

Subject: Ken Crotty: How to File Tax Returns for Disregarded Entities and Grantor Trusts, with Sample Forms

“The most common disregarded entities are single member LLCs and ‘defective’ Grantor trusts. As a general rule, disregarded entities and Grantor trusts are not required to obtain employer identification numbers. However, many financial institutions require employer identification numbers for income reporting purposes and will not allow the social security number of the owner or Grantor to be used.”

Ken Crotty provides members with commentary that reviews how to file tax returns for disregarded entities and grantor trusts. Members will find his commentary most helpful as it includes links to sample forms.

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Here is his commentary:

EXECUTIVE SUMMARY:

The most common disregarded entities are single member LLCs and "defective" Grantor trusts. As a general rule, disregarded entities and

Grantor trusts are not required to obtain employer identification numbers. However, many financial institutions require employer identification numbers for income reporting purposes and will not allow the social security number of the owner or Grantor to be used.

COMMENT:

Reporting Disregarded Entities

If a disregarded entity has an employer identification number and the ownership of the entity changes so that it no longer qualifies as a disregarded entity, the disregarded entity should retain its old employer identification number.ⁱ For example, if a disregarded single member LLC has an employer identification number, and then a second member buys into the LLC so that it is now treated as a partnership, the partnership should continue using the employer identification number that was assigned to the LLC when it was disregarded.

Generally disregarded entities do not need to file a separate tax return.ⁱⁱ The items of income and deduction from the activities of the disregarded entity will be picked up on the owner's tax return on the following Schedules:

- Schedule C B Profit or Loss from Business (sole proprietorship)
- Schedule E B Supplemental Income or Loss
- Schedule F B Profit or Loss from Farming

The disregarded entity is treated as separate from its owner for employment tax purposes for wages paid on or after January 1, 2009 and for excise taxes reported and paid on Forms 720, 730, 2290, 11-C, or 8849 after December 31, 2007.ⁱⁱⁱ In these situations, the employment tax and excise tax return instructions should be reviewed to be certain that the disregarded entity is reporting the necessary information.

Reporting Grantor Trusts

If a trustee is not using one of the optional methods of filing, which are discussed below, and the entire trust is a Grantor trust, the trustee need only fill in the entity information on the Form 1041 and not show any dollar

amounts on the Form 1041 itself. Instead, the trustee should show the dollar amounts on attachments to the Form 1041. The attachment should not be a Schedule K-1. The trustee must give the Grantor of the trust a copy of the attachment.

If the trust is only partially by a Grantor trust, then the items of income and deduction for the non-Grantor portion of the trust should be reported on the Form 1041 as normally would be done and the portion of the items treated as owned by a Grantor trust should be shown on an attachment.

The attachment must show the name, identifying number, and address of the persons to whom the income is taxable.^{iv} The income must be reported in the same detail as it would be reported on the Grantor's income tax return if it had been received directly by the Grantor. Any deductions or credits that apply to the income also need to be reported in the same detail as they would be if they had been received directly by the Grantor. The Grantor then reports the items of income, deductions and credits on the Grantor's personal return.

For Grantor trusts, there are three optional methods of filing, which the trustee may choose instead of filing the Form 1041. If a trust is treated as owned by one person, then the trustee may select Option 1 or Option 2 described below. If a husband and wife are treated as the owners of a trust, they will be deemed to be one person and therefore the trustee may select either Option 1 or Option 2 below. If the trust is treated as owned by more than one person, then the trustee may select Option 3 below.

Attached at the end of this memo are sample documentation that could be used to inform the IRS that a trust is disregarded for income tax purposes. There is a sample default Form 1041 which can be filed for a Grantor Trust. Also provided are samples showing the reporting necessary under Option 1 and Option 2.

Option 3 has the same reporting requirements as Option 2 but only applies in situations where there is more than one Grantor, and the Grantors are not husband and wife. In this situation the trustee needs to determine which portion of the trust assets were payable to Grantor 1 and which portion of the trust assets were payable to Grantor 2. The trustee would

then provide each of Grantor 1 and Grantor 2 with the same information as shown under Option 2.

Option 1: The trustee must give all of the payers of income during the year to the trust the social security number of the individual treated as the owner of the trust and the trust's address. To use this method, the owner of the trust must provide the trustee with a signed W-9. If the owner of the trust is not the trustee or co-trustee, then the trustee must (1) give the owner a statement showing all of the items of income, deduction, and credit of the trust; (2) identify the payer of each item of income; (3) explain how the owner takes such items into account when preparing the owner's tax return; and (4) inform the owner that these items must be included on his or her tax return. If the trustee reports under Option 1 and the trust does not have an employer identification number, the trust does not need to obtain an employer identification number to satisfy Option 1.

Option 2: The trustee must give all of the payers of income during the year to the trust the full name of the trust, the trust's address and the trust's tax identification number. The trustee also must file with the IRS the appropriate Forms 1099 to report the income paid to the trust during the tax year. These forms show the trust as the payer and the individual treated as the owner of the trust as the payee. If the owner of the trust is not the trustee or co-trustee, then the trustee must (1) give the owner a statement showing all of the items of income, deduction, and credit of the trust; (2) explain how the owner takes such items into account when preparing the owner's tax return; and (3) inform the owner that these items must be included on his or her tax return. If

the trustee reports under Option 2 and the trust does not have an employer identification number, the trust needs to obtain an employer identification number to satisfy Option 2.

Option 3: The trustee must give all of the payers of income during the year to the trust the full name of the trust, the trust's address and the trust's tax identification number. The trustee also needs to file with the IRS the appropriate Forms 1099 to report the income paid to the trust during the tax year. These forms would show the trust as the payer and the owners as the payees. The trustee must (1) give each owner a statement showing all of the items of income, deduction, and credit of the trust attributable to such owner; (2) explain how each owner takes such items into account when preparing his or her tax return; and (3) inform each owner that these items

must be included on his or her tax return. If the trustee reports under Option 3 and the trust does not have an employer identification number, the trust needs to obtain an employer identification number to satisfy Option 3.^v

If a trustee has been filing a Form 1041, the trustee can change to one of the three optional methods listed above at any time. The trustee can do this by filing a final Form 1041 for the tax year immediately preceding the first tax year that the trustee elects to use one of the optional methods of filing. On the form of the final Form 1041, the Final return box in item F must be checked and the words APursuant to section 1.671-4(g), this is the final Form 1041 for this grantor trust@ should be written on the first page of the Form 1041.^{vi}

The filing of the relevant 1099s by the trustee, in relation to Options 2 and 3 above depends on the type of income for the Trust. For example the trustee may be required to file a 1099-DIV for dividend income and file a 1099-INT for relevant interest income.

In relation to the reporting of income from long-term gain or loss from a partnership, S Corporation, or trust, Treasury Regulation 1.671-4(b)(5) provides that in the case of a trust that owns an interest, the distributive share belonging to the trust as a partner, shareholder, or beneficiary will not be includable by the trustee on any Form 1099 because the distributive share is reportable by the partnership, S corporation, or trust on the Schedule K-1.^{vii}

Certain trusts are not allowed to use the optional filing methods. These include the following:

1. The common trust fund;
2. A foreign trust or trust that has any of its assets located outside
of the United States;
3. A qualified Subchapter S trust;
4. A trust which is treated as owned by one or more individuals
who have a tax year other than a calendar year;

5. A trust which is owned by one or more persons who are not U.S. persons; and
6. A trust which is owned by one or more persons if at least one person is an exempt recipient for informational reporting

purposes unless at least one other person is not an exempt recipient and the trustee reports the information without treating any of the owners as exempt recipients.viii

If the owner of a disregarded single member LLC has exempt status from federal income tax, then the LLC is not required to (1) pay federal income tax, (2) file a federal tax return, or (3) file an informational return. Any such requirement to file a federal tax return or informational return on behalf of the LLC is the responsibility of the owner rather than the LLC. A disregarded entity has the option to report and pay employment tax for its employees.

The federal income tax-exempt status of the sole owner will also apply to a disregarded single member LLC.^{ix} If the owner of a disregarded LLC is claiming exempt status, the owner must treat the finances and operations of the LLC as its own for federal tax and information reporting. The LLC's disregarded status is with respect to its classification as a separate entity, but the LLC is treated as an activity of the sole owner. Any entity activities that are outside the tax-exempt purposes of the sole owner may impact the tax-exempt status of the owner, and may even create tax liability.

It is important to note that if the owner of the disregarded LLC has exempt status, the LLC should not file a Form 1023 or Form 990 exemption application. By filing this application, the previously disregarded LLC will become an organization that is treated as separate from its owner. If the owner of the LLC is concerned that transactions with or by the LLC may cause the owner to lose its exempt status, then the owner should request a private letter ruling.

If an LLC elects to be regarded as an entity separate from its owner on a Form 8832 or becomes an entity with two or more owners, then Section 508 of the Code applies to trigger the exemption notification requirements.^x Subsequently the LLC must apply for federal tax exemption recognition, within the 27 month period after the end of the month when the LLC is no longer a disregarded entity.

ESBTs (Electing Small Business Trust)

A Grantor Trust is eligible to be a shareholder of an S corporation if all of the trust is owned by an individual. Often planners who have clients selling or gifting ownership interests in S corporations to gifting trusts that are

Grantor Trusts will also have the trust make an election to become an Electing Small Business Trust or “ESBT.” By making this election, if another person contributes assets to the gifting trust causing it to no longer be a solely owned gifting trust, this will not cause the loss of the S corporation status because an ESBT is an eligible shareholder for S corporations.

An ESBT can have multiple shareholders or beneficiaries. It can also accumulate its own income, and may distribute both principal and accumulated income to beneficiaries. In order to make the ESBT election:

1. All trust beneficiaries must be individuals, estates, non-resident aliens for 2018 and subsequent tax years, and charities, or must meet other specific requirements described in §170(c)(1) or §170(c)(2)-(5), as applicable;
2. Trust interests must not be available for purchase; and
3. The Trustee of the trust must file for the ESBT election.

Certain trusts are prohibited from making an ESBT election including (1) Qualified Subchapter S Trusts; (2) Charitable remainder annuity trusts; and (3) Charitable remainder unitrusts.

Pursuant to Treasury Regulations, an ESBT has an “S Portion,” a “non-S Portion,” and if the trust is a Grantor Trust a “Grantor Portion.”^{xi}

If a solely owned Grantor Trust has made an ESBT election, then the Grantor Portion comprises 100% of the Trust. During the lifetime of the Grantor the trust is subject to the regular taxation rules that apply to Grantor Trusts. The Grantor’s income tax return will reflect any income, deduction and credit that can be attributed to the ESBT which is considered to be owned by the Grantor.

After the death of the grantor, the Grantor Portion ceases to exist and the items of income and deduction for the trust need to be split between the S Portion and the non-S Portion. This point often confuses practitioners. After the death of the grantor of a wholly owned Grantor Trust, the resulting trust or trusts are not taxed as normal simple or complex trusts.

The portion of the ESBT that consists of any assets other than the S corporation stock will compromise the non-S portion. The income included in the non-S Portion will also consist of any corporation distributions classified as dividends, as well as interest accrued for installment payments for the sale of S corporation stock. For the non-S Portion of the trust, the taxation of this portion of the trust is governed by the normal tax rules applicable to non-Grantor Trusts.

This is not true for the S Portion of the ESBT. The S Portion of an ESBT, that is not a Grantor Trust, is treated as a separate trust and the taxable income is calculated separately. The income of the S Portion includes:

1. Any gains and losses on disposition of S corporation stock;
2. The items of income, loss, deduction or credit required to be taken into account by an S corporation shareholder by §1366 and the regulations thereunder, except for the items mentioned above in the calculation of the non-S Portion’s income;

3. Income taxes and administrative expenses related to the assets of the S Portion of the trust and any interest expense paid or accrued on indebtedness for acquiring S corporation stock.^{xii}

Generally, the income calculated for the S portion of the trust is taxed at the highest marginal rate for trusts. It is important to note that capital gains are not subject to tax at this highest rate.

Because assets of the S Portion of the trust are a separate part of the ESBT, the income and deductions from such items are excluded when calculating the distributable net income (DNI) of the ESBT. The S Portion is not allowed a deduction if these items are distributed to the beneficiaries and the beneficiaries may not include such distributions when calculating their personal income.

Reporting Agents for Disregarded Entities and filing Form 8655

If an LLC is a single member LLC, the entity's classification will determine who may sign a Form 8655. If the entity is classified as disregarded, then the Form 8655 must be signed by the owner or by an authorized representative who can demonstrate the authority to sign the form.

A filed Form 8655 is required for a reporting agent to have authorization. Such authorization may also be submitted on a substitute form approved by the IRS.^{xiii}

The Form 8865 authorizes the reporting agent to (1) sign and file certain returns on behalf of the individual or entity; (2) make deposits and payments for certain returns; (3) receive duplicate copies of tax information, notices, and other communication regarding the individual or entity; and (4) provide the IRS with information related to penalty relief determinations for any authority granted under the Form 8655.

A Form 8655 for a corporation, including an LLC treated as a corporation, may be signed by (a) any officer with authority to bind the corporation, (b) any person designated by the governing body of the corporation, (c) any officer or employee granted written authority to sign by a principal officer, and (d) any other authorized person.

For a partnership, including an LLC treated as a partnership, the Form 8655 may be signed by any person who was a member of the partnership during any part of the tax period described in the Form 8655.

For a trust or estate, the Form 8655 must be signed by the fiduciary. Form 8858 Filing for Foreign Disregarded Single Member LLCs

Form 8858 is the information return of a U.S. person which reports activity related to foreign disregarded entities ("FDEs"). The accompanying Schedule M reports transactions between foreign disregarded entities of a foreign tax owner and the filer or other related entities. This form must be filed by U.S. person that is considered to be the tax owner of FDEs, or that owns

certain interests in foreign tax owners of FDEs. Form 8858 is due with the U.S. persons income tax or informational returns, and must be filed each year.

Form 8858 has three categories of “U.S. Persons” who are required to file.^{xiv}

Category 1. U.S. persons who are treated as the tax owner of a foreign disregarded entity at any point during the taxable year. A disregarded entity is not considered a U.S. person. So if a domestic or foreign parent disregarded entity owns a subsidiary FDEs, then the owner of the parent

disregarded entity has the obligation to report the foreign disregarded entity.

Category 2. U.S. persons who must file Form 5471 may be required to file Form 8858 if the controlled foreign corporation owns a FDE. Form 5471 deals with controlled foreign corporations and has various categories of filers. Only those persons who are considered to be Category 4 and Category 5 filers for Form 5471 are required to file a Form 8858. These are U.S. persons who controlled the controlled foreign corporation for at least 30 consecutive days during the taxable year, and/or a shareholders of a controlled foreign corporation who owned at least 10% of the voting stock of the controlled foreign corporation for at least 30 consecutive days. U.S. persons who are neither Category 4 nor Category 5 filers of Form 5471 do not have to file Form 8858.

Category 3. U.S. persons who must file Form 8865 may also be required to file Form 8858. Form 8865 is filed to report information related to controlled foreign partnerships which are treated as the tax owners of FDEs during the taxable year. If a U.S. person controls 50% of the foreign partnership then that U.S. person needs to file the Form 8858. If no U.S. person controls 50% of the partnership then U.S. persons owning 10% or more of the foreign partnership must file Form 8858.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Ken Crotty

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CITATIONS:

ⁱ I.R.S., Single Member Limited Liability Companies (Sept. 13, 2013), *available at* <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Single-Member-Limited-Liability-Companies>.

ⁱⁱ *Id.* ⁱⁱⁱ *Id.*

^{iv} I.R.S., Instruction for Form 1041 and Schedules A, B, G, J, and K-1 (2012) (Sept. 13, 2013), *available at* <http://www.irs.gov/instructions/i1041/>.

^v I.R.S., Instructions for Form 1041: Grantor Type Trusts (Sept. 13, 2013), *available at* <http://www.irs.gov/instructions/i1041/ch01.html#d0e740>.

^{vi} *Id.*

^{vii} Treas. Reg. § 1.671-4(b)(5) (2006).

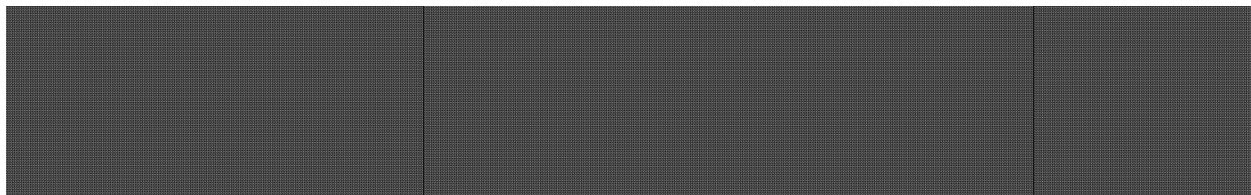
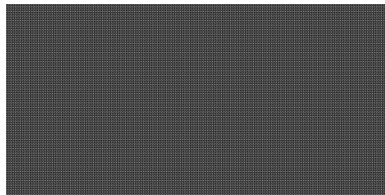
^{viii} I.R.S., Instructions for Form 1041: Optional Filing Methods for Certain Grantor Type Trusts (Sept. 13, 2013), *available at* <http://www.irs.gov/instructions/i1041/ch01.html#d0e740>.

^{ix} I.R.S., *supra* note 1, at 1.

^x I.R.S., Instructions for Limited Liability Company Reference Guide Sheet (Sept. 13, 2013), *available at* http://www.irs.gov/pub/irs-tege/lc_guide_sheet_instructions.pdf.

^{xi} Treas. Reg. § 1.641(c) (2006); *See also* I.R.S., *supra* note 5, at 3. ^{xii} Treas. Reg. § 1.641(d) (2006).

^{xiii} *See* I.R.S. Pub. No. 1167 (2013).



^{xiv} I.R.S., Instructions for Form 8858 (Dec. 2012) *available at* <http://www.irs.gov/pub/irs-pdf/i8858.pdf>.