S Corporation Corner

By Nelson Toner

The Disproportionate Distribution and Its Consequences on the S Corporation Election

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I anticipate (although I have never kept any statistics) that the majority of the questions that I field concerning S corporations from my colleagues concern the payment of a disproportionate distribution to one or more of the shareholders and the concern that the payment of the disproportionate distribution may cause the corporation to be considered to have a second class of stock. My colleagues are aware that a finding of a second class of stock terminates the S corporation election and the attendant tax benefits. I have always practiced (perhaps too conservatively for some) with the belief that a disproportionate distribution to a shareholder of an S corporation is strong evidence of a second class of stock and must be rectified as soon as possible once discovered. The challenge is finding the disproportionate distributions because they are not always obvious. They can arise in the easy situation, where one shareholder receives a distribution that is not proportionate to his stock ownership. But disproportionate distributions also can arise in less obvious ways, such as a difference in the timing of distributions, the payment of excessive compensation to a shareholder or the payment of state income taxes for some of the shareholders. This article takes a look at some of the situations causing a disproportionate distribution and the outcome or tax consequence of the disproportionate distribution. The article ends with some tax tips when a disproportionate distribution is discovered and actions that can be taken to mitigate its consequences.

One of the cornerstones of the S corporation rules is the one class of stock requirement. A corporation qualifies to make an S corporation election only if,

among other requirements, the corporation has one class of stock.[1] For these purposes, a corporation will be treated as having one class of stock even if there are differences in voting rights among the shares of stock.[2] Therefore, an S corporation can have voting stock and nonvoting stock and still have one class of stock so long as the shares of stock do not have any other differences in rights.

The rules concerning a disproportionate distribution are part of the one-class-of-stock requirement. A corporation is treated as having only one class of stock if all of the outstanding shares of stock confer *identical* rights to distribution and liquidation proceeds.[3] Therefore, the right of a shareholder to identical operating and liquidating distributions as compared to all of the other shareholders is the primary factor to determine if a corporation has one class of stock and, therefore, if the corporation can make or retain an S corporation election.

The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law and binding agreements relating to distribution and liquidation proceeds.[4] This grouping of materials is known as the "governing provisions." If the governing provisions confer identical rights to distribution and liquidation proceeds to all of the shareholders, then (for the purposes of the S corporation rules) the corporation has one class of stock. The corporate charter, articles of incorporation and the bylaws of the corporation are the core incorporation documents. The attorney forming the corporation must be aware of any applicable state laws that may affect the rights of the outstanding shares to distribution and liquidation proceeds. A "binding agreement relating to distribution and liquidation proceeds" is a broader category of documents. For example, a shareholders agreement signed by all of the shareholders could be a "binding agreement relating to distribution and liquidation proceeds."[5] The regulations add that a commercial contractual agreement, such as a lease, employment agreement or loan agreement is not a binding agreement relating to distribution and liquidation proceeds and, thus, is not a governing provision, unless a principal purpose of the agreement is to circumvent the one-class-of-stock requirement.[6]

Against this backdrop, a disproportionate distribution must be analyzed. For purposes of this article, a disproportionate distribution is a distribution to one or more shareholders which is disproportionate with respect to stock ownership. This distribution can be different in amount or timing when compared to a distribution to another shareholder. For example, assume that a corporation has two equal shareholders, and the corporation distributes $20x in cash to one of the shareholders and $10x in cash to the other shareholder. This is a disproportionate distribution as to amount. Continuing with this example, assume that the corporation makes a $10x distribution to the second shareholder in the next tax year. This is a disproportionate distribution as to time.

In the case of a disproportionate distribution, the regulations provide that an actual, constructive or deemed disproportionate distribution does not cause the corporation to be considered to have a second class of stock if the governing provisions confer identical rights to distribution and liquidation proceeds to all of the shareholders. However, any actual, constructive or deemed distributions that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances of the situation.[7] Therefore, the determination of whether a corporation has one class of stock is a document test. If the governing provisions confer identical distribution rights to all of the shareholders, then any actual disproportionate distribution should not cause an S corporation to be treated as having a second class of stock. If this is true, then why do some many taxpayers request private letter rulings when an actual, constructive or deemed disproportionate distribution is made? Let's review several different examples when a disproportionate distribution is made and the possible consequences to the S corporation and its shareholders.

Example One–Governing Provisions Confer Different Distribution Rights

In this first example, the governing provisions do not confer identical rights to distribution and liquidation proceeds to the shareholders. When the corporation is formed, some shareholders contribute cash to the corporation, and some shareholders contribute real estate to the corporation. Assume that under state law, any shareholder who contributes real estate must waive his or her rights to distributions from the corporation until the shareholders who contributed cash have received distributions from the corpora-

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tion equal to the amount of cash contributed. In this example, the governing provisions (state law) do not provide identical rights to distribution and liquidation proceeds. Therefore, the corporation is treated as having two classes of stock—one for the shareholders who contributed cash and a second for the shareholders who contributed real estate.[8]

As a slight modification to this first example, assume that a corporation has governing provisions that initially provide identical rights to distribution and liquidation proceeds. After the formation of the corporation, the corporation modifies its articles of incorporation and its bylaws to allow tax distributions to its shareholders based upon actual income tax liabilities such that each shareholder will have equal after-tax distributions. In this case, the actual tax distributions will not be the same; larger distributions will be made to shareholders with heavier state tax burdens. In this case, the corporation is treated as having more than one class of stock.[9]

This first example and its modification are easy to analyze. In accordance with the Regulations, the corporation is treated as having more than one class of stock because the governing provisions do not provide identical rights to distribution and liquidation proceeds. The more challenging situations arise when the governing provisions do provide identical rights, but distributions are not proportionate.

> **If the governing provisions confer identical distribution rights to all of the shareholders, then any actual disproportionate distribution should not cause an S corporation to be treated as having a second class of stock.**

Example Two—Governing Provisions Confer Identical Distribution Rights; Timing Difference for Actual Distributions

In the second example, the governing provisions provide for identical rights to distribution and liquidation proceeds, but the timing of the distributions to the shareholders is different. For example, a corporation has two equal shareholders. One shareholder receives a distribution in one year, and the other shareholder receives an equal distribution in the next year. Because the governing provisions provide for identical rights, the difference in timing of the distributions does not create a second class of stock.[10] This result may not be difficult to accept because the equalizing distribution in the second year is equal to the disproportionate distribution in the first year. Over a short period of time, both shareholders have received equal distributions from the corporation.

What if the distribution in the second year is not equal to the distribution in the first year? In all of the private letter rulings that I reviewed concerning a disproportionate distribution, the IRS holds that the corporation will not lose its S corporation status if the governing provisions confer identical rights to distribution and liquidation proceeds and the corporation makes an equalizing distribution to correct the initial disproportionate distribution.[11] Therefore, if the corporation does not make an equalizing distribution so that all of the shareholders have received overall equal distributions, the corporation could jeopardize its S corporation status.

Would the tax result be the same (*i.e.*, the corporation does not have two classes of stock) if the equalizing distribution occurred over a period of years? How long does the corporation have to make the equalizing distribution before the violation of the governing provisions (which provide for identical rights to distribution proceeds) will be treated as creating a second class of stock?

In this example, the conclusion (that the corporation does not have two classes of stock) would be different if the disproportionate distribution occurred by reason of a binding agreement relating to distribution or liquidation proceeds. If this type of binding agreement existed, which allowed this disproportionate distribution, then the corporation would be treated as having a second class of stock because the binding agreement is a governing provision that does not confer identical rights to distribution proceeds to all of the shareholders.[12]

Finally, in this second example, even if the disproportionate distribution does not create a second class of stock, the below-market loan rules of Code Sec. 7872 and other recharacterization principles may apply to determine the appropriate tax consequences to the corporation and the shareholders.[13]

Example Three—Governing Provisions Confer Identical Distribution Rights; Excessive Compensation Paid to One Shareholder

In this example, the governing provisions confer identical rights to distribution and liquidation proceeds to all of the shareholders. The corporation has two shareholders, and each shareholder is an employee of the corporation. One shareholder is paid reasonable compensation, and the compensation paid to the other shareholder is found to be excessive. Therefore, the corporation can deduct only a portion of the salary paid to this shareholder. Each shareholder has a binding employment agreement. Because the governing provisions provide for identical rights, the corporation is not treated as having more than one class of stock, even though one shareholder was paid excessive compensation for the services provided to the corporation.[14]

The stated conclusion above assumes that the employment agreement for each shareholder is not a governing provision. However, this document can be classified as a governing provision if a principal purpose of the employment agreement is to circumvent the one-class-of-stock requirement.[15] If a tax advisor is faced with this situation, the tax advisor should carefully review the employment agreement and the circumstances surrounding its creation.

The regulations provide that even if a disproportionate distribution does not create a second class of stock, any distribution that differs in timing or amount is to be given appropriate tax effect. In this example, how should the corporation treat the excessive compensation under applicable "tax principles"? The corporation cannot deduct the excessive compensation paid. If the corporation treats the excessive compensation as a dividend distribution, then, as was required under Example Two above, the corporation must make an equalizing distribution to the other shareholder as soon as possible after the determination of excessive compensation is made. If the equalizing distribution is not made, then the corporation jeopardizes its S corporation status.

> The Regulations provide that even if a disproportionate distribution does not create a second class of stock, any distribution that differs in timing or amount is to be given appropriate tax effect.

Example Four—Governing Provisions Do Not Confer Identical Distribution Rights; Constructive Distribution Under State Law

In this example, not all of the governing provisions confer identical rights to distribution and liquidation proceeds to all of the shareholders. Assume that the articles of incorporation and the bylaws provide that all shareholders have identical rights to distribution and liquidation proceeds. However, under applicable state law, the corporation is required to pay state income taxes on behalf of nonresident shareholders. Pursuant to state law, the corporation makes a payment to the state taxing authority to cover the state taxes of the nonresident shareholders. No similar payment is made for the benefit of the resident shareholders, and no distribution is made to the resident shareholders in an amount that corresponds to the payments made for the nonresident shareholders. In this example, the corporation has made a constructive disproportionate distribution in accordance with state law. Because state law is a governing provision, the governing provisions do not confer identical distribution rights to all of the shareholders. Therefore, the corporation is deemed to have two classes of stock.[16]

The conclusion changes (and the corporation is not treated as having two classes of stock) if the other governing provisions (such as the articles of incorporation or the bylaws) take into account the payments that the corporation makes on behalf of its nonresident shareholders. If the other governing provisions take these payments into account, then the shares of stock confer identical rights to distribution and liquidation proceeds because the distributions to resident shareholders take into account the "constructive distributions" made to the nonresident shareholders.[17]

The tax advisor should note that, most likely, the payments of state tax for the nonresident shareholders will not occur at the same time as the equalizing distributions to the resident shareholders. However, this difference in timing does not cause the corpora-

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ENDNOTES

1. Reg. §301.7702-2(a).
2. Reg. §301.7701-1(a)(2).
3. See Code Sec. 875(1) and *Donroy, Ltd.*, CA-9, 62-1 USTC ¶9373, 301 F2d 200, *aff'g*, 61-1 USTC ¶9467.

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the Hedge Fund, how could Paige Capital Management have managed the fund?" *Id.* The court concluded that the Paiges breached their information obligations. However, breach of information rights did not trigger withdrawal rights unless the breach was not cured after receipt of notice from the Investor. The court concluded that under New York notice and cure law to give proper notice of default, the Investor should have clearly advised that the cure period had started and the legal consequences of a failure to cure. The Investor did not provide proper notice to trigger its withdrawal rights.

9. *Id.* at 64.
10. *Id.*
11. *Id.* at 4.
12. *In re USACafes*, 600 A.2d 43 (Del. Ch. 1991).
13. *Id.* at 67.
14. The parties also cited *Bay Center Apartment Owner, LLC v. Emery Bay PKI, LLC*, Del. Ch., 2009 Del. Ch. Lexis 54, 2009 WL 1124451 at 8–9 (Del. Ch. April 20, 2009), as another decision describing when persons have sufficient control to owe fiduciary duties in these circumstances.
15. The court addressed one argument of the Paiges that it concluded was "nothing if not innovative." Case No. 5502-CS at p. 69. Essentially, the Paiges argued that because the General Partner and Michele owed duties to the General Partner and its sole member, *i.e.*, also Michele, they could not act in the best interests of the investors in the Partnership because doing so would cause them to breach the duty they owed themselves (and Michele as the sole member of the General Partner). The court rejected this argument for two reasons. First, citing Lubaroff and Altman, *Delaware Limited Partnerships*, §11.2.2 (2010), the court noted that "a general partner of a Delaware limited partnership owes a fiduciary duty to the limited partnership and the other partners in the limited partnership." *Id.* at 70, fn 189. Second, the court noted that "the existence of a conflict does not absolve a governing fiduciary for acting in its own self-interest ... when a fiduciary acts in a conflicted situation it is, for that very reason, subjected to a far more searching form of judicial review, most commonly known as the entire fairness standard of review." *Id.* at 70–71. In the court's view "[t]o find that a conflicted fiduciary is by virtue of that status absolved of fiduciary responsibility would be an astounding decision with deleterious consequences for investors, the cost of capital, and the integrity of our law." *Id.* at 71.
16. *Gotham Partners*, 2000 WL 1476663 at 5 (Del. Ch. Sept. 27, 2000).
17. *Gelfman*, 792 A2d 977 (Del. Ch. 2001).
18. *Id.* at 73.
19. *Cantor Fitzgerald*, 2001 WL 1456494 at 7 (Del. Ch. Nov. 5, 2001).
20. Case No. 5502-CS at p. 73.
21. In support of this conclusion, the court cited *Miller v. Am. Real Estate Partners, L.P.*, 2001 WL 1045643, at *8 (Del. Ch. Sept. 6, 2001) (citing *Sonet v. Timber Co., L.P.*, 772 A2d 319, 322 (Del. Ch. 1998)) ("But just as investors must use due care, so must the drafter of a partnership agreement who wishes to supplant the operation of traditional fiduciary duties. In view of the great freedom afforded to such drafters and the reality that most publicly traded limited partnerships are governed by agreements drafted exclusively by the original general partner, it is fair to expect that restrictions on fiduciary duties be set forth clearly and unambiguously."). [Case No. 5502-CS at p. 74, fn 197.]
22. *Cont'l Ins. Co. v. Rutledge & Co., Inc.*, 750 A2d 1219, 1240 (Del. Ch. 2000).
23. *Id.* at 79.
24. *Id.* at 80.
25. *See* Steven G. Frost, Passthrough Finance Techniques Corner, *The Implied Contractual Covenant of Good Faith and Fair Dealing: Recent Delaware Case law*, J. PASSTHROUGH ENTITIES, Jan.–Feb. 2011, at 25, for a further discussion of the implied covenant of good faith and fair dealing and recent Delaware case law examining the implied covenant.
26. Case No. 5502-CS at p.93.

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tion to be treated as having two classes of stock, if the governing provisions confer identical rights to distribution and liquidation proceeds to all shareholders by taking into account the payments for the nonresident shareholders when determining the correct amount of distributions for the resident shareholders.[18] Nonetheless, the tax advisor must advise the corporation when to make the equalizing distributions to the resident shareholders. In addition, the tax advisor must determine the possible tax consequences to the nonresident shareholders with respect to the disproportionate payments until the equalizing payments are made to the resident shareholders.

There are two possible alternative approaches to deal with the constructive disproportionate distributions under state law and protect the S corporation status of the corporation. First, under some state laws, the corporation also can make state tax payments for the resident shareholders. For example, in my home state, Maine tax law allows the corporation to make payments for the resident shareholders.[19] Then, all of the shareholders are treated equally with respect to the state tax payments. This eliminates the constructive disproportionate distributions. Either the articles of incorporation or the bylaws or both should provide for these payments for the resident shareholders. Second, the corporation could treat the tax payments made on behalf of the nonresident shareholders as advances and the other governing provisions of the corporation (the articles of incorporation or the bylaws) can require that the advances be repaid or offset by reductions in later distributions to the nonresident shareholders.[20]

A disproportionate distribution can arise in many different situations and circumstances. When the tax advisor learns that a disproportionate distribution has occurred, the tax advisor should consider taking the following remedial steps:

1. Review the circumstances under which the disproportionate distribution occurred. Did the corporation intend to circumvent the one-class-of-

stock requirement, or was the disproportionate distribution unintentional and the corporation did not realize the possible consequences of the disproportionate distribution?

2. Review the governing provisions of the corporation. Was the disproportionate distribution allowed under any of the governing provisions, such as the articles of incorporation or the bylaws? Also remember to check applicable state law, which may require the corporation to withhold and remit state income taxes for its non-resident shareholders.
3. Review any other corporate agreements that may constitute binding agreements relating to distribution and liquidation proceeds, such as employment agreements for shareholder-employees and shareholders' agreements.
4. Modify and amend the articles of incorporation and the bylaws of the corporation to take into account any constructive disproportionate distributions for some shareholders and not for other shareholders, such as required state tax payments for nonresident shareholders.
5. Advise the corporation to make an equalizing distribution to the shareholders who did not receive the initial disproportionate distribution as soon as possible.
6. Advise the corporation to consider requesting a private letter ruling that, if the disproportionate distribution did cause a second class of stock and a termination of the S corporation status, the termination was inadvertent.

Taking these steps should help protect the S corporation status of the corporation and the tax benefits available to the corporation and its shareholders.

ENDNOTES

1. Code Sec. 1361(b)(1)(D).
2. Code Sec. 1361(c)(4); Reg. §1.1361-1(l)(1).
3. Reg. §1.1361-1(l)(1).
4. Reg. §1.1361-1(l)(2)(i).
5. *See* LTR 200934021 (May 12, 2009) where the S corporation formalized its practice to submit composite returns and to pay taxes for its nonresident shareholders. The S corporation requested (and the IRS granted) a private letter ruling that if the payments for the nonresident shareholders created a second class of stock, then the termination was inadvertent.
6. Reg. §1.1361-1(l)(2)(i).
7. *Id.*
8. Example (1) in Reg. §1.1361-1(l)(2)(vi).
9. Example (6) in Reg. §1.1361-1(l)(2)(vi).
10. Example (2) in Reg. §1.1361-1(l)(2)(vi).
11. *See, e.g.*, LTR 201105017 (November 4, 2010) and LTR 200935015 (May 12, 2009).
12. *Id.*
13. *Id.*
14. Example (3) in Reg. §1.1361-1(l)(2)(vi).
15. Reg. §1.1361-1(l)(2)(i).
16. Example (7) in Reg. §1.1361-1(l)(2)(vi); *see also* LTR 201105017 (November 4, 2010) where the corporation made constructive disproportionate distributions to non-resident shareholders and when it realized that the payment of state income tax might cause the corporation to have two classes of stock requested a private letter ruling that any loss of S corporation status was inadvertent under Code Sec. 1362(f).
17. Reg. §1.1361-1(l)(2)(ii).
18. Reg. §1.1361-1(l)(2)(i).
19. 36 M.R.S.A. §5250-B(2); see FAQ 3 concerning Passthrough Withholding under Maine Revenue Services internet site (Maine.gov).
20. Example (7) in Reg. §1.1361-1(l)(2)(vi).

Tax Tip

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debt that gave rise to the COD income also results in a deemed distribution of cash under Code Sec. 752 to the extent that the partner's share of partnership liabilities has been correspondingly reduced.[15] This could cause substantial tax consequences to a partner who may realize gain under Code Sec. 731 if the deemed distribution of cash exceeds the tax basis in his partnership interest. However, the tax impact of the deemed distribution to the partner under Code Sec. 752 will be either partially or wholly offset by the step-up in the partner's tax basis for his allocable share of the COD income under Code Sec. 705(a)(1)(A). This step-up in basis will occur even if the taxpayer is able to exclude the COD income under Code Sec. 108(a).[16] Most importantly, the step-up in basis resulting from an allocation of COD income will be deemed to take place prior to the deemed distribution of cash under Code Sec. 752(b).[17]

There are also some special rules for S corporations. The primary difference between a partnership and an S corporation is that for an S corporation, the determination of whether one of the exclusions applies is made at the corporate level.[18] Where COD income is being generated, an S corporation is more likely to be insolvent than a partnership's individual partners. It is also much easier to take advantage of the bankruptcy exclusion in an S corporation setting, where only the corporation is required to file for bankruptcy (as compared to a partnership where each of the partners must file).

Additionally, the attribute reduction applies to corporate-level attributes in the case of an S corporation, not to the shareholder's individual attributes. However, a shareholder's suspended losses (under the basis limitation rules of Code Sec. 1366(d)), will be treated as a "net operating loss" for this purpose.[19] Another consideration

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