

**AMERICAN BAR ASSOCIATION**

**SECTION OF TAXATION**

**REPORT TO THE HOUSE OF DELEGATES**

**RECOMMENDATION**

- 1 **RESOLVED**, that the American Bar Association recommends that Section 1361(e)(2)
- 2 of the Internal Revenue Code of 1986, which defines the term “potential current
- 3 beneficiary”, be amended by inserting "(determined without regard to any unexercised, in
- 4 whole or in part, power of appointment during such period)" after the phrase "of the trust"
- 5 in the first sentence.

## REPORT

### Definition of Electing Small Business Trust: In General

Prior to the enactment of the Small Business Job Protection Act of 1996, Pub. L. No. 104-188 (SBJPA), a discretionary or accumulation trust, which did not meet the definition of a grantor trust,<sup>1</sup> generally could not own shares of stock in an S corporation.<sup>2</sup> A trust permitted to hold S stock instead had to be either a grantor trust or a qualified Subchapter S trust or QSST.<sup>3</sup> Since an accumulation trust is commonly used in funding multi-generational bequests, this long-standing limitation in Subchapter S impeded the estate planning objectives of many owners of small business corporations. As a consequence, prior to 1997, the estate plan for a shareholder of an S corporation frequently involved a separate plan for the S stock and another plan for handling the individual's other assets. After nearly 40 years of this restriction on the use of S corporations, Congress finally responded by permitting the use of an accumulation trust to own S stock provided it satisfied certain requirements.<sup>4</sup>

Section 1302 of the SBJPA added the "electing small business trust" (ESBT) to the list of permitted shareholders of an S corporation. I.R.C. §1361(c)(2)(A)(v). Pub. L. No. 104-188.<sup>5</sup> The ESBT, is required to pay federal income tax with respect to its pro rata share of income which is passed through from S corporation operations or as a result of a taxable dividend or similar taxable distribution.<sup>6</sup> Special rules pertaining to the taxation of an ESBT and its beneficiaries are contained in Section 641(c).<sup>7</sup>

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<sup>1</sup> See I.R.C. §§671-679, et. seq.

<sup>2</sup> Exception was provided for certain revocable trusts for a period of time after the grantor's death, or a testamentary trust, again for a limited period of time. I.R.C. §§1361(c)(2)(A)(ii) and (iii). Voting trusts created "primarily" to exercise stock voting power may also own stock in an S corporation. I.R.C. § 1361(c)(2)(A)(iv).

<sup>3</sup> I.R.C. §1361(d). In contrast with the ESBT, a qualified Subchapter S trust or QSST may only have a single income beneficiary. Among the requirements of a QSST are that it may only have one income beneficiary and all the fiduciary accounting income of the trust must be distributed (or is required to be distributed under the trust instrument) each year. Distributions of principal may only be made on behalf of the income beneficiary. The QSST's income beneficiary is treated as the shareholder of the S stock for purposes of the flow-through rules under Subchapter S. Treas. Reg. §§1.1361-1(j)(7), -1(j)(8). The QSST provisions were enacted in 1982 as part of the Subchapter S Revision Act. Pub. L. No. 97-354, §2 (10/19/82).

<sup>4</sup> In addition to the enactment of the electing small business trust provision, Congress, in 1996, extended the applicable 60 day rule to two years for ownership of S stock (1) upon the death of the grantor of a grantor trust even if the assets of the trust were not includable in the grantor's gross estate, and (2) for a testamentary trust.

<sup>5</sup> Final regulations to the ESBT provisions were issued by the Treasury in May, 2002. TD 8994.

<sup>6</sup> See I.R.C. §§ 1368(b)(2), 1368(c)(2), 1368(c)(3).

<sup>7</sup> The portion of an ESBT that consists of stock in one or more S corporations is treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. The

An ESBT is defined in Section 1361(e)(1)(A) as a domestic trust<sup>8</sup> that does not have as a beneficiary any person other than: (1) an individual; (2) an estate; (3) a charitable organization described in paragraphs (2), (3), (4) or (5) of Section 170(c); or (4) a governmental entity described in Section 170(c)(1) so long as it is a contingent remainder beneficiary and not a potential current beneficiary. The statutory definition further requires that no interest in the trust be acquired by purchase, and an election is made with respect to such trust.<sup>9</sup>

## **Distinction Between the Terms “Beneficiary” and “Potential Current Beneficiary”**

### **“Beneficiary” of an ESBT**

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trust is taxed at the highest individual rate on this portion of the trust's income, although the preferential rate for long-term capital gains also applies. For AMT purposes, the ESBT's exemption is zero. I.R.C. §§ 55(d)(1)(D), 55(d)(3)(C).

Treas. Reg. §1.641(c)-1(a) segregates the ESBT into separate trusts for federal income tax purposes, i.e., the S portion and the non-S portion, even though the ESBT is a single trust for tax administration purposes. The taxable income attributable to the S portion of the trust includes: (1) the items of income, loss, or deduction allocated to it as an S corporation shareholder under the rules of Subchapter S; (2) gain or loss from the sale of the S corporation stock; (3) to the extent provided in regulations, any state or local income taxes and administrative expenses of the trust properly allocable to the S corporation stock. Capital losses of the S portion are allowed only to the extent of capital gains. Furthermore, in computing the trust's income tax on the S portion of the trust, no deduction is allowed for amounts distributed to beneficiaries, who are entitled to receive distributions sourced or allocable from such portion as nontaxable, and no deduction or credit is allowed for any item other than the items described above. Treas. Reg. §1.641(c)-1(i).

Subject to the rules described below, where the grantor or other person is not treated as an owner under Subpart E, as to the non-S stock portion of an ESBT, the general rules of Subchapter J control, including the distribution deduction provision. The non-S portion is allocated all tax items realized by the trust other than those attributable to the S stock. Under I.R.C. §§651(a) or 661(a), distributions sourced from the trust's distributable net income allocable to the non-S portion will be taxable to a beneficiary/recipient. When the trust ceases to be an ESBT (e.g., it sells all of its S stock), any unused loss and deduction carryovers attributable to the S stock will be allowed to the rest of the trust, in the same manner that such carryovers are allowed by §641(c)(4) to trust remainder beneficiaries on termination of the trust.

Where the grantor or other person is treated as an owner under Subpart E, Treas. Reg. §1.641(c)-1(a) provides that such person (or persons) is treated as the owner of all or a portion of either or both of the portion of the trust which holds S stock and the other portion that holds all other assets of the trust. This is referred to as the “grantor portion”. Treas. Reg. §1.641(c)-1(b)(1). Thus, for example, the holder of a Crummey power in many instances will be a deemed owner of a portion of an ESBT. I.R.C. §678. Accordingly, many ESBTs will have multiple owners of the grantor portion. Unfortunately, the appropriate method to segregate the tax items of the S portion, non-S portion and multiple grantor portions of an ESBT where there are multiple grantor portions of an ESBT, e.g., presence of one or more Crummey power holders, is a subject fraught with complexity and obscurity until and unless the Service provides detailed guidance.

<sup>8</sup> A trust is ineligible to make an ESBT election where it is a QSST, a tax-exempt trust, or a charitable remainder trust described in §664. I.R.C. §1361(e)(1)(B). Although a charitable remainder trust cannot be an ESBT, a charitable lead trust may qualify. See PLR 199908002 (3/01/99).

<sup>9</sup> I.R.C. §1361(e)(3). An ESBT election is made by the trustee. Once made, it is irrevocable unless the IRS grants consent to the termination.

For purposes of Section 1361(e)(1)(A)(i), the Regulations define a “beneficiary” of an ESBT, in general, as any person who has a present, remainder, or reversionary interest in the trust.<sup>10</sup> Thus, for example, a non-resident alien individual, who is otherwise not permitted to own stock in an S corporation, may be a remainderman in an ESBT. The Regulations allow distributee trusts, which are frequently used in drafting multi-generational, family trusts, i.e., to provide for minors or after-borns, to be ignored in testing for who is a beneficiary of an ESBT. The Regulations look through the distributee trust and test the designated beneficiaries for eligibility purposes. Thus, as long as the beneficiaries of the distributee trust are described in Section 1361(e)(1)(A)(i), such persons are eligible beneficiaries of an ESBT.<sup>11</sup> Distributee trusts must also be tested under the potential current beneficiary provision.<sup>12</sup>

With respect to powers of appointment, a potential appointee is not treated as a beneficiary until the power is actually exercised in that person's favor.<sup>13</sup>

### **“Potential Current Beneficiary” of an ESBT**

Under Section 1361(c)(2)(B)(v), each “potential current beneficiary” of an ESBT is treated as a shareholder, and for any period where there is no potential current beneficiary of such trust, the trust is treated as the shareholder. Accordingly, each potential current beneficiary must be eligible to own stock in an S corporation and each potential current beneficiary is counted as one shareholder in applying the 75 shareholder limitation.<sup>14</sup>

The statute defines the term “potential current beneficiary” as, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. Thus, for example, where a nonresident alien individual or an organization exempt from tax under Section 170(c)(1) may currently receive a distribution from the trust under a sprinkle power held by the trustee, the trust

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<sup>10</sup> Treas. Reg. §1.1361-1(m)(1)(ii)(A).

<sup>11</sup> Treas. Reg. § 1.1361-1(m)(1)(ii)(B). Actually, the Service published earlier guidance applying the same concept to allow distributee trusts. Notice 97-49, 1997-2 CB 304.

<sup>12</sup> See Treas. Reg. §1.1361-1(m)(4)(iv)(under the potential current beneficiary rule, a distributee trust in existence must be a qualified trust under §1362(c)(2)(A) were it to own the S stock directly, and, if so, then the persons who would be the potential current beneficiaries of such trust if it were an ESBT, or QSST or eligible grantor or testamentary trust).

<sup>13</sup> Treas. Reg. §1.1361-1(m)(1)(ii)(C)

<sup>14</sup> I.R.C. §§1361(b)(1)(A), 1361(b)(1)(C).

May not make an ESBT election, or if already made, the trust will lose its ESBT status. A loss of ESBT status will immediately jeopardize the corporation's S election.<sup>15</sup>

With respect to powers of appointment, any person to whom property could potentially be appointed pursuant to the present exercise of a power of appointment is treated as a potential current beneficiary.<sup>16</sup> Where some or all of the named beneficiaries of a family trust are also potential current beneficiaries, e.g., the group or class of current income beneficiaries subject to a spray or sprinkle power, the ability to stay within the boundaries of the ESBT rules is straightforward and predictable. The trust will qualify as an ESBT and the S corporation or corporations in which it owns stock will remain eligible small business corporations provided each current income beneficiary would otherwise be permitted to own S stock and the total number of potential current beneficiaries and other shareholders of the corporation does not exceed the present limitation of 75 shareholders. Where a presently exercisable power of appointment is broadly defined in the trust instrument so it could be exercised in favor of any number of appointees, or to any single appointee who is ineligible to own S stock, the trust will violate the ESBT rules regardless of whether the power is exercised, or, if exercised, would not have otherwise resulted in the presence of one or more ineligible shareholders or violate the number of permitted shareholders rule. This is the rule that the recommendation would change.

In applying the ESBT qualification rules, it is critical to distinguish between a power of appointment, either a general power or a special power exercisable in favor of a class, from a simple power of withdrawal. With respect to the holder of a general power, for example, such person can cause the income or corpus of the trust to be distributed to himself or his creditors or his estate or the creditors of his estate. A holder of a "5/5" or Crummey power is viewed under the Regulations as being able to cause a distribution to be made from the trustee only to himself and results in only a single potential current beneficiary to be considered for ESBT purposes. While it is possible that the Treasury could have treated the two types of powers alike under the potential current beneficiary rule, a Crummey power holder is simply viewed as only having the power to withdraw for himself, even if such person could direct the trustee to transfer trust funds pursuant to the exercise of the withdrawal right to a non-resident alien or to any number of individuals that could possibly cause the S corporation to have more than 75 shareholders.<sup>17</sup>

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<sup>15</sup> Treas. Reg. §1.1361-1(m)(5)(iii). When an ESBT acquires an ineligible potential current beneficiary the law permits the trust to avoid a termination of the corporation's S election provided it disposes of all of the stock, which it holds in a S corporation within 60 days of such disqualifying event. I.R.C. §1361(e)(2).

<sup>16</sup> Treas. Reg. §1.1361-1(m)(4)(vi). The same rule was contained in the earlier proposed regulations. Where the power of appointment is not currently exercisable, the class of potential appointees are neither beneficiaries nor potential current beneficiaries for ESBT purposes. A non-currently exercisable power of appointment would include, for example, a general testamentary power of appointment held by an individual.

<sup>17</sup> While there may be state law differences between a power to withdraw contributions only for oneself and a power of appointment, the tax differences outside of the ESBT rules are harder to identify. See I.R.C. §§2514, 2041 and 678. See also Treas. Reg. §25.2514-1(b)(i). The presence of one or more Crummey power holders will, however, result in substantial complexity in properly reporting the income of the ESBT for federal income tax purposes. See note 7, *supra*.

Many trusts in existence as of January 1, 1997, the effective date of the ESBT provision, violated the power of appointment rule as applied to potential current beneficiaries. This substantial qualification problem had previously been brought to the Service's attention in formulating its rulemaking projects under ESBT. Nevertheless, the Final Regulations continued to take a hard line, presumably on the basis that the statutory language defining the term "potential current beneficiary" did not allow for a more liberal interpretation. Some commentators had advanced the position that the trustee could limit the scope to only the actual exercise of a power by temporarily waiving, limiting or releasing a power of appointment should be tested under the potential current beneficiary rule. Others suggested that the trustees, by appropriate resolution or trust amendment, could circumscribe the exercise of the power for a limited period in order to meet the ESBT requirements. Although the Final Regulations ignored or rejected such alternatives, they did, however, effectively permit a trust to seek retroactive reformation of its governing instrument to conform with Section 1362 provided such reformation occurred for a tax year beginning before May 14, 2002<sup>18</sup>.

While some trusts may have obtained such relief by timely instituting reformation proceedings, others may either have not qualified under the extended effective date rule or trust advisors may simply have overlooked this problem with the statute and interpretative regulations. For trusts established after the effective date of the Regulations, the rule still poses a trap for the unwary, inflicts a tremendous cost for a violation, i.e., loss of the corporation's Subchapter S election, and, in general, may easily thwart the estate planning objectives for employing accumulation trusts to hold S stock.

### **Need For Legislative Amendment**

In summary, a presently exercisable power to appoint to an overly broad class will cause the ESBT's election to terminate, which in turn will terminate the S election of each corporation in which it holds stock—even if the power is allowed to lapse or if an actual limited exercise of the power would not otherwise cause a termination of the ESBT election. While Congress, in enacting the ESBT provisions intended that the term "potential current beneficiary" be broadly defined, it is arguable that it did not intend that powers of appointment could nullify not only qualification as an ESBT but also disqualify the S corporation's election.

While various commentators, including individual members of the Committees on S Corporations and Fiduciary Income Tax, had submitted comments and engaged in informal discussions with the National Office of the IRS and Treasury during the rulemaking process exposing the problem with powers of appointment, the response given was that the language in

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<sup>18</sup> See Treas. Reg. §1.1361-1(m)(4)(vi)(B). The Regulation notes the Treasury's rejection of the possibility of limiting the class of potential appointees by special amendment to the trust, providing that any "attempt to temporarily waive, release, or limit a currently exercisable power of appointment will be ignored" in determining who are the potential current beneficiaries. Nevertheless, the same Regulation respects a permanent release of the power that is valid under local law in limiting the set of potential current beneficiaries after the effective date of the release. The other possible solution currently available is the trust's disgorgement of all of its S stock within 60 days of the disqualifying event.

the statute did not allow for an “actual exercise” approach for testing currently exercisable powers of appointment.

It is noted that Section 305 of the Subchapter S Modernization Act of 2003, H.R. 1896, which addresses this problem and provides, in effect, the same legislative solution as that proposed herein by testing currently exercisable powers of appointment only upon the actual exercise of the power and not with respect to its potential exercise.<sup>19</sup> The Section of Taxation has further just submitted its Comments to the House Subcommittee on Select Revenue Measures of the House Ways and Means Committee endorsing the set of proposals contained in H.R. 1896, including the amendment set forth herein.

### **Description of Legislative Amendment**

The legislative recommendation is that potential appointees or discretionary distributees are not considered “potential current beneficiaries” until the presently exercisable power is actually exercised. This is accomplished by amending the first sentence in Section 1361(e)(2) in defining a potential current beneficiary as “ with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust, ‘(determined without regard to any unexercised, in whole or in part, power of appointment during such period)’”. Again, the recommendation made by the Fiduciary Income Tax and S Corporations Committees is the same as that contained in the Subchapter S Modernization Act of 2003 and prior versions of the same set of reforms.<sup>20</sup>

The recommendation would remove a major problem that presently exists in qualifying an accumulation trust as an ESBT and, in turn, a termination of S status for the corporations in which an accumulation trust owns S stock. It would further place owners of S corporation stock on a level playing field with owners in entities treated as partnerships for federal income tax purposes since accumulation trusts do not face any eligibility constraints in holding interests in partnerships or limited liability companies.

Richard A. Shaw, January 2004

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<sup>19</sup> This recommendation was previously contained in H.R. 2576, and S. 1201 In the 107th Congress, Sen. Hatch introduced the Subchapter S Modernization Act of 2001 in the Senate (S. 1201), while Rep. Shaw introduced a companion bill in the House of Representatives. Rep. Shaw, as well as Reps. Matsui, McInnis and Jones, are original co-sponsors of H.R. 1896.

<sup>20</sup> The Subchapter S Modernization Act would further amend the second sentence in I.R.C. §1361(e)(2) by permitting a one-year grace period for an ESBT to dispose of its S stock upon having a potential current beneficiary who is not eligible to own S stock instead of the current grace period of 60 days. This change is also reflected in Act §305.

## GENERAL INFORMATION FORM

Submitting Entity: Section of Taxation

Submitted By: Richard A. Shaw

### 1. Summary of Recommendation

That Section 1361(e)(2) of the Internal Revenue Code of 1986, which defines the term “potential current beneficiary”, be amended by inserting “(determined without regard to any unexercised, in whole or in part, power of appointment during such period)” after the phrase “of the trust” in the first sentence.

### 2. Approval by Submitting Entity

The Recommendation was approved by the Council of the Section of Taxation on Saturday, August 9, 2003 and will be approved by the Section of Taxation at its January 29-31, 2004 Midyear Meeting and is submitted contingent on that approval.

### 3. Has this or a similar recommendation been submitted to the House or Board previously?

No.

### 4. What existing Association policies are relevant to this recommendation and how would they be affected by its adoption?

None.

### 5. What urgency exists which requires action at this meeting of the House?

Congress’s intent to allow most common types of trusts to hold S Corporation stock under the Small Business Job Protection Act of 1996 is defeated by the language of Section 1361(e)(2), which gives the Treasury and IRS no flexibility to draft regulations that practically effectuate that intent. Because scores of trusts contain broad powers of appointment for estate planning purposes and many of these trusts are incapable of judicial reformation or reformation is impractical, the trusts are chilled from holding the S Corporation stock under current law.

### 6. Status of Legislation

This recommendation is the same that was submitted on July 1, 2003 to the House Subcommittee on Select Revenue Measures of the House Ways and Means Committee

endorsing the identical legislative solution addressed in Section 305 of the Subchapter S Modernization Act of 2003, H.R. 1896. This legislation remains with the House Ways and Means Committee.

7. Cost to the Association.

None.

8. Disclosure of Interest.

No member of the originating Committee or the Council of the Section of Taxation is known to have a material interest in the resolution by virtue of a specific employment or engagement to obtain the results of the resolution.

9. Referrals.

All sections and divisions.

10. Contact Persons

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11. Contact persons (who will present to the House)

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12. Contact person regarding amendments to this recommendation.

No amendments have been received, but if any are submitted, the persons listed in paragraph 11 are the contact persons.

## **EXECUTIVE SUMMARY**

**a) Summary of the recommendation**

That Section 1361(e)(2) of the Internal Revenue Code of 1986, which defines the term “potential current beneficiary”, be amended by inserting “(determined without regard to any unexercised, in whole or in part, power of appointment during such period)” after the phrase “of the trust” in the first sentence.

**b) Summary of the issue which the recommendation addresses**

Originally, only trusts owned by the grantor (typically a revocable trust) could hold S stock. Through a series of statutory amendments, most common types of trusts are now eligible. To permit trusts designed to span multi-generations as well as to include charities as potential beneficiaries, the Small Business Job Protection Act of 1996 (SBJPA) provided that an electing small business trust (ESBT) could hold S stock. When final regulations were issued in May, 2002, it was apparent that a perceived flaw in the statute would frustrate the Congressional intent with respect to future trusts and prevent many existing trusts from qualifying. The problem relates to the application of the power of appointment rule in determining who are the “potential current beneficiaries” of the ESBT. This rule, which is presently contained in section 1361(e)(2), has the effect of preventing many existing trusts from meeting the ESBT requirements and further represents a trap for the unwary draftspersons of newly organized trusts.

**c) Explanation of how the proposed policy position will address the issue**

The amendment removes this present impediment to the ESBT rules by testing whether a particular appointee under a power of appointment is eligible to own S stock until actual exercise. It removes an impediment to ownership of S stock compared with ownership of interests in a family limited partnership or limited liability company. This amendment will further simplify the drafting of trusts designed to take advantage of the unified gift and estate tax credit. With recent increases in the unified credit, such trusts are now part of the estate plan in most substantial estates.

The amendment reflects the identical recommendation, which was just submitted by the Section of Taxation on July 1, 2003 to the House Subcommittee on Select Revenue Measures of the House Ways and Means Committee on the subject of The Subchapter S Modernization Act of 2003, H.R. 1896.

**d) Summary of any minority views or opposition, which have been identified**

No minority views were expressed.