S-CORP

Defending America's Individually & Family Owned Businesses

October 21, 2021

The Honorable Richard Neal
Chairman
Committee on Ways and Means
1102 Longworth HOB
Washington, DC 20515

The Honorable Kevin Brady
Ranking Member
Committee on Ways and Means
1139 Longworth HOB
Washington, DC 20515

Dear Chairman Neal and Ranking Member Brady:

On behalf of The S Corporation Association (S-Corp), I wanted to express our strong opposition to the changes to the grantor trust rules included in H.R. 5376, the Build Back Better Act. These proposed changes would do irreparable harm to Main Street businesses, the workers they employ, and the communities that rely on them.

H.R. 5376 would create a new Chapter 16 under Subtitle B of the Internal Revenue Code (Code), targeting grantor trusts. The new Chapter would dramatically change how these trusts are treated by 1) including all the assets of a grantor trust at the time of death of the grantor in the deceased grantor's gross estate (despite the fact that most grantor trusts give the grantor no significant, or in many cases, no control at all, over the trust), 2) treating lifetime transfers between the grantor and the trust as a gift or sale rather than as a disregarded transaction, and 3) treating lifetime transfers from the trust to anyone other than the grantor or the grantor's spouse as a gift.

Applied to new trusts, these rules would completely gut the usefulness of the grantor trust for normal and legitimate business (non-tax) purposes, such as facilitating the transfer of business ownership between generations, and protecting the asset transferred from liability or creditor claims of a trust beneficiary.

The new chapter also would endanger decades of planning by threatening existing grantor trusts. The new rules would be effective upon "date of enactment," apparently grandfathering existing grantor trusts. But the rules include an important caveat whereby any new "contribution" to an existing grantor trust would result in a corresponding portion of the grantor trust being included in the deceased grantor's gross estate.

Finally, the rules would trigger capital gains recognition for pre-enactment trusts when in-kind distributions of property are necessary to pay an obligation due to the grantor or to make annuity payments from grantor retained annuity trusts (GRATs). These arrangements would not have been created if it was known the transfer back to the original grantor would be designated a taxable event. Therefore, treating such payments as triggering events, especially when the legal obligation requiring the payment existed before the date of enactment of the new rules, is fundamentally unfair.

These new rules would unconscionably punish taxpayers who relied on decades-old laws and Internal Revenue Service (IRS) guidance to establish estate plans to transfer family businesses to future generations, threatening the continued viability of thousands of large family businesses across the country.

The proposed rules are particularly harmful to family-owned S corporations. The Code permits a trust with multiple beneficiaries to hold S corporation stock only if the trust is a grantor trust or an electing small business trust (ESBT). If the proposed rules are enacted, grantor trusts would no longer be feasible for shares transferred during life unless they were subject to gross estate inclusion, which means the trust would have to elect ESBT treatment. ESBT treatment, however, would subject the trust's income in excess of $100,000 to the highest proposed rates of tax. Under H.R. 5376, those rates would include the higher 39.6% regular income tax rate, the new 3% surtax and, possibly, the expanded 3.8% tax on net investment income.

These changes are a private company challenge only. Public corporations like Amazon and Apple are effectively immune from the estate tax and have no use for grantor trusts. While some small portion of their owners may pay the tax, the company itself is largely unaffected. Public companies don't engage in estate tax planning, they don't have to pay for life insurance or to otherwise set aside resources to pay the eventual tax, they have access to massive pools of capital that also don't pay the estate tax (or any tax for that matter), and they don't have to reorganize their ownership to ensure a smooth transition of leadership and control.

Meanwhile, every single successful family business or farm in this country struggles with the estate tax. As one of our members observed, the estate tax forces families to buy back a large portion of the business from the federal government every generation. The changes to the treatment of grantor trusts included in H.R. 5376 will make these challenges much more acute, resulting in fewer successful transitions and fewer family businesses.

Examples of Harm

As noted, nearly all successful family businesses struggle with the estate tax. These families face the daunting challenge of keeping the business intact while paying the estate tax owed. If the assets used in the operation of the business represent the bulk of the estate, the challenge is magnified, particularly at a time when the combined rates for applicable state and federal estate taxes can exceed 50 percent.

A primary area of concern raised in H.R. 5376 is with the payment of income taxes owed on the trust's income. In a grantor trust, the trust is disregarded and the grantor is deemed to own the trust's assets for purposes of making income tax payments. Congress designed this policy to ensure that taxpayers can't reduce their tax liabilities by creating multiple trusts, each with incomes qualifying for lower income tax rates. As most trusts pay the maximum individual tax rate these days, the policy is no longer necessary, but it does still apply. A grantor is required to make the income tax payments for any income earned within a grantor trust. Do these required tax payments also constitute a contribution under the proposed rules? If so, then the assets of the trust would be included in the gross estate as well, defeating the purpose of the trust.

Another area of evolving policy concern is where the business owner acquires a life insurance policy (most often owned by a trust) for the specific purpose of having liquid assets (cash) available to pay estate tax on the family business included in her or his estate. Premiums on the policy can be paid by the grantor (as taxable gifts) while the death benefit remains outside the gross estate at death. When the grantor passes away, the proceeds of the insurance policy are available to pay the estate tax. Under the grantor trust rules, a trust that can use income to pay premiums on a life insurance policy on the life of its grantor is automatically a grantor trust.

Under H.R. 5376, however, premium payments made by the grantor on policies owned by a grandfathered grantor trust would cause some or all of the insurance proceeds to be moved back into the gross estate. For term policies, this may cause the entire trust to be included in the gross estate. This outcome makes absolutely no sense. Not only does the result have the potential to upend decades of planning to make certain there are sufficient resources to pay the estate taxes, but the change would subject the insurance proceeds designed to pay estate taxes to the same tax! For new trusts, the entire death benefit would be included in the gross estate regardless of what type of insurance policy is involved.

The grantor trust rules were created by Congress and have been in place for more than fifty years. The practices described above are in full compliance with the rules and, in fact, have been blessed by the courts and by Congress multiple times. Moreover, these tools would need to exist with or without an estate tax. Trusts are used to facilitate the transfer of ownership of a business and to give younger generations a stake in the business while also protecting the business' assets from creditor claims, claims of a spouse in divorce, etc. There are many non-tax reasons why trusts are necessary.

Given this background, it is one thing for Congress to change these rules looking forward. It is entirely different, and wrong, to retroactively apply these changes to grantor trusts created in the past. Considering the length of time some of these plans have been in place, Congress should take great pains to ensure that established grantor trusts that have relied on rules in place for decades are not upended now, just before they are called upon to preserve a family business.

Other problems exist. One example is the treatment of gifts to a trust that is eligible for the marital deduction. When such a trust is created by the grantor for the lifetime benefit of the grantor's spouse and then the grantor's children, no gift tax is due because the trust assets will be subject to estate tax when the spouse dies. Under the proposed rules, however, because such a trust is a grantor trust, the trust assets will also be subject to estate tax when the grantor dies, effectively causing a double estate tax. In a similar vein, a grantor trust with the spouse as the beneficiary (non-marital) would be precluded from utilizing the unified exemption from gift/estate tax during the grantor's lifetime, despite the fact that Congress specifically created a gift or estate tax exemption that could be used either during lifetime or at death.

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These issues are just a few of the multitude of concerns raised by the proposed changes to the grantor trust rules included in H.R. 5376.

A More Targeted Approach

Because of the many generational challenges that are facilitated by the use of grantor trusts, and because of the broad reach these trusts have under the current rules (e.g., trusts with life insurance or a spouse as a beneficiary are defined as grantor trusts), we believe any change to the grantor trust rules calls for a more targeted approach. The changes contained in H.R. 5376 would eliminate the usefulness of new grantor trusts, and they threaten the viability of the thousands of existing trusts. If Congress is going to make changes in this area, these changes should be done thoughtfully and in a transparent manner – not rushed to the House floor after a few days of consideration. S-Corp stands ready to work on reasonable solutions to address specific concerns raised against grantor trusts.

Conclusion

The changes to the grantor trust rules contained in H.R. 5376 will knee-cap thousands of successful family businesses at a very difficult time, driving many of them into forced liquidations or sales. As a result, the proposed rules will encourage continued consolidation of economic power and decision-making within the c-suites of a few thousand public companies. These large, multi-national corporations have thrived during the pandemic. H.R. 5376 will make this trend worse by further tilting the rules away from locally- and family-owned businesses.

If the Committee wishes to support the role family businesses play in providing jobs and a strong economic base, then it should discard these provisions and make certain family businesses have the tools necessary to survive the transition from one generation to the next, including surviving the estate tax.

We appreciate your consideration of these concerns and look forward to hearing from you on this important issue.

Sincerely,

Brian Reardon
S Corporation Association

CC: Mr. Thomas Barthold, Chief of Staff, Joint Committee on Taxation