



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-117062-18]

RIN 1545-BO93

Electing Small Business Trusts with Nonresident Aliens as Potential Current Beneficiaries

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This notice of proposed rulemaking provides rules regarding the recent statutory expansion of the class of permissible potential current beneficiaries (PCBs) of an electing small business trust (ESBT) to include nonresident aliens (NRAs). In particular, these proposed regulations would ensure that the income of an S corporation will continue to be subject to U.S. Federal income tax when an NRA is a deemed owner of a grantor trust that elects to be an ESBT.

DATES: Comments and requests for a public hearing must be received by **[INSERT DATE 45 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Submit electronic submissions via the Federal Rulemaking Portal at www.regulations.gov (indicate IRS and REG-117062-18) by following the online instructions for submitting comments. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to: CC:PA:LPD:PR (REG-117062-18), Room 5203, Internal Revenue

Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-117062-18), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC, 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Cynthia Morton, (202) 317-5279; concerning submissions and the hearing, Regina Johnson, (202) 317-6901(not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

1. Overview

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 641 and 1361 of the Internal Revenue Code (Code).

Section 13541(a) of "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Public Law 115-97, 131 Stat. 2054, 2154 (TCJA) amended section 1361(c)(2)(B)(v) of the Code to allow NRAs to be PCBs of ESBTs. As amended, section 1361(c)(2)(B)(v) provides that NRA PCBs will not be taken into account for purposes of the S corporation shareholder-eligibility requirement that otherwise prohibits NRA shareholders. See section 1361(b)(1)(C).

A. S Corporations and NRAs

An S corporation is a "small business corporation" for which an election, made under section 1362(a), is in effect. Section 1361(b)(1) defines the term "small business corporation" as a domestic corporation that (i) is not an ineligible corporation (as defined in section 1361(b)(2)); (ii) does not have more than 100 shareholders; (iii) does not have

a shareholder who is not an individual, estate, a certain type of trust, or a certain type of tax-exempt organization; (iv) does not have more than one class of stock; and (v) as relevant to these proposed regulations, does not have an NRA as a shareholder.

Section 7701(b)(1)(B) defines an NRA as an individual who is neither a citizen of the United States nor a resident of the United States, within the meaning of section 7701(b)(1)(A). Section 7701(b)(1)(A) provides that an alien individual is treated as a resident of the United States with respect to any calendar year if (and only if) such individual (i) is a lawful permanent resident of the United States at any time during such calendar year; (ii) meets the substantial presence test of section 7701(b)(3); or (iii) makes the first-year election provided in section 7701(b)(4).

B. Categories of Trusts Permitted to be S Corporation Shareholders

Only certain trusts are permitted to be an S corporation shareholder. Specifically, sections 1361(c)(2) and (d)(1)(A) provide that the following trusts may be an S corporation shareholder: (i) A grantor trust wholly owned by an individual who is a citizen or resident of the United States; (ii) a voting trust; (iii) certain grantor trusts that continue to exist for a period generally not longer than two years after the grantor's death; (iv) certain testamentary trusts for two years after the S corporation stock is transferred to it; (v) a qualified subchapter S trust; (vi) certain individual retirement accounts under section 408(a) that hold certain bank or company stock; and (vii) as relevant to these proposed regulations, a domestic trust that qualifies as an ESBT.

C. Overview of ESBTs

To expand the categories of trusts permitted to be S corporation shareholders under section 1361(c)(2) and thereby, in particular, to facilitate family financial planning,

Congress added ESBTs to the list of permitted categories of S corporation shareholders over two decades ago. See H. Rept. 104-586, at 82 (1996); S. Rept. 104-281, at 46 (1996). An ESBT must be a domestic trust based on the flush language under section 1361(c)(2)(A), which provides that a foreign trust cannot be an eligible S corporation shareholder. Read together with section 1361(e)(1), an ESBT is any domestic trust that satisfies the following requirements: (i) The trust does not have as a beneficiary any person other than an individual, an estate, or an organization described in section 170(c)(2) through (5), or an organization described in section 170(c)(1) that holds a contingent interest in such trust and is not a PCB; (ii) no interest in the trust was acquired by purchase; and (iii) an election has been made under section 1361(e) with respect to the trust. An ESBT may hold S corporation stock as well as other property, and may accumulate trust income. In addition, and as relevant to these proposed regulations, (i) a PCB may be one of multiple beneficiaries of an ESBT, and (ii) a grantor trust may elect to be an ESBT.

i. PCB as an ESBT Beneficiary

For purposes of determining whether a corporation is an S corporation, each PCB of an ESBT is treated as a separate S corporation shareholder. See section 1361(c)(2)(B)(v). A PCB, with respect to any period, is any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the ESBT (determined without regard to any power of appointment to the extent such power remains unexercised). See section 1361(e)(2). As relevant to these proposed regulations, a PCB also can be the deemed owner of a grantor trust that elects to be an ESBT.

ii. ESBTs Divided into Portions for Tax Liability Determinations

An ESBT that owns stock of an S corporation, as well as other property, is treated as two separate trusts (S portion and non-S portion, respectively) for purposes of chapter 1 of subtitle A of the Code (chapter 1), even though the ESBT is treated as a single trust for administrative purposes. See §1.641(c)-1(a). Specifically, section 641(c)(1)(A) provides that the S portion, which consists solely of S corporation stock, is (i) treated as a separate trust for purposes of chapter 1, and (ii) taxed in accordance with section 641(c)(2). The non-S portion of the ESBT remains subject to the normal trust income taxation rules of subparts A through D of subchapter J of chapter 1 (subchapter J) that govern simple and complex trusts. In addition, the S portion or non-S portion (or both) can be treated as owned by a grantor under §1.641(c)-1(b)(1), referred to as the “grantor portion,” and is subject to the rules under subpart E of subchapter J.

iii. Effect of ESBT Election by a Grantor Trust

A grantor trust generally is a trust over which the grantor or other deemed owner retains the power to control or direct the trust’s income or assets. If a trust is a grantor trust, then (i) the deemed owner is treated as the owner of the assets, (ii) the trust is disregarded as a separate entity for Federal income tax purposes, and (iii) all items of income, deduction, and credit are taxed to the deemed owner. Wholly or partially-owned grantor trusts can make an ESBT election but the grantor trust taxation rules of the Code override the ESBT provisions. Therefore, an ESBT pays tax directly at the trust level on its S corporation income and that income is not passed through to the

beneficiaries, except for the amount that is taxed to the owner of the grantor trust portion.

The Department of the Treasury (Treasury Department) and the IRS promulgated regulations in 2002 to clarify that the items of income, deduction, and credit of the portion of an ESBT treated as owned by a grantor or other person under the grantor trust rules are taken into account by the deemed owner (rather than the ESBT) under section 671 in computing the deemed owner's taxable income. See §1.641(c)-1(c). Therefore, under those regulations, a wholly-owned grantor trust can be an ESBT, but with no immediate change to the grantor trust's taxation. While an ESBT may be divided into a non-S portion, an S portion, and a grantor trust portion, the statutory definitions of an ESBT and of a PCB focus on all the persons who are beneficiaries or PCBs of the entire trust, rather than beneficiaries of only the S portion. As relevant to these proposed regulations, the deemed owner of the grantor trust portion is treated as a PCB of the ESBT.

2. TCJA Expansion of Qualifying Beneficiaries of ESBTs

A. Prior Law and TCJA Change

Prior to the enactment of the TCJA, a change in the immigration status of a PCB of an ESBT that owns S corporation stock from resident alien to NRA would have terminated an ESBT election, and therefore also terminated the corporation's election as an S corporation. This result would have occurred because, prior to the TCJA-enacted exception to the section 1361(b)(1)(C) eligible-shareholder requirement, section 1361(c)(2)(B)(v) provided, in relevant part, that each PCB of an ESBT must be treated as a shareholder of the S corporation. As discussed in part 1(A) of this

Background section, if a purported S corporation has an NRA shareholder, such S corporation would fail the qualification requirements listed in section 1361(b)(1), resulting in the termination of its status as an S corporation.

Section 13541(a) of the TCJA amended section 1361(c)(2)(B)(v) to provide that the rule treating each PCB of an ESBT as a shareholder does not apply for purposes of the eligible-shareholder requirement of section 1361(b)(1)(C). As a result of that TCJA amendment, if a resident alien PCB of an ESBT becomes an NRA, the status of that PCB as an NRA will not cause the S corporation of which the ESBT is a shareholder to fail the requirement in section 1361(b)(1)(C), which otherwise would terminate its S election. While Congress amended section 1361(c)(2)(B)(v) to expand the scope of qualifying beneficiaries of ESBTs, Congress left unaltered the rule under section 1361(b)(1)(C) that an S corporation cannot have an NRA as a shareholder.

B. TCJA Expansion

Prior to the TCJA, only individuals subject to Federal income taxation could receive an ESBT's share of S corporation income because a grantor trust that elected ESBT status could not have had a deemed owner who was an NRA. Without these proposed regulations, the TCJA's expansion of an ESBT's permissible PCBs to include an NRA would allow S corporation income attributed to the grantor portion of an ESBT that is received by a NRA deemed owner of that portion, to escape Federal income taxation, contrary to Congressional intent. For example, if an NRA were to be a deemed owner of a grantor trust that elected to be an ESBT, and thus were to be allocated foreign source income of the S corporation or income not effectively connected with the conduct of a U.S. trade or business under section 864(c)(4)(B), that

NRA would not be required to include such S corporation items in income under section 671 because the NRA would not be liable for Federal income tax on such income under section 871(a) or (b). Additionally, if that NRA is a resident of a country with which the United States has an income tax treaty, U.S. source income of the S corporation also might be exempt from tax or subject to a lower rate of Federal income tax in the hands of that NRA.

Under section 672(f)(2)(A)(ii), trust income, deductions, and credits are taxed to NRA grantors if the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor. Such a trust would not be a foreign trust solely because the grantor retained this right, provided that (1) a U.S. court had primary jurisdiction over the trust, as required by section 7701(a)(30)(E)(i), and (2) U.S. persons controlled substantial trust decisions, as required by section 7701(a)(30)(E)(ii). Accordingly, a domestic trust described in section 672(f)(2)(A)(ii) that elects ESBT status would be a grantor trust, and the income from the trust would be taxed to the NRA grantor-owner(s) (that is, the grantor and the grantor's spouse) during the grantor's lifetime. These NRA deemed owners would not be subject to U.S. Federal income tax on the S corporation income unless this income was U.S. source fixed or determinable income or income effectively connected with a U.S. trade or business.

C. Income from S Portion of ESBT Should Not Escape U.S. Federal Income Taxation

In discussing the amendment to section 1361(c)(2)(B)(v) allowing an NRA to be a PCB of an ESBT, the Conference Report made the following two observations regarding present S corporation law: First, the portion of an ESBT that consists of S

corporation stock “is treated as a separate trust” and generally (that is, not taking into account capital gains) is “taxed on its share of the S corporation’s income at the highest rate of tax imposed on individual taxpayers.” H. Rept. 115-466, at 517 (2017). See also §1.641(c)-1(e)(1) (articulating the capital gains exception regarding Congress’ use of the word “generally”). Second, Congress noted that an “[ESBT’s share of S corporation] income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT.” Id. These observations reflect the general rule of ESBT taxation that (i) subjects the ESBT to tax on its S corporation income at the trust level, rather than the beneficiary level, and accordingly (ii) is indifferent to the citizenship or residence status of the ESBT’s beneficiaries because the ESBT must be domestic. The observations do not take into account the interaction between the ESBT and grantor trust tax regimes, which allows a trust to be an ESBT for S corporation qualification purposes while permitting all or a portion of the trust subject to the grantor trust provisions to be taxed as a grantor trust, rather than as an ESBT. As described earlier, §1.641(c)-1(c) provides that the taxable income of a grantor trust that elects to be an ESBT is treated as the taxable income of the deemed owner of the trust (including a deemed owner who is an NRA), regardless of whether the ESBT distributes the income.

The report accompanying the Senate bill (Senate Report) similarly indicates that Congress assumed that the taxation of income at the ESBT level would protect against potential tax avoidance that might otherwise result from permitting an NRA to be a PCB of an ESBT: “An ESBT that is an S corporation shareholder is taxed on its share of the S corporation’s income at the highest rate of tax imposed on individual taxpayers. For that reason, the Committee believes that allowing a nonresident alien individual to be a

potential current beneficiary of an ESBT presents little risk of tax avoidance.” S. Comm. on the Budget, Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Print No. 115-20, at 235-236 (2017).

Based on this legislative history of section 1361(c)(2)(B)(v), the Treasury Department and the IRS have determined that the expansion of that clause to allow an NRA to be an ESBT PCB was not intended to override longstanding statutory provisions that have operated to ensure that all of the S corporation income remains subject to Federal income tax. In the absence of regulations, the post-TCJA ability of an NRA to be a PCB of an ESBT, in combination with the potential for a grantor trust portion of an ESBT to be owned by an NRA under section 672(f)(2)(A)(1)(ii), could result in S corporation income passing without tax from the domestic ESBT to the NRA and escaping Federal income taxation.

Explanation of Provisions

These proposed regulations would ensure that, with respect to situations in which an NRA is a deemed owner of a grantor trust that has elected to be an ESBT, the S corporation income of the ESBT would continue to be subject to U.S. Federal income tax. Specifically, the proposed regulations would modify the allocation rules under §1.641(c)-1 to require that the S corporation income of the ESBT be included in the S portion of the ESBT if that income otherwise would have been allocated to an NRA deemed owner under the grantor trust rules. Accordingly, such income would be taxed to the domestic ESBT by providing that, if the deemed owner is an NRA, the grantor portion of net income must be reallocated from the grantor portion of the ESBT to the ESBT’s S portion.

The proposed regulations also would implement Congress' amendment to section 1361(c)(2)(B)(v) by making conforming revisions to §1.1361-1(m). For example, the proposed regulations would update the description of PCBs in §1.1361-1(m)(4)(i) to reflect the ability of NRAs to be PCBs of ESBTs. The proposed regulations similarly would update other provisions in §1.1361-1(m) to reflect that ability.

Proposed Effective/Applicability Date

Section 7805(b)(1)(A) and (B) of the Code generally provide that no temporary, proposed, or final regulation relating to the internal revenue laws may apply to any taxable period ending before the earliest of (A) the date on which such regulation is filed with the **Federal Register**, or (B) in the case of a final regulation, the date on which a proposed or temporary regulation to which the final regulation relates was filed with the **Federal Register**. However, section 7805(b)(2) provides that regulations filed or issued within 18 months of the date of the enactment of the statutory provision to which they relate are not prohibited from applying to taxable periods prior to those described in section 7805(b)(1). Furthermore, section 7805(b)(3) provides that the Secretary may provide that any regulation may take effect or apply retroactively to prevent abuse.

Accordingly, to prevent abuse of sections 641 and 1361 and the regulations thereunder, these proposed regulations are proposed to apply to all ESBTs after December 31, 2017.

Special Analyses

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the

Department of the Treasury and the Office of Management and Budget regarding review of tax regulations.

This notice of proposed rulemaking does not impose a collection of information on any small entities. Accordingly, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Notwithstanding this certification, the Treasury Department and the IRS invite comments from interested members of the public on both the number of entities affected and the economic impact on small entities.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the **ADDRESSES** heading.

All comments will be available at <http://www.regulations.gov> or upon request. A public hearing may be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Cynthia Morton of the Office of Associate Chief Counsel (Passthroughs and Special Industries). However,

other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.641(c)-1 is amended by:

1. Revising paragraphs (b)(1) and (2).
2. Adding a sentence to the end of paragraph (k).
3. In paragraph (l), designating Examples 1 through 5 as paragraphs (l)(1) through (5).
4. In newly designated paragraph (l)(3)(i), removing the language “Example 2” and adding “Example 2 in paragraph (l)(2) of this section” in its place.
5. Adding paragraph (l)(6).

The revisions and additions read as follows:

§1.641(c)-1 Electing small business trust.

* * * * *

(b) * * *

(1) Grantor portion--(i) In general. Subject to paragraph (b)(1)(ii) of this section, the grantor portion of an ESBT is the portion of the trust that is treated as owned by the grantor or another person under subpart E of the Code.

(ii) Nonresident alien deemed owner. If, pursuant to section 672(f)(2)(A)(ii), the deemed owner of a grantor portion of the ESBT is a nonresident alien, as defined in section 7701(b)(1)(B) (NRA), the items of income, deduction, and credit from that grantor portion must be reallocated from the grantor portion to the S portion, as defined in paragraph (b)(2) of this section, of the ESBT.

(2) S portion--(i) In general. Subject to paragraph (b)(2)(ii) of this section, the S portion of an ESBT is the portion of the trust that consists of S corporation stock and that is not treated as owned by the grantor or another person under subpart E of the Code.

(ii) NRA deemed owner of grantor portion. The S portion of an ESBT also includes the grantor portion of the items of income, deduction, and credit reallocated under paragraph (b)(1)(ii) of this section from the grantor portion of the ESBT to the S portion of the ESBT.

* * * * *

(k) * * * Paragraphs (b)(1) and (2) of this section, and Example 6 in paragraph (l)(6) of this section, apply to all ESBTs after December 31, 2017.

(l) * * *

(6) Example 6: NRA as potential current beneficiary. Domestic Trust (DT) has a valid ESBT election in effect. DT owns S corporation stock. The S corporation owns U.S. and foreign assets. The foreign assets produce foreign source income. B, an NRA, is the grantor and the only trust beneficiary and potential current beneficiary of DT. B is not a resident of a country with which the United States has an income tax treaty. Under section 677(a), B is treated as the owner of DT because, under the trust

documents, income and corpus may be distributed only to B during B's lifetime. Paragraph (b)(2)(ii) of this section requires that the S corporation income of the ESBT that otherwise would have been allocated to B under the grantor trust rules must be reallocated from B's grantor portion to the S portion of DT. In this example, the S portion of DT is treated as including the grantor portion of the ESBT, and thus all of DT's income from the S corporation is taxable to DT.

Par. 3. Section 1.1361-1 is amended by:

1. Revising paragraph (m)(1)(ii)(D).
2. Revising paragraph (m)(2)(ii)(E)(2).
3. Adding two sentences to the end of paragraph (m)(4)(i).
4. Revising the second sentence of paragraph (m)(5)(iii).
5. In paragraph (m)(8), designating Examples 1 through 9 as paragraphs (m)(8)(i) through (ix).
6. Redesignating paragraphs (m)(8)(i)(i) through (iii) as paragraphs (m)(8)(i)(A) through (C).
7. Redesignating paragraphs (m)(8)(ii)(i) and (ii) as paragraphs (m)(8)(ii)(A) and (B) and revising the second sentence of newly redesignated paragraph (m)(8)(ii)(A).
8. In newly redesignated paragraph (m)(8)(ii)(B), removing the language "Example 2(i)" and adding "Example 2 in paragraph (m)(8)(ii)(A) of this section" in its place.
9. Redesignating paragraphs (m)(8)(vi)(i) through (iii) as paragraphs (m)(8)(vi)(A) through (C) and revising the first sentence of newly redesignated paragraph (m)(8)(vi)(B).

10. In newly redesignated paragraph (m)(8)(vi)(C), removing the language “paragraph (i) of this Example 6” and adding “Example 6 in paragraph (m)(8)(vi)(A) of this section” in its place.

11. In paragraph (m)(9):

i. Removing the language “Paragraphs (m)(2)(ii)(A), (m)(4)(iii) and (vi), and (m)(8), Example 2, Example 5, Example 7, Example 8, and Example 9” and adding “Paragraphs (m)(2)(ii)(A) and (m)(4)(iii) and (vi) of this section and Examples 2, 5, and 7 through 9 in paragraphs (m)(8)(ii), (v), and (vii) through (ix)” in its place.

ii. Adding a sentence at the end of the paragraph.

The revisions and additions read as follows:

§1.1361-1 S corporation defined.

* * * * *

(m) * * *

(1) * * *

(ii) * * *

(D) Nonresident aliens. A nonresident alien (NRA), as defined in section 7701(b)(1)(B), is an eligible beneficiary of an ESBT and an eligible potential current beneficiary.

* * * * *

(2) * * *

(ii) * * *

(E) * * *

(2) All potential current beneficiaries of the trust meet the shareholder requirements of section 1361(b)(1); for this purpose, an NRA potential current beneficiary does not violate the requirement under section 1361(b)(1)(C) that an S corporation cannot have an NRA as a shareholder.

* * * * *

(4) * * *

(i) * * * An NRA potential current beneficiary of an ESBT is treated as a shareholder for purposes of the 100-shareholder limit under section 1361(b)(1)(A). However, an NRA potential current beneficiary of an ESBT is not treated as a shareholder in determining whether a corporation is a small business corporation for purposes of the NRA-shareholder prohibition under section 1361(b)(1)(C).

* * * * *

(5) * * *

(iii) * * * For example, the S corporation election will terminate if a charitable remainder trust becomes a potential current beneficiary of an ESBT. * * *

* * * * *

(8) * * *

(ii) * * *

(A) * * * On January 1, 2006, A, a partnership, becomes a potential current beneficiary of Trust. * * *

* * * * *

(vi) * * *

(B) * * * Assume the same facts as Example 6 in paragraph (m)(8)(vi)(A) of this section except that D is a charitable remainder trust. * * *

* * * * *

(9) * * * Paragraphs (m)(1)(ii)(D), (m)(2)(ii)(E)(2), (m)(4)(i), (m)(5)(iii), and (m)(8) of this section apply to all ESBTs after December 31, 2017.

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

[FR Doc. 2019-07919 Filed: 4/17/2019 4:15 pm; Publication Date: 4/19/2019]