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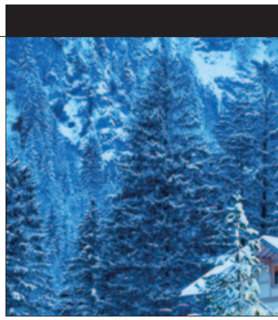

The Electing Small Business Trust—25 Years Later

A reminder of a underutilized planning tool.

JAMES G. BLASE

25 years ago, Section 1361 (e), commonly referred to as the Electing Small Business Trust (ESBT), became law. The provision was initially praised by attorneys and their business owner clients, because it did not include the two major restrictions of the Qualified Subchapter S Trust (QSST), i.e., that the trust could only have one beneficiary, and that all of the income of the trust needed to be distributed currently to the sole beneficiary. At the same time, the ESBT was criticized because all of the trust's income from the S corporation was taxed at the highest federal income tax rate, even if the income was distributed to one or more of the trust's beneficiaries. Further study of the applicable Code provisions and regulations reveals that this criticism of the ESBT may have been unwarranted, however, and that for most business owners the ESBT may actually be the clear choice for holding S corporation interests in trust.

Overview of Tax Treatment of QSSTs and ESBTs

Section 1361(c)(2)(A)(i) provides that a "trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen of the United States" is a permissible shareholder of an S corporation. Section 1361(d)(1)(A) then provides that a QSST with respect to which a beneficiary makes an election is treated as a trust described in (c)(2)(A)(i). Finally, Section 1361(d)(1)(B) provides that, for purposes of Section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the beneficiary makes the election. As the deemed owner of the trust's S corporation's shares, the beneficiary of a QSST is therefore taxed on the entirety of the trust's share of the S corporation's income.

An ESBT is handled differently. With an ESBT, whether and to what extent the beneficiaries of the trust are treated as owners of the trust for purposes of section 678(a) is up to the drafter of the trust. Section 1361(c)(2)(A)(v) provides merely that an ESBT is a permissible shareholder of an S corporation. The ESBT and its beneficiaries are then taxed under Section 641(c) of the Code and the regulations thereunder. Section 1.641(c)-1 of the regulations clarifies that, although in general the ESBT's portion of the income from the S cor-

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poration will be taxed at the highest federal income tax rate, taxation of the trust's beneficiaries under Section 678(a) of the Code takes precedence over this general rule.

Limitations of the QSST

Except in the case of a QSST which is being used in conjunction with a QTIP trust, where only the surviving spouse can be a lifetime beneficiary and all of the trust's income must be distributed to the surviving spouse currently, the significant disadvantages of the QSST in estate planning, when compared to an ESBT, include:

1. There can be only one lifetime beneficiary of a QSST, which is not the case for an ESBT;
2. Unlike an ESBT, all of the ordinary income of the QSST must be distributed to the beneficiary currently, regardless of need, thus causing unnecessary (i) build up of the beneficiary's taxable estate by the compounded value of the QSST's share of the S corporation's distributed income, (ii) exposure of the compounded value of the QSST's share of the S corporation's distributed income to potential lawsuits against the QSST's beneficiary, and (iii) exposure of the compounded value of the QSST's share of the S corporation's distributed income to potential marital rights of the QSST's beneficiary; and
3. Because the clients will most likely not want the income generated by all of their other assets, including IRA and 401k plan benefits, to be automatically distributed to the trust beneficiary, unlike an ESBT two separate trusts (or at least two separate shares of one trust) will normally need to be established for each beneficiary.

The ESBT as an Alternative

In light of the above-described limitations of the QSST when compared to the ESBT, the latter option for holding S corporation interests in trust may need to be explored more than it has been in the past. Judicious use of Section 678 in the drafting of the ESBT, for example, can largely eliminate the relevance of the maximum federal trust income tax rate on the trust's share of the S corporation's income. The ESBT is not taxed to the extent the trust beneficiaries are taxed under Section 678. What is more, utilizing Section 678 of the Code will leave an estate or generation-skipping tax-exempt ESBT unreduced by the annual income taxes which are payable by the trust's beneficiaries, thereby further buttressing the ESBT's significance in estate planning for business owners.

Utilizing Section 678 merely means that the beneficiaries of the ESBT are granted the sole power to withdraw the income of the trust, annually, and are therefore taxed on this trust income, at their own tax rates. The ESBT itself is not taxed on the income of the trust attributable to the S corporation to the extent the beneficiaries are taxed under Section 678. If the ESBT beneficiaries need funds to pay the income tax attributable to their Section 678 withdrawal rights, they need merely exercise their withdrawal power to the extent so necessary. An alternative would be to allow an independent trustee to pay these taxes, either directly or indirectly by reimbursing the beneficiaries.

The beneficiaries' withdrawal rights should be designed to fully or partially (i.e., subject to a "hanging power") lapse at the end

The ESBT itself is not taxed on the income of the trust attributable to the S corporation to the extent the beneficiaries are taxed under Section 678.

of each year, but only to the extent of 5% of the value of the trust each year, per beneficiary, in order to avoid annual taxable gifts by the beneficiaries under Section 2514(e). In most states, and under the Uniform Trust Code, the beneficiaries' annual withdrawal powers (including, presumably, any "hanging power") will not be protected from lawsuits against the beneficiaries, but the lapsed portions of the withdrawal rights generally will be so protected.[1] In the balance of the states which do not protect the lapsed portions of the withdrawal rights from the beneficiaries' creditors the question must be asked: Who is the real "creditor" here, when the alternative to "Section 678 planning" is to either pay the maximum income tax to the IRS on the ESBT's share of the S corporation's income, or suffer all of the above-outlined negative estate tax

1 The American College of Trust & Estate Counsel, or ACTEC, has an excellent discussion of this topic available at https://www.actec.org/assets/1/6/State_creditor_protection_statutes_re_PEG_power_and_Lapses.pdf?hssc=1

2 For more on the technical aspects of utilizing I.R.C. Section 678, including sample forms, see Blase, *6-7-8: Estate Planning with Section 678 of the Internal Revenue Code* (2022).

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and other consequences associated with the QSST, including the full exposure of the distributed income to potential creditors of the beneficiary?[2]

It is doubtful whether the income which the trust beneficiaries do not elect to withdraw from the trust will be considered divisible marital property in most states, not just because it can be argued that it is property received by way of inheritance or gift, but primarily because the property is not actually owned by the beneficiaries, once the power to withdraw the same has lapsed. An ESBT with other beneficiaries (including remainder beneficiaries) does not constitute the beneficiaries' property, marital or nonmarital. Arguably in some states a beneficiary's spouse has the power to force the beneficiary to exercise his or her power of withdrawal over the trust's income, thereby also arguably causing the trust income to become marital property to the extent it is so withdrawn. If the spouse does not exercise this power, however, then he or she has presumably waived the right to argue this "lapsed income" is divisible marital property, assuming the trustee even possessed the fiduciary power to release these funds in the event a beneficiary divorces. Instead, and at best, it would seem the following provision from the Uniform Marital Property Act should apply: "The right to manage and control marital property transferred to a trust is determined by the trust."[3]

3 Uniform Marital Property Act section 5(c).

4 Note that the tax issues here would be compounded if the provisions in the Build Back Better Act, which impose 5% and 8% surtaxes at levels of trust income of as low as $200,000, are passed.

5 See O'Grady and Schooley, "Changing Existing Trusts: The GST Trap," 28 ETPL 11 (November, 2001).

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A Word of Caution

There needs to be one word of caution when applying Section 678 to ESBTs. In certain situations it may be impossible to cause all of the taxable income allocable to the ESBT's interest in the S corporation to be taxed to the trust's beneficiaries under Section 678. By way of background, Section 1.671-2(b) of the regulations provides:

> [W]hen it is stated in the regulations under subpart E that "income" is attributable to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes. When it is intended to emphasize that income for trust accounting purposes (determined in accordance with the provisions set forth in § 1.643(b)-1) is meant, the phrase "ordinary income" is used.

In the case of an ESBT, it is of course impossible for income (including taxable income) not actually distributed by the S corporation to the trust (i.e., in the way of dividends) to be withdrawable by the trust's beneficiaries. Only the ordinary income of the S corporation portion of the ESBT is therefore withdrawable. In this situation Reg. section 1.678(a)-1 refers to Reg. sections "1.671-1 and 1.671-3 for rules for treatment of items of income, deduction, and credit where a person is treated as the owner of... only a portion of a trust."

Reg. section 1.671-3(b)(1) provides that "[o]nly ordinary income is included by reason of an interest in or a power over ordinary income alone. Thus, if a grantor . . . or another person is treated under sections 674-678 as an owner of a portion by reason of a power over ordinary income only, items of income allocable to corpus are not included in that portion."

Based on these regulations, if a portion of the taxable income of the S corporation is not distributed to the ESBT (i.e., as a result of working capital or other needs), and in effect is therefore allocable to trust corpus, this retained taxable income of the S corporation will be taxed to the ESBT at the highest federal income tax rate. If the client's family controls the S corporation, one possible workaround to this situation would be for the S corporation to distribute this income to the ESBT and then have the trustee of the ESBT voluntarily invest the same back into the corporation.

If the client's situation is such that there will be significant annual retained income of the S corporation that cannot be distributed to the ESBT and recontributed to the corporation via a work around, then the QSST may be the preferred estate planning choice over the ESBT, provided the client's family is able to control distributions of the corporation's income to the trust.[4] The reason for this is that only the income which the corporation actually distributes to the trust need be distributed to the trust beneficiary, under the QSST rules and Section 1361(d)(3)(B). The balance can remain in the corporation (and therefore in the protected trust), yet still be taxed to the beneficiary as the Section 678 deemed owner of that portion of the trust which consists of the trust's interest in the corporation.

Existing QSSTs

If a trustee feels that an existing irrevocable QSST would be better structured as a ESBT with Section 678 income withdrawal powers in the beneficiary, the use of a state decanting statute or other form of nonjudicial or judicial modification of the trust, or perhaps even a power granted the trustee in the trust document itself, may be in order. In drafting the decanting or other trust modification documents, the advisor should bear in mind the potential federal estate and gift tax issues involved. If the modification documents are carefully drafted so that the only change relates to the right to withdraw income distributed from the S corporation to the trust (i.e., trust accounting income, within the meaning of Sections 643(b) and 1361(d)(3)(B)), however, it would seem that the income beneficiary has given up nothing, on a current basis, i.e., because he or she has retained the right to withdraw the same trust accounting income distributed by the S corporation to the trust.

Note, however, that when dealing with a trust which is grandfathered from the 1986 generation-skipping transfer tax laws, at least where the modification power is not granted the trustee in the trust document itself, an argument can be fashioned by the Internal Revenue Service that this change constitutes a "substantial modification" of the trust instrument, i.e., because it shifts a beneficial interest in the trust (i.e., the income not withdrawn) down to succeeding generations, and therefore destroys the grandfathered generation-skipping transfer tax-exempt status of the trust.[5]

Finally, the trustee may also desire to change an existing ESBT lacking Section 678 income withdrawal rights to one which does include them, or at least to a QSST. Again, subject to potential transfer tax consequences, this may be possible depending on the particular powers granted the trustee in the trust document or other state trust modification laws. ■