in responding to the future needs of trust beneficiaries, there are several rules that must be dealt with when the trustee makes that ESBT election.

*Potential Current Trust Beneficiary:* For purposes of qualifying the S corporation in which the ESBT hold stock as a *small business corporation,* each *potential current trust beneficiary* is treated as a shareholder of the S corporation. Thus, in order for the irrevocable trust to be a permitted shareholder of an S corporation, each of its *potential current trust beneficiaries* must also be an *eligible shareholder.*

As is all too typical with the Tax Code, there is then a limited exception to this rule; a nonresident alien is also an eligible beneficiary of an ESBT, but such individual is not treated as shareholder in the determination of whether a corporation is a *small business corporation,* i.e., determining the maximum number of S corporation shareholders. [Regulation 1361(m)(1)(ii) (D) and 1.1361-1(m)(4)(i).]

A *potential current trust beneficiary*, with respect to any period, is any person who at any time during such period is entitled to, or in the discretion of any persons, may receive a distribution of principal or income from the trust. [Regulation 1.1361-1(m)(1)(ii)(B).] Accordingly, an ESBT election is made with a discretionary distribution trust.

Taxation of EBST: The Tax Code provides that in determining the income tax liability of an S corporation shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a trust which terminates before the end of the taxable year) there will be taken into account the shareholder's *pro rata* share of the corporation's (A) items of income, loss, deduction or credit the separate treatment of which could affect the liability for tax of any shareholder; and (B) non-separately computed income or loss. [IRC 1366(a).] However, despite the requirement that an ESBT beneficiary be an *eligible shareholder,* the S corporation pass-through rules are applied not to these beneficiaries but to the ESBT itself. Thus, for purposes of the (i) pass-through of items of S corporation income, loss, deduction, or credit; (ii) the adjustments to basis of shareholder's stock; and (iii) the treatment of distributions by an S corporation, the ESBT itself is treated as a separate taxpayer, not its beneficiaries. [IRC 641(c).] In short, the ESBT's' *pro rata* share of the S corporation's income does not flow-through to the beneficiaries, unlike a QSST elected trust. [IRC 641(c)(2)(C)(i).] Moreover, any gain from the disposition of the S corporation stock is taxable to the ESBT and not its beneficiaries. [ [IRC 641(c)(2)(C)(ii).]

No Distribution Deduction: Most importantly, unlike a QSST, the ESBT is *not entitled to a deduction for distributions to its beneficiaries.* [*IRC 641(c)(3)(B); Regulation 1.641(c)-1(i).*]

Separate Portions: An ESBT will be treated as two (2) separate trusts for purposes of income taxation. [IRC 641(e)(1).] Nonetheless, the ESBT will use a single EIN and it will file one tax return. [Regulation 1.641(c)-1(a).] The portion of an ESBT that consists of stock in one or more S corporations is treated as one portion, (called the *S portion.*) [Regulation 1.641(c)-1(b)(2).] The portion of the ESBT that consists of all other assets held in the trust is treated as a separate trust (the *non-S portion.*) The amount of tax imposed on the *S portion* is determined with some modifications, including: (i) the amount of tax imposed on the ESBT is determined by using the highest rate of tax applicable to individuals with respect to ordinary income or long term capital gain, as the case may be [Regulation 1.641(c)-1(e);] and (ii) the only items taken into account by the S portion are the ESBT's *pro rata* share of the S corporation's income, loss, deduction, or credit, and any gain or loss from the ESBT's disposition of stock in an S corporation. [Regulation 1.642(c)-1(d)(3).] If the ESBT owns stock in more than one S corporation, items of income, loss, deduction or credit from all the S corporations are aggregated for purposes of determining the S portion's taxable income. [Regulation 1.642(c)-1(d)(2)(iii).] The *non-S portion* income is taxed like any other corporation. [More on this aggregation concept below.]

Basis: The adjustments to basis in the S corporation stock of each S corporation must be determined separately with respect to each S corporation. As such, items of income, loss, deduction or credit of an S corporation that are taken into account by the ESBT can only result in an adjustment to the basis of the stock of that S corporation and it cannot affect the income tax basis in the stock held by the ESBT of the other S corporations. Upon the termination or revocation of an ESBT election, if the *S portion* has a net operating loss (NOL), a capital loss carryover, or deductions in excess of gross income, then any such loss, carryover, or excess deductions are allowed as deductions to the trust, or to the beneficiaries who succeed to the trust property of the trust if the entire trust then terminates. Which brings us to a recent Chief Counsel Advice.

Chief Counsel Advice: The unique taxation of ESBTs was in the news recently with a Chief Counsel Advice. That Advice centered on whether the *S portion* of an ESBT may carry to another taxable year a net operating loss (NOL) [meaning that allowable deductions exceeded the S corporation's gross income] that was attributable to the ESBT's *pro rata* share of a business loss incurred by the S corporation of which the ESBT was a shareholder. The S corporation passed this NOL through to its sole shareholder, an ESBT. The ESBT possessed sufficient basis in its stock to fully claim the loss, thus creating an NOL at the trust level. The Chief Counsel considered whether the ESBT could carry its NOL to its next taxable year in which the ESBT could use the NOL against the income of the *S portion* of the trust for that year. The CCA affirmed (eliminating apparently a lot of confusion by tax advisors) that the rules otherwise applicable to trusts apply to determine the extent to which a loss or deduction may be taken into account by the *S portion* of an ESBT. In short, a trust would normally be able to carry over a loss that passed through an S corporation using the appliable NOL rules. Per the Chief Counsel, if an ESBT owned stock in two different S corporations, it would clearly be able to offset flow-through gain from one S corporation with a flow-through loss from the other S corporation because the corporations' separate items of income, gain, loss, deduction or credit are *aggregated* for purposes of determining the *S portion's* taxable income. To summarize, the Chief Counsel stated that if a loss flowing through to the *S portion* of an ESBT under the *S corporation* rules cannot be used in the current taxable year because of the lack of offsetting income, that loss is nonetheless an item 'taken into account' by reason of those rules in a subsequent year, in which it would be deductible under the rules that are appliable to NOLs.

Conclusion: We encounter lots of S corporations in estate plans, primarily family or closely held business interests. If that stock is to be held in an irrevocable trust for tax planning purposes, then there will be the need to elect either QSST or ESBT classification for that trust. Distinguishing between the two classifications is important, both when drafting the trust and when administering the trust to preserve the perceived income tax benefits of an S election for the corporation. Additionally, continuous monitoring of the election made and the complying with the different rules associated with the S election is critical to avoid 'blowing the S election.'