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IRS Finalizes Regulations Addressing Nonresident Alien Beneficiary of Electing Small Business Trusts

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Tucked away in the recently enacted Tax Cuts and Jobs Act (TCJA)¹ is a provision (one of a few) dealing specifically with S corporations. It is one of these particular provisions that caused the Internal Revenue Service to recently issue a notice of proposed rule-making (Notice)² in order to stem the tide of S corporation income that could potentially go untaxed. The proposed regulations have now been finalized without change effective June 18, 2019, and applicable to all Electing Small Business Trusts (ESBTs) after December 31, 2017.³

First, a very brief primer on S corporations. The classification as a small business corporation generally provides for “pass-through” treatment in the guise of a regular corporation, the overall effect of which is to provide for one level of tax. However, treatment as an S corporation comes with a number of conditions. For example, the corporation may not have more than 100 shareholders; it cannot be an ineligible corporation; it cannot have shareholders other than individuals, estates, and certain types of trusts or tax-exempt entities; it cannot have more than one class of stock; and, most importantly in the context of the Notice, it cannot have a nonresident alien individual (NRA) as a shareholder.

With respect to trusts, only certain ones are eligible shareholders of an S corporation, e.g., a grantor trust

wholly owned by an individual who is a citizen or resident of the United States; qualified subchapter S trusts; and, as relevant here, a domestic trust qualifying as an ESBT.

An ESBT must be a domestic trust (a foreign trust is ineligible) that, among other requirements, cannot have as a beneficiary any person other than an individual, or estate or certain qualifying tax-exempt organization. Permissible beneficiaries of an ESBT are referred to as permissible potential current beneficiaries (PCBs). As relevant here, a grantor trust may elect to be an ESBT, and a PCB can also be the deemed owner of a grantor trust that elects to be an ESBT.

Prior to the TCJA, if the immigration status of a resident alien PCB of an ESBT changed to an NRA, this would terminate the S corporation’s election because the PCB of the ESBT (treated as a shareholder of the S corporation) would then be a prohibited NRA shareholder of the S corporation.

Enter the TCJA, which amended the relevant S corporation rules to provide that the treatment of each PCB of an ESBT as a shareholder does not apply for purposes of the shareholder eligibility rule. Thus, if the individual resident alien becomes an NRA, that NRA status would not violate the shareholder eligibility rule and will not terminate the S corporation election.

However, in its Notice (and in the final regulations), the IRS was quick to observe that the TCJA left undisturbed the general rule that an S corporation cannot have an NRA shareholder. As a result, the IRS further observed that the amendment made by the TCJA could have the effect of allowing a portion of the S corporation’s income to escape tax.

For example, prior to the TCJA, if a grantor trust elected ESBT status, the deemed owner of the grantor trust had to be a U.S. person and could not be an NRA. However, as a result of the TCJA amendment allowing permissible PCBs of any ESBT to include NRAs, S corporation income attributable to the grantor trust portion of an ESBT of which an NRA is the grantor could escape U.S. tax. This could occur, for example, if the NRA grantor were allocated foreign-source income or non-effectively connected

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¹ Pub. L. No. 115-97 (Dec. 22, 2017).

² REG-117062-18.

³ T.D. 9868, 84 Fed. Reg. 28,414 (June 18, 2019).

income, or if, under a treaty, the income were exempt or subject to a reduced rate.

Now, you might immediately point out that it is, generally, not permissible for a trust to be regarded as a grantor trust when the grantor is an NRA. You would be correct based upon §672(f)(1).⁴ However, §672(f)(2)(A) provides that a trust can be a grantor trust if the grantor has the power of revocation generally without the approval of others (§672(f)(2)(A)(i)), or if the only amounts distributable from both income and corpus during the grantor's lifetime are amounts distributable to the grantor or the grantor's spouse (§672(g)(2)(S)(ii)).

Now we're zeroing in on the problem that the IRS sees. We know, as discussed earlier, that an ESBT must be a domestic trust. In a §672(f)(2)(A)(i) situation, the right of revocation by the NRA would make the grantor trust a foreign one under §7701(a)(E) because U.S. persons would not be controlling substan-

tial trust decisions. So, this is not what the IRS is concerned about.

However, it is concerned about the situation described in §672(f)(2)(A)(ii) in which the trust is a grantor trust and the NRA is taxed on the income of the trust if the only amounts distributable during the grantor's lifetime are to the grantor or grantor's spouse. In this situation, the trust would still be regarded as a U.S. trust as required for ESBT status provided the two-pronged test of §7701(a)(E) is met — i.e., a U.S. court has primary jurisdiction over the trust, and U.S. persons control substantial trust decisions. However, in this case, without the rules set forth in the final regulations, portions of S corporation income would, indeed, potentially go untaxed.

Accordingly, the final regulations provide that, if an NRA-owned grantor trust elects ESBT status, it must include in its income the S corporation income if that income otherwise would have been allocated to an NRA deemed owner under the grantor trust rules. In other words, the ESBT would be taxed on S corporation income at the trust level rather than the beneficiary level.

⁴ All section references are to the Internal Revenue Code, as amended (Code), or the Treasury regulations thereunder, unless otherwise indicated.