When an S corporation trust shareholder fails to become an Electing Small Business Trust

Tax: Gross Income Tax

The taxpayer requested a Letter Ruling regarding the tax consequences to an S corporation in which one of its shareholders, a trust, fails to elect to become an Electing Small Business Trust (“ESBT”) for New Jersey Gross Income Tax purposes.

Facts
Taxpayer is a discoverer, developer, and marketer of high-quality, scientifically-supported ingredient solutions for the natural products, food and beverage, and cosmeceuticals markets (cosmetics that have some claimed medicinal properties). The taxpayer claims its goal is to bring innovative and impactful solutions that help its consumer products customers develop new concepts, new products and grow successful brands.

The taxpayer is an S corporation for federal income tax purposes and New Jersey Corporation Business Tax purposes. One of its shareholders is a trust (“the Trust”). Historically, the Trust was a grantor trust within the meaning of subpart E of part I of subchapter J of Title A of the Internal Revenue Code. However, the Trust lost its grantor trust status in October, 2015. Shortly thereafter, the Trust elected to be taxed as an ESBT for federal income tax purposes.

Issues
1. Whether the taxpayer will lose its status as a New Jersey S corporation because the shareholder trust did not make a New Jersey ESBT election;

2. Whether the Trust files form NJ-1041 and computes its tax in the same manner as would a “regular” (i.e., non-ESBT) trust when the S corporation retains its status as a New Jersey S corporation despite the Trust’s failure to make a New Jersey ESBT election; and

3. Whether there are any other ancillary New Jersey tax consequences from the Trust’s failure to make a New Jersey ESBT election.

Discussion
For federal income tax purposes, only certain types of trusts are eligible to own stock in an S corporation. See Internal Revenue Code section 1361(b) (1) (B). Both grantor trusts and ESBTs are eligible to own stock in an S corporation. See Internal Revenue Code sections 1361(c) (2) (A) (i), 1361(c)(2)(A)(v). Importantly, an “ineligible” trust’s ownership of S corporation stock terminates the corporation’s S election. See Internal Revenue Code section 1362(d) (2).

Historically, the Trust was a grantor trust, and thus was permitted to own stock of the taxpayer without adversely impacting the taxpayer’s ability to be an S corporation. See Internal Revenue Code section 1361(c) (2) (A) (i). Although the Trust lost its grantor trust status in October 2015, and thus the taxpayer potentially could have lost its status as an S corporation for federal income tax purposes, the taxpayer retained its status as an S corporation for federal income tax.
purposes because the Trust made a federal ESBT election. See Treas. Reg. 1.1361-1(m). Had the
trust not made a federal ESBT election, Taxpayer would have lost its status as an S corporation
for federal income tax purposes because it would have had an ineligible shareholder. See
Internal Revenue Code section 1362(d) (2).

The NJ-1041SB instructions make clear that a trust that elects to be taxed as an ESBT for federal
income tax purposes does not automatically become an ESBT for New Jersey tax purposes.
Rather, a trust only becomes an ESBT for New Jersey tax purposes if it affirmatively files a New
Jersey ESBT election. See the first page of the NJ-1041SB instructions for the 2015 tax year which
states:

“A federal electing Small Business Trust makes an election to be taxed as a New Jersey Electing
Small Business Trust by filing a New Jersey Gross Income Tax Fiduciary Return, Form 1041SB and
signing the election statement at the bottom of the return.”

See also page 3 of Bulletin GIT-12, Estates and Trusts (Rev. 12/15), (“A Federal Electing Small
Business Trust may make a New Jersey election to be taxed in the same manner as for Federal
tax purposes. Form NJ-1041SB contains the New Jersey election information and filing
instructions.”)

The 2015 Form NJ-1041SB, in turn, contains the following statement: “Election Statement: I
declare that this trust is a federal Electing Small Business Trust and consents to be taxed as a
New Jersey Electing Small Business Trust for tax year 2015.”

New Jersey’s requirement that a trust affirmatively elect to qualify as an ESBT, rather than merely
follow the federal classification of the trust, is consistent with New Jersey’s treatment of S
corporations generally: a corporation that elects to be taxed as an S corporation for federal
income tax purposes is not automatically taxed as an S corporation for New Jersey corporation
business tax purposes. Rather, the corporation must affirmatively elect to be taxed as a New
Jersey S corporation by filing form CBT-2553. See N.J.A.C. 18:7-11.16(c), which states:

S corporation status may be elected for New Jersey purposes by the shareholders of a Federal S
corporation. It is required to file an election form CBT-2553 with the Division to be recognized
as a New Jersey S corporation.

As detailed above, for federal income tax purposes, an S corporation loses its status as an S
corporation if a trust that would not otherwise be an eligible S corporation shareholder fails to
make an ESBT election.

The election to be treated as an ESBT for New Jersey purposes is not a mandatory election. As
stated above, the consent to the ESBT election is permissive. As a result, a federal ESBT is
permitted to file Form NJ-1041 with New Jersey when the ESBT election is not made for New
Jersey purposes. Consequently, a trust that did not make an ESBT election for New Jersey
purposes can be an S corporation shareholder in New Jersey, provided form CBT-2553 was
properly filed and the S corporation will not lose its New Jersey S status as a result of the trust
failing to make the ESBT election.
Therefore, if the Trust does not file form NJ-1041SB and execute the required consent statement to elect to become an ESBT, then the New Jersey S status is not affected by the type of trust that is a shareholder.

A Letter Ruling is limited to the facts set forth therein and is binding on the Division of Taxation only with respect to the person or entity to whom it is issued and only if the person or entity fully and accurately describes all relevant facts. A Letter Ruling is based on the law, regulations, and Division policies in effect as of the date the Letter Ruling is issued or for the specific time period at issue in the Letter Ruling.