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BENEFICIARIES OF TRUSTS THAT OWN S CORP STOCK

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On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (TCJA). As this substantial legislation continues to be analyzed, attention shifts to its subtler effects on the US tax code, such as a change in the permissible current beneficiaries of certain trusts that hold S corp stock.

Since 1958, US tax law has allowed certain corporations to elect S status and thus to be taxed generally as partnerships for income tax purposes. So-called S corps— named for the location of their governing rules in Code subchapter S— essentially combine the advantageous legal structure of a US corporation (such as liability protection and corporate governance) with the benefits of US flow through taxation (taxed only at the shareholder level). As defined in US tax law, an "S corp" must be a small business corporation, which means, among other things, that the corporation (1) is a domestic corporation, (2) has 100 or fewer shareholders, (3) has only individuals as shareholders (exceptions exist for estates, certain trusts, and certain tax-exempt organizations), (4) does not have a non-resident alien as a shareholder, and (5) has only one class of stock.

A trust can hold stock in an S corp only if it (1) is treated as owned by its grantor for income tax purposes under us grantor trust rules, (2) was a grantor trust immediately before its grantor's death (the trust can be a shareholder only for two years from that date), (3) received stock from the will of a decedent (the trust can be a shareholder only for two years from the date of receipt), (4) was created primarily to exercise voting power over stock transferred to it, (5) is an electing small business trust, or (6) qualifies as a qualified subchapter s trust. In the first four cases, either the trust grantor must be alive (or have recently died) or the trust must exist for voting-control (that is, non-economic) purposes. Thus, if a grantor wants to leave S corp stock to a trust for her family members after her death without terminating the company's election, the trust must qualify either as an electing small business trust (ESBT) or as a qualified subchapter s trust (QSST). An ESBT gives the trustee the discretion to accumulate income within the trust for the benefit of one or more individual beneficiaries, and is subject to us income tax at the highest marginal tax rate. A QSST requires all income to be distributed annually to one individual

beneficiary, and that beneficiary is subject to US income tax on the QSST income at his or her individual tax rate.

A US non-resident alien cannot be a shareholder of an S corporation. Historically, a non-resident alien could not be a potential current beneficiary of either an ESBT or a QSST: a trust created for a Canadian citizen and resident beneficiary could not own S corp stock, and the Canadian citizen and resident could not own the stock directly, either. In addition to the more straightforward application, this issue may manifest itself in subtler ways. For example, a US-citizen parent owned S corp stock and established a trust that qualified as an ESBT or a QSST for her US-citizen child. The trust provides that the child's spouse becomes a trust beneficiary upon the child's death. But if the child moves to Canada and is married to a Canadian citizen and resident, his or her spouse cannot become a trust beneficiary upon the child's death without terminating the corporation's S election. And the child who held a power of appointment over the trust could not exercise that power in favour of the spouse (or a trust for the spouse's benefit) without terminating the S corp's election, either.

The TCJA changed the rules applicable to an ESBT effective January 1, 2018, so that a US non-resident alien (such as a Canadian citizen and resident) may be an ESBT's potential current beneficiary: a US non-resident alien may now be entitled to, or at the discretion of any person may receive, a distribution from an ESBT (including cases in which the nonresident alien is the only such person). The TCJA did not change the rules with respect to direct ownership of stock in an S corp by a US non-resident alien or with respect to ownership by a QSST: a US non-resident alien remains unable to own S corp stock directly and cannot be a QSST's current beneficiary.

This subtle change to the ESBT rules creates potential planning opportunities in both the estate-planning and corporate-structuring contexts. In the estate-planning context, a US grantor may now establish a trust (that elects to be an ESBT) for a US non-resident alien beneficiary (such as a Canadian citizen and resident) and may fund that trust with S corp stock without terminating its election. In addition, an existing ESBT's beneficiary may now exercise a power of appointment in favour of a non-resident alien beneficiary. In the corporate-structuring context, a Canadian citizen and resident wanting to acquire an S corp's stock (which, before the TCJA, could not be done without terminating the corporation's S election) may own the stock through a us trust of which the Canadian citizen and resident is a potential current beneficiary and for which an ESBT election is made.