Background

On October 7, 1986, the IRS published in the **Federal Register** a notice of proposed rulemaking containing proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 1361 of the Internal Revenue Code (Code). These amendments were proposed to conform the regulations to sections 2 and 6 of the Subchapter S Revision Act of 1982 and to section 721(c) and (f) of the Tax Reform Act of 1984. After consideration of all comments received by Treasury and the IRS regarding the proposed amendments, those amendments are adopted as revised by this Treasury decision. The final regulations also reflect the amendments made to section 1361 by sections 901(d)(4)(G) and 1879(m) of the Tax Reform Act of 1986, section 1018(q)(2) of the Technical and Miscellaneous Revenue Act of 1988, and section 7811(c)(6) of the Omnibus Budget Reconciliation Act of 1989.

On January 26, 1983, the IRS published temporary regulation § 18.1361–1 under section 1361(d)(2) of the Internal Revenue Code of 1954 (TD 7872) in the **Federal Register** to provide guidance as to the election to treat a qualified subchapter S trust as a wholly-owned grantor trust. The temporary regulations are adopted as revised by this Treasury decision, and § 18.1361–1 of the temporary regulations is removed.

Explanation of Provisions

The proposed regulations define a domestic corporation as a corporation as defined in section 7701(a)(2) created or organized in the United States or under the law of the United States or any state or territory. Commentators recommended that this definition be clarified to provide that an association, unincorporated but taxable as a corporation, may elect to be treated as an S corporation. The final regulations revise the definition of a domestic corporation for purposes of the S corporation provisions by providing that an entity that is classified as an association taxable as a corporation under § 301.7701–2 of the Procedure and Administration Regulations may elect to be treated as an S corporation provided it meets the other requirements of a small business corporation.

Section 1361(b)(2)(C) provides that an insurance company subject to tax under subchapter L may not elect to be treated as an S corporation. However, the Subchapter S Revision Act of 1982 (the Act) provided a grandfather rule for a qualified casualty insurance electing small business corporation. The proposed regulations provide the grandfather rules for a qualified casualty insurance electing small business corporation. Additionally, the Act provided a grandfather rule with regard to the affiliation rule under section 1361(b)(2)(A) for a corporation that is affiliated with a foreign corporation or DISC. The final regulations remove the grandfather rules for a qualified casualty insurance electing small business corporation since they are no longer generally applicable. However, corporations that fit within those grandfather rules and certain corporations having oil and gas production should refer to section 6(c) of Public Law 97–354 for appropriate guidance.

The proposed regulations provide a special rule for a corporation having a shareholder who has a legal life estate or usufruct interest in the stock. The proposed regulations provide requirements for such shareholder to qualify as an eligible shareholder. Upon further consideration by the IRS and Treasury, the final regulations remove this special rule from the proposed regulations. The issue will be addressed in other published guidance.

The proposed regulations provide that persons for whom stock of a corporation is held by a nominee, guardian, custodian, or agent are generally considered to be shareholders of the corporation, but if stock is owned by a partnership, the partnership (and not its partners) is considered to be the shareholder and the corporation does not qualify as a small business corporation. Commentators questioned why stock which is held by a partnership as nominee for an individual should not be considered to be owned by the individual rather than the partnership for purposes of determining whether a corporation qualifies as an S corporation. Commentators suggested that this point be clarified. The final regulations adopt this suggestion by providing that a partnership may hold S corporation stock as a nominee for a person who will be treated as the shareholder.

The proposed regulations contain a rule that prohibits a nonresident alien from being an eligible S corporation shareholder. Commentators recommended an additional rule that would warn that a U.S. citizen married to a nonresident alien who, under applicable local law, has an interest in the U.S. citizen's stock could not be a shareholder of an S corporation. The final regulations provide that, if a U.S. shareholder's nonresident alien spouse has a current ownership interest in the shareholder's stock under applicable local law, the S corporation has an ineligible shareholder and therefore does not qualify as a small business corporation. For example, the laws of a nonresident alien spouse's country may give the nonresident alien spouse a community property interest in the U.S. spouse's property. In that case, the corporation would not constitute a small business corporation as of the date the nonresident spouse acquired an interest in the stock of the corporation, and the corporation's S election would terminate. See *Ward* v. *United States,* 661 F.2d 226 (Ct. Cl. 1981). If the termination is inadvertent, relief may be available under section 1362(f) of the Code.

The final regulations add and reserve § 1.1361–1(g)(2) addressing the status of dual residents. When the proposed regulations under § 301.7701(b)–7(a)(4) (published in the **Federal Register** (26 CFR 518) on April 27, 1992) are finalized, this section will contain a cross reference to those final regulations.

For purposes of section 1361(c)(2)(A)(i), the proposed regulations define a subpart E trust as a trust all of which (income and corpus) is treated (under subpart E, part I, subchapter J, chapter 1 of the Code) as owned by one individual (whether or not the grantor) who is a citizen or resident of the United States. Commentators expressed concern regarding the definition of a subpart E trust and suggested that for purposes of determining whether a trust meets the subpart E requirements under section 1361(c)(2)(A)(i), the relevant period for making that determination is the period during which the trust holds S corporation stock. The final regulations adopt the commentators' suggestion. Therefore, whether the trust is a wholly-owned trust during any period in which the trust does not hold S corporation stock is not relevant. In addition, the final regulations define a subpart E trust as a trust all of which is treated as owned by an individual. This definition tracks the language of section 1361(c)(2)(A)(i). Therefore, the trust is a permitted shareholder if the grantor or another person includes in computing taxable income and credits all of the trust's items of income, deductions, and credits against tax under the rules in § 1.671–3.

The final regulations clarify that a voting trust is a permitted shareholder only if it is a subpart E trust. Further, the final regulations add rules concerning who is treated as the shareholder for purposes of sections 1366, 1367, and 1368 when certain permitted trusts hold stock of an S