

S Corporation Corner

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A corporation can only elect S corporation status if it qualifies as a “small business corporation.”¹ A small business corporation is a domestic corporation that is not an ineligible corporation (as described in Code Sec. 1361(c)) and that meets four specific requirements, one of which is the requirement that the corporation have only one class of stock.² This column will focus on the one class of stock requirement in the formation of an S corporation. The following example will be used as a basis to explain the one class of stock rules. The topics raised in the example are based upon questions posed recently by my colleagues.

Example. Lindsay and Melanie propose to start a high-fashion clothing boutique. They would like to form a corporation (in State A) to run the business and have asked about the possibility of making an S corporation election. They will have the same voting rights except that Lindsay can elect one of the two members of the board of directors and Melanie can elect the other member of the board of directors. They will have the same distribution rights and liquidation rights.

Lindsay is a resident of State B and Melanie is a resident of State A. The laws of State A require that a flow-through entity (which includes an S corporation) withhold and remit State A income taxes on behalf of any nonresident owner. The bylaws of the corporation will provide that the corporation will take into account this withholding and remittance of state income taxes when making equal distributions to the shareholders.

Lindsay and Melanie would like to enter into a shareholders agreement. Under the terms of the



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agreement, when one of them dies, the corporation will purchase the stock of the deceased shareholder. The purchase price of the stock will be set at the fair market value of the stock at the time of the signing of the agreement.

Lindsay and Melanie know that they will need more capital to cover the initial costs of purchasing inventory. Lisa has agreed to loan them cash to cover these costs. The loan will be evidenced by a promissory note that is properly secured. The interest on the promissory note will be the prime rate plus one percent and will be paid annually. Principal can be paid when the corporation has sufficient funds, but not later than five years from the date of the loan. Lisa has also asked that the debt be convertible into stock. The conversion price will be the fair market value of the stock at the date of the loan.

General Rules For One Class of Stock

For these purposes, a corporation is not treated as having more than one class of stock if the only difference among shares of stock is voting rights.³ In its simplest form, a corporation can have voting common stock and nonvoting common stock and it will not be treated as having two classes of stock. The Treasury Regulations provide for more sophisticated voting rights that are accepted differences in voting without creating a second class of stock.⁴ For example, a corporation may limit the voting rights to some of its shareholders to certain corporate issues as compared to the other shareholders and a corporation may allow each shareholder to select a member of the board of directors. None of these differences in voting rights among the shareholders will create a second class of stock.

The Treasury Regulations provide that a corporation has different classes of stock if the shares of stock provide different liquidation rights or distribution rights.⁵ For example, if one shareholder has a preference to a distribution from operations when compared to the other shareholders, then the corporation has two classes of stock and the corporation would not qualify to be an S corporation.

In order to determine if a corporation has two classes of stock, one must review the governing provisions of the corporation.⁶ The Treasury Regulations provide that the governing provisions of a corporation include its articles of incorporation, its bylaws, applicable state law, and binding agreements relating to

distribution and liquidation proceeds.⁷ In general, a lease, corporate contract, employment agreement or loan agreement is not a governing provision unless a principal purpose for entering into the agreement is to circumvent the one-class-of-stock rules.⁸ Although the reasons to enter into these documents may be business related, each of these types of documents could create a second class of stock if a (as compared to *the*) principal purpose is to circumvent the one class of stock rules. Therefore, the tax practitioner should carefully review the corporate leases, contracts, employment and loan agreements to make sure that each does not provide different distribution or liquidation rights among the shareholders.

Over the past years, many states have adopted tax withholding rules for income allocated to a shareholder of a flow-through entity who is not a resident of the state where the flow-through entity is located. A "flow-through entity" generally will include an S corporation. Many states discovered that nonresident owners of flow-through entities would not report income based in the state where the flow-through entity was located. Therefore, laws were passed to obligate the flow-through entity to withhold on behalf of the nonresident owners and to remit these withheld amounts to the state taxing authority. The Treasury Regulations incorporated special rules for S corporations with nonresident shareholders for whom the corporation was required to withhold and remit income taxes.⁹ In general, the required withholding and remittance of the income tax to the state taxing authority does not create a second class of stock if, after taking this withholding and remittance into account, the stock of the corporation provides identical distribution and liquidation rights to all of its shareholders.¹⁰ The Treasury Regulations provide an example of the application of this rule.¹¹ A corporation has resident and nonresident shareholders and the corporation is located in a state that requires the corporation to pay state income taxes on behalf of nonresident shareholders. Under state law, the bylaws of the corporation, or a binding agreement, the resident shareholders have the right to equal distributions from the corporation after taking into account the remittance of state tax payments for the nonresident shareholders. The Example concludes that the stock confers identical distribution rights and liquidation rights on all of the shareholders and the corporation does not have two classes of stock.¹²

The tax practitioner should note that the right to take into account the payments made on behalf of the non-

resident shareholders must be present under state law, the bylaws, a binding agreement or pursuant to some other governing provision. If state law does not contain this provision, then the bylaws or other binding agreement must take into account the income taxes paid on behalf of the nonresident shareholders and remitted to the state taxing authority. Otherwise, the withholding and remittance of the state tax could create a second class of stock. For example, the Maine tax law requiring the withholding and remittance of Maine income taxes for a nonresident owner of an S corporation does not contain a specific provision that the amount withheld and remitted be taken into account when determining distributions to all shareholders.¹³

Example. In our example, in general, each of Lindsay and Melanie have the same distribution and liquidation rights. Each votes separately for a member of the board of the corporation. Otherwise, each of them votes on all other corporate issues. Lindsay is not a resident of State A and Melanie is a resident of State A. The corporation withholds and remits State A income tax for Lindsay and the bylaws provide that the corporation must take this withholding and remittance into account when determining distributions to the shareholders. The law of State A does not contain a provision requiring that the corporation take into account the amount withheld and remitted to the State A taxing authority with respect to its distributions. Based upon these facts, the corporation has only one class of stock. Each of Lindsay and Melanie have equal distribution and liquidation rights, because the corporation must take into account any amounts withheld and remitted to the state taxing authority on behalf of Lindsay (*i.e.*, Melanie receive a corresponding distribution).

Agreements Among Shareholders

The shareholders of many S corporations enter into agreements concerning the restrictions on the transfer of stock, the cross purchase of stock among shareholders, or the redemption of stock at certain designated times (“shareholders agreements”). The terms of these agreements may create a second class of stock and jeopardize the chances of a corporation

to make an S corporation election or to maintain the S corporation election after it is made.

The Treasury Regulations provide a taxpayer friendly rule for shareholder agreements. In general, a shareholder agreement will not create a second class of stock unless (1) a principal purpose of the agreement is the circumvent the one class of stock requirement, and (2) the shareholders agreement establishes a purchase price for the stock that is significantly in excess of or below the fair market value of the stock.¹⁴ The determination of whether the stated purchase price meets this second requirement is made at the time that the shareholders agreement is signed and not at a later time, such as when the stock is sold under the shareholders agreement.¹⁵

The Treasury Regulations do not provide a definition or parameters for what is “significantly” above or below the fair market value of the stock subject to the shareholders agreement. However, the Treasury Regulations do provide some helpful guidelines when determining the appropriate purchase price of the stock. First, a purchase

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price in a shareholders agreement determined in accordance with the book value of the corporation is considered to satisfy the valuation of stock rules if the book value is determined in accordance with Generally Accepted Accounting Principles or is used for any substantial non-tax purpose.¹⁶

Second, a purchase price in a shareholders agreement falling between the book value and the fair market value of the stock is considered to satisfy the value-of-stock rules.¹⁷ For the purposes of the Treasury Regulations, a good faith determination of fair market value will be accepted, unless it can be shown that the determined fair market value was substantially in error and the determination of the value was not performed with reasonable diligence.¹⁸ The shareholders of the S corporation may want to consider a valuation of the stock performed by a business appraiser when determining the fair market value of the stock. If the shareholders do not wish to engage a business appraiser, then certainly some amount of due diligence should be made to determine the fair market value of the stock. At least, the shareholders should speak with the accountant for the S corporation about the possible fair market value of the S corporation stock.

The Treasury Regulations provide a general exception to the second class of stock rules for a “bona fide” agreement to redeem or purchase stock at death, divorce, disability or termination of employment.¹⁹ The Treasury Regulations do not provide a definition of a “bona fide agreement” among the shareholders of an S corporation. In other circumstances, a “bona fide agreement” means that the deal struck by the parties to the agreement is an arm’s-length agreement supported by a primary business (or non-tax) purpose.²⁰ For example, three persons are shareholders of an S corporation and one of the shareholders is also an employee. The S corporation and the shareholder-employee have entered into an agreement to redeem the stock of the shareholder-employee when the shareholder-employee terminates employment with the S corporation. The redemption agreement is disregarded when determining if the S corporation has a second class of stock.²¹

Example. In our example, Lindsay and Melanie have signed a shareholders agreement providing that upon the death of one of them, the corporation will purchase the stock of the deceased shareholder at a price equal to the fair market value of the stock at the time they signed the shareholders agreement. The shareholders agreement does not create a second class of stock under the general safe harbor for a bona fide shareholders agreement requiring a redemption of stock at the time of the death of a shareholder. The purchase price meets the requirements of the Treasury Regulations because it is the fair market value of the stock at the time of the signing of the shareholders agreement. The tax practitioner should be careful to note that the value set in the shareholders agreement most likely will not be accepted by the IRS as the value of the stock at the date of death of the deceased shareholder for estate tax valuation purposes, where the deceased shareholder and any of the remaining shareholders are “related.”²²

Straight Debt Safe Harbor

The lending of money to the corporation and the documentation of the loan can also create a second class of stock. The Code provides a safe harbor for “straight debt” of an S corporation.²³ Any debt that qualifies as “straight debt” will not be considered a second class of stock. For these purposes, “straight debt” is any written unconditional promise to pay on demand or on a specified date a sum certain in money if (1) the interest rate (and the interest payment dates) are not contingent on profits, the borrower’s discretion or similar fac-

tors, (2) the note is not convertible into S corporation stock, and (3) the creditor is an individual (other than a nonresident alien), an estate, a trust described in Code Sec. 1361(c)(2), or a person who is actively and regularly engaged in the business of lending money.²⁴ With respect to this definition of “straight debt,” the tax practitioner should note that the payment of interest (and not principal) must not be based upon the ability of the S corporation to pay or the discretion of the S corporation to make payments.

The Code authorizes the issuance of Treasury Regulations to provide for the proper treatment of straight debt and for the coordination of these rules with other income tax provisions of the Code.²⁵ These Treasury Regulations add several additional factors to the definition and use of straight debt. First, the Treasury Regulations added another factor to the list of contingencies for the payment of interest. The terms of the debt must not provide for the payment of dividends with respect to common stock.²⁶ As stated above, this contingency does not apply to the payment of principal. Second, debt still qualifies as straight debt even if it is subordinated to other debt of the corporation.²⁷ This will be helpful when the corporation needs to borrow from a bank or other lending institution which requires that its debt have a superior position to other debt of the corporation. Third, any debt that qualifies as straight debt can lose its status if the debt instrument is modified so that it no longer meets the requirements of straight debt or the debt is transferred or assigned to a person who is not qualified to be a shareholder of an S corporation under the Treasury Regulations.²⁸ The tax practitioner should notice that the list of possible holders of straight debt under the Code and under the Treasury Regulations is not the same. The Code does not take into account the expansion of the persons who are qualified to hold S corporation stock under Code Sec. 1361(c)(6), while the Treasury Regulations do take this change into account.²⁹ Therefore, some caution is suggested when a person listed in Code Sec. 1361(c)(6) is lending funds to the corporation.

In order to allow some flexibility in planning, debt that qualifies as straight debt still qualifies as such even if the debt would be considered equity for federal tax purposes.³⁰ This allows the debt to have certain equity payment features, such as the payment of principal at the discretion of the S corporation. The lender then may obtain certain rights under the debt instrument that are similar to rights of the shareholders of the S corporation.

Example. In our example, Lisa plans to loan money to the corporation and take back a promissory note that provides that she will be paid interest annually and will be paid principal at the end of five years. Lisa is an individual and is not a nonresident alien. The terms of the note provide that she can convert her debt into a certain number of shares of the corporation based upon its value at the time of conversion. Because the note provides for conversion, the note is not straight debt and *could* be considered a second class of stock.

Convertible Debt

The analysis, however, does not end there. The Treasury Regulations have special rules for convertible debt. Any convertible debt is considered a second class of stock if (1) it would be treated as a second class of stock under Reg. §1.1361-1(l)(4)(ii) (relating to instruments, obligations, or arrangements treated as equity under general principles) or (2) it embodies rights equivalent to those of a call option that would be treated as a second class of stock under Reg. §1.1361-1(l)(4)(iii) (relating to certain call options, warrants and similar instruments).³¹

Debt is treated as a second class of stock under Reg. §1.1361-1(l)(4)(ii) if (1) the debt is treated as equity under general principles of federal tax law, and (2) a principal purpose of issuing or entering into the debt arrangement is to violate the requirement that all shareholders have the same distribution and liquidation rights or to circumvent the rules on eligible shareholders of an S corporation.³² The Treasury Regulations also contain two safe harbors—certain written advances of \$10,000 or less and debt held in proportion to stock ownership.³³ All of these factors must be analyzed to determine if the convertible debt is a second class of stock.

The rules to determine if debt should be considered as debt or equity under the federal income tax rules are beyond the scope of this column. The tax advisor needs to review all of the facts and circumstances surrounding the issuance of the debt, the documents evidencing the debt and the purposes of the parties involved in the debt. Even assuming that the debt could be classified as an equity under the federal income tax rules, the debt will not be treated as a second class of stock under Treasury Regulations if (1) it meets one of the safe harbors (small unwritten advances or debt held in proportion to stock ownership) or (2) the principal purpose requirement of issuing or entering into the debt is not satisfied. The determination of the

purpose for entering into the debt is based upon the facts and circumstances surrounding the issuance of the debt. If the convertible debt offers the holder the same distribution and liquidation rights after conversion as the other shareholders of the S corporation and if the issuer of the debt is a qualified shareholder of an S corporation, then the convertible debt may not meet the second prong of this test (an improper purpose to issue the debt) and therefore would not be treated as a second class of stock.

Convertible debt is treated as a second class of stock under Reg. §1.1361-1(l)(4)(iii) if (taking into account all of the facts and circumstances surrounding the issuance of the debt) (1) the debt is substantially certain to be exercised and (2) the debt has a conversion price (strike price) substantially below the fair market value of the stock of the S corporation on (a) the date of the issuance of the debt, (b) the date the debt is transferred from a person who is eligible to be a shareholder of an S corporation to a person who is not, or (c) the date that the debt is materially modified.³⁴ In the first instance, the determination of whether the convertible debt is a second class of stock is made at the time that the debt is issued. However, the satisfaction of the second component (the comparison of the strike price and the fair market value of the stock) can be made at a later date if the debt is transferred or materially modified.

The Treasury Regulations do provide some additional guidance about material modifications of the convertible debt and the determination whether the strike price is substantially below fair market value. If the time period for the conversion is extended in conjunction with a change to the terms of the debt, the extension of the period of conversion is not considered a material modification.³⁵ The conversion price is not substantially below fair market value if the conversion price is at least ninety percent of the fair market value of the stock on the date the debt is issued, transferred from a person who is qualified to hold S corporation stock to a person who is not, or is materially modified.³⁶ Failure to meet this rule does not mean that the convertible debt is a second class of stock.³⁷ However, we do know that a stock option with a strike price equal to fifty percent of the fair market value of the stock at the determination date is considered a second class of stock if the stock option is substantially certain to be exercised.³⁸ In addition, the conversion price of the debt is not substantially below the fair market value of the stock if the debt instrument provides that the conversion price cannot be substantially below the fair market value at the time of exercise.³⁹

The Treasury Regulations provide two specific exemptions from these rules. A stock option issued to a person who is in the business of lending and in conjunction with a commercially reasonable loan to the corporation is not treated as a second class of stock.⁴⁰ In addition, a call option issued to an employee or an independent contractor will not be treated as a second class of stock if the call option is not transferable under Code Sec. 83 and its regulations and the call option does not have a readily determined value at the time of issuance.⁴¹

Example. In our example, Lisa plans to loan money to the corporation. The debt instrument provides that her debt can be converted into equity of the corporation based upon a strike price equal to the value of the stock on the date that Lisa made the loan to the corporation. The debt instrument is in writing and the interest on the debt is equal to the prime rate plus one percent payable annually. After conversion, Lisa will have the same distribution and liquidation rights as Lindsay and Melanie. It appears, based upon the facts and circumstances, that the debt will not be treated as equity for federal income tax purposes, that a purpose for issuing the debt is not to circumvent the one class of stock rules or the rules concerning eligible shareholders of an S corporation, or that Lisa

is substantially certain to exercise her right to convert the debt into stock of the S corporation. Because the conversion price is the fair market value of the stock on the date of the issuance of the debt, the conversion price is not substantially below the fair market value of the stock. Therefore, the convertible debt issued to Lisa is not a second class of stock.

Conclusion

The tax practitioner must be keenly aware of the one-class-of-stock rules. Although they are generally interpreted as restrictive, these rules can provide reasonable flexibility for the formation, funding and financing of a corporation, for which its shareholders plan to make an S corporation election. The shareholders can have different voting rights and can enter into complicated and flexible buy-sell agreements. The corporation can borrow money without jeopardizing its S corporation status and the lender can take back convertible debt in the right circumstances. The one absolute that the tax practitioner must remember is that there can never be any differences between the shareholders with respect to distribution rights and liquidation rights. If these differences exist, then the corporation cannot make an S corporation election.

ENDNOTES

¹ Code Sec. 1361(a)(1).

² Code Sec. 1361(b)(1)(D).

³ Code Sec. 1361(c)(4).

⁴ Reg. §1.1361-1(l)(1).

⁵ *Id.*

⁶ Reg. §1.1361-1(l)(2)(i)

⁷ *Id.*

⁸ *Id.*

⁹ Reg. §1.1361-1(l)(2)(ii).

¹⁰ *Id.*

¹¹ Reg. §1.1361-1(l)(2)(vi), Example 7.

¹² *Id.*

¹³ 36 MRSA §5250-A. In a related provision, the amount withheld and remitted to Maine Revenue Services is "deemed to have been paid to the Assessor on behalf of the person for whom withheld and the person is credited with having paid this amount of tax...." 36 MRSA §5252. This type of provision probably deals with crediting the correct tax account with the payment of tax and

not with taking the amount withheld and remitted to the Maine Revenue Services into account when measuring distributions to all shareholders.

¹⁴ Reg. §1.1361-1(l)(2)(iii)(A).

¹⁵ Reg. §1.1361-1(l)(2)(iii)(A)(2).

¹⁶ Reg. §1.1361-1(l)(2)(iii)(C).

¹⁷ Flush language after Reg. §1.1361-1(l)(2)(iii)(A)(2).

¹⁸ *Id.*

¹⁹ Reg. §1.1361-1(l)(2)(iii)(B).

²⁰ See, e.g., *W.C. Bongard Est.*, 124 TC 95, 118, Dec. 55,955 (2005).

²¹ Reg. §1.1361-1(l)(2)(vi), Example 8.

²² Code Sec. 2703. This provision deals with the value of stock subject to a buyout agreement when the shareholders are related.

²³ Code Sec. 1361(c)(5)

²⁴ *Id.*

²⁵ Code Sec. 1361(c)(5)(C).

²⁶ Reg. §1.1361-1(l)(5)(i)(A).

²⁷ Reg. §1.1361-1(l)(5)(ii).

²⁸ Reg. §1.1361-1(l)(5)(iii).

²⁹ Reg. §1.1361-1(b)(ii).

³⁰ Reg. §1.1361-1(l)(5)(iv).

³¹ Reg. §1.1361-1(l)(4)(iv).

³² Reg. §1.1361-1(l)(4)(ii)(A)

³³ Reg. §1.1361-1(l)(4)(ii)(B)

³⁴ Reg. §1.1361-1(l)(4)(iii)(A).

³⁵ *Id.*

³⁶ Reg. §1.1361-1(l)(4)(iii)(C). The corporation must make a good faith effort to determine the fair market value of the stock.

³⁷ *Id.*

³⁸ Reg. §1.1361-1(l)(4)(v), Example 1. The determination of whether the stock option is substantially certain to be exercised is based upon all of the facts and circumstances.

³⁹ Reg. §1.1361-1(l)(4)(iii)(A).

⁴⁰ Reg. §1.1361-1(l)(4)(iii)(B)(1).

⁴¹ Reg. §1.1361-1(l)(4)(iii)(B)(2).

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