

New Interest Deduction for Electing Small-Business Trusts

By Marc J. Gerson

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Introduction

On May 25, 2007, President Bush signed into law H.R. 2206, the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007.¹ The legislation included the Small Business and Work Opportunity Act of 2007, which included a package of small-business tax incentives aimed at providing relief to taxpayers negatively affected by an increase in the federal minimum wage, which was also included in the legislation. The package included a series of subchapter S corporation reform provisions, including one provision of particular importance to electing small-business trusts (ESBTs) that finance the purchase of S corporation stock.

Electing Small-Business Trusts

Before the enactment of the Small Business and Job Protection Act of 1996, S corporation shareholders were limited in their ability to engage in basic estate tax planning because of the limited types of trusts that could hold S corporation stock — essentially grantor trusts and qualified subchapter S trusts.² QSSTs, however, may have only one income beneficiary and are required to distribute their income on a current basis.³ In light of those limitations, Congress recognized the need for a more flexible vehicle for estate tax planning purposes:

The Congress believed that a trust that provides for income to be distributed to (or accumulated for) a class of individuals should be allowed to hold S corporation stock. This would allow an individual to establish a trust to hold S corporation stock and "spray" income among family members (or others) who are beneficiaries of the trust. The Congress

believed allowing such an arrangement will facilitate family financial planning.⁴

In light of those concerns, Congress created ESBTs as eligible S corporation shareholders.⁵ In contrast with a QSST, an ESBT can have multiple beneficiaries and trust income can be accumulated (that is, an ESBT is not required to distribute its income currently).

Taxation of ESBTs

To qualify as an ESBT, all beneficiaries of the trust must be individuals or estates eligible to be S corporation shareholders (or specified charitable organizations).⁶ No interest in the trust may be acquired by purchase (that is, it must be acquired by gift or bequest).⁷ Also, a trust must make an election to qualify as an ESBT.⁸

To maintain simplicity, an ESBT is premised on taxing the S corporation income at the trust level — applying the highest individual rates.⁹ To allow normal trust taxation rules to apply to the portion of the trust not holding S corporation stock, Congress divided the trust into an S portion and a non-S portion, treating them as separate trusts. The statute specifies that the only items of income and expense that fall into the S portion of the trust are the items of income, loss, or deduction allocated to it as an S corporation shareholder under the subchapter S rules (that is, the items on the S corporation's Schedule K-1); any gain or loss from the sale of S corporation stock; and to the extent provided in regulations, any state or local income taxes and administrative expenses of the ESBT to the extent allocable to the first two items.¹⁰ Under that statutory regime, however, interest paid by an ESBT to finance the purchase of S corporation stock was not deductible unless it would be considered an "administrative expense" under regulations.¹¹

⁴Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in the 104th Congress" (JCS-12-96) 113 (1996). See also H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 218-220 (1996); S. Rep. No. 281, 104th Cong., 2d Sess. 46-48 (1996); H.R. Rep. No. 586, 104th Cong., 2d Sess. 82-84 (1996).

⁵Section 1361(c)(2)(A)(v), enacted by P.L. 104-188, section 1302 (1996). See Corneel, "The Electing Small Business Trust: Subchapter S's User-Friendly Estate Planning Tool," 86 *J. of Tax'n* 215 (1997); Corneel, "Estate Planning for S Corporations Using Electing Small Business Trusts — Better Than Ever," 88 *J. of Tax'n* 22 (1998). See also reg. sections 1.1361-1(h)(1)(vi), -1(m).

⁶Section 1361(e)(1); reg. section 1.1361-1(m)(1)(i).

⁷*Id.*

⁸*Id.*

⁹Section 641(c).

¹⁰Section 641(c)(2)(C).

¹¹The ability to use an ESBT as an estate planning tool is largely dependent on the deductibility of such interest expense. In this regard, an ESBT could be established to enable a younger

(Footnote continued on next page.)

¹P.L. 110-28 (2007).

²Section 1361(c)(2)(A).

³Section 1361(d)(3). See also reg. section 1.1361-1(j).

TAX PRACTICE

Regulatory History

On enactment of the ESBT provisions, commentators explained to Treasury that, consistent with the ESBT goal of facilitating estate tax planning, regulations should clarify that the division of an ESBT into an S portion and a non-S portion should not result in the loss of an otherwise available tax deduction for interest expense incurred to purchase S corporation stock.¹² Commentators noted that the separation of the ESBT into an S portion and non-S portion merely facilitated the ability to tax S corporation income currently at the trust level and should not have created a substantive change in the ability to deduct interest expense.

Despite that commentary, the IRS proposed ESBT regulations in 2000 providing that interest paid by an ESBT to acquire S corporation stock was not deductible because the interest was allocable to the S portion of the trust, and because the interest was not an "administrative expense" or otherwise within the limited categories of deductions allowable to the S portion of the trust.¹³ The regulations were widely criticized by commentators as unfairly denying a deduction otherwise available to taxpayers and being inconsistent with the congressional intent in enacting the ESBT legislation.¹⁴ Commentators noted that the regulations placed ESBTs at a disadvantage relative to all other taxpayers regarding the deductibility of interest incurred to purchase S corporation stock. Moreover, a denial of the interest expense was especially harsh in light of the fact that any such interest would be included in the gross income of the payee, who would generally be a related taxpayer in light of the intended use of ESBTs for estate tax planning purposes.¹⁵

generation to purchase the stock of a family-owned S corporation stock from a more senior generation. If the resulting interest expense were not deductible, however, it would not be efficient to use an ESBT when such a purchase would need to be financed with debt.

¹²See, e.g., "AICPA Asks for Additional Guidance on ESBTs," *Doc 97-19320*, 97 *TNT* 128-29 (June 24, 1997); "AICPA Proposes S Corporation Items for Inclusion in the IRS/Treasury Business Plan," *Doc 98-7405*, 98 *TNT* 39-42 (Feb. 3, 1998); "AICPA Requests More Guidance on ESBTs," *Doc 2000-524*, 2000 *TNT* 4-23 (Dec. 21, 1999).

¹³Prop. reg. section 1.641(c)-1(d)(4)(ii) (2000). ("Interest paid by the trust on money borrowed by the trust to purchase stock in an S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion.")

¹⁴See, e.g., "Deloitte & Touche Recommends Changes to Proposed Regs on ESBTs," *Doc 2001-9939*, 2001 *TNT* 67-25 (Apr. 4, 2001); "Attorney Suggests Changes to Proposed Regs Revising the Definition of Trust Income," *Doc 2001-11825*, 2001 *TNT* 84-21 (Apr. 12, 2001); "Deloitte & Touche Says ESBT Regs Need Clarification," *Doc 2001-11831*, 2001 *TNT* 81-6 (Apr. 26, 2001); "AICPA Comments on Proposed ESBT Regs," *Doc 2001-24565*, 2001 *TNT* 187-29 (Sept. 14, 2001); "Bankers Association Voices Strong Support for Subchapter S Modernization," *Doc 2002-26390*, 2002 *TNT* 230-23 (Nov. 15, 2002).

¹⁵"Attorney Says Proposed ESBT Regs Need Some Changes," *Doc 2001-10325*, 2001 *TNT* 72-30 (Mar. 28, 2001) (disallowing the interest deduction "is especially harsh in light of the fact that such interest is undoubtedly INCLUDED in the

(Footnote continued in next column.)

On issuance of the final ESBT regulations in 2002, the IRS acknowledged this criticism but maintained that a deductible "administrative expense" did not include interest expense incurred to acquire S corporation stock.¹⁶ The preamble to the regulations stated that the IRS believed that administrative expenses included "traditional expenses necessary for the management and preservation of trust assets" but not "expenses incurred to acquire additional assets."¹⁷ Therefore, the preamble noted, "the final regulations . . . continue to provide that, in all cases, interest incurred to purchase S corporation stock is a nondeductible expense allocable to the S portion."¹⁸

Prior Legislative Attempts

In light of the approach taken by the proposed and final ESBT regulations, a statutory provision to provide a deduction for interest expense incurred by an ESBT to purchase S corporation stock (the ESBT proposal) was pursued in Congress and included in a number of introduced bicameral and bipartisan subchapter S corporation reform packages.¹⁹ The ESBT proposal received the support of the American Bar Association, the American Institute of Certified Public Accountants, and other commentators.²⁰ Also, support for the ESBT proposal was expressed in public testimony before the Select Revenue Measures Subcommittee of the House Ways and Means Committee in 2003²¹ and the Regulatory Reform and Oversight Subcommittee of the House Small Business Committee in 2006.²² Despite that support, however, the ESBT proposal was not enacted.

The 2007 Small Business Legislation

At the beginning of the 109th Congress, both the Senate Finance Committee and the Ways and Means

gross income of the payee, who in the necessarily closely-held environment of an S corporation will often be a related taxpayer") (emphasis in original).

¹⁶Reg. section 1.641(c)-1(d)(4)(ii).

¹⁷T.D. 8994, 2002-1 C.B. 1078, 1082. See August, Huffaker, and Agran, "Clarifications Made by ESBT Final Regulations Demonstrate the Need for More Statutory Changes," 97 *J. of Tax'n* 69 (2002).

¹⁸2002-1 C.B. at 1082.

¹⁹The S Corporation Reform Act of 2006, S. 3838, section 302 (2006); The Subchapter S Modernization Act of 2003, H.R. 1896, section 304 (2003); The Subchapter S Modernization Act of 2001, S. 1201, section 304 (2001); The Subchapter S Modernization Act of 2001, H.R. 2576, section 304 (2001). See also JCT, "Background and Proposals Relating to S Corporations" (JCX-62-03) (June 18, 2003).

²⁰"ABA Tax Section Issues Comments on S Corporation Modernization," *Doc 2003-16380*, 2003 *TNT* 133-14 (July 1, 2003); "AICPA Makes Recommendations for S Corporation Reform," *Doc 2006-6682*, 2006 *TNT* 67-23 (Apr. 3, 2006).

²¹"Treasury Testimony at W&M Subcommittee Hearing on S Corporation Reform," *Doc 2003-14892*, 2003 *TNT* 119-26 (June 19, 2003); "AICPA Testimony at W&M Subcommittee Hearing on S Corporation Reform," *Doc 2003-14894*, 2003 *TNT* 119-28 (June 20, 2003).

²²"AICPA Representative Testifies That S Corp. Rules Should Be Modernized," *Doc 2006-12446*, 2006 *TNT* 124-61 (June 27, 2006).

Committee began work on a small-business tax incentive package, the Small Business and Work Opportunity Act of 2007, to offset the effects of a proposed increase in the federal minimum wage. An unsuccessful attempt was made to amend the package that originally passed the Senate to include the ESBT proposal.²³ Nevertheless, the Senate did include the ESBT proposal when the Small Business and Work Opportunity Act of 2007 was later included in an unrelated supplemental spending bill to fund the Iraq war.²⁴ The ESBT proposal was then included in the House-Senate conference report to the supplemental spending bill, but, unfortunately, that bill was vetoed by the president for reasons unrelated to the ESBT proposal.²⁵ H.R. 2206, the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007, a second supplemental spending bill including the Small Business and Work Opportunity Act of 2007 (including the ESBT proposal)

²³Senate Amendment 131 to H.R. 2 (2007), 152 *Cong. Rec.* S939 (Jan. 23, 2007). See Wesley Elmore, "Senate Approves Combined Tax, Wage Bill," *Doc 2007-2752, 2007 TNT 23-1* (Feb. 2, 2007) ("A last-minute push by . . . [Sen.] George V. Voinovich, R-Ohio, to make . . . minor changes to some tax provisions in the bill was . . . unsuccessful."); Ritterpusch, "Senate Approves Minimum Wage Increase With Tax Package Facing Uncertain Future," 22 *BNA Daily Report for Executives* GG-1 (Feb. 2, 2007) ("Senators tried to fold two minor changes in to the bill prior to final passage, but they were turned away by a Republican objection. One would have corrected a drafting error in the last minimum wage increase enacted a decade ago that barred certain trusts owning shares in S corporations from deducting interest costs, according to a spokeswoman from Sen. George Voinovich (R-Ohio), who insisted on the change.")

²⁴H.R. 1591, section 7536 (2007).

²⁵H.R. Conf. Rep. No. 107, 110th Cong., 1st Sess. 88 (2007).

then quickly passed both the House and Senate.²⁶ That bill was then signed into law by the president on May 25, 2007, as P.L. 110-28.

New Section 641(c)(2)(iv)

P.L. 110-28, section 8246(a) creates new section 641(c)(2)(C)(iv), which allows an ESBT to deduct "any interest expense paid or accrued on indebtedness incurred to acquire stock in an S corporation." The Joint Committee on Taxation explanation accompanying the legislation describes the provision as follows: "The provision provides that a deduction for interest paid or accrued on indebtedness to acquire stock in an S corporation may be taken into account in computing the taxable income of the S portion of an ESBT."²⁷ The provision applies to tax years beginning after December 31, 2006.²⁸

Conclusion

Under prior law, all taxpayers other than ESBTs were entitled to deduct interest expense incurred to acquire S corporation stock. Despite this unfair and inconsistent treatment, prior administrative and legislative attempts to resolve the issue were unsuccessful. Fortunately, the Small Business and Work Opportunity Act of 2007 provided an ideal legislative vehicle and resulted in enactment of a provision that extends this valuable interest deduction to ESBTs. This change is consistent with the underlying policy behind enactment of the ESBT provision and enhances the value of an ESBT as a flexible estate tax planning tool for S corporation owners.

²⁶H.R. 2206, section 8236 (2007).

²⁷JCT, "Technical Explanation of the 'Small Business and Work Opportunity Tax Act of 2007' Contained in H.R. 1591 as Reported by the Conference Committee" (JCX-24-07), Apr. 24, 2007, at 25-26.

²⁸P.L. 110-28, section 8246(b) (2007).

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