Trust Planning after the Tax Cuts and Jobs Act [1] – Part 1

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Electing Small Business Trusts ("ESBTs")

While LLCs taxed as partnerships have been the default choice of entity for most businesses for decades, there remain millions of S corporations owned by individuals. Thus, estate planning frequently (and in the view of the authors almost always) results in assets, including S corporation shares, being held in trust.

Nevertheless, only certain specific types of trusts may hold S corporation stock long term: grantor trusts with respect to individual US taxpayers (which may be used less frequently after the Act), qualified subchapter S trusts ("QSSTs"), and electing small business trusts ("ESBTs"). IRC (the "Code") Sec. 1361(c)(2)(A). In addition, some, but not all, tax-exempt entities may be shareholders of S corporations. IRC Sec. 1361(c)(2)(6).

1 When the Bill was in the Senate, the name "Tax Cuts and Jobs Act" was removed to satisfy the procedural rule (the so-called Byrd Rule) for budget reconciliation, but the new tax Act is sometimes being referred to by its former name. Herein, the new tax Act is referred to simply as the "Act."

InterActive Legal

Practitioners should become familiar with the intricate planning opportunities afforded under the Act in order to determine how and whether to employ ESBTs as part of an overall wealth transfer strategy. The Act raises important considerations, as follows:

- Lowered maximum individual tax rates to 37%. (Act section 11001.)
- Possible application of the "pass-thru" deduction for qualified business income (Act section 11011: new section 199A of the Code).
- Considerations of possibly forfeiting S corporation status to take advantage of the lower 21 percent corporate tax rates. (Act section 13001.)
- New bonus depreciation and larger section 179 expensing deductions which may flow through to the S shareholders, including an ESBT. (Act sections 13101, 13201.)
- Limitations on the deductibility of state and local taxes ("SALT") by individuals and trusts which may prompt the review of the situs of some ESBTs and the possible move to a state with lower tax burdens. (Act section 11042.)

Unlike many of the provisions set forth in the Act, the changes relating to the ESBT are made permanent.

ESBT Taxation Post-Act

The portion of a trust owning stock of an S corporation with a valid ESBT election is treated as a separate trust while the other assets are treated as though held by a separate trust, which could be treated as a simple or complex for income tax purposes. The ESBT is generally taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers.

The Act has reduced that maximum rate to 37%, although the net investment income tax of 3.8% under Act section 1411 may also apply. In addition, if the new pass-through deduction rules under section 199A apply, the S corporation income may be eligible for an additional deduction of up to 20%, thereby lowering the effective rate of tax.

Though distributions from a complex or simple trust would ordinarily pull out income to the recipient beneficiary, an ESBT's net income (whether distributed by the ESBT or not) is not taxed to the beneficiaries of the ESBT. A beneficiary of a trust with an ESBT portion would only be taxed on the distributable net income (DNI) under Code section 643(a) from the non-ESTB portion of the trust, if any. See Treas. Reg sec. 1.641(c)-1(i).

ESBT Beneficiaries

Generally, the eligible beneficiaries of an ESBT include individuals, estates, and certain charitable organizations eligible to hold S corporation stock directly. A nonresident alien individual may not be a shareholder of an S corporation and may not be a potential current beneficiary of an ESBT. Code sections 1361(b)(1)(C) and (c)(2)(B)(v). The Act expands the list of permissible beneficiaries of an ESBT to allow a nonresident alien individual to be a potential current beneficiary of an ESBT. Code section 1361 as modified by Act section 13541. A nonresident alien still is not an eligible shareholder of an S corporation.

Planning Consideration: If steps had been taken to exclude a non-resident alien from inadvertently becoming a beneficiary of an ESBT, this may now be reversed to permit such participation.

Charitable contribution deduction for ESBT

An S corporation reports to each of its shareholders each's pro rata shares of certain separately stated items of income, loss, deduction, and credit. For this purpose, charitable contributions (as defined in Code section 170(c)) of an S corporation are separately stated. The deductibility of a charitable contribution passing through from an S corporation depends on the shareholder.

Planning point: An S corporation may only make deductible contributions if the governing instruments of the S corporation permits the Board of Directors to make charitable gifts.

Under prior law, the deduction for charitable contributions applicable to trusts, rather than the deduction applicable to individuals, had applied to ESBTs. Generally, a trust is allowed a charitable contribution deduction without limitation for amounts of gross income which are paid for a charitable purpose, pursuant to the terms of the governing instrument. See Code section 642(c). No carryover of excess contributions is allowed.

The Act changes the charitable contribution deduction of an ESBT and provides that the rules under section 170 applicable to individuals should control the deductibility of charitable contributions attributable to the ESBT. Thus, the percentage of contribution base limitations and carryforward provisions applicable to individuals apply to charitable contributions deemed made by the portion of an ESBT holding S corporation stock.

Further, the ESBT should be able to deduct the fair market value of long-term capital gain property gifted in-kind to charity, subject to applicable percentage limitations. The substantiation rules of section 170 would seem to apply, although those rules do not generally apply to trusts. Code Sec. 642(c) as modified by Sec. 13542 of the Act.

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