AVOIDING S CORPORATION I.E.D.'S

INCLUDING:

LLC CONVERSIONS
S TERMINATIONS
QUALIFIED S TRUSTS
SHAREHOLDER AGREEMENTS
AND
COMMUNITY/SEPARATE PROPERTY ISSUES

ROBERT H. KRONEY
M. SETH SOSOLIK
Kroney Morse Lan, P.C.
12221 Merit Drive, Suite 825
Dallas, Texas 75251

State Bar of Texas
34TH ANNUAL
ADVANCED ESTATE PLANNING
AND PROBATE COURSE
June 23-25, 2010
San Antonio

CHAPTER 11

ROBERT H. KRONEY

KRONEY MORSE LAN, PC
12221 Merit Drive, Suite 825
Dallas, Texas 75251
Phone: 972-386-8500
Fax: 972-701-0307
bkroney@kmllaw.com

ACTIVITIES AND PROFESSIONAL AFFILIATIONS

Certifications:

- Board Certified, Estate Planning and Probate Law, Texas Board of Legal Specialization
- Board Certified, Tax Law, Texas Board of Legal Specialization

Memberships:

Dallas Bar Association

- Chair, Probate, Trusts and Estates Section, 1993-1994
- Chair-Elect, Probate, Trusts and Estates Section, 1992-1993
- Treasurer, Probate, Trusts and Estates Section, 1990-1991
- Director, Probate, Trusts and Estates Section, 1989-1990

Dallas Estate Planning Council

- Director, 1972, 1984, and 1985

Dallas Chapter of Charter Life Underwriters

- Director, 1976-1983
- President, 1982
- Vice-President, 1980
- Chairman, Advanced Education, 1978
- Fellow, Texas Bar Foundation

State Bar of Texas

- Chair, Advanced Estate Planning and Probate Course, 1991
- Trust Editor, Real Estate, Probate and Trust Law Newsletter, Section of Real Estate, Probate and Trust Law, 1972-1978

College of the State Bar of Texas

American Bar Association

- Chair, Estate Planning and Drafting, Partnerships Committee of Real Property, Probate and Trust Section, 1989-1990

American College of Trust and Estate Counsel

EDUCATION AND PROFESSIONAL BACKGROUND

- Southern Methodist University, LL.M. in Taxation, 1972
- University of Texas at Austin, LL.B., 1964
- University of Oklahoma, B.S., 1962
- Special Probate Judge, Dallas County, Texas, 1988
- Captain, United States Army, Judge Advocate General School, Charlottesville, Virginia

M. SETH SOSOLIK
KRONEY MORSE LAN, PC
12221 Merit Drive, Suite 825
Dallas, Texas 75251
Phone: 972-386-8500
Fax: 972-701-0307
ssosolik@kmllaw.com

Practice Emphasis:
Seth concentrates his practice in the areas of federal, state and local tax planning and tax controversy. Seth also advises and counsels clients on general business and transactional matters, estate and business succession planning, and the administration of trusts and estates.

Admissions:
State Bar of Texas
U.S. Tax Court
United States Court of Appeals for the Fifth Circuit

Memberships:
Member, Tax Section and Probate, Trust & Estate Section, Dallas Bar Association
Member, Business Law Section and Taxation Section, American Bar Association

Honors and Awards:
Texas Rising Star, Tax, Texas Monthly magazine – 2006, 2007, 2009, and 2010

Education and Professional Background:
Southern Methodist University School of Law, LL.M. in Taxation, 2002
Baylor University School of Law, J.D., 2001
Baylor University, B.B.A. in Accounting, cum laude, 1998

TABLE OF CONTENTS

I. INTRODUCTION. 1
A. Overview. 1
B. Recent GAO Study. 1
1. S Corporation Popularity. 1
2. High Noncompliance Level. 1

II. ELIGIBLE S CORPORATION SHARE-HOLDERS. 1
A. Number of Shareholders. 1
1. Husbands and Wives. 2
2. Members of a Family. 2
3. Joint Owners. 2
4. Beneficial Owners. 2
5. Executors, Trustees, and Beneficiaries. 2
B. Types of Shareholders. 2
1. Individuals. 2
2. Entities. 2
3. Charitable Organizations. 2
4. Estates. 2
5. Trusts as Shareholders. 3

III. BUY-SELL AGREEMENTS. 11
A. Necessity of Agreement. 11
B. Protecting Eligibility. 12
C. Other Considerations. 12
1. Distributions. 12
2. Close-Out of Books. 12
3. Trust Elections. 13
4. Representations. 13
D. Types of Agreements. 13
1. Cross Purchase. 13
2. Redemption 13
E. Creation of Two Classes of Stock. 13
1. Bona Fide Agreements. 13
2. Agreement With Principal Purpose To Circumvent One-Class-of-Stock and Substantially Higher/Lower Than FMV. 14
F. Complexities Reduced. 14
1. Income Allocation. 14
2. Continuation of S Election. 14

IV. CONVERSIONS. 14
A. Reasons for Converting From S Corporation to Partnership May Not Overcome Income Tax Consequences. 14
B. Analysis of Tax Implications of Converting From S Corporation to Partnership. 14
1. Deemed Liquidation Resulting From Election To Treat Q-Sub as Q-Sub. 14
2. Deemed Complete Liquidation of S-Corp and Q-Sub. 15
C. If the Income Tax Implications Are Too Much To Bear, Retention of S Election in New LLC Is Possible. 18

V. SECOND CLASS OF STOCK. 18
A. Restriction To Single Class of Stock May Hamper Raising Capital in New Economic Times. 18
B. Single Class of Stock. 18
1. Debt as Second Class of Stock. 18
2. Options and Warrants. 21

3. Convertible Notes. 23

VI. OTHER ESTATE PLANNING CONSIDERATIONS. 23
A. Corporate Recapitalization. 23
1. Traditional Freeze Techniques - Not Available. 23
2. Voting Rights May Vary. 23
3. Transfer of Value Without Losing Control. 23
4. Premium - Voting Stock. 23
5. Passing Control of the Family Business. 24
6. Characteristics of Stock. 24
7. Revocation by Nonvoting Shareholders. 24
8. Use of Debt. 24
B. Redemptions. 24
1. 303 Redemptions. 24
2. Redemption to Pay Taxes. 25
3. Appreciated Property. 25
C. Effect of S Election of Property Rights. 25
1. Community vs. Separate. 25
2. Inception of Title. 25

VII. VAULATION OF S CORPORATIONS AND UNSUCCESSFUL ATTEMPTS TO "TAX-AFFECT" THE VALUATION. 26

VIII. STATE AND LOCAL TAXATION OF S CORPORATIONS. 26
A. Recognition of S Corporation Status. 26
B. State Taxation of Shareholders. 26

AVOIDING S CORPORATION I.E.D.'S

I. INTRODUCTION.[1]

A. Overview.

Subchapter S of the Code was adopted by Congress as a taxpayer relief measure. As a result, a large number of businesses in the United States are taxed as S corporations. Unfortunately, however, over the years the IRS, in strictly enforcing the technical S corporation tax provisions, has created a number of risks and dangers for those businesses electing to be taxed as S corporations and for those planners having to deal with businesses taxed as S corporations. The current economic and tax climate is only working to further increase those risks and dangers. Consequently, it is important for estate planners to re-examine familiar techniques and devices used when planning for business taxed as S corporations. While space does not permit a detailed discussion of all of the operating rules governing S corporations, this outline will attempt to focus on those issues an estate practitioner will more likely encounter.

B. Recent GAO Study.

A new Government Accountability Office ("GAO") report outlines S corporation noncompliance problems and makes specific suggestions for correcting the perceived problems.[2]

1. <u>S Corporation Popularity.</u>

The number of S corporations grew by 35% from tax year 2000 to 2006, for a total of nearly 4 million businesses in 2006, and also grew as a proportion of all businesses, from 11.4% of all entities in tax year 2000 to 12.6% in tax year 2006. In 2006, they were the second most common entity type after sole proprietorships.

2. <u>High Noncompliance Level.</u>

Approximately 68% of S corporation returns filed for tax years 2003 and 2004 misreported at least one item.

a. Misreporting of Basis and Possible Solutions.

A common area of noncompliance is use of losses beyond a shareholder's allowable stock and debt basis. To remedy this, the GAO proposed a legislative change which would require the entity to calculate basis and report each shareholder's basis on Schedule K-1.

b. Underreporting of Shareholder Compensation and Possible Solutions.

Another significant area of noncompliance is improperly paying lower shareholder wages, while increasing other payments to shareholders, such as distributions, and thereby lowering employment tax liabilities. Approximately 13% of S corporations paid inadequate wage compensation, resulting in just over $23.6 billion in net underpaid wage compensation to shareholders. The median misreporting adjustment for underpaid shareholder compensation in all categories was $20,000. To remedy this, the GAO proposed the following legislative changes:

(1) base employment tax liability for shareholders on the net business income reported by S corporations (optional variations proposed were to: make net business income subject to employment taxes; make net business income for service sector businesses subject to employment taxes; and make net business income for majority shareholders subject to employment taxes); or

(2) base employment tax liability on all types of payments made to active shareholders (optional variations proposed were to: make payments to active shareholders subject to employment tax; and make payments to active shareholders up to a dollar tolerance subject to employment tax).

II. ELIGIBLE S CORPORATION SHARE-HOLDERS.

A. Number of Shareholders.

An S corporation may not have more than 100 shareholders at any one time during a taxable year. An S corporation will not be disqualified, however, if it has, in the aggregate, more than 100 shareholders during a taxable year (*e.g.*, because of stock transfers).[3]

---

[1] Prior Articles Dealing with S Corporation Issues: *Driving Through the Subchapter S Maze:Bonanza or Time Bomb: Conversion of "C" Corporations to "S" Corps – Pros and Cons; Problem Aspects of QSST Trusts; Interrelationship of Generation-Skipping Tax; Traps In Buy-Sell Agreements* - Corpus Christi Business & Estate Planning Council, May 6, 1988, and *Estate Planning Forms For Dealing With S Corporations* – Advanced Drafting: Estate Planning and Probate Course, San Antonio, November 1-2, 1990.

[2] *Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules*, United States Government Accountability Office, Report to the Committee on Finance, U.S. Senate, GAO-10-195 – December 2009.

[3] IRC § 1361(b)(1)(A); *See also* Rev. Rul. 78-390, 1978-2 C.B. 220.

1. Husbands and Wives.

Spouses and their estates are treated as one shareholder, regardless of whether the spouses own shares jointly or separately or solely by operation of community property laws.[4]

2. Members of a Family.

"Members of a family" are treated as one shareholder. Members of a family are the common ancestor, the lineal descendants of a common ancestor (up to a maximum of six generations), and the current and former spouses of the lineal descendants or the common ancestor.[5]

3. Joint Owners.

When two or more persons (other than a husband and wife) own stock as tenants in common or joint tenants, each person is counted as a separate shareholder.[6]

4. Beneficial Owners.

Shares held by a nominee, agent, guardian, or custodian are deemed to be owned by the persons for whom the stock is held. So, if a guardian holds shares for the benefit of two minor children, each minor child is counted as a separate shareholder.[7]

5. Executors, Trustees, and Beneficiaries.

The effect of the holding S corporation ownership interests in estate and trusts is discussed in detail, below.

B. Types of Shareholders.

1. Individuals.

All individual shareholders must be U.S. citizens or resident aliens.[8]

2. Entities.

With a few very narrow exceptions, corporations, partnerships, limited liability companies, and other business entities are not eligible to be S corporation shareholders.[9]

a. Disregarded Entities.

Disregarded entities (such as single-member limited liability companies) are permissible shareholders if their owners are eligible S corporation shareholders.

b. Q-Subs.

An entity that is validly taxed as an S corporation (regardless of whether it is a partnership, limited liability company, or corporation for state-law purposes) can own shares or membership interests in another entity that is taxed as an S corporation if: (i) the parent S corporation owns all of the outstanding shares or membership interests in the subsidiary S corporation and (ii) the parent validly elects to treat the subsidiary S corporation as a "qualified subchapter S subsidiary ("Q-Sub").[10]

3. Charitable Organizations.

Qualified plans and charities described in IRC §§ 401(a) or 501(c)(3) and exempt from taxation under IRC § 501(a) may be S corporation shareholders.[11]

4. Estates.

A decedent's estate may be an S corporation shareholder.[12]

a. Election**.**

There is no requirement that the executor file an election to continue the S status when the stock of an S corporation owned by the decedent at the time of his death is held in the decedent's estate. If the corporation is not an S corporation at the time of the decedent's death, but an election is desirable after his death, the executor must consent along with all of the other shareholders to the S corporation election.[13]

b. Term of Administration.

An estate can be held open until the administration has been completed for estate tax purposes (which includes the time period for making installment payments under IRC §§6161 or 6166). However, once the estate administration has been completed for federal income tax purposes, regardless of whether the probate continues under state law, the estate may be treated as a testamentary trust for federal income tax purposes, in which case the corporation may lose its status as an S corporation (unless the trust is otherwise qualified to hold S corporation stock, as discussed below).[14]

[4] IRC § 1361(c)(1).

[5] IRC §§ 1361(c)(1)(A)(ii) and 1361(c)(1)(B).

[6] Treas. Reg. §1.1361-1(e)(1).

[7] Treas. Reg. § 1.1361-1(e)(1).

[8] IRC § 1361(b)(1).

[9] IRC § 1361 (b)(1)(B).

[10] IRC § 1361(b)(3)(B).

[11] IRC § 1361 (c)(6) and 1361(b)(1)(B).

[12] IRC § 1361(b)(1)(B).

[13] §1362(a)(2).

[14] *See Old Virginia Brick Co. v. Commissioner*, 367 F. 2d 276 (4th Cir. 1966); *See also* Treas. Regs. §1.641(b)-3(a);

c. Definition of "Estate."

For purposes of IRC §1361, the term "estate" includes only a decedent's estate or the estate under Title 11 of an individual shareholder, and does not include the estate of a minor or incompetent person.[15]

5. Trusts as Shareholders.

Only the following trusts qualify as S corporation shareholders.

a. Grantor Trusts.

(1) General.

A trust qualifies as an S corporation shareholder if it is treated as "wholly owned" by the grantor or another person under any of IRC §§ 671 through 678.[16] A grantor trust is effectively disregarded for federal income tax purposes because all of the trust's tax items are reported by the grantor/deemed owner. Thus, for purposes of the 100-shareholder limitation, the grantor/deemed owner is the one counted as the shareholder (not the beneficiaries). Consequently, the grantor/deemed owner of the trust must be a qualifying individual shareholder, *i.e.*, a U.S. citizen or a resident alien.

(a) Irrevocable.

The Code does not make a distinction between revocable and irrevocable trusts. Even though revocable trusts are the more common form of lifetime holding, it is possible that other irrevocable trusts will qualify to hold S corporation stock. For example, an irrevocable trust for the benefit of the grantor (or even the grantor's spouse) is a trust described in Subpart E and thus a qualified shareholder of S corporation stock. Furthermore, a grantor retained annuity trust can qualify as an S corporation shareholder.[17]

(b) Community Property.

During grantor's life, if the trust is created by husband and wife in a community property state, husband and wife are treated as one shareholder.[18] Before allowing a husband-wife grantor trust, an S corporation should realize that S status may be lost if the husband and wife get divorced (See (5)(ii), below).

(2) Gifts.

If S corporation stock is held in a revocable grantor trust, gifts by the grantor should pass through the grantor to the donee rather than affecting a direct transfer from the revocable trust to the donee. The IRS has held that a transfer from a revocable trust to a donee will cause the inclusion of the property in the grantor's estate if the grantor dies within 3 years of the transfer.[19]

(3) Planning Technique.

Grantor establishes an irrevocable trust funded with S corporation stock. Although the trust is defective for income tax purposes, since the gift is complete, trust assets are excludible from the grantor's estate. Because of defective provisions in the trust, the grantor is taxable on trust income, including S corporation income. The grantor must meet any income tax liability from assets other than trust distributions since he does not receive trust distributions. Grantor is benefited by the reduction of his estate due to the transfer of the S corporation stock to the trust. Grantor also benefits by not sharing in future appreciation of the stock. At the same time he has made indirect, tax-free gifts to the beneficiary to the extent he pays the income tax liability attributable to the S corporation income.

(4) Administration Upon Death of the Grantor/Deemed Owner.

(a) Termination/Continuation of Trust.

If the grantor trust terminates at the grantor's/deemed owner's death, the distributees of the trust become the new S corporation shareholders. If the distributees are individuals or other qualifying trusts, the S corporation status is unaffected, and the distributees are taxed under the usual rules of Subchapter S. If one or more of the distributees is a corporation, partnership, ineligible trust, or foreign individual, or if the transition from a single-deemed owner to a group of individuals increases the total number of shareholders to more than 100, the S election automatically terminates. If the trust continues after the grantor's/deemed owner's death, the grantor's/deemed owner's estate is treated as the eligible S corporation shareholder for purposes of determining whether the Code's qualification requirements relating to number and identity of shareholders are satisfied. This remains true for the two-year period after the former deemed owner's death, after which, the trust will need to qualify as a QSST or ESBT. If, however, the trust distributes the S corporation stock during the two-year period, of course, the distributee(s) become(s) the shareholder(s).

(i) Election to Treat Estate and Trust as One Taxpayer.

Rev. Rul. 76-23, 1976-1 C.B. 264; PLRs 9247035 and 200226031.

[15] *See* Rev. Rul. 66-266, 1966-2 C.B. 356; IRC § 1361(c)(3).

[16] IRC § 1361(c)(2)(A)(i).

[17] IRC §§ 1361(c)(2)(A)(i) and 677.

[18] IRC § 1361(c)(2)(B)(ii); PLR 8505032.

[19] IRC §§ 2038(a) and 2035(a); TAM 8609005.

While, an estate can hold S corporation stock for its entire period of administration, a revocable trust that becomes irrevocable on the grantor's death can only hold S corporation stock for two years after the grantor's death. If the related estate and qualified irrevocable trust make an election to be jointly taxed as an estate under IRC § 645, the trust can hold the S stock throughout the election period. The same result applies where there is no related estate and the trust itself makes the Section 645 election.[20]

(ii) Death of One Spouse When Both Are Grantors.

As discussed above, a special problem may arise if a husband and wife set up a joint grantor trust. When one spouse dies, the result depends, in part, on the terms of the trust. For example, S status may not be threatened if the trust by its terms splits into two trusts, with the decedent's share becoming a qualified subchapter S trust and the survivor's share becoming a separate grantor trust. On the other hand, if the trust remains one trust, its S status should be protected for up to two years.

(b) Ownership and Taxation.

While, upon the death of the grantor/deemed owner, the estate of the grantor/deemed owner is treated as the shareholder of the S corporation stock during the two-year period, it is the trust that is treated as the successor shareholder for income tax purposes (and, thus, it is the trust that reports the income, deductions, distributions, and basis of the S corporation during the two-year period following the grantor's/deemed owner's death).[21] When the grantor/deemed owner dies, by default, the corporate income is allocated between the deceased grantor/deemed owner and the successor shareholder on a daily basis before and after death. Income allocated to the period before death is included on the decedent's (grantor's/deemed owner's) final income tax return, while income allocated to the period after death is included on the successor's income tax return.[22] Alternatively, the S corporation may elect the interim closing of the books method. This divides the corporation's taxable year into two separate years, the first of which ends at the close of the day the grantor/deemed owner died.[23] This election is only available if the corporation and all the "affected shareholders" agree and the corporation attaches the election to its tax return for the year it is effective.[24] Affected shareholders are those whose interest is terminated and those to whom shares are transferred during the year.[25]

NOTE: The above only applies if the grantor status is terminated due to the grantor's death. They do not apply if the grantor status terminated as a result of the relinquishment by the grantor of the powers which cause the trust to be a grantor trust in the first place. If this happens, the S status will terminate unless the trust otherwise qualifies as a QSST or ESBT

(c) S Elections.

(i) Continuation of Election after Death.

There is no requirement to make a new election at the time of the grantor's death.

(ii) Executor Makes New Election.

In the event an election is made to convert an existing entity to S corporation status after the death of the grantor, the corporation makes the election, but it is not valid unless the executor or administrator of the estate (not the trustee) consents to the election.[26]

(iii) Revocation of Election.

A revocation of the S election follows only if a majority of the shareholders vote to terminate the election or if there is an event (such as distribution of stock to a non-qualified shareholder) which terminates the corporation's S election.

b. The Qualified Subchapter S Trust. (QSST)

(1) Statutory Requirements.

A QSST is a trust for which an election is made and which satisfies the following requirements:[27]

(a) Domestic Trust.

The trust must be a domestic trust, *i.e.,* a court within the United States has primary supervision over the administration of the trust *and* one or more United States fiduciaries control all "substantial decisions" of the trust.[28] "Substantial decisions" that a fiduciary may have the power to make include, among others: (i) whether and when to make distributions of income and principal; (ii) the amount of distributions; (iii) whether a receipt is allocated to income or principal; (iv) the selection of a beneficiary; and (v) whether to appoint a

[20] Treas. Reg. §§ 1.645-1(e)(2)(i) and 1.645-1(e)(3)(i).

[21] IRC §§ 1361(c)(2)(A)(ii); Treas. Reg. §§ 1.1361-1(h)(3)(i)(B), 1.1361-1(h)(3)(ii)(A), and 1.1361-1(j)(9)(i); PLR 9729025.

[22] IRC § 1377(a)(1); Treas. Reg. § 1.1377-1(a).

[23] IRC § 1377(a)(2); Treas. Reg. § 1.1377-1(b)(1).

[24] Treas. Reg. 1.1377-1(b)(5).

[25] Treas. Reg. 1.1377-1(b)(2).

[26] IRC §1361(c)(2)(B).

[27] *See* IRC § 1361(d).

[28] *See* IRC §§ 7701(a)(30)(E) and 7701(a)(31)(B).

successor to succeed another trustee that is unable or unwilling to serve or continue to serve.[29]

(b) One Beneficiary.

There can be only one current income beneficiary ("CIB") who is also the only permissible distributee of principal and whose interest does not terminate prior to the earlier of (i) termination of the trust and distribution of all assets to the CIB or (ii) the CIB's death. If the QSST terminates during the CIB's life, all assets must be distributed to him or her.

(i) Separate Shares.

A QSST may have multiple income beneficiaries if they have separate shares. Separate shares that are treated as separate trusts under IRC § 663(c) are also treated as separate trusts for S purposes.[30] However, the IRS has ruled that a separate share of a trust cannot qualify as a QSST if there is even a remote possibility that the trust corpus will be distributed during the CIB's lifetime to someone else.[31]

(ii) Multiple Beneficiaries After CIB Dies.

The fact that there may be multiple beneficiaries after the CIB dies does not disqualify the trust. However, if S Corp stock passes to a new trust after the CIB dies, a new QSST election will have to be made for each new trust for each subsequent beneficiary.

(c) Income Distributions.

All of the income (as defined by IRC § 643(b)) must be distributed (or required to be distributed) at least annually to a CIB who is a citizen or resident of the United States.[32]

(i) Failure to distribute (if discretionary) terminates the election.
(ii) No payments can be made from the trust that discharges someone else's obligations to support the CIB.
(iii) "Income" does not include corporate income retained by the corporation and not actually distributed to the trust.
(iv) Each income interest in the trust terminates on the earlier of the death of the CIB or the termination of the trust.

(d) Corpus Distributions.

Any corpus distributed during the term of the trust must be distributed only to the CIB (there can be no inter vivos power of appointment, except in favor of the CIB).

(i) If the QSST trust terminates prior to the death of the CIB, the trust must distribute all of the trust assets to the CIB (this is to be distinguished from the termination of the QSST election, in which case, the trust can continue pursuant to its otherwise applicable terms).

NOTE: Some trusts, such as the QTIP marital trust will likely automatically satisfy the QSST requirements, while most others will need to be specifically drafted to satisfy the requirements outlined in 2, 3, and 4, above. If the specific drafting required for QSST status is not possible or was not included, keep in mind that ESBT qualification may still be possible, as discussed below.

(2) The QSST Election.
(a) Elections.
(i) QSST Election.

The CIB of the trust or the legal representative of the CIB (or a natural or an adopted parent of a minor CIB in the case where a legal representative has not been appointed) must make the QSST election.[33] The trustee is not required to consent to this election. A trust with the attributes of a QSST is a qualified shareholder only if and when the CIB makes a timely election. In the case of trust owning shares in a C corporation that becomes an S corporation, the QSST election is made on Part III of the Form 2553. If the corporation's S election is already in effect when the trust receives the shares, the QSST election is made by signing and filing a statement with the service center where the corporation files its tax return.[34]

(ii) Separate Election For Each S Corporation.

A separate election is required with respect to each S corporation with stock held in the trust.

(iii) Election Continuing.

Once the QSST election is made, it is irrevocable unless the IRS otherwise consents. A successive income beneficiary of a QSST trust that is newly created upon the death of the CIB of a previous QSST trust is deemed to join in the previous election, unless he affirmatively refuses to consent to it. The affirmative refusal to consent by a successive income

---

[29] Treas. Reg. § 301.7701-7(d)(1)(ii).

[30] IRC § 1361(d)(3).

[31] Rev. Rul. 93-31, 1993-1 C.B. 186.

[32] IRC § 1361(d)(3)(b); Treas. Reg. § 1.1361-1(e)(1).

[33] IRC §§ 1361(d)(2)(A) and 1361(d)(2)(D); Treas. Reg. 1.1361-1(j)(6).

[34] Treas. Reg. 1.1361-1(j)(6)(ii).

beneficiary must be filed within 75 days (2 months and 15 days) after the date on which he became the income beneficiary.[35]

(iv) Effect of Election.

The CIB of the QSST is treated as the owner for purposes of §678(a) of that portion of the trust which consists of stock in the S corporation. Accordingly, under the grantor trust income tax rules, all income, deduction, and credits relating to the portion of the trust which consists of S corporation stock will be reportable by the CIB whether or not actually distributed. §1361(d)(1)(B). The CIB is not treated as owner of that portion of the trust consisting of other assets except to the extent he is treated as the owner of those assets under another provision in the Code.

(b) QSST Election Filing Deadlines.

(i) When to file.

The CIB of a QSST must elect within a narrow time period to allow the trust to be an S shareholder. The election can be made up to two months and sixteen days after the trust becomes a shareholder or two months and sixteen days after the beginning of the first taxable year in which the S corporation election is to be effective.[36] The combination of the two rules creates a window for electing. The regulations supply some examples regarding the first day on which an election can be filed.

(A) Trust Acquires Stock In An Existing S Corporation.

Suppose that a QSST acquires stock of a corporation that is already an S corporation. The income beneficiary must elect within the two-month-and-sixteen-day window that opens on the day the trust acquires the stock.[37]

(B) C Corporation Elects Prospectively; Trust Already Owns Stock.

If a C corporation elects under IRC § 1362 before the first day for which the corporate election will take effect, and if a trust owns stock on the day the corporate election is made, the election period for the beneficiary starts to run on the day on which the corporation makes its election.[38]

(C) C Corporation Elects Prospectively; Trust Then Acquires Stock Before The Election Takes Effect.

Suppose that a C corporation elects under Section 1362 before the first day for which the corporate election will take effect and that a QSST acquires shares after the corporate election is made but before it takes effect. In that case, the period for the QSST election starts to run on the day the trust acquires stock.[39]

(D) Trust Owns Stock of C Corporation, Which Elects Retroactively To Be An S Corporation.

Suppose that a corporation elects under Section 1362 on or after the first day for which the election takes effect. Suppose further that a QSST owns some of the stock on the first day of the taxable year for which the S election will take effect. In this case, the income beneficiary of the trust must elect within the two-month-and-sixteen-day window that opens on the day the S election takes effect.[40]

(E) C Corporation Elects Retroactively; Trust Acquires Stock After The Effective Date of the Election But Before The Election Is Made.

Suppose that a trust acquires some of the stock of a C corporation. After that date, the corporation elects to be an S corporation. The election takes effect on the first day of the corporation's taxable year, which started before the trust acquired stock. It appears that the income beneficiary of the trust must file the QSST election within the two-month-and-sixteen-day period starting on the day the trust acquired stock.[41]

(F) Recommendation.

In view of the complexities of the election rules, it is recommended to transfer the stock to the trust on day one, make the corporate election on the following day, and make the QSST election on the next day thereafter (or the same day as the election under the Proposed Regulations).

---

[35] Treas. Reg. § 1.1361-1(j)(10).

[36] IRC § 1361(d)(2)(D); Treas. Reg. § 1.1361-1(j)(6)(ii)(C).

[37] Treas. Reg. § 1.1361-1(j)(6)(iii)(A).

[38] Treas. Reg. § 1.1361-1(j)(6)(iii)(B).

[39] Treas. Reg. § 1.1361-1(j)(6)(iii)(A).

[40] Treas. Reg. § 1.1361-1(j)(6)(iii)(B).

[41] IRC § 1361(d)(2)(D) provides the general grace period. Treas. Reg. § 1.1361-1(j)(6) may not contain a sentence directly on point, although the first sentence of Treas. Reg. § 1.1361-1(j)(6)(iii)(A) may apply. The first sentence of Treas. Reg. § 1.1361-1(j)(6)(iii)(B), if it applied, would start the period for filing on the first day of the corporation's taxable year.

(c) Disqualification.

A QSST may lose that status in one of two ways. First, the terms of the trust may cease to meet the statutory requirements.[42] For example, when an income beneficiary dies, the terms of the trust may then provide for more than one current income beneficiary. In such a case, the trust ceases to be a QSST immediately.[43] Second, a trust (other than a simple trust) may fail to meet the requirement that income be distributed currently.[44] In that case, the trust ceases to be a QSST on the first day of the next taxable year.[45] It is not entirely clear whether the words "taxable year" refer to the taxable year of the trust or the corporation, but they appear to refer to the trust's taxable year.

(d) Considerations in Making Elections.
(i) Income Tax Liability.
(A) Trustee's Concerns.

In making the *S corporation election*, the trustee should endeavor to negotiate a dividend-paying policy that will protect its beneficiary. The trustee should insure that there are corporate cash distributions in an amount at least necessary to pay the income tax liability attributable to owning the S corporation stock.

(B) Beneficiary Concerns.

The beneficiary *making the QSST election* should also consider negotiating an agreement among the trustee, the corporation, and other shareholders to insure that the beneficiary has sufficient income to pay his taxes attributable to the S corporation stock ownership of the QSST.

(ii) Trustees' Responsibility - Potential Conflict of Interest.

What is the responsibility of the trustee to participate as a director or in electing directors to cause dividends to be paid to protect its beneficiary? If the trustee is a director, what are its responsibilities to the corporation and other shareholders in limiting distributions, if appropriate for the corporation's best interest? What is the trustee's duty in electing S corporation status?

(iii) Trustee Authority.

Where S corporation stock is a potential asset, the trust document should provide that the trustee has specific authority to enter into agreements with the corporation and shareholders re: dividend policy, transferability of shares, and other matters that are likely to arise in connection with the ownership of the S corporation stock. The trust document should exonerate the trustee from both maintaining or making any S corporation election.

(iv) Leverage.

Before a complex trust can hold S corporation stock as a QSST, the complex trust must contain the specific language necessary to satisfy the QSST requirements (outlined above). Furthermore, unless there is a stock agreement limiting transfers (as discussed further, below), the trustee could transfer the S corporation stock to a non-eligible shareholder thus causing the loss of the S corporation election.

(e) Taxation After Election.
(i) Taxation.

The CIB of the QSST is treated as if he or she is the direct owner of the portion of the QSST that owns the S corporation stock under IRC § 678(a).[46] As such, the beneficiary is taxed on the entire amount shown on the trust's Schedule K-1 received from the S corporation. Accordingly, income, gains, and losses will pass through from the corporation to the beneficiary. To this extent, the trust entity is disregarded as a separate taxpayer. But when the QSST disposes of the stock, the trust rather than the beneficiary of the QSST recognizes gain or loss.[47]

(ii) Effect on Other Assets.

Other trust assets are still accounted for in the same manner as if the QSST election had not been made, *i.e.*, a simple or complex trust.[48]

(iii) Fiduciary Income Tax Return.

A QSST must file a Form 1041 regardless of whether its only asset is the S corporation stock or not.[49] If the QSST only owns stock, the QSST files a form 1041 with a statement (prepared by the tax professional – not an IRS form) reflecting the separately stated S items, which it furnishes to the income beneficiary to report on his or her own Form 1040. If the QSST owns other assets in addition to the S corporation stock, the QSST's other income and deductions are reflected on page 1 of the Form 1040 and taxed according to the general rules of Subchapter J.[50]

---

[42] IRC § 1361(d)(3)(A); Treas. Reg. § 1.1361-1(j)(5).

[43] IRC § 1361(d)(4)(A); Treas. Reg. § 1.1361-1(j)(5).

[44] IRC § 1361(d)(3)(B); Treas. Reg. § 1.1361-1(j)(5).

[45] IRC § 1361(d)(4)(B); Treas. Reg. § 1.1361-1(j)(5).

[46] IRC § 1361(d)(1)(B).

[47] Treas. Reg. 1.1361-1(j)(8); PLR 9721020.

[48] IRC § 1361(d)(1)(B).

[49] Treas. Reg. § 1.671-4(b)(6)(iii).

[50] Treas. Reg. § 1.1361-1(j)(8).

(f) Revocation of QSST Election.

(i) CIB Only With Consent of Commissioner.

The general rule is that once a QSST election is made it cannot be revoked by the CIB without the consent of the Commissioner.[51]

(ii) Successor CIB.

A successor income beneficiary may affirmatively refuse to consent to an election and thus, terminate the S election.[52]

(iii) Trustee.

The trustee has the ability to terminate an S election by a variety of methods. If the trust is a discretionary trust, he can fail to distribute all the net income (if the trust so permits) or he can dispose of the stock to a non-qualified shareholder.

c. Electing Small Business Trusts (ESBT).

(1) Statutory Requirements.

An ESBT is a trust for which an election is made and which satisfies the following requirements:

(a) Proper Beneficiaries and Potential Current Beneficiaries.

Determining whether a trust can make an ESBT election requires an analysis of the trust "beneficiaries" and "potential current beneficiaries" (PCBs). The two categories overlap, but are distinct. A "beneficiary" is not always a PCB and a PCB may not be a "beneficiary." In essence, the question is whether the trust has an ineligible "beneficiary" or PCB and whether the trust has too many PCBs.

(i) Beneficiaries.

All beneficiaries of the trust must be individuals, estates, charitable organizations described in IRC §§ 170(c)(2) through (5), or a government organization described in IRC § 170(c)(1) that holds a contingent interest in the trust (a government organization cannot, however, be a potential current beneficiary).[53] A beneficiary generally includes any person who has a present, remainder, or reversionary interest in the trust. Furthermore, beneficiaries of distribute trusts that are beneficiaries of the EBST are also treated as beneficiaries of the ESBT itself (a distribute trust is a trust that receives or may receive a distribution from the ESBT, whether the right to receive is fixed or contingent, immediate or deferred).[54]

The term "beneficiary" does not, however, include a person whose interest is so remote as to be negligible. Nor does it include a person in whose favor a power of appointment can be exercised (such person is not a beneficiary until the power of appointment is actually exercised in favor of that person).[55] Charitable remainder annuity trusts and unitrusts (CRATS and CRUTS) defined in IRC § 664(d) are also statutorily excluded from eligibility as ESBT shareholders.[56]

(A) Entire Trust Must Be Considered.

The rules regarding eligible beneficiaries of and ESBT apply to the entire trust, even if only a portion of the trust is treated as an ESBT.

(ii) Potential Current Beneficiaries (PCBs).

(A) Definition.

The term "potential current beneficiaries" means, with respect to any period, 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 trust (determined without regard to any power of appointment to the extent such power remains unexercised at the end of such period). No person is treated as a PCB solely because that person holds any future interest in the trust.[57] If a grantor trust makes and ESBT election, the grantor-owner is a PCB in addition to other persons meeting the above definition and whether or not the grantor-owner otherwise meets the definition.[58]

(B) Each PCB Treated as Shareholder of Corporation.

For purposes of determining whether a corporation is an S corporation within the meaning of IRC § 1361(b)(1), each PCB of an ESBT is generally treated as a shareholder of the corporation. Thus, each PCB (including beneficiaries of distribute trusts entitled to receive either principal or income from an ESBT) must be an otherwise eligible S corporation shareholder and each such beneficiary counts toward the 100-shareholder limit.

(b) No Interest Acquired by Purchase.

No interest in the trust can be acquired by purchase.[59] Thus, an interest in the trust must generally be acquired by gift, bequest, or transfer in trust. If any portion of the basis in the acquired interest in the trust is determined under IRC § 1012, such interest has been acquired by purchase. Purchasing an

---

[51] IRC § 1361(d)(2)(C); Treas. Reg. § 1.1361-1(j)(11).

[52] IRC § 1361(d)(2)B(ii).

[53] IRC § 161(e)(1)(A)(i).

[54] Treas. Reg. § 1.1361-1(m)(1)(ii)(B).

[55] Treas. Reg. § 1.1361-1(m)(1)(ii)(c).

[56] IRC § 1361(e)(1)(B)(iii); PLR 200703023.

[57] IRC § 1361(e)(2); Treas. Reg. 1.1361-1(m)(4)(i).

[58] Treas. Reg. 1.1361-1(m)(4)(ii).

[59] IRC § 1361(e)(1)(a)(ii).

interest in the trust should not, however, be confused with the trust itself purchasing S corporation shares to hold in the trust, which is perfectly permissible without disqualifying the ESBT.[60]

(c) Election.

(i) Trustee Makes the Election**.**

The trustee (rather than the beneficiary) makes the election.[61]

(ii) Place.

The election is filed with the service center where the S corporation files its income tax return.[62]

(iii) Contents.

The election is in the form of a statement, attached to the S corporation tax return, that contains the name, address, and TIN of the trust, the PCBs, and the S corporations in which the trust currently holds stock. If the trust includes a power of appointment, the election must disclose the existence of the power, but need not include any detailed information about the power. The election must also identify the election as an ESBT election made under IRC § 1361(e)(3), indicate the first date on which the trust owned the stock in the S corporation, the date the election is to become effective, and represent that the trust meets the statutory requirements of an ESBT.[63]

(iv) Time for Filing.

The election cannot become effective earlier than two months and 15 days before the date on which the election is filed and, generally, must be filed within the two-month and sixteen day period beginning on the day the stock is transferred to the trust (see the timing for filing a QSST election for further guidance).[64]

(v) Revocation.

The election can only be revoked with the IRS's consent.[65]

(d) Taxation.

While the requirements for an ESBT are easier to meet than the requirements for a QSST, the price for ease lies in the taxation of the trust's income. The trust itself (not the beneficiaries) must pay tax on the income related to the S corporation stock at the highest trust tax rate (*i.e.*, 35%), except for long-term capital gains which are taxed at the capital gain rate that applies.[66]

(i) Under Treas. Reg. § 1.641(c)-1, an ESBT treated as two separate trusts for purposes of determining its tax liability – the S portion, which consists of the S corporation stock, and the Non-S Portion, which consists of all of the trusts other assets. The ESBT's S portion is treated as a separate taxpayer subject to special rules under IRC § 641(c). The Non-S Portion is treated as a normal trust subject to tax under the rules of Subchapter J, Subparts A through D.

(ii) The tax on the S portion is determined by reference to the general rules for taxation of trusts, but with the following modifications:

(A) The highest trust rate of tax is applied;

(B) The exemption amount under IRC § 55 is zero; [67] and

(C) The only items of income, gain, loss, deduction, or credit taken into account are:

i. The items required to be taken into account under IRC § 1366.

ii. Gain or loss from the sale of the S corporation stock, but not interest income on installment sale of the S stock.[68]

iii. State and local income taxes and administrative expenses directly related to the S portion.[69]

iv. Interest expense on indebtedness incurred to acquire S corporation stock.[70]

v. Capital losses to the extent of capital gains.

(D) The ESBT is not entitled to an alternative minimum tax exemption.[71]

(e) Reporting.

The tax on these items of income, deduction, gains, and losses is calculated separately on a plain paper schedule attached to the Form 1041 and entered on the Form 1041. The ESBT is also required to make estimated tax payments under the same rules as

[60] Treas. Reg. 1.1361-1(m)(1)(iii).

[61] IRC § 1361(e)(3).

[62] Treas. Reg. § 1.1361-1(m)(2)(i).

[63] Treas. Reg. § 1.1361-1(m)(2)(i).

[64] Treas. Reg. § 1.1361-1(m)(2)(i) and (m)(2)(iii).

[65] IRC § 1361(d)(2)(C).

[66] IRC § 641(c)(2)(A).

[67] IRC § 641(c)(2)(C)(iv).

[68] Treas. Reg. § 1.1361-1(j)(8).

[69] Treas. Reg. § 1.641-1(d)(4).

[70] IRC § 641(c)(2)(C)(iv).

[71] IRC § 641(c)(2)(B).

individuals.[72] The S portion items are disregarded when figuring the tax liability of the "other portion," which is taxed under the normal trust taxation rules. Distributions from the "other portion" and the "S portion" are deductible (limited to DNI of the "other portion") in computing the taxable income of the "other portion."

d. Testamentary Trusts.

(1) Limited Eligibility.

All testamentary trusts are permitted S corporation shareholders for a two-year period beginning on the date the stock is transferred to the trust.[73]

(2) Subsequent Qualification.

Thereafter the trust must satisfy the requirements of a QSST, ESBT, or grantor trust to be eligible as an S corporation shareholder.

(3) Taxation and Ownership.

During the two-year grace period, the trust and (or) its beneficiaries pay the tax on the items of income, gain, loss, deduction, and credit attributable to its share of the S corporation's stock if no one is the deemed owner of the trust. The testator, on the other hand, is treated as the shareholder for purposes of applying the 100-shareholder limitation.

e. Voting Trusts.

Voting trusts, which are created primarily to exercise the voting power of the S corporation stock are permitted shareholders. The beneficial owners of the trust are treated as the owners of their portion of the trust. The beneficial owners must be citizens or residents of the United States. In addition, a written trust agreement entered into by the shareholders must delegate the right to vote to one or more trustees, require all distributions with respect to the stock of the corporation held by the trust to be paid to, or on behalf of, the beneficial owners of the stock, require title and possession of the stock to be delivered to the beneficial owners upon termination of the trust, and terminate, under its terms of by state law, on or before a specific date or event.[74]

f. Estate Planning Trust.

(1) Marital Deduction Trusts.

The requirements to qualify a trust as a marital deduction trust need not conflict with the requirements for a QSST.

(a) Estate Trusts.

The estate trust is used where the decedent desires to permit the trustee to accumulate income. Because this type of trust is used to avoid the marital deduction income payment requirement, it may not satisfy the income payment requirement of a QSST.

(b) Power of Appointment Trust.

The income payment requirement of the general power of appointment type marital deduction trust satisfies the corresponding income payment requirement of the QSST. Further, where a testamentary general power of appointment is used to complete the marital deduction rules, the QSST requirements on corpus distributions are satisfied. Accordingly, a general power of appointment trust where the power of appointment is testamentary qualifies as a QSST. However, a general power of appointment trust where the surviving spouse has a lifetime power of appointment in favor of others violates the QSST requirement that any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary.

(c) QTIP Trusts.

(i) General Planning.

Planning for today's estates may, in many cases, require directing the S corporation stock to a QTIP trust for the surviving spouse. Accordingly, it is important to determine if a QTIP marital deduction trust will qualify to hold S corporation stock and what, if any, special provisions must be included in the trust for it to qualify.

(ii) Qualification.

The requirements to qualify for a QSST and a QTIP are similar. The surviving spouse must be entitled for life to all the income from the trust, payable annually, or in more frequent intervals. No person, including the spouse, may have any power to appoint any part of the property to any person other than the surviving spouse during the surviving spouse's life. Powers over the corpus may be retained in others or be granted to others provided such powers are only exercisable at or after the surviving spouse's death.

(iii) Termination During Life of Surviving Spouse.

IRC § 1361(d)(3)(A)(ii) requires that upon termination of a QSST trust during the life of the current income beneficiary, the trust must distribute its assets to that beneficiary. This provision is not usually found in a QTIP trust. However, since a QTIP must continue until the death of the surviving spouse, a QTIP trust should meet the requirements for a QSST election without such provision.

[72] IRC § 6654(1).

[73] IRC § 1361(c)(2)(A)(iii).

[74] Treas. Reg. § 1.1361-1(h)(1)(v).

(iv) Income Interests - Assignment.

The QTIP trust provisions contemplate that the surviving spouse could release or assign all or portion of the life income interest. In that event, the release or assignment of the income interest results in a transfer for gift tax purposes of the remainder. If the release of the income interest would also result in the termination of the trust under local law in favor of the remainder beneficiary, then the prohibited transfer of trust assets to someone other than the income beneficiary could occur. Arguably this could disqualify the trust from QSST status but not QTIP trust status.

(2) Bypass Trusts.

A common estate planning technique is to allocate a portion of a decedent's property to a bypass trust in the amount of the unified credit exemption equivalent. Generally, the beneficiaries of the bypass trust are the surviving spouse and the decedent's children. Further, the trustee generally has the power to spray income among the beneficiaries and the surviving spouse often has a special power to appoint the trust property by will among the decedent's descendants.

(a) Qualification.

Because the typical bypass trust violates most of the QSST requirements, modifications must be made to the bypass provisions in order to allow it to hold S corporation stock. These modifications include:

- (i) **One Beneficiary.** Surviving spouse should be the sole income beneficiary during the surviving spouse's lifetime.
- (ii) **Distributions to Surviving Spouse.** All income of the trust should be distributed to the surviving spouse at least annually. No distributions of corpus should be permitted to anyone other than the surviving spouse.
- (iii) **Termination.** The trust should provide that if it is terminated during the surviving spouse's lifetime, then all the trust assets are distributed to the surviving spouse.

(b) Drafting.

The trust could be drafted so that these modified provisions govern only when the trust holds S corporation stock. This allows the more typical provisions (power to spray income and corpus among surviving spouse and descendants) to be used during times that no S corporation stock is currently being held by the trust.[75]

(c) After Death of Surviving Spouse.

If QSST status is desired to continue after the death of the surviving spouse, then the trustee must either distribute the S corporation stock outright to the children or place it in a separate trust for each child. Each trust must satisfy the requirements of a QSST.

(3) Crummey Trusts.

The terms of QSST must require that any corpus distributed during the life of the current income beneficiary be distributed only to that beneficiary. This would preclude granting Crummey withdrawal rights to any beneficiary other than the current income beneficiary. Therefore, when drafting trusts intended to qualify as an eligible S corporation shareholder one should realize that adding Crummey withdrawal rights for multiple beneficiaries will preclude the trust from qualifying for QSST status. The trust could, however, make an ESBT election because the ESBT rules do not preclude Crummey withdrawal rights. However, beneficiaries with such rights must be individuals, estates, and certain charitable organizations.

(4) 2503(c) Minors Trust.

A trust utilized for a gift to a minor which is intended to obtain the exclusion under §2503(c) for a present interest gift, should qualify as a QSST, provided that all of the income of the trust is distributed currently to the minor.

III. BUY-SELL AGREEMENTS.

A. Necessity of Agreement.

Because of the unique characteristics of an S corporation (in particular, the restrictions on the types and number of shareholders), a shareholders' agreement, including buy-sell arrangements is often more important for an S corporation than for other closely held businesses. The numerous requirements limiting a corporation's eligibility to be taxed as an S corporation and the variety of elections available to the S corporation and its shareholders, make it advisable for the shareholders to enter into an agreement addressing a variety of matters peculiar to the S corporation in addition to the buy-sell arrangements. The existence of a well-planned buy-sell agreement can provide a great deal of protection for the stockholders of an S corporation.

[75] *See* PLR 8351095 regarding effect of modification to QSST as it affects grandfathered generation skipping trust; PLR 8336069 regarding testamentary bypass trust qualification as QSST; PLR 8607044 approving bypass trust as QSST where surviving spouse is sole beneficiary receiving all income annually.

B. Protecting Eligibility.

Considerations unique to S corporations in planning to protect the S election, include:

1. **Shareholder Eligibility.** A prohibition on transfer of shares to anyone who is not eligible to own S corporation shares.
2. **Lifetime Purchase Option.** A requirement that any shareholder wishing to transfer his shares during his lifetime must first offer the shares to the corporation and other shareholders before offering his shares to a third person (who must be eligible to hold S corporation shares).
3. **Govern Transfers at Death.**

   a. Provide for prompt transfers to eligible shareholders during any limited period of eligibility.
   b. Deal with dispositions of stock by estates of shareholders and by grantor trusts following death of deemed owner.
   c. If there is a possibility of an uncooperative estate of a deceased shareholder or deemed owner, provide for a form of transfer taking effect without any action on part of estate, such as an escrow agreement taking effect at death.

4. **Pledges.** Restrict pledges and other encumbrances of stock to prevent two-step transfers to ineligible shareholders.
5. **Terms of Transfer Restrictions.**

   a. Voluntary revocation of S election.
   b. Public offering of stock.
   c. Lender's requirements in event of long-term corporate financing of a specified amount.
   d. Determination by specified officers or specified shareholder vote.

6. **Number of Shareholders.** Limit transfers that would result in the termination of the S election because the number of shareholders is in excess of the numerical limit (100) for S corporations.
7. **Consenting to S Corporation Election.** Specify the procedures for determining if the S corporation election is to be made or consented to or the conditions under which it is to be made. Provide for penalties or option to purchase in the event the required S election is not made or consented to.
8. **Covenant Against Terminating Election.** Limit a shareholder's right to take any action (direct or indirect) that would terminate the S election, without the consent of a specified percentage of the shareholders.
9. **Revocation.** Provide for the conditions or circumstances under which the corporation will terminate S status. The Code requires that shareholders owning a majority of the shares must consent to a revocation.[76] The shareholders may, however, wish to agree among themselves to require the approval of more than a majority to effect a revocation of the S election.
10. **Damages.** A buy-sell agreement can provide for remedies for breach of its provisions, including specific performance, liquidated damages, and indemnification for the other shareholders for tax benefits lost as a result of the termination of the S election. In the event of a transfer or any other action that terminates S corporation status:

    a. Provide for the attempt to obtain from the IRS a waiver of the terminating event on grounds of inadvertency or to obtain IRS approval to make a new election before the 5-year waiting period has expired (with violating shareholder bearing expense).
    b. "No-fault" damages provisions may be desirable because of difficulty of determining intent and because the ineligible shareholder terminations are preventable with minimal planning.
    c. List factors to be considered in setting damages or provide for liquidated damages.
    d. Use tax indemnification provisions as alternative to damages.

C. Other Considerations.

1. <u>Distributions.</u>

Shareholders of an S corporation may wish to agree among themselves to require the corporation to distribute to them at specified times amounts sufficient to discharge any tax liability (federal and state) on pass-thru of net earnings of corporation.

2. <u>Close-Out of Books.</u>

In the event a shareholder terminates his interest in the corporation, the agreement should set forth a procedure for determining if the corporation is to make the election to close its books as permitted by IRC § 1377 for purposes of allocating the corporation's items of income, loss, deduction, credit for the year of

[76] IRC § 1362(d)(1)(B).

termination as of the date of termination. If an election is made under IRC § 1377, then, there is an effective closing of the books on the date of the election and all items of income, loss, deduction, and credit incurred up to date of the election will be allocated among those who were shareholders up to the date of the election. If no election is made, then items of income, loss, deduction, and credit for the *entire year* will be allocated among the shareholders on a per day/per shareholder basis.

3. Trust Elections.

Govern elections required with respect to any stock held by a QSST or ESBT.

4. Representations.

Include representations and warranties by all shareholders that they meet standards to be eligible S corporation shareholders.

D. Types of Agreements.

1. Cross Purchase.

The parties to a cross purchase agreement are shareholders only. Considerations in utilizing a cross purchase agreement include:

a. **Positive.**

(1) Step-up in basis by continuing stockholders in shares purchased from selling shareholder.

b. **Negative.**

(1) Complexity.
(2) Difficult to control insurance policies, including acquiring policies from terminated stockholder (might consider trust arrangement to hold policies).
(3) Difficult for stockholders to understand.
(4) Difficulty to implement, particularly where there are a large number of shareholders.
(5) Personal liability of stockholders for shares purchased.
(6) Shareholders' after-tax dollars used to pay premiums on the insurance.
(7) Transfers of policies of terminating stockholder to other stockholders may result in tainting the policies and creating transfer for value problems.
(8) Each shareholder pays the premiums due on the policy he owns on the other stockholders. For example, if there was an older and younger stockholder, the younger stockholder would be required to pay the greater insurance premiums on the older stockholder's life.

2. Redemption**.**

A redemption agreement is made between the corporation and the shareholders with the corporation purchasing the shares. Considerations in utilizing a redemption agreement include:

a. **Positive.**

(1) Simplicity in understanding, implementation, and operation.
(2) Control of insurance policies.
(3) Premiums paid with company dollars (the company dollars used to pay insurance premiums will, however, be taxable to the shareholders).
(4) Insurance premium costs shared ratably based on stock ownership.
(5) No transfer for value issues.
(6) No personal liability for shares purchased, except to the extent agreement so provides.

b. **Negative.**

(1) No step-up in basis by continuing stockholders in shares purchased by corporation.

E. Creation of Two Classes of Stock.

There is concern whether a buy-sell agreement can create a second class of stock because of the rights, duties, and limitations placed upon a shareholder's shares by the stock purchase agreement. The Treasury Regulations contain complex rules regarding when a buy-sell agreement may affect a shareholder's rights to distributions or liquidation proceeds and, therefore, create a second class of stock.

1. Bona Fide Agreements.

That being said, however, in determining whether all shares have the same rights to distributions and liquidation proceeds, the Treasury Regulations ignore bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment.[77] This exception protects an S corporation that has a very basic buy-sell agreement. Such an agreement apparently does not have to apply to all shareholders to qualify for protection. This exception may also protect a portion of a more complex agreement.

[77] Treas. Reg. § 1.1361-1(l)(2)(iii); PLRs 90404020, 9720021, and 9807002.

2. Agreement With Principal Purpose To Circumvent One-Class-of-Stock and Substantially Higher/Lower Than FMV.

In determining whether shares have the same distribution and liquidation rights, the regulations also generally ignore buy-sell agreements among shareholders, agreements restricting the transfer of stock, and redemption agreements.[78] However, such an agreement is taken into account if the agreement (1) has a principal purpose of circumventing the one-class-of-stock requirement and (2) establishes a purchase price that, when the agreement is entered into, is significantly higher or lower than the fair market value of the stock.[79]

a. Safe Harbors.

The regulations recognize that a test based on fair market value may be hard for taxpayers to apply. To ease the burden, the regulations contain two safe harbors. First, the regulations treat an agreement as setting an acceptable price if the price equals book value or an amount between book value and fair market value.[80] For this purpose, the Service will accept a taxpayer's book value if it is determined in accordance with generally accepted accounting principles (including permitted optional adjustments) or if the book value is used for any substantial non-tax purpose.[81] In many cases, however, an S corporation will not be sure that a price that differs from book value falls between book value and fair market value. For example, the value of the corporation's assets may suggest a price higher than book value, while a discount for the shareholder's minority interest may suggest a price lower than book value. Second, the Service will respect a good faith determination of fair market value unless (i) the value was substantially in error and (ii) the determination was not performed with reasonable diligence.[82] The term "reasonable diligence" suggests that getting an appraisal would be prudent.

F. Complexities Reduced.

1. Income Allocation.

The concept of splitting income on a daily basis eases income allocation problem in buy-sell agreements. Under old law, all of the income for the year was allocated to the shareholders owning stock at the end of the fiscal year.

2. Continuation of S Election.

After the stock is transferred the agreement protects the S election, unless the corporation ceases to be a small business corporation or there is a conscious decision to revoke the S election.

IV. CONVERSIONS.

A. Reasons for Converting From S Corporation to Partnership May Not Overcome Income Tax Consequences.

During the recent economic meltdown, many traditional sources of credit either disappeared entirely or became much more difficult to obtain. As a result, many businesses are considering, and will be in the future forced to consider, obtaining operating funds from non-traditional sources, such as private investors and funds. As pointed out in the previous sections, however, the limitations on the number and types of shareholders, as well as the restriction to one class of stock may substantially limit the funds available to many S corporations. For these reasons, many traditional S corporations may consider converting to an LLC taxed as a partnership. There are several potential tax traps that must be considered in this conversion. Ultimately, however, if the tax implications prohibit such a conversion for income tax purposes, the traditional S corporation can still convert to an LLC and retain the S status.

B. Analysis of Tax Implications of Converting From S Corporation to Partnership.

To cover all of the potential issues, the following analysis will assume that the S corporation/parent (the "Parent-S corp.") has a Qualified Subchapter S Subsidiary (the "Q-Sub") (if this is not the case, the same principals will apply to just and S corporation). With this structure in mind, the analysis of the tax consequences can be divided into three separate steps. The first step in the analysis is the effect of the election to treat Q-Sub as a Qualified Subchapter S Subsidiary, which is in effect a liquidation of the Q-Sub into the Parent-S Corp. The second step in the analysis is the resulting deemed liquidation of the Parent S-Corp to its shareholders. The third step is the resulting deemed re-contribution of the assets and liabilities by the shareholders (now partners) to the newly created LLC/partnership and LLC/disregarded entity.

1. Deemed Liquidation Resulting From Election To Treat Q-Sub as Q-Sub.

Under the Code, an election to treat a subsidiary of Parent-S Corp as a Q-Sub effects as complete liquidation of Q-Sub into the Parent-S Corp.[83] Generally speaking, the result of the complete

[78] Treas. Reg. § 1.1361-1(l)(2)(iii)(A).

[79] Treas. Reg. §§ 1.1361-1(l)(2)(iii)(A)(1) and 1.1361-1(l)(2)(iii)(A)(2).

[80] Treas. Reg. § 1.1361-1(l)(2)(iii)(A).

[81] Treas. Reg. § 1.1361-1(l)(2)(iii)(C).

[82] Treas. Reg. § 1.1361-1(l)(2)(iii)(A).

[83] Treas. Reg. § 1.1361-4(a)(2).

liquidation is that all assets and liabilities of Q-Sub at the time of the liquidation become the assets and liabilities of Parent-S Corp and, following the liquidation, all assets, liabilities, items of income, deduction and credit of Q-Sub are deemed to be the assets, liabilities, items of income, deduction and credit of Parent-S Corp.

a. Gain or Loss to Parent-S Corp and to Q-Sub Under Code § 332, § 334, and § 337.

(1) No gain or loss is recognized (by the Parent-S Corp) upon Parent-S Corp's receipt of assets and liabilities from Q-Sub, unless (i) Q-Sub is insolvent or (ii) Q-Sub is deemed to distribute liabilities it owes to the Parent-S Corp in satisfaction of those liabilities.[84]

(2) No gain or loss is recognized (by Q-Sub) upon Q-Sub's distribution of assets and liabilities to Parent-S Corp in complete liquidation, unless the Q-Sub is insolvent.[85]

b. Parent-S Corp's Basis In Stock of Q-Sub and Assets Received From Q-Sub Under § 334.

(1) Parent-S Corp's investment in Q-Sub (*i.e.*, Parent-S Corp's adjusted basis in Q-Sub's stock) *is completely lost forever*. It is not allocated among the assets received from Q-Sub and, thus, it is not taken into account when Parent-S Corp sells or otherwise disposes of the assets acquired from Q-Sub in the liquidation.[86]

(2) Parent-S Corp's adjusted basis in the property received from Q-Sub is the same as Q-Sub's former adjusted basis in the property.[87]

c. Holding Period of Assets Received From Q-Sub Under Code § 334.

Parent-S Corp's holding period for the property received includes the period for which Q-Sub held the property.[88]

d. Character of Assets and Liabilities Received From Q-Sub.

Although Parent-S Corp has a carryover basis in the assets received from Q-Sub, the character of the assets in the hands of Parent-S Corp is not determined by their character in the hands of Q-Sub. Instead, the character will depend on the use of the assets in the hands of Parent-S Corp and will be determined under the generally applicable provisions of the Code. By way of example, in *Acro Mfg. Co. v. Commr.*[89], the Tax Court held that the sale at a loss by a parent of accounts receivable, inventories, land, and depreciable assets acquired upon the complete liquidation of its subsidiary under Code § 332 resulted in a capital loss. In this case, the Tax Court found that the parent was engaged in a business substantially different from the business conducted by the subsidiary. On these grounds, the Tax Court held that the assets of the subsidiary had not been "acquired in" or "used in" the parent's business and, therefore, did not fall within the exceptions from the term capital assets as defined in Code § 1221.

e. Other Tax Attributes Under Code § 381.

Certain tax attributes of Q-Sub (*i.e.*, net operating losses, earnings and profits, capital loss carry-overs, methods of accounting and business history) should also carry over to Parent-S Corp.[90]

In this first step, the key point is that Parent S-Corp has completely lost its basis in Q-Sub's stock, which could result in taxable gain in the deemed liquidation occurring in the second step (discussed below).

2. <u>Deemed Complete Liquidation of S-Corp and Q-Sub.</u>

The change in tax treatment from an S Corp to a partnership is treated as a complete liquidation of the S Corp under Code § 336 and § 331. This deemed complete liquidation is, itself, a two-step process. First, the S Corp is deemed to sell all of its assets and recognize the resulting gain or loss (which will be passed through to the shareholders pursuant to the generally applicable provisions of the Code governing S Corps). Second, the S Corp is deemed to distribute all of its assets and liabilities to its shareholders in exchange for their stock in the S Corp. The tax consequences of each of these steps are outlined as follows:

a. Deemed Sale of Assets by Parent-S Corp Under Code § 336.

[84] IRC § 332.

[85] IRC § 337.

[86] IRC § 334; *Peerless Investment Co.*, 58 TC 892 (1965); *Barkley Co. of Ariz.*, TC Memo. 1988-324.

[87] IRC § 334(b)(1).

[88] IRC § 1223(2).

[89] 39 TC 377 (1962), *aff'd*, 334 F.2d 40 (6th Cir. 1964), *cert. denied*, 379 U.S. 887 (9164).

[90] IRC § 338(a)(1).

(1) **Gain or Loss on Deemed Sale of Assets.** Parent-S Corp recognizes gain or loss on its distribution of property to its shareholders as if it sold the property to the distributee-shareholders for the properties' fair market value.[91] The gain or loss is calculated on an asset-by-asset basis.[92] The fair market value of each asset is generally determined pursuant to the willing buyer-willing seller methodology.[93]

(2) **Fair Market Value Cannot be Less Than Liabilities.** If the property distributed is subject to a liability or the distributee-shareholder assumes a liability in connection with the distribution, and the amount of such *liability exceeds the fair market value of the property, the fair market value of the property is deemed to equal the amount of the liability*. It is not clear how liabilities that are not associated with a particular property should be allocated. Ultimately, however, to the extent the liabilities exceed Parent-S Corp's basis in the property, the entity will likely recognize gain. The fact that there is no guidance on how to allocate these liabilities could be problematic in determining which assets triggered the gain and, thus, the character of that gain. For example, and assuming Parent-S Corp is an accrual basis taxpayer, it would generally recognize no gain from accounts receivable; however, if some of the debt is allocated to the accounts receivable and thereby increases the value of the accounts receivable over the basis, a gain could be triggered and that gain could be ordinary in character.

(3) **Goodwill Can Trigger Gain Recognition.** In this process, there is *no specific exception for goodwill or going concern value*. It appears that the IRS will attempt, and has argued in the past, to value and tax the goodwill or going concern value of the entity even though that goodwill or going concern value was not booked for federal income tax purposes (and was not amortized/amortizable under Code § 197).[94] The arguments against the taxation of goodwill or going concern value are (a) it has no value, (b) it was not the property of the entity (Martin Ice Cream), or (c) it was not transferable.[95]

(4) **Character of the Gain or Loss.** The character of the gain or loss related to those *assets owned directly* by Parent-S Corp will be determined by the use of those assets by Parent-S Corp pursuant to the generally applicable provisions of the Code. The character of the gain or loss related to those *assets obtained from Q-Sub* pursuant to the deemed liquidation will not necessarily be controlled by the use of those assets by Q-Sub. Instead, as explained above, the character of the assets obtained from Q-Sub pursuant to the deemed liquidation will depend on the use of the assets in the hands of Parent-S Corp.

(5) **Gain or Loss Flows Through to Shareholders.** Any gain or loss recognized by Parent-S Corp will flow through to the shareholders and increase or decrease their adjusted basis in their stock, pursuant to the generally applicable provisions of the Code governing S Corps.[96]

As mentioned above, the key point here is the potential recognition of gain as a result of either (i) taxable off-balance sheet goodwill or (ii) taxable deemed disposition of the assets due to the increase in their fair market value as a result of the liabilities. Consequently, as a result of the way the Code treats this conversion, there is a significant likelihood that gain will be triggered. The positive of this is that the gain will flow through to the shareholders, thereby increasing their basis in their stock, potentially creating an off-setting loss if there are liabilities involved (as discussed below).

---

[91] IRC § 1371(a) and § 336(a).

[92] *Williams v. McGowan*, 152 F2d. 570 (2nd Cir. 1945).

[93] *Commr. v. Marshman*, 279 F.2d 27 (6th Cir.), *cert. denied*, 364 U.S. 918 (1960); *Helvering v. Walbridge*, 70 F.2d 683 (2nd Cir.), *cert. denied*, 293 U.S. 594 (1934).

[94] *MacDonald v. Commr*. 3 TC 720 (1944); *Rudd v. Commr*., 79 TC 225 (1982); *Norwalk v. Commr*., 76 TC Memo 208 (1998); *Martin Ice Cream Co. v. Commr*., 110 TC 189 (1998).

[95] *Id*.

[96] *See* IRC § 1366 and § 1367.

b. Complete Liquidation of Parent-S Corp Assets Under Code § 331 and § 334.

(1) **Gain or Loss on Deemed Liquidation of Assets.** Amounts received by shareholders in a liquidating distribution are treated as full payment in exchange for the shareholders' stock.[97] Thus, each shareholder will recognize gain or loss based on the difference between (i) the cash and "net fair market value" of the property received and (ii) the shareholders' respective adjusted basis in their S Corp stock.[98] "Net fair market value" is the fair market value of the asset determined in accordance with the willing buyer-willing seller methodology, *less the amount of corporate liability that the shareholder assumes or subject to which the shareholder takes the property*.[99]

(2) **Adjusted Basis of Property Received in Complete Liquidation Under Code § 334.** The basis of the property received in a liquidating distribution in which gain or loss is recognized by the shareholder is the fair market value of such property on the date of distribution.[100] For this purpose, fair market value is *not reduced by the amount of any liabilities that the shareholder assumes or subject to which he or she takes the property*.[101]

(3) **Character of the Shareholders' Gain or Loss.** The character of the shareholders' gain or loss is determined by the character of the stock in the shareholders' hands.[102] (Likely capital in this case). As pointed out above, the key issue here is whether a loss is created at the shareholder level that may be used to off-set the gain that will likely be generated at the entity level. The measure of the gain at the shareholder level is the difference between the net fair market value of the assets distributed to the shareholders and the adjusted basis of their stock. In this case, regardless of which assets you value (goodwill or no goodwill) or how you value the assets, the "net" fair market value of the assets should be zero since the liabilities equal or exceed the total value of the assets as set forth on the balance sheet. Thus, the shareholders will likely be deemed to have received no value, thereby, generating a loss equal to the basis in their stock. The character of this loss will likely be capital in nature and, thus, to the extent the gain flowing through from entity level is capital (but see above regarding accounts receivable), the loss at the shareholder level could potentially be used to off-set that gain.

c. Contribution of Assets and Liabilities to the New LLC/Partnership and LLC/Disregarded Entity.

Following the liquidation, for state law purposes, the former shareholders of Parent-S Corp will be deemed to contribute those assets related to former Parent-S Corp to the newly created parent-LLC (which will be taxed as a partnership) and those assets related to former Q-Sub to the newly created subsidiary-LLC (which will be taxed as a disregarded entity). For federal income tax purposes, however, because the newly created Subsidiary-LLC will be 100% owned by the newly created Parent-LLC and will be taxed as a disregarded entity, just as with Parent-S Corp and Q-Sub, all assets, liabilities, items of income, deduction and credit of the newly created Subsidiary-LLC will be deemed to be the assets, liabilities, items of income, deduction and credit of Parent-LLC. Thus, when considering the federal income tax implications of the contribution of the assets and liabilities to the new LLC, the focus will be on the contribution of all of the assets and liabilities to Parent-LLC. This contribution can effectively be broken into two separate contributions – one of assets and the second of liabilities.

(1) Contribution of Assets to the Partnership.

(a) Gain or Loss Upon Contribution of Property Under Code § 721.

No gain or loss will be recognized to a partnership or to any of its partners upon the contribution of property to the partnership in exchange for an interest in the partnership.[103]

---

[97] IRC § 331.

[98] IRC § 1001.

[99] IRC § 1001; *Ford v. U.S.*, 311 F.2d 951 (Ct. Cl. 1963); Rev. Ruls 72-137, 1972-1 C.B. 101, and 59-228, 1959-2 C.B. 59.

[100] IRC § 334(a).

[101] *Ford v. U.S.*, 311 F.2d 951 (Ct. Cl. 1963).

[102] IRC § 1221.

[103] IRC § 721(a).

(b) Adjusted Basis of Partner's Interest Under Code § 722.

The adjusted basis of an interest in a partnership acquired by a contribution of money and property to a partnership shall be equal to the amount of money and the adjusted basis of such contributed property in the hands of the contributing partner.[104]

(2) Contribution of Liabilities to the Partnership Under Code § 752.

If the partnership assumes a liability of the contributing partner or takes contributed property subject to a liability, then, that partner is deemed to be relieved of a portion of the liability and that portion of the liability that is allocated to the other partners is treated as a cash distribution from the partnership to the contributing partner.[105] Under the generally applicable distribution rules, this deemed cash distribution decreases the contributor's basis in his or her partnership interest, but not below zero, and any deemed cash distribution in excess of the basis generates taxable capital gain to the contributing partner.[106] The basis of the other partners in their partnership interests are increased by the portions of the new partnership liability allocated to them.[107] It is important to consider the fact that when you have a mix of shareholder-debt and third-party debt, the debts may not be allocated to the partners based merely on their respective partnership interest. Under the Treasury Regulations for Code § 752, debt that a partnership owes to a partner is allocated entirely to that partner because he or she bears the economic risk of loss. This could trigger additional interesting income tax consequences.

C. If the Income Tax Implications Are Too Much To Bear, Retention of S Election in New LLC Is Possible.

If, the tax consequences of changing from an S corporation to a partnership for federal income tax purposes are too great, but there is still a desire to convert from a partnership to an LLC for state law purposes, with the new LLC continuing to be taxed as an S corporation, then, such a conversion can generally be accomplished tax free. The conversion will qualify as a "Type F" reorganization, with neither the old entity or the new LLC recognizing gain or loss. The S election will not terminate and the new LLC will continue to use the old entity's employer identification number. The only required filing will be the new LLC's filing of an IRS Form 8832, Entity Classification Election.[108]

V. SECOND CLASS OF STOCK.

A. Restriction To Single Class of Stock May Hamper Raising Capital in New Economic Times.

In these new economic times, traditional sources of credit have either disappeared all together or become very difficult to tap. As a result, businesses are reaching out to private investors or funds, which typically want a piece of the action in return for their capital infusions. The restriction on S corporations having only one class of stock presents a number of potential tax traps for S corporations seeking such funding.

B. Single Class of Stock.

Only entities with one class of stock are eligible to elect S corporation status, and the presence of multiple classes of stock will terminate an S election.[109] Generally speaking, an entity is treated as having only one class of stock if all outstanding ownership interests of the entity confer identical rights to distribution and liquidation proceeds.[110] This determination is made based on the "governing provisions," *i.e.,* the documents forming the entity; the bylaws; applicable state law; and any other binding agreements relating to distribution and liquidation proceeds.[111] While there are other factors that can trigger a second class of stock, the three that are addressed in this paper are (i) the reclassification of debt as equity, (ii) the issuance of call options, warrants, and similar instruments, and (iii) issuance of debt with a convertibility feature.

1. <u>Debt as Second Class of Stock.</u>

a. General Rule.

Generally speaking, debt will be recharacterized as equity and, thus, will likely create a second class of stock if the debt:

(1) constitutes equity or stock under *general principles of federal tax law*; *and*
(2) has a *principal purpose* of contravening *either* (i) the requirement of identical rights to distributions or liquidation proceeds *or* (ii) the limits on permitted shareholders for S corporations.[112]

---

[104] IRC § 722(a).

[105] IRC § 752.

[106] IRC §§ 731, 733, and 741.

[107] IRC § 752.

[108] *See* Rev. Rul. 2008-18 and PLR 200839017.

[109] IRC § 1361(b)(1)(D).

[110] Treas. Reg. § 1.1361-1(l)(1).

[111] Treas. Reg. § 1.1361-1(l)(2).

[112] Treas. Reg. § 1.1361-1(l)(4)(ii)(A).

There are literally hundreds of judicial opinions and administrative rulings addressing the question of whether debt constitutes equity or stock under "general principles of federal tax law."[113] This determination is highly factual and the courts and the IRS have looked at many different factors.[114] Unfortunately, there is no bright-line test that can be discerned from the cases and rulings and, consequently, each case must stand on its own facts and circumstances.

b. Debt Safe Harbors.

Because both elements of the general test outlined above are highly subjective, the Code and Treasury Regulations provide various objective safe harbors.[115] Under these safe harbors, debt is treated as debt for purposes of the one class of stock requirement, even though it may be treated as stock under other provisions of the Code or Treasury Regulations or under general principles of federal tax law developed in the cases and rulings.

(1) Safe Harbor for Small, Unwritten Advances.

A second class of stock does *not* result on account of unwritten advances from a *shareholder* that: (i) do not exceed $10,000 in total at any time during the corporation's taxable year, (ii) that are treated as debt by the parties, *and* (iii) that are expected to be repaid within a reasonable time.[116]

(2) Safe Harbor for Pro Rata Debt.

A second class of stock does *not* result on account of (i) obligations of the same class, (ii) owned solely by an *S corporation's shareholders,* and (iii) held in proportion to the stock ownership.[117]

(3) Straight Debt.

(a) General Requirements.

An S corporation can issue "straight debt" and be assured that such debt will *not* be considered a second class of stock.[118] To be classified as "straight debt," such debt must meet the following criteria:

(i) it must be in writing;[119]
(ii) it must be an unconditional promise to pay in money a sum certain on a specified date or on demand;[120]
(iii) the interest rate and interest payment dates must not be contingent on the borrower's profits, the borrower's discretion, the payment of dividends with respect to the common stock, or similar factors;[121]
(iv) the debt must not be convertible *directly or indirectly* into stock or any other equity interest of the S corporation;[122] *and*
(v) the creditor is *either* (1) an individual (other than a nonresident alien), an estate, a trust described in Code § 1361(c)(2) (*i.e.*, a trust that's an eligible S corporation shareholder), *or* (2) a *person* (other than an individual) that is *actively and regularly engaged in the business of lending money*.[123]

The note itself does not have to be in the form of a formal promissory note.[124] Although straight debt is prohibited from bearing certain types of contingent interest, interest on straight debt may depend on outside factors such as the prime rate.[125] Furthermore, the straight debt safe harbor does not provide for an upper or lower limit on the rate of interest which straight debt may carry.[126] If the interest rate is unreasonably high, however, a portion of the interest may be recharacterized and treated as a payment that is

[113] *See* 730 3rd Tax Management Portfolio, *S Corporations: Formation and Termination*, Page A-52 through A-53 and 758 Tax Management Portfolio, *Transfers to Controlled Corporations: In General*, for a further discussion of the existing case law.

[114] *Mixon Est. v. U.S.*, 464 F.2d 394, (5th Cir. 1972); *Laidlaw v. Comr.*, T.C. Memo 1998-232, and Notice 94-47, 1994-1 C.B. 357.

[115] IRC § 1361(c)(5) and Treas. Reg. §§ 1.1361-1(l)(4)(ii)(B) and 1.1361-1(l)(5).

[116] Treas. Reg. § 1.1361-1(l)(4)(ii)(B)(1).

[117] Treas. Reg. § 1.1361-1(l)(4)(ii)(B)(2).

[118] IRC § 1361(c)(5) and Treas. Reg. §§ 1.1361-1(b)(5), 1.1361-1(l)(5)(i), and § 1.1361-1(l)(5)(iv).

[119] IRC § 1361(c)(5)(B) and Treas. Reg. § 1.1361-1(l)(5)(i).

[120] IRC § 1361(c)(5)(B) and Treas. Reg. § 1.1361-1(l)(5)(i).

[121] IRC § 1361(c)(5)(B)(i) and Treas. Reg. § 1.1361-1(l)(5)(i)(A).

[122] IRC § 1361(c)(5)(B)(ii) and Treas. Reg. § 1.1361-1(l)(5)(i)(B).

[123] IRC § 1361(c)(5)(B)(iii) and Treas. Reg. § 1.1361-1(l)(5)(i)(C).

[124] IRC § 1361(c)(5)(B) and Treas. Reg. § 1.1361-1(l)(5)(i).

[125] IRC § 1361(c)(5)(B)(i) and Treas. Reg. § 1.1361-1(l)(5)(i)(A).

[126] IRC § 1361(c)(5)(B)(i) and Treas. Reg. § 1.1361-1(l)(5)(iv).

not interest.[127] This does not, however, result in a second class of stock.[128]

(b) Who May Hold Straight Debt.

A straight debt creditor can be an individual, however, that individual cannot be a nonresident alien (regardless of whether the nonresident alien is actively and regularly engaged in the business of lending money). As a general rule, a creditor that is a trust must qualify as one of the permitted shareholders under Code § 1361(c)(2) in order to hold straight debt.[129] Although it also appears that the statute generally excludes a foreign trust from holding straight debt, a foreign trust may be able to hold the obligation if the trust is actively and regularly engaged in the business of lending money.[130] Although certain charities and pension trusts are now allowed to own the stock of S corporations, they are only allowed to hold straight debt if they are actively and regularly engaged in the business of lending money.[131]A straight debt creditor can also be any other type of business entity, so long as that business entity is actively and regularly engaged in the business of lending money. The term "actively and regularly engaged in the business of lending money," however, is not defined in the Code or Treasury Regulations, or the related cases or rulings, applicable to the straight debt safe harbor. Furthermore, although this term is used in various other provisions in the Code and Treasury Regulations (not related to the straight debt safe harbor), it is not definitively defined in those provisions nor does it appear to be defined in the cases or rulings under those other provisions.[132] That being said, the term certainly includes banks, savings and loans, certain insurance companies, and pension trusts. Beyond that, however, there is little guidance as to what constitutes being "actively" and "regularly" engaged in the "business of lending money." Consequently, any issuance of debt to a creditor that wishes to qualify under the straight debt safe harbor as an entity actively and regularly engaged in the business of lending money will have to be reviewed on a case by case basis.

(c) Convertibility, Subordination, Modification of Straight Debt.

(i) Straight Debt Can Not Be Convertible.

Straight debt cannot be convertible *directly or indirectly* into stock.[133] This rule may create some uncertainty if an S corporation issues its notes and warrants together in an investment unit. For the lowest risk, the warrants should expire well before the notes are due. For example, an S corporation wishes to have its notes qualify under the straight debt safe harbor, but also wishes to sell its notes together with warrants to buy the S corporation's stock. The notes will be due in five years, while the warrants will expire in four years. In this situation, an investor that wishes to buy the S corporation's stock will have to obtain the cash for the exercise price from a source other than the S corporation's note. Thus, the notes should *not* be viewed as indirectly convertible into stock. Before issuing the warrants, however, an analysis must be made as to whether the warrants themselves will create a second class of stock (discussed in detail below).

(ii) Subordination.

An instrument may qualify as straight debt even if it is subordinated to other debt.[134]

(d) Retesting – Modification or Transfer.

The straight debt safe harbor applies only as long as an instrument continues to meet the tests of the Code and Treasury Regulations. An obligation that originally qualified as straight debt will cease to qualify as straight debt if the obligation:

(i) is transferred to a third party who is not an eligible shareholder, *or*

(ii) is *materially modified* so that it no longer satisfies the definition of straight debt.[135]

The reference to persons not eligible to be S shareholders includes the various types of ineligible persons, such as corporations and partnerships and trusts other than those discussed above. Further, if a corporation has 100 shareholders, it appears that *any* additional person would be ineligible for this purpose and, thus, trigger a retest.**[136]**

[127] IRC § 1361(c)(5)(B)(i) and Treas. Reg. § 1.1361-1(l)(5)(iv).

[128] IRC § 1361(c)(5)(B)(i) and Treas. Reg. § 1.1361-1(l)(5)(iv).

[129] IRC § 1361(c)(5)(B)(iii) and Treas. Reg. § 1.1361-1(l)(5)(i)(C). These trust are grantor trusts, qualified subchapter S trusts, and electing small business trusts.

[130] IRC § 1361(c)(5)(B)(iii) and 1361(c)(2)(A) (last sentence).

[131] IRC §§ 1361(c)(6) and 1361(c)(5)(B)(iii).

[132] See IRC § 465(b)(6)(D)(i) (incorporating by reference IRC § 49(a)(1)(D)(iv)) regarding the at-risk limitations.

[133] IRC § 1361(c)(5)(B)(ii) and Treas. Reg. § 1.1361-1(l)(5)(i)(B).

[134] Treas. Reg. § 1.1361-1(1)(5)(ii).

[135] Treas. Reg. § 1.1361-1(1)(5)(iii).

[136] Treas. Reg. § 1.1361-1(1)(4)(iii)(A) (referring to Treas. Reg. § 1.1361-1(b)(1), which includes the limit on the number of shareholders).

Neither the Code nor the Treasury Regulations define the term "materially modified" and there do not appear to be any cases or rulings addressing what constitutes a material modification in the context of the straight debt safe harbor. That being said, the concept of material modification arises in the context of Code § 1001 and the related Treasury Regulations, which deal with debt modifications in the context of a sale or exchange. The Code § 1001 Treasury Regulations and related cases and rulings may be used to provide some guidance as to what might constitute a material modification in the context of the straight debt safe harbor. Ultimately, however, it would be prudent to prevent the debt from being modified in any manner without the review of counsel to determine whether such modification might trip the material modification retesting provisions.

2. Options and Warrants.

a. General Rule.

As a general rule, a call option, warrant, or similar instrument (generically referred to as an "option") issued by a corporation *is a second class of stock if*, *taking into account all the facts and circumstances*, the option:

(1) is substantially certain to be exercised by the holder or a potential transferee, *and*

(2) has a strike price substantially below the fair market value of the underlying stock on the date that the option is issued, transferred by a person who is an eligible shareholder to a person who is not an eligible shareholder, or materially modified.[137]

The apparent concern is that a "deep-in-the-money" option may be the equivalent of the ownership of stock that differs from a corporation's outstanding stock. The Treasury Regulations are practical enough, however, to ignore deep-in-the-money options except on the issue date, the date the option is transferred by a person who is an eligible shareholder to a person who is not an eligible shareholder, or the date the option is materially modified.

b. Substantial Certainty as to Exercise.

Whether an option is substantially certain to be exercised depends on all the facts and circumstances.[138] Even when a strike price is only 50% of the stock's fair market value, the regulations still refer to all the facts and circumstances and do not draw an automatic conclusion.[139]

(1) Strike Price Substantially Below Fair Market Value.

The general rule under the Treasury Regulations, outlined above, is clear. A strike price that is equal to the fair market value of the underlying stock on the date the option is *issued* will not create a second class of stock when such option is *issued* (further assuming the option is not substantially certain to be exercised). Further, an option with a strike price equal to fair market value on the date of *issue* should not create any problem, regardless of what the stock price does, unless and until there is a later transfer or material modification, *i.e.*, a retesting event, at which time there may be a problem if the fair market value of the stock has substantially increased over-and-above the strike price. However, the Treasury Regulations are not a model of clarity because they add that a strike price is *not* substantially below fair market value if the price at the time of *exercise* cannot, under the terms of the option, be substantially below the fair market value of the underlying stock at the time of *exercise*.[140] One could interpret this provision (potentially) as being in conflict with the general rule that the strike price is tested at issuance of the option. Since statutory construction mandates that all provisions be read in harmony, we do not see this "time of exercise" provisions as a problem because, under the terms of the Treasury Regulations, it is "in addition to" the general rule and states a conclusion based on a different fact patter (*i.e.*, one that does not provide for a specific dollar amount as the strike price). Finally, it also appears clear that a strike price equal to only 50% of fair market value (*either at issuance or exercise*) will be considered substantially below the fair market value and, thus, create a second class of stock.[141] Thus, unless one of the safe harbors (discussed below) applies, the question of whether a strike price that is greater than 50% of fair market value (on issue or exercise), but not equal to fair market value (on issue or exercise), will be deemed to be substantially below fair market value, and thus create a second class of stock, will depend on an analysis of all the facts and circumstances surrounding the issuance of the option.[142]

---

[137] Treas. Reg. § 1.1361-1(1)(4)(iii)(A).

[138] Treas. Reg. § 1.1361-1(1)(4)(iii)(A).

[139] Treas. Reg. § 1.1361-1(1)(4)(v), Ex. 1.

[140] Treas. Reg. § 1.1361-1(1)(4)(iii)(A).

[141] Treas. Reg. § 1.1361-1(1)(4)(v), Ex. 1.

[142] Treas. Reg. § 1.1361-1(l)(4)(iii)(A).

c. Retesting – Transfer or Modification.

The determination of whether an option constitutes a second class of stock under the general rule is retested when the option is:

(a) transferred by a person who is an eligible S shareholder to a person not eligible to be an S shareholder; *or*
(b) materially modified.[143]

The reference to persons not eligible to be S shareholders includes the various types of ineligible persons, such as corporations and partnerships and trust other than those discussed above. Further, if a corporation has 100 shareholders, it appears that *any* additional person would be ineligible for this purpose and, thus, trigger a retest.[144]

In this case, the Code and Treasury Regulations provide very little guidance as to what constitutes a material modification of an option. In this respect, the Code and Treasury Regulations only provide that, with regard to options, a "material modification" does *not* occur if an option is issued in connection with a loan and the period in which the option can be exercised is extended in connection with, and in a manner consistent with, a modification of the terms of the loan.[145] Thus, such an extension does not trigger a new test to see if the strike price is substantially below the value of the stock and if exercise is substantially certain. Other than this, however, neither the Code nor the Treasury Regulations further define the term "material modification" and there do not appear to be any cases or rulings substantially addressing what constitutes a material modification in the context of retesting options. Consequently, it may be possible to look to the modification rules applicable to debt (as discussed above in connection with the straight debt safe harbor) or to the modification rules applicable to deferred compensation plans under Code § 409A for guidance as to what might constitute a material modification of an option.

As a planning matter, an option issued by an S corporation generally *should prohibit transfer* to a person that is not eligible to be an S shareholder (under the limits on both the types and number of shareholders) and should prohibit modification without the review of counsel. Such a clause will prevent a transfer or modification of the option that otherwise would trigger a new testing date to see if the option was substantially certain to be exercised and if the strike price was substantially less than fair market value.

d. Option Safe Harbors.

Because, just as with debt, the test under the general rules for determining whether an option creates a second class of stock is highly subjective, the Code and Treasury Regulations provide various objective safe harbors. Two of those safe harbors are outlined below (a third safe harbor applicable to options issued employees is not discussed).

(1) Safe Harbor for Options Issued to Lenders.

An option is *not* treated as a second class of stock if it is issued:

(a) to a *person* that is *actively and regularly engaged in the business of lending*; *and*
(b) in connection with a commercially reasonable loan to the corporation.[146]

Thus, subject to these conditions, an S corporation can give an equity "kicker" to a lender without losing S status. *If, however, the lender is a corporation, limited liability company, partnership, or other non-permitted shareholder, exercise of the option will result in the loss of S status.*

Just as with the straight debt safe harbor, there is virtually no guidance as to what constitutes being actively and regularly engaged in the business of lending for purposes of this safe harbor for options issued to lenders. Accordingly, each lender will have to be analyzed on a case by case basis to determine whether the facts and circumstances surrounding any given lender support a claim that the lender is "actively" and "regularly" engaged in the "business of lending."

This safe harbor for an option issued to a lender may continue to apply if the lender assigns the option along with an assignment of the loan or assigns a portion of the option along with a corresponding portion of the loan.[147] The safe harbor ceases to apply, however, if the lender transfers the option and keeps the loan or if the option is transferred without a corresponding portion of the loan.[148] Such a disqualifying transfer will result in a retesting event under the general rules applicable to options to see if a second class of stock exists.[149]

[143] Treas. Reg. § 1.1361-1(l)(4)(iii)(A).

[144] Treas. Reg. § 1.1361-1(1)(4)(iii)(A) (referring to Treas. Reg. § 1.1361-1(b)(1), which includes the limit on the number of shareholders).

[145] Treas. Reg. § 1.1361-1(1)(4)(iii)(A).

[146] Treas. Reg. § 1.1361-1(1)(4)(iii)(B)(1).

[147] Treas. Reg. § 1.1361-1(1)(4)(iii)(B)(1).

[148] Treas. Reg. § 1.1361-1(1)(4)(iii)(B)(1).

[149] Treas. Reg. § 1.1361-1(1)(4)(iii)(B)(1) (referring to Treas. Reg. § 1.1361-1(1)(4)(iii)(A)).

(2) Safe Harbor for Options with Strike Price Equal to At Least 90% of Value.

An option is *not* treated as a second class of stock if the strike price of the option is at least 90% of the fair market value of the underlying stock on the date that the option is (i) issued; (ii) transferred by a person who is an eligible shareholder to a person who is not an eligible shareholder; *or* (iii) materially modified.[150] Again, there is little or no guidance as to what constitutes a material modification in the context of this safe harbor. That being said, it will likely be necessary to consider the same rules outlined above in connection with the straight debt safe harbor and the general test for whether an option creates a second class of stock. For purposes of this safe harbor, a good faith determination of fair market value by the corporation will be respected *unless* it can be shown that:

(a) the value was substantially in error; *and*
(b) the determination was not made with reasonable diligence.[151]

Because of the language regarding reasonable diligence, it may be wise to obtain an appraisal to support compliance with this safe harbor.

3. Convertible Notes.

A convertible debt instrument is considered a second class of stock if it either:

(a) is treated as equity under general principles of federal income tax law and is used to contravene the rights to distribution or liquidation proceeds or to contravene the limitation on eligible shareholders; *or*
(b) embodies rights equivalent to those of an option that is substantially certain to be exercised and has a conversion price that is substantially below the fair market value of the underlying stock on the date of issuance, transfer from an eligible shareholder to an ineligible shareholder, or material modification.[152]

This means convertible debt is actually subject to a two-fold test – first, the debt vs. equity test and, then, the option test. If either test triggers a second class of stock, the convertible debt would terminate S corporation status.

VI. OTHER ESTATE PLANNING CONSIDERATIONS.

A. Corporate Recapitalization.

1. Traditional Freeze Techniques - Not Available.

The most common technique previously used to freeze values in family businesses is the so-called capital freeze. It is achieved by recapitalizing the existing corporation with two classes of stock (common and preferred) with the older generation owning the preferred stock and the younger generation owning common stock. The traditional freeze technique of using common and preferred stock is not available to an S corporation because an S corporation can have only one class of stock.

2. Voting Rights May Vary.

While only one class of stock is permitted, the S corporation can have common stock with different voting rights.[153] The shareholders must continue to ratably share all remaining rights.

3. Transfer of Value Without Losing Control.

Many business owners are reluctant to transfer voting control of the business (which is their livelihood) to their children or others. By using voting and nonvoting stock, the older generation may shift a substantial portion of stock ownership to the younger generation by gifting nonvoting shares. This shifting of stock ownership results in a transfer of a substantial portion of the stock's value to the younger generation. At the same time, the older generation retains voting control of the corporation.

Example: If parents owned an S corporation with common stock worth $100,000, they could only retain 51% control by transferring 49% of stock to the children. By recapitalizing the company and designating 10% of the stock of the company voting and 90% nonvoting, then the parents could give up to 94% of the company to the children and still retain 51% voting control.

4. Premium - Voting Stock.

S corporation voting stock may carry a premium over corresponding nonvoting common stock even though both shares pay identical dividends. Correspondingly, the parent could give away the voting stock and retain the nonvoting stock. The nonvoting stock retained by the parents, while includable in their gross estate, should be subject to a discounted value since it carries no voting rights or control.

---

[150] Treas. Reg. § 1.1361-1(1)(4)(iii)(C) (this regulation provides that failure to meet the safe harbor tests does not necessarily mean that the option is a second class of stock).

[151] Treas. Reg. § 1.1361-1(1)(4)(iii)(C).

[152] Treas. Reg. § 1.1361-1(l)(4)(iv), which refers to Treas. Reg. §§ 1.1361-1(l)(4)(ii) and 1.1361-1(i)(4)(iii).

[153] §1361(c)(4).

5. Passing Control of the Family Business.

By reclassifying the S corporation shares as voting and nonvoting, the parents can keep the ownership equal among the children, but allocate to children active in the business the voting stock.

6. Characteristics of Stock.

Regulations have not been issued defining the rules applicable to the creation of voting verses non-voting rights of an S corporation. The statute says: "a corporation shall not be treated as having more than one class of stock *solely* because there are differences in voting rights among the shares of common stock." Presumably, except with respect to voting rights, the shares must have substantially identical rights.

7. Revocation by Nonvoting Shareholders.

Use of nonvoting shares are not free from potential conflicts.

a. The S corporation election may be revoked if shareholders owning more than 50% of the shares of stock consent.[154]
b. No distinction is made between voting and nonvoting stock for purposes of satisfying this 50% requirement.
c. Accordingly, 50% of the shares, whether voting or nonvoting, will have the capacity to revoke the S election.

Comment: A shareholder's agreement concerning revocation would be especially important to protect the S election even if non-voting shares were used.

8. Use of Debt.

a. Recapitalization Process.

The use of indebtedness may be incorporated into the recapitalization process.

(1) Safe Harbor Debt.

The indebtedness may be structured to meet the safe harbor provisions of IRC §1361(c)(5) to avoid any assertion of a second class of stock.

(2) Exchange Stock for Debt.

The older generation can exchange shares of the S corporation stock for debt and nonvoting stock.

Caveat: Debt may trigger §2036(c), causing shares to be included in older generation's estate.

(3) Recognition of Income.

The older generation will recognize income on the exchange of shares for debt to the extent of the principal amount of any debt received. §354(a)(2)(A).

b. **Safe Harbor Debt.**

So-called "straight debt" does not create a second class of stock for qualification purposes. Straight debt means any written unconditional promise to pay on demand or on a specified date a sum certain in money if:

(1) **No Contingencies.** The interest rate and payment dates are not contingent on profits, the borrower's discretion or similar factors, however, the interest rate can be made to be dependent upon the prime rate or a similar factor not related to a debtor corporation;
(2) **No Convertibility.** There is no convertibility (directly or indirectly) into stock; and
(3) **Specified Creditors.** The creditor is an individual (other than a non-resident alien), an estate, or a permitted trust.

c. Safe Harbor Not All Inclusive.

While straight debt may qualify for S corporation eligibility purposes, it may be treated as equity for other income tax purposes. Thus, the concept of "thin capitalization" will apply to determine whether the debt is stock for purposes other than the IRC §1361(c)(5) "safe harbor" test.

d. Organization.

Debt may be used in connection with the organization of a new S corporation. Parents would retain debt and a small number of share of voting common shares. Children would receive a larger number of shares of non-voting common.

Caveat: The effect of §2036(c) must be evaluated in connection with structuring the above plan.

B. Redemptions.

S corporation stock may be redeemed under §302 to terminate a stockholder's interest or to reduce it disproportionately, or under §303 to provide funds for death taxes and administration expenses.

1. 303 Redemptions.

Because the tax rate is the same for capital gains and dividends, are §303 redemptions needed anymore? Yes, because:

a. **Basis.** Can still subtract basis in stock in determining the amount of taxable gain. Without §303, the entire distribution will be taxable as a dividend if it is from a C corporation.
b. **Interest.** If interest is paid on corporate obligations it is deductible. If a distribution is treated as a dividend, no portion of the

[154] IRC § 1362(d)(1)(B).

payment is treated as deductible by the corporation.

c. **Maintaining Voting Parity.** Voting parity can be preserved by utilizing nonvoting stock to effect the redemption. A post-death recapitalization can be used to create the nonvoting stock to effect the 303 redemption.

2. Redemption to Pay Taxes.

Will a redemption be necessary to withdraw cash to pay taxes?

a. Sole Shareholder.

Perhaps not if the decedent was the sole shareholder.

b. Other Shareholders.

If there are other shareholders, a distribution will have to be made pro rata.

c. Cash Requirements.

Will depend on whether the amount of cash required exceeds the "accumulated adjustments account".

d. Tax Impact.

If there is a redemption, the taxable amount will be measured by the difference between the basis in the stock (stepped up at death) and the amount received. If there is a non-redemption distribution, it will be nontaxable to the extent it is from post-election accumulations and a dividend to the extent it is from pre-election C corporation earnings and profits.

3. Appreciated Property.

Distribution of appreciated property in exchange for stock may be a problem if the corporation has more than one stockholder.

a. Sale.

Distribution is treated as a sale by the corporation to the shareholder receiving the property at its FMV.[155]

b. Recognition of Gain.

Gain realized by corporation is taxed to all stockholders on a pro rata basis even though redeemed stockholder receives all of the property.

c. Basis Adjustments.

Redeemed stockholder will receive increase in stock basis only for his pro rata share of the gain.

d. Redemption of Deceased Stockholder's Stock.

(1) 100%.

If all of a deceased stockholder's stock is redeemed, that stockholder will realize a loss equal to his share of the corporate gain - because the stock's basis is stepped up to estate tax value (which we will assume here is also the redemption value), and the basis will be further increased by the pro rata share of the gain distributed.

(2) Partial.

If less than all of the redeemed stockholder's stock is redeemed, that stockholder will pay a tax on the gain passed through with respect to the unredeemed shares.

e. Other Stockholder's Recognition.

Other stockholders must pay tax on portion of gain passed through to them.

C. Effect of S Election of Property Rights.

1. Community vs. Separate.

If S corporation stock is owned by a spouse as separate property, does the S election alter the separate or community property characteristics of the corporation's retained earnings? Because S corporation income is taxable to the shareholders on a conduit theory, does this mean that the corporate build-up of earnings is community property instead of separate property which it would have been (subject to possible right of reimbursement) had the corporation continued as a C corporation? In *Thomas v. Thomas*[156] the Court held that previously taxed and retained earnings of an S corporation are corporate assets and are neither the community nor the separate property of the shareholder, but are the exclusive property of the corporation. The Court of Appeals reversed the trial court which had ordered the husband to pay his wife one-half of his share of the previously taxed income retained by the corporation. The appellate court based its decision on the theory that an S corporation shareholder has no greater rights than any other shareholder in a regular corporation who has no absolute right to corporate earnings.

2. Inception of Title.

The inception of title rule would appear to apply to S corporations in the same manner as C corporations. Whether the corporation is a C or S corporation should not affect the community/separate property right characteristics of that corporation.

Question: Do reimbursement claims arise to the extent that the community estate bears income taxes on S corporation profits? If a corporation which is the

[155] IRC § 1363(d).

[156] 738 S.W. 2d. 342, (Tex. Civ. App.-Houston, 1987, no writ).

separate property of H, distributes only that amount of earnings necessary for H to pay his income taxes on corporate earnings, does the use of the distribution (which is community property) by H to pay income taxes on the accumulated earnings of the corporation give rise to right of reimbursement to the community estate? Would the answer be different if all earnings were retained by the corporation and the community estate paid the taxes due as a result of the corporation's retained earnings?

VII. VAULATION OF S CORPORATIONS AND UNSUCCESSFUL ATTEMPTS TO "TAX-AFFECT" THE VALUATION.

The valuation of the stock of a closely held corporation is always difficult, because each closely held corporation is unique. That being said, most, if not all, of the factors applicable in valuing entities taxed as corporations and partnerships can potentially be applicable to entities taxed as S corporations. Lack of marketability and lack of control are the two factors most generally applied. Other factors that may be considered are significant reliance on a key person, excessive debt, economic, governmental, or environmental factors unique to the business, *etc*.

In the S corporation context, some experts have attempted to argue that the tax-sensitive nature of the S corporation creates an additional overall negative impact on the value of the S corporation. Generally, the argument is that the additional restrictions required to protect the S election and its related tax benefits weight in favor a further reduction of the value of the S corporation. In *Gross v. Commissioner,*[157] the donors gave away small minority blocks of the shares of an S corporation. The shareholders had signed an agreement to maintain the S election. The donors' and the IRS's appraiser both applied the "discounted future cash flow" method by which the value of the stock is based on the present value of the corporation's future earnings and then that value adjusted by a discount for lack of marketability. The donors' appraiser, however, reduced the corporate projected earnings by a 40 percent corporate income tax that would have been paid were the corporation not operating under an S election ("tax affecting" the earnings). The donors' appraisers also took a 35 percent discount for lack of marketability, while the IRS appraiser allowed only a 25 percent discount.

The Tax Court accepted the IRS's expert's valuation. According to the Tax Court, the principal benefit that shareholders expect from an S corporation election is a reduction in the total tax burden imposed on the enterprise. Because the owners expect to save money, the Tax Court saw no reason why that savings should be ignored as a matter of course in valuing an S corporation. The Tax Court emphasized, however, that IRS's expert did *not* ignore shareholder level taxes in valuing the corporation. The expert simply disregarded them *both* in projecting the corporation's available cash *and* in determining the appropriate discount rate. The Tax Court determined that, if in determining the present value of any future payment, the discount rate is assumed to be an after-shareholder-tax rate of return, then the cash flow should be reduced ("tax affected") to an after-shareholder-tax amount. The Tax Court further determined that, if on the other hand, a *pre* shareholder-tax discount rate is applied, then *no* adjustment for taxes should be made to the cash flow. According to the Tax Court, because the IRS's expert had assumed a *pre* shareholder-tax discount rate, he made no error in failing to "tax affect" the expected cash flow.

VIII. STATE AND LOCAL TAXATION OF S CORPORATIONS.

Most practitioners are very familiar with the federal income tax benefits of S corporation status. Many, however, fail to consider the potential state tax consequences that result from the flow through of income to shareholders that may live in a state different from where the S corporation is located and which may also be different from where the S corporation conducts its business.

A. Recognition of S Corporation Status.

Most states that recognize S corporation status for income tax purposes accept the federal election for state qualification. Those states that do recognize an entity's federal S corporation status either completely exempt the entity from tax or only levy tax on those items of income subject to federal taxation, such as built-in gains and passive income. States that do not recognize an entity's federal S corporation status generally tax S corporations as regular corporations.

B. State Taxation of Shareholders.

In general, a state can tax income earned by an individual from work performed in the state, income received from business property located in the state, and income derived from business transacted in the state. Based on these principals, most states tax resident shareholders on their entire distributive shares of S corporation income, regardless of the source of such income or the state to which it is attributed. Most of the states that do not recognize the S election do not tax the shareholders on the amount of their distributable shares, but rather tax the resident shareholder on some portion of dividends received from the S corporation.

[157] *Gross v. Commissioner*, TC Memo 1999-254, *aff'd*, 272 F.3d 333 (6th Cir. 2001).

Nonresidents are generally only taxed on income "sourced" to the state. The determination of whether income is "sourced" to a particular states is generally based on the notion that the income must have been derived from activities of the S corporation (not the shareholder) sufficiently connected to the state to justify taxation of the income. Because tracking nonresident shareholders is a difficult task, most states rely on information provided by the S corporation to identify nonresident shareholders and quantify their associated tax liabilities. As a means of gathering this information, states may require S corporations to withhold taxes from shareholder distributions, pay taxes at the corporate level on the distributive shares of the nonresident shareholders income, or file information reports or register the shareholders and the amount of their distributions.

As you can see, the state taxation of S corporation shareholders can quickly get complicated, especially where the S corporation operates in multiple states and even more so if the shareholders reside in multiple states.

Doc. No. 288284.1