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October 8, 2007

The Honorable Max Baucus
Chairman
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Charles Grassley
Ranking Member
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Charles B. Rangel
Chairman
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Jim McCrery
Ranking Member
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairmen and Ranking Members:

The attached comments recommend that Congress change the law to allow "electing small business trusts" to have nonresident aliens as potential current beneficiaries. The comments are being submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law (the "Section"). The comments have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

The comments were prepared by members of the Income and Transfer Tax Planning Group of the Trust and Estate Division of the Section. Although the members of the Section who prepared this letter have clients who are affected by the Federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or the outcome of, the specific subject matter of this letter.

If you have any questions, please do not hesitate to contact Ed Manigault, 404-581-8340, emmanigault@jonesday.com.

Very truly yours,

Kathleen M. Martin
Section Chair

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

cc: Armando Lasa-Ferrer, ABA Secretary
Denise Cardman, ABA Governmental Affairs
Alan F. Rothschild, Jr., Section Vice-Chair, Trust and Estate Division
Steve R. Akers, Chair Elect, ABA Section of Real Property, Trust and Estate Law

RECOMMENDATION THAT NONRESIDENT ALIENS BE PERMITTED AS POTENTIAL CURRENT BENEFICIARIES OF ELECTING SMALL BUSINESS TRUSTS

These comments are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law (the "Section"). The comments have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

These comments were prepared by members of the Income and Transfer Tax Planning Group of the Trust and Estate Division of the Section, including members of the International Tax Planning Committee. Principal responsibility was exercised by Edward M. Manigault of Jones Day, Vice Chair of the Income and Transfer Tax Planning Group of the Section, Leigh-Alexandra Basha of Holland & Knight LLP, Chair of the International Tax Planning Committee, Rozlyn Anderson of Merrill Lynch, Co-Vice Chair of the International Tax Planning Committee and Michael A. Spielman of Kahn Kleinman, LPA, Co-Vice Chair of the International Tax Planning Committee. This letter was reviewed by Ellen K. Harrison of Pillsbury Winthrop Shaw Pittman LLP on behalf of the Section's Committee on Governmental Submissions.

Although the members of the Section who prepared this letter have clients who are affected by the Federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or the outcome of, the specific subject matter of this letter.

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Date: October 8, 2007

I. EXECUTIVE SUMMARY.

We recommend that Congress amend the Internal Revenue Code (specifically, Code § 1361(c)(2)(B)(v)) to allow nonresident aliens to be potential current beneficiaries of electing small business trusts.

II. PRESENT LAW.

S corporations – generally. An S corporation is a corporation taxed under subchapter S of the Internal Revenue Code (the "Code"). Unlike other corporations, an S corporation generally does not pay Federal income tax at the corporate level. Instead, items of income, loss, deduction or credit are passed through proportionately to the shareholders of an S corporation.

S corporations restrictions. S corporations must meet several requirements to take advantage of this one level of taxation. For example, an S corporation may not have more than

100 shareholders (although spouses and certain family members are treated as one shareholder).[1] In addition, there are only a few types of shareholders who can own (directly or indirectly) stock in an S corporation. The general rule is that an S corporation shareholder must be an individual. There are, however, exceptions that permit estates, certain tax-exempt organizations and some trusts to own stock in an S corporation. A nonresident alien may not, however, own stock in an S corporation. Code § 1361(b)(1)(C). (In contrast, an entity taxed as a partnership under subchapter K of the Code is not subject to any of these limitations.)

ESBTs. An "electing small business trust" (or ESBT) may own S corporation stock. Code § 1361(c)(2)(A)(2)(v). Unlike the other trusts that can own S corporation stock, an ESBT is a separate taxpayer, the S corporation income of which is taxed at the highest marginal income tax rate – without regard to when or whether the S corporation dividends are distributed. Code § 641(c). A trust that has only individuals, an estate or certain charitable organizations as beneficiaries may qualify as an ESBT if no interest in the trust was acquired by purchase. Code § 1361(e). Unlike some other trusts that are permitted to own S corporation stock, an ESBT may have multiple beneficiaries and may accumulate income. Thus, greater flexibility is available with an ESBT. For this reason an ESBT is favored where a long-term trust is used for estate planning for S corporation shareholders. Unfortunately, and as discussed below, the use of ESBTs, particularly for long-term trusts, can ultimately lead to problems – not only for the ESBT, but also for the S corporation in which it is a shareholder, and all of the shareholders of that S corporation.

Every "potential current beneficiary" is deemed to be an owner of the S corporation stock. Code § 1361(c)(2)(B)(v). This "look-through" rule makes sense from a policy perspective – to prevent avoidance of the limitation on the number of shareholders of an S corporation. However, the look-through rule also prohibits an ESBT from having a nonresident alien as a potential current beneficiary.

III. PROBLEMS IN ESTATE PLANNING FOR S CORPORATION SHAREHOLDERS.

The S corporation requirements and limitations can materially limit the estate planning options available to shareholders in S corporations. There are also a variety of pitfalls which can result in the involuntary and unanticipated termination of an S corporation election – including when normal and customary estate planning techniques are employed. We focus in this letter on only one of those limitations and pitfalls – the nonresident alien beneficiary of an ESBT.

Suppose that a U.S. individual and S corporation shareholder engaged an estate planning attorney to prepare a very basic testamentary plan that provided upon her death, all of her assets would be held in trust "for my descendants and their spouses." Upon its face, this trust could qualify as an ESBT. However, because of the look-through rule, there are a variety of circumstances that either could exist upon the death of the shareholder, or arise over time, that could result in the trust having a nonresident alien as a potential current beneficiary.

[1] There are other requirements. S corporations may not have more than one class of stock. An insurance company cannot be an S corporation, and a financial institution that is an S corporation cannot use the reserve method of accounting. An S corporation cannot be (or have been) a domestic international sales corporation, or a corporation which has taken advantage of the tax credit under Code § 936.

The nonresident alien spouse or descendant. Assume that the U.S. citizen son of the deceased shareholder works in the Paris office of a U.S. multi-national corporation. If that son falls in love and marries a French national, the testamentary trust described above would *immediately* fail to qualify as an ESBT. Even if the above trust language only permitted distributions to descendants, and not to spouses, the future birth of a great-grandchild of the deceased shareholder could cause the trust to fail to qualify as an ESBT.[2]

The result of failure. The drastic result in either of the above situations – a marriage to or birth of a nonresident alien beneficiary - is the termination of the corporation's status as an S corporation. The termination of S corporation status would cause the corporation to have to pay income taxes, thereby adding a second level of tax. This scenario is a potential financial disaster, not only for the beneficiaries of the trust, but also for the S corporation and all of its other shareholders (even if they are not related to the ESBT beneficiaries). Although "inadvertent termination" relief may be available under Code § 1362(f), we believe there should be a change in the law to eliminate this pitfall.

The importance of the global family. We choose to focus on these scenarios because it is readily apparent to many in our practice area that as businesses become global, many U.S. citizens seek business opportunities outside U.S. borders. U.S. citizens are moving to other jurisdictions and establishing families which are truly global in nature. Such individuals and members of their families should not be excluded from owning interests in S corporations provided that U.S. tax revenue and enforcement is unaffected. Just as Congress enacted the "qualified domestic trust" provisions in Code § 2056A to grant the federal estate tax marital deduction to U.S. citizens with non-citizens spouses where a U.S. trustee has assumed the responsibility for collection of estate tax, the recommended change would be a comparable yet minor accommodation to recognize the increasingly common tax situation of families consisting of both U.S. and non-U.S. members. The proposal endorsed herein would also protect the other shareholders of S corporations from inadvertent S corporation terminations.

IV. RECOMMENDATION.

We recommend that the trust look-through rule of Code § 1361(c)(2)(B)(v) be amended by adding at the end thereof the following new sentence: "This clause shall not apply for purposes of subsection (b)(1)(C)."

The above change has been passed twice in the United States Senate – once as part of H.R. 2, The Fair Minimum Wage Act of 2007, and the second time as part of H.R. 1591.

There should be no tax avoidance that will result by reason of the proposed change, as all ESBTs pay Federal income tax at the highest marginal tax rate, without regard to whether or when any S corporation dividends are distributed to the ESBT beneficiaries. For this reason alone it should not matter whether nonresident aliens are beneficiaries of ESBTs, as the citizenship and residency status of the beneficiaries is not relevant to the collection of the income

[2] *See* 8 U.S.C. § 1401(g). Although the decedent's grandchildren (the children of the deceased shareholder's son) would be U.S. citizens at birth by reason of having one U.S. citizen parent (the son) who had resided in the U.S., if those grandchildren do not meet U.S. residency requirements, their children will not be U.S. citizens.

taxes attributable to the S corporation.[3] Additionally, when the Joint Committee of Taxation reviewed the revenue effects of this provision for purposes of H.R. 1591, it estimated the cost as being only $1 million in the first year after enactment and only a total of $37 million in the ten year period following enactment.

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We appreciate the opportunity to submit our recommendations and would welcome the opportunity to offer any additional assistance that may be desired.

[3] For this reason there may be other persons that should be permitted to be beneficiaries of ESBTs.