A NEW OPPORTUNITY FOR NONRESIDENT ALIENS – OWNERSHIP IN AN S-CORP

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INTRODUCTION

Changes to U.S. tax law brought about by the 2017 Tax Cuts and Job Act[1] ("T.C.J.A.") have affected many longstanding tax planning tools. One favorable change amends the rules regarding the persons who can own shares of an S-corporation. Historically, the S-corporation election was terminated if a foreign individual became an owner. Under the T.C.J.A., a foreign individual may now utilize an Electing Small Business Trust ("E.S.B.T.") to obtain an interest in an S-corporation.

BENEFITS OF S-CORPORATION INVESTING

Similar to limited liability companies ("L.L.C.'s"), S-corporations are pass-thru entities whose corporate income, losses, deductions, and credits flow through to their shareholders for Federal tax purposes.[2]

The S-corporation is a creature of Federal tax law. Any corporation that meets certain hurdles can elect S-corporation status. In comparison, L.L.C.'s are creatures of state company law. The state law controls the rights and powers of the entity formed under the L.L.C. statute. I.R.S. regulations recognize an L.L.C. as a pass-thru entity.

Under the rules applicable to an S-corporation, a shareholder's deduction for corporate losses is limited to the sum of the shareholder's adjusted basis in the S-corporation stock and the shareholder's adjusted basis of any debt issued by the S-corporation to the shareholder.[3] Losses not allowed by reason of this limitation generally are carried forward by the corporation to the succeeding year.[4]

Generally, the tax basis in the stock of the S-corporation is (i) increased by the items of S-corporation income attributable to shares owned by the shareholder and passed through to the shareholder's personal tax return and (ii) decreased by corporate distributions, losses, and deductions attributable to the shareholder's interest.[5] In this manner, an S-corporation shareholder is not subject to tax on corporate distributions unless the distributions exceed the shareholder's basis in the stock of the corporation.

As opposed to a partner in an L.L.C., a shareholder in an S-corporation can be paid a salary in addition to the flow through of income and gains. Indeed, if the

1 Pub. L. No. 115-97.

2 Code §§1363, 1366.

3 Code §1366(d)(1).

4 Code §1366(d)(2).

5 Code §1367.

shareholder works in the business, he or she will be treated as receiving a reasonable amount of compensation even if none is paid. That salary is subject to social security taxes for the corporation and the employee-shareholder.

LIMITATIONS ON INVESTORS

To make an S-corporation election, certain restrictions apply to the make-up of the shareholder group:

- The corporation cannot have more than 100 shareholders.
- There cannot be more than one class of stock.
- The corporation cannot have shareholders other than U.S. citizens or individual residents, certain tax-exempt organizations, and certain trusts and estates.[6]

Regarding the stock restriction, the corporation will be considered to have met this requirement if two classes of shares have all the same economic rights to income and appreciation of assets at the time of liquidation, even if one class has voting rights and the other class has limited rights or no rights at all.[7] As a result, an S-corporation with two or more shareholders cannot make special allocations to shareholders.[8]

Historically, a trust could be a shareholder of an S-corporation in extremely limited circumstances.[9] These include the following:

- A grantor trust with a U.S. citizen or resident individual as a grantor
- A grantor trust covered in the preceding bullet once the grantor died (but only for two years)
- A trust receiving stock under a will (but only for two years)
- A trust to control voting power
- A trust established pursuant to an individual retirement account to hold shares in depository institution in limited circumstances

The T.C.J.A. expands the circumstances in which a trust can hold shares in an S-corporation, enabling a nonresident to be a current potential beneficiary if the trust qualifies as an E.S.B.T.[10]

WHAT IS AN E.S.B.T.?

An E.S.B.T. is a domestic trust that has following types of beneficiaries:

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6 Code §1361 (b).

7 Code §1361(c)(4); Treas. Reg. §1.1361-1(l)(1).

8 Treas. Reg. §1.1361-1(l)(2)(i).

9 Code §1361(c)(2).

10 Code §1361(c)(2)(A)(iv).

- Individuals
- Estates
- Certain types of charitable organizations[11]

To be an E.S.B.T., the trust must make a timely election. The election can be made – and remains valid – if no beneficiary acquires an interest in the E.S.B.T. through a purchase.[12] For this purpose, an interest is acquired through a purchase if a cost basis exists for the beneficial interest under Code §1012.[13]

For purposes of the E.S.B.T. election, the concept of a "potential current beneficiary" is important. This term refers to a person who has a present, remainder, or reversionary interest in the trust.[14] The E.S.B.T. and all its potential current beneficiaries are treated as shareholders of the S-corporation.

"Now, a nonresident, noncitizen individual can be a potential current beneficiary of an E.S.B.T."

Under prior law, a nonresident, noncitizen individual was eligible to be a future beneficiary without jeopardizing the status of the corporation as an S-corporation, but if that individual became a potential current beneficiary of the E.S.B.T., the S-corporation risked a loss of status because the nonresident, noncitizen individual was considered to be a shareholder.[15]

The T.C.J.A. eliminates this risk. Now, a nonresident, noncitizen individual can be a potential current beneficiary of an E.S.B.T., and that will not be taken into account in determining whether the S-corporation has a nonresident, noncitizen individual as a shareholder.

TAX TREATMENT OF AN E.S.B.T.

Generally, an E.S.B.T. is treated as two separate trusts for tax purposes, the portion of the E.S.B.T. that reflects shares of stock in one or more S-corporation(s) is treated as one trust – the S portion – and the portion reflecting all other assets is treated as a second trust – the non-S portion. However, for administrative purposes, an E.S.B.T. is treated as a single trust.[16]

An E.S.B.T. can be both a grantor and a non-grantor trust at the same time. Furthermore, if the E.S.B.T. consists of a grantor trust only in part, the E.S.B.T. will be treated as three separate trusts:

- A grantor portion
- A non-grantor S portion
- A non-grantor non-S portion[17]

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11 Code §1361(e)(1).

12 Treas. Reg. §1.1361-1(m). Purchase means any acquisition if the basis of the property is determined under Code §1012.

13 Code §1361(e)(1)(C).

14 Treas. Reg. §1.1361-1(m)(ii).

15 Treas. Reg. §1.1361-1(m).

16 Treas. Reg. §1.641(c)-1(a).

17 Treas. Reg. §1.641(c)-1(b).

The grantor portion of the trust is taxed under the grantor tax rules of Subpart E of the Code.[18] Only the non-grantor S portion of the trust is treated as the shareholder for income tax, basis, and distribution purposes under Code §§1366, 1367, and 1368.[19] Again, note that the ownership of S-corporation shares through an E.S.B.T. that is a grantor trust should not result in the loss of S-corporation status.

Taxation of the S Portion

The S portion of an E.S.B.T. is taxed under Code §641(c). Even though the entire trust qualifies as an E.S.B.T., only that portion of the trust consisting of the S-corporation stock is taxed under Code §641(c). Consequently, the items of income, deduction, and credit of the S portion of an E.S.B.T. are limited to the following:

- Items passed through from the S-corporation pursuant to Code §1366
- Gain or loss from the disposition of the S-corporation stock
- State and local income taxes or administrative expenses allocable to such items[20]

The S portion of the E.S.B.T. generally is taxed at the highest individual tax rate.[21]

If S-corporation stock is distributed to a beneficiary, the beneficiary takes a carryover basis in the shares received in the distribution. Distributions to the E.S.B.T. from the S-corporation that exceed the basis maintained in the shares of the S-corporation are taxed as a capital gain.[22] If an E.S.B.T. owns stock in more than one S-corporation, then items of income, loss, deduction, or credit from all the S-corporations are aggregated for purposes of determining the S portion's taxable income.[23]

As stated above, a gain realized by an E.S.B.T. on the sale of shares of S-corporation stock will be allocated to the S portion of the trust.[24] However, if income from the sale or disposition of stock in an S-corporation is reported by the trust under the installment method, the interest on the installment obligation is includible in the gross income of the non-S portion.[25] Finally, if the E.S.B.T. makes a charitable contribution, the deduction is limited to the non-S portion's gross income. Finally, If the S-corporation stock is donated to the charity, neither the S portion nor the non-S portion may claim a deduction.[26]

Taxation of the Non-S Portion

The taxable income of the non-S portion of the E.S.B.T. is determined by taking into account all items of income, deduction, and credit to the extent not taken into

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18 Treas. Reg. §1.641(c)-1(c).

19 Treas. Reg. §1.641(c)-1(d).

20 Code §641(c)(2)(C).

21 Treas. Reg. §1.641(c)-1(e).

22 Treas. Reg. §1.641(c)-1(d)(3)(iii).

23 Treas. Reg. §1.641(c)-1(d)(2)(iii).

24 Treas. Reg. §1.641(c)-1(d)(3)(ii).

25 Treas. Reg. §1.641(c)-1(g)(3).

26 Treas. Reg. §1.641(c)-1(l), Ex. 4.

account by either the grantor portion or the S portion of the trust.[27] Whenever state and local income taxes or administration expenses relate to more than one portion of an E.S.B.T., the items are allocated to the relevant portions of the E.S.B.T. and apportioned between them. The allocation is done in any manner that is reasonable in light of all the circumstances, including the terms of the governing instrument, applicable local law, and the practice of the trustee with respect to the trust if applied in a manner that is consistent.[28]

Under prior law, an E.S.B.T. was allowed a charitable contribution deduction at the trust level without any limitation, and the contribution was deemed to come from the non-S portion to the extent it was made out of the non-S portion's gross income.[29] Under the T.C.J.A., an E.S.B.T.'s charitable deduction is subject to the limitation that applies to individuals.

CROSS-BORDER PLANNING IMPLICATIONS

The T.C.J.A. adopts a provision that allows a nonresident, noncitizen individual to become a potential beneficiary of an E.S.B.T. without causing an S-corporation to lose its status by having a nonresident, non-citizen as a deemed shareholder. This change in law could have a major impact on, for example, the way Canadian-resident individuals invest in the U.S. C.R.. – the tax authority in Canada – has adopted the position that a U.S. L.L.C. is not entitled to treaty benefits as it is not subject to tax in the U.S. and for that reason does not fall within the definition of a resident provided in the treaty.[30] As a result, an L.L.C. that is formed in the U.S. can be a resident of Canada for Canadian tax purposes, and the tiebreaker provision of the Canada-U.S. Income Tax Treaty is irrelevant. However, C.R.A. does not take a similar position with regard to S-corporations. Thus, the tiebreaker provision becomes relevant in preventing an assertion of Canadian residence for an S-corporation. Under the tiebreaker provision,[31] the residence of an otherwise dual-resident entity is allocated, for treaty purposes, exclusively to the country under the laws of which it was formed.

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27 Treas. Reg. §1.641(c)-1(g)(1).

28 Treas. Reg. §1.641(c)-1(h).

29 Treas. Reg. §1.641(c)-1(g)(4).

30 Article IV (Residence), paragraph 1 of the Canada-U.S. Income Tax Treaty, which in pertinent part, defines a resident in the following terms:

> 1. For the purposes of this Convention, the term 'resident' of a Contracting State means any person that, under the laws of that State, is liable to tax therein by reason of that person's domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature . . . .

31 *Id.*