S Corporation Corner

By Nelson A. Toner

Eligible S Corporation Shareholder Conundrum– The Individual Retirement Account

I am a gardener. During Maine's short growing season, I regularly make time to work in the gardens around my house. One of my chores is to pull up and rid my garden of weeds and other invasive plants, which inhibit the growth of the annuals and perennials that I have planted. With respect to many weeds, if I do not pull up the entire plant, including its root, then the weed grows back. The long central root of the weed, such as a dandelion, is called a taproot. The taproot often has smaller lateral roots which spawn other weeds. It is the duty of the gardener to pull the weed, its taproot and any lateral roots to rid the garden of this menace. The gardener knows that if the taproot is not removed, a new batch of weeds will grow.

It may be my adoration of gardening, or my knowledge of the workings of the root system of weeds, that drew my specific attention to the Ninth Circuit Court of Appeals decision in the case of *Taproot Administrative Services, Inc.* ("*Taproot*").[1] In most reports about the *Taproot* case written soon after the decision, the commentators stated simply that the Ninth Circuit Court of Appeals had agreed with the decision of the Tax Court[2] that an individual retirement account ("IRA") is not a permitted shareholder of an S corporation and provided a brief review of the facts.[3] As I read the case, I discovered that the questions in the case may have run deeper than this simple result. The taproot arguments that supported the taxpayer's position were intriguing and provided a good opportunity to review the eligible S corporation shareholder rules when there is a division between the titleholder of the S corporation stock and the person who is treated as the owner of such stock for

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S corporation qualification purposes. The decision of the Tax Court and the Ninth Circuit Court of Appeals attempted to pull out the taproot supporting the taxpayer's position in the *Taproot* case. However, as we gardeners know, if the decision did not retrieve all of the taproot, the arguments could arise again at a later time. In this column, I will review two arguments raised in the Tax Court and Ninth Circuit Court of Appeals opinions concerning the question of whether an IRA is a permitted shareholder of an S corporation. I am hopeful that knowledge and understanding of these important points may prove helpful to understand the S corporation shareholder eligibility rules when the titleholder of the stock and the beneficial owner (the person treated as owning the stock for tax purposes) are not the same.[4] The column begins with a brief summary of the *Taproot* case, then follows with a review of the S corporation shareholder eligibility rules pertinent to the *Taproot* case and the basic tax rules applicable to IRAs (both traditional IRAs and Roth IRAs) and finishes with a brief analysis of two issues raised in the Taproot case.

> The taxpayer in the *Taproot* case made two distinct arguments to support its position that a custodial Roth IRA is an eligible shareholder of an S corporation.

A. The *Taproot* Case

On September 29, 2009, in a case of first impression, the Tax Court ruled that Taproot Administrative Services Inc. could not qualify for S corporation status because the corporation's sole shareholder, a custodial Roth IRA, was not a permitted shareholder for an S corporation.[5] In late 2002, Paul DiMundo formed the corporation in Nevada. The corporation issued 2,500 shares of stock to First Trust Co. of Onaga (Kansas) as custodian for a Roth IRA for the sole benefit of Paul DiMundo. The shareholder of the corporation elected S corporation status, and for the calendar year 2003, the corporation filed a Form 1120S, *U.S. Income Tax Return for an S Corporation*, with the IRS. The IRS audited the corporate income tax return and issued a notice of deficiency stating that the corporation could not file a tax return as an S corporation because it had an ineligible shareholder. The taxpayer petitioned the matter to the Tax Court. The IRS filed a motion for summary judgment on the issue of whether the taxpayer qualified for S corporation status and the Tax Court ruled in favor of the IRS.[6] The taxpayer then appealed the case to the Ninth Circuit Court of Appeals and the Appeals Court held for the IRS, agreeing with the Tax Court and the IRS that the custodial Roth IRA is not a permitted shareholder, and therefore, the corporation did not qualify as an S corporation for the 2003 tax year.[7]

B. Eligible Shareholder Rules for an S Corporation

The shareholders of a corporation can make an S corporation election only if the corporation qualifies as a "small business corporation."[8] For these purposes, a "small business corporation" is a domestic corporation that meets several requirements, including a requirement concerning the types of eligible shareholders.[9] The types of eligible shareholders are limited to an individual (who is not a nonresident alien), an estate, certain defined trusts and certain defined exempt organizations.[10] The permitted allowed trusts include, among others, a trust all of which is treated as owned by an individual who is a citizen or resident of the United States under Code Secs. 671–678 (a "grantor trust").[11] In the case of a grantor trust, the grantor (the individual who is treated as owning the trust assets as determined under Code Secs. 671–678) is treated as the shareholder for the purposes of the S corporation rules.[12]

Until 2004, the shareholder eligibility rules in the Internal Revenue Code ("the Code") did not specifically mention an IRA.[13] In that year, the American Jobs Creation Act[14] expanded the list of eligible shareholders to *a trust* which constitutes an IRA or a Roth IRA for banks whose shareholders had elected S corporation status.[15] The ability of a trust which constitutes an IRA or Roth IRA to be an S corporation shareholder is extremely limited. First, the corporation must be a bank and second, the trust which constitutes an IRA or Roth IRA must have held the bank stock on the date of enactment of the provision. After the date of enactment of the provision, a bank that is an S corporation will lose its tax status if its stock is purchased or otherwise acquired by an IRA or Roth IRA. This tax provision is a moment-in-time rule. The provision applies only to a bank where the shareholders elect S corporation after the date of enactment of the

provision and any IRA or Roth IRA that owns stock of such corporation purchased or otherwise acquired such stock on or before the date of enactment of the provision. If an IRA or Roth IRA qualifies as an eligible shareholder, then the individual for whose benefit the IRA or Roth IRA was created is treated as the shareholder of the S corporation.[16]

Although there is no direct mention of an IRA or Roth IRA qualifying as an eligible shareholder in the Code, the Treasury Regulations state that an IRA is not an eligible S corporation shareholder.[17] This pronouncement is made at the end of the regulation provision explaining the bank exception for IRA and Roth IRA ownership of S corporation stock.

Therefore, under these rules, in the case of a grantor trust or a trust which constitutes an IRA, the titleholder of the S corporation stock is the grantor trust or the trust. However, for S corporation qualification purposes, the grantor of the trust or the beneficiary of the IRA is treated as the shareholder of the S corporation stock. Thus, these two types of eligible shareholders illustrate the situation where the titleholder of the S corporation stock and the person treated as the shareholder for tax purposes are different. This separation is the primary basis of the arguments presented by the taxpayer in the *Taproot* case, which arguments are discussed later in this column.

C. The Individual Retirement Account

An "individual retirement account" (called a "traditional IRA") is a trust created or organized in the United States for the exclusive benefit of an individual or such individual's beneficiaries, but only if the written governing instrument creating the trust meets a series of requirements.[18] An individual who sets up a traditional IRA may deduct (subject to restrictions on the amount) on his or her income tax return the amount contributed to the traditional IRA.[19] In general, the earnings on the assets in the traditional IRA are not subject to income tax. However, a traditional IRA is subject to unrelated business taxes under Code Sec. 511.[20] In general, any distribution from the traditional IRA to the beneficiary of the traditional IRA is subject to tax in accordance with Code Sec. 72.[21] A traditional IRA may be established as a custodial account, and the custodial account will be "treated as a trust" if the assets are held by a bank or other appropriate person and the custodial account will (except for the fact that it is not a trust) constitute a traditional IRA under Code Sec. 408(a).[22] Therefore, with respect to a traditional IRA, the contributions are deductible, the earnings on the assets in the account are not subject to income tax, and the distributions from the traditional IRA are subject to income tax.

A Roth IRA is an individual retirement plan which is designated at the time of the establishment of the plan as a Roth IRA. For these purposes, an "individual retirement plan" is an individual retirement account under Code Sec. 408(a).[23] In general, the Roth IRA and the traditional IRA share the same tax attributes, including the treatment of the Roth IRA as a trust, the general exemption of earnings on the assets in the Roth IRA from income tax and the application of the unrelated business tax rules.[24] However, the contributions to the Roth IRA are not deductible, and the distributions from the Roth IRA to the beneficiary of the Roth IRA are (in general) not subject to income tax.[25] Similar to a traditional IRA, a Roth IRA also can be set up as a custodial account. This structure is important to the taxpayer in the *Taproot* case.

D. Arguments for and Against an IRA or Roth IRA Being a Permitted Shareholder

The taxpayer in the *Taproot* case made two distinct arguments to support its position that a custodial Roth IRA is an eligible shareholder of an S corporation. First, the custodial Roth IRA should be treated as a grantor trust under Code Sec. 1361(c)(2)(A)(i), and second, the individual beneficiary of the custodial Roth IRA (and not the Roth IRA itself) should be treated as the shareholder under the S corporation rules.

1. The IRA Is Equivalent to a Grantor Trust

A grantor trust qualifies as an eligible shareholder of an S corporation, and in the case of a grantor trust, the grantor is treated as the shareholder for the purpose of the S corporation rules.[26] The grantor of a grantor trust is taxed on the earnings of the grantor trust because the grantor has retained certain significant controls over the assets in the trust, the investment of the assets in the trust or the use of the earnings in the trust. For example, if the grantor retains a reversionary right in the corpus of the trust and at the time of the funding of the trust the value of the reversionary interest is greater than five percent of the trust corpus, then the grantor is considered to control the corpus

of the trust and will be subject to income tax on the earnings of the trust assets.[27] The grantor's retained control over the trust assets and the inclusion of the earnings from the trust assets in the grantor's income form the basis for the tax position that the grantor is treated as the shareholder of the S corporation under Code Sec. 1361(c)(2)(B)(i).

The taxpayer in the *Taproot* case argued that based upon Roth IRA custodial documents, the beneficiary of a custodial Roth IRA had certain retained powers over the assets held in the custodial account, such as the designation of beneficiaries, the selection of investments of the Roth IRA assets and ability to change the custodian.[28] These powers and retained control over the custodial Roth IRA assets are equivalent to the powers retained by the grantor under the grantor trust rules. In addition, the IRA is subject to taxes on its earnings under the unrelated business tax rules.[29] In general, the custodial IRA documents required that the beneficiary pay for fees, taxes and taxes imposed upon the account.[30] Because the beneficiary of the custodial Roth IRA retained controls over the assets in the account and the beneficiary was obligated to cover any taxes imposed upon the custodial account, the custodial Roth IRA was the equivalent of a grantor trust under the S corporation rules. The beneficiary of the custodial Roth IRA, Mr. DiMundo, a domestic individual, qualifies as a shareholder of an S corporation. Therefore, the custodial Roth IRA is an eligible shareholder of an S corporation, so said the taxpayer.

> The dissenting opinion in the *Taproot* case has made some intriguing arguments that support the position that an IRA can be a permitted shareholder.

In opposition, the IRS argued that a custodial Roth IRA is not the equivalent of a grantor trust and based its argument on Rev. Rul. 92-73.[31] In this revenue ruling, the IRS held that a trust which qualifies as an IRA under Code Sec. 408(a) is not a permitted shareholder of an S corporation. The reason for this holding is the incompatibility of the tax rules applicable to grantor trusts and to IRAs. In the case of a grantor trust, the grantor is taxed currently on the trust's income (including the trust's share of the S corporation income), and in the case of an IRA, the beneficiary is generally taxed only when a distribution is made to the beneficiary, under the rules of Code Sec. 72.[32] The IRS does not attack the power of the IRA beneficiary over the IRA assets; rather, the agency focused its argument on the lack of current income tax liability of the beneficiary of the IRA. Unlike the grantor in the grantor trust, who is absolutely subject to annual income tax on the earnings of some or all of the grantor trust, the beneficiary of the IRA is generally only taxable on the earnings of the IRA assets upon distribution.

The taxpayer countered the arguments of the IRS by analyzing an apparent limitation on the scope of Rev. Rul. 92-73; the effect of later rulings, Treasury Regulations and changes to the Code; and a possible misreading of Code Sec. 408(h).

The stated issue in Rev. Rul. 92-73 is whether a trust that qualifies as an IRA under Code Sec. 408(a) is an eligible shareholder of an S corporation. The focus of the revenue ruling is a "trust" that qualifies as an IRA. The revenue ruling certainly covers a traditional IRA under Code Sec. 408(a) and a Roth IRA under Code Sec. 408A(a) that are established as trusts. On the other hand, the revenue ruling may not cover an IRA or a Roth IRA which is set up as a custodial account, such as the custodial Roth IRA in the *Taproot* case. A custodial IRA or Roth IRA is merely treated as a trust under Code Sec. 408(h). Several years after the issuance of the revenue ruling, Congress amended the S corporation rules and expanded the class of eligible shareholders of an S corporation to certain exempt organizations, including trusts under Code Sec. 401(a).[33] The taxation of these types of tax-exempt trusts is also "incompatible" with the taxation of the grantor of a grantor trust. Therefore, the expansion of the class of eligible shareholders to tax-exempt trusts must weaken the underpinnings of the holding of the revenue ruling.[34] Finally, Code Sec. 408(h) states that "for the purposes of this section" a custodial account will be treated as a trust with respect to the IRA rules under Code Sec. 408. This language limits the special treatment of the custodial account as a trust to Code Sec. 408. It does not extend that special treatment to other sections of the Code. Therefore, for the purposes of the S corporation rules, the custodial Roth IRA is a custodial account and not a trust. Therefore, the determination of whether a custodial Roth IRA is an eligible shareholder is based upon its structure as a custodial account and not as a trust.

This appears to constitute the basis of the taxpayer's second argument.

2. The Beneficiary of the IRA Is the Shareholder of the S Corporation

The first argument of the taxpayer in the *Taproot* case to permit an IRA to be a shareholder of an S corporation applies equally well to both an IRA that is formed as a trust or a custodial account. The taxpayer's second argument is better suited for the IRA formed as a custodial account. Under this argument, the IRA is a mere form of ownership. It is an agent or nominee for another person. The actual owner of the S corporation stock is the person for whom the stock is being held. Like the first argument, this second argument is also based upon the concept that the titleholder of the S corporation stock can be different from the person treated as the shareholder for S corporation purposes.

The support for the argument that the beneficiary of a custodial IRA should be treated as the shareholder of the S corporation is based upon Treasury Regulations and a revenue ruling concerning custodial accounts. Reg. §1.1361-1(e)(1) concerning stock held on behalf of someone else states:

> The person for whom stock of a corporation is held by a nominee, guardian, custodian, or agent is considered to be the shareholder of the corporation . . ..

In the case of a custodial IRA, the person with the custody of the assets is the equivalent of the nominee, guardian, custodian or agent in the Treasury regulation, and the beneficiary is the equivalent of the person for whom the stock is being held. Rev. Rul. 66-266 concerns S corporation stock eligibility rules applicable to custodian accounts.[35] The revenue ruling held that a custodial account set up for the benefit of a person under disability, incompetent or minor is an eligible S corporation shareholder. The individual who benefits from the custodial account is treated as the shareholder of the S corporation. Under this revenue ruling, the set of permitted shareholders is not based upon the format of ownership (the custodial arrangement which holds title to the stock), but the beneficiary of the ownership structure which is treated as the shareholder.[36] In the case of a custodial IRA, the bank or other custodian merely holds title to the S corporation stock. As provided in the Treasury regulation and the revenue ruling, the person treated as the S corporation shareholder is the beneficiary of the custodial account. If such beneficiary qualifies as a shareholder of an S corporation, then the custodial IRA is a permitted S corporation shareholder.

The IRS based its argument in opposition on Rev. Rul. 92-73. The holding of the revenue ruling is that an IRA is not an eligible shareholder of an S corporation. Based upon the deference given to this revenue ruling, this pronouncement of the IRS is sufficient to support the IRS position. To bolster the IRS position, after the year in question in the *Taproot* case, the Treasury added Reg. §1.1361-1(h)(1)(vii) to explain the new rules concerning IRA ownership of bank stock where the bank elects S corporation status. The regulation provision concludes that an IRA is not a permitted S corporation shareholder. As additional support for its position, the IRS argued that the beneficiary of the custodial account described in Rev. Rul. 66-266 pays taxes annually on the earnings of the custodial account.[37] In the case of an IRA, in general, there is no current tax on the earnings arising from the investment of the IRA assets. For these reasons, the custodial Roth IRA cannot be treated like a custodial account and cannot be an eligible S corporation shareholder.

E. Conclusion

So, what can be learned from the result of the *Taproot* case with respect to the S corporation shareholder eligibility rules?

1. Under Code Sec. 1361(c)(2)(A)(vi), an IRA may be an eligible S corporation shareholder of a bank that has elected S corporation status only if the IRA held the bank stock on the effective date of the tax provision. Under Code Sec. 1361(c)(2)(B)(vi), the beneficiary of the IRA is treated as the shareholder of the S corporation. This is a very narrow and limited provision.
2. The Tax Court and the Ninth Circuit Court of Appeals have concluded that a custodial Roth IRA is not an eligible shareholder of an S corporation, and the analysis is sufficiently broad to cover both a traditional IRA and a Roth IRA established as a trust or a custodial account.
3. Reg. §1.1361-1(e)(1) states that an IRA is not an eligible shareholder of an S corporation.
4. At least with respect to a grantor trust and a custodial account, when the titleholder of the stock and the beneficial owner (the person treated as owning the stock for tax purposes) are not the same,

then the titleholder can be an eligible shareholder of an S corporation if: (A) the beneficial owner has significant continuing control over the assets while the assets are held by the titleholder; (B) the beneficial owner is taxed on the earnings of the assets held by the titleholder annually; and (C) the beneficial owner otherwise qualifies as a permitted S corporation shareholder.

The Tax Court and the Ninth Circuit Court of Appeals have ruled that an IRA (either a traditional IRA or a Roth IRA) cannot satisfy the second part of this test. Despite these positions, legislation continues to be introduced to allow an IRA to be a permitted shareholder.[38] The dissenting opinion in the *Taproot* case has made some intriguing arguments that support the position that an IRA can be a permitted shareholder.[39] Congress has added to the list of permitted shareholders on an *ad hoc* basis and often adds to the list when the situation appears appropriate. The taproot allowing the IRA to be a permitted shareholder of an S corporation has been plucked, but (maybe) the taproot has not been completely removed from the ground. Perhaps the arguments about the IRA will reappear or the arguments for another beneficial ownership structure will grow in its place. Then, we can deal with them again.

ENDNOTES

1 *Taproot Administrative Services, Inc.*, 133 TC 202, Dec. 57,950, *aff'd*, CA-9, 2012-1 USTC ¶50,256, 679 F3d 1109.
2 *Taproot Administrative Services, Inc.*, 133 TC 202, Dec. 57,950 (2009).
3 *See, e.g.*, Bloomberg BNA Weekly Report, dated May 26, 2012, Technical Developments.
4 For example, stock may be titled in the name of a voting trust, but for tax purposes, each beneficiary is treated as the shareholder. *See* Code Sec. 1361(c)(2)(A)(iv) and (B)(iv). The owner of the stock and the person treated as the shareholder are different persons.
5 *Supra* note 2 at 215.
6 *Id.* at 215.
7 *Taproot Administrative Services, Inc.*, CA-9, 2012-1 USTC ¶50,256, 679 F3d 1109, 1120.
8 Code Sec. 1361(a)(1).
9 Code Sec. 1361(b)(1)(A)–(D).
10 Code Sec. 1361(b)(1)(B).
11 Code Sec. 1361(c)(2)(A)(i).
12 Code Sec. 1361(c)(2)(B)(i).
13 This is noted by the majority opinion of *Taproot Administrative Services, Inc.*, 133 TC 202, Dec. 57,950 at 209.
14 Act Sec. 233(a) of the American Jobs Creation Act of 2004 (P.L. 108-357).
15 Code Sec. 1362(c)(2)(A)(vi); Act Sec. 233(a) of P.L. 108-357 (italics added). The reader should note that the eligible shareholder is a trust which constitutes an IRA or Roth IRA under Code Sec. 408(a) or Code Sec. 408A(a).
16 Code Sec. 1361(c)(2)(B)(vi).
17 Reg. §1.1361-1(h)(1)(vii).
18 Code Sec. 408(a).
19 Code Sec. 219(b)(1)(A).
20 Code Sec. 408(c)(1).
21 Code Sec. 408(d)(1).
22 Code Sec. 408(h).
23 Code Sec. 408A(b) and Code Sec. 7701(a)(37).
24 Code Sec. 408A(a).
25 Code Sec. 408A(c) and (d).
26 Code Sec. 1361(c)(2)(A)(i) and (B)(i).
27 Code Sec. 673(a).
28 *Taproot Administrative Services, Inc.*, 133 TC 202, Dec. 57,950, at 224.
29 Code Sec. 408(e).
30 *Supra* note 28.
31 Rev. Rul. 92-73, 1992-2 CB 224. The Tax Court held that it could grant deference to, and base its holding on, this Revenue Ruling under the standard enunciated by the Supreme Court in *Skidmore v. Swift & Co.*, 323 US 134, 140 (1944).
32 *Id.*
33 Code Sec. 1361(c)(6). 34 *See* the dissenting opinion in *Taproot Administrative Services, Inc.*, 133 TC 202, Dec. 57,950 at 227, fn. 22.
35 Rev. Rul. 66-266, 1966-2 CB 356.
36 *See* the dissenting opinion in *Taproot Administrative Services, Inc.*, 133 TC 202, Dec. 57,950 at 221.
37 Rev. Rul. 66-266, 1966-2 CB 356.
38 *Taproot Administrative Services Inc.*, 133 TC 202, Dec. 57,950 at 215, fn. 25.
39 *Id.* at 217.