TAXATION

QSSTs vs. ESBTs in Estate Planning

By James G. Blase, CPA, JD, LLM

Twenty-five years ago, Section 1361(e) of the Internal Revenue Code (the Code), commonly referred to as the Electing Small Business Trust, or ESBT, became law. The provision was initially praised by advisers and their business owner clients because it did not include the two major restrictions of the Qualified Subchapter S Trust (QSST), which Congress had passed 15 years earlier. Those two primary restrictions of the QSST were that the trust could only have one beneficiary, and that all of the ordinary income of the trust needed to be distributed currently to the sole beneficiary. This article compares the relative advantages and disadvantages of the QSST versus ESBT in estate planning.

Tax Treatment of QSSTs and ESBTs

Section 1361(c)(2)(A)(i) of the Code 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, regardless of whether the income is distributed to the trust.

An ESBT is handled differently under the Code. With an ESBT, whether and to what extent the beneficiaries of the trust are treated as owners of the trust's share of the corporation's stock 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 S corporation's income 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.

Advantages of an ESBT over a QSST

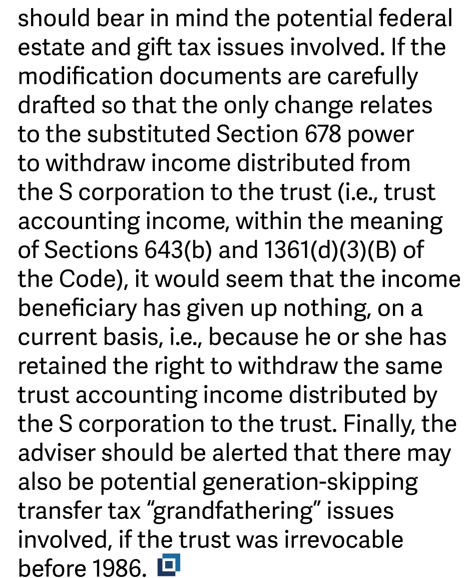
The advantages of an ESBT in estate planning, when compared to a QSST, include:

- There can be only one lifetime beneficiary of a QSST, meaning that the beneficiary's children cannot also be beneficiaries of the trust, which is not the case for an ESBT;
- Unlike an ESBT, all of the ordinary income of the QSST must be distributed to the beneficiary currently, regardless of need, thus causing potentially 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, (iii) exposure of the compounded value of the QSST's share of the S corporation's distributed income to potential marital rights of a divorced spouse of the QSST's beneficiary, and (iv) full access to the QSST's share of the S corporation's distributed income to underaged and spendthrift beneficiaries.
- 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.

In light of the 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 Code 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. Utilizing Code Section 678 merely means that the beneficiaries of the ESBT are granted the sole power to withdraw the income of the S corporation, which is distributed to the trust, annually, and are therefore taxed on this trust income, at their own tax rates, regardless of whether they actually withdraw the same. 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.

Each of the beneficiaries' withdrawal rights should be designed to fully or partially lapse at the end of each year, but only to the extent of 5 percent of the value of the trust each year, in order to avoid annual taxable gifts by the beneficiaries under IRC Section 2514(e). In most states, including Missouri, the beneficiaries' annual withdrawal powers will not be protected from lawsuits against the beneficiaries, but the lapsed portions of the withdrawal rights will be so protected.[1]

It is doubtful whether the income that the trust beneficiaries do not elect to withdraw from the trust will be considered divisible marital property, 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. 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."[2]



Advantages of a QSST over an ESBT

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. 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.

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 first distribute this portion of the 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 workaround, 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.[3] The reason for this is that only the income that the corporation actually distributes to the trust need be distributed to the trust beneficiary, under the QSST rules and Section 1361(d)(3)(B) of the Code. 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.

The problem, of course, is that in many family situations there will be family members who are actively involved in the business (and who can therefore benefit from salaries and bonuses) and family members who are not so involved. All or some of the latter family members may want the corporation to distribute as much income as possible to their trust(s), in the way of dividends. Because these dividend distributions must be made proportionately to all of the corporation's shareholders, the QSST may then have the effect of "overfunding" the shares of the family member beneficiaries who are actively involved in the business as well as the shares of other family member beneficiaries who do not need more current income, with income which must then be distributed to them outright.

Modification of Existing QSSTs and ESBTs

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, or that an existing ESBT lacking Section 678 withdrawal rights should be modified to include the same, utilization 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. Note, however, that under an overly narrow reading of the Internal Revenue Code and regulations, some state decanting statutes, including Missouri's, may appear at first blush to restrict the decanting of a QSST to anything other than another QSST. In most cases, however, a closer examination of the state decanting statute restrictions, when compared to the terms of the intended new (decanting) trust, will reveal that this form of decanting is, in fact, permitted.

In drafting the decanting or other trust modification documents, the adviser 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 substituted Section 678 power 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) of the Code), 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. Finally, the adviser should be alerted that there may also be potential generation-skipping transfer tax "grandfathering" issues involved, if the trust was irrevocable before 1986.

James Blase is a principal with Blase & Associates, LLC in Chesterfield, Mo.

jimblase@blaselaw.com

linkedin.com/in/jim-blase-606a5213/

1. For more information on the technical aspects of utilizing IRC Section 678, including sample forms, see J. Blase, *6-7-8: Estate Planning with Section 678 of the Internal Revenue Code* (2022).
2. Uniform Marital Property Act Section 5(c).
3. Note that the tax issues here would be compounded if the provisions in the Build Back Better Act, which impose 5 percent and 8 percent surtaxes at levels of trust income of as low as $200,000, are passed.