Single Class of Stock in S Corporations

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SINGLE CLASS OF STOCK IN S CORPORATIONS

— by Neil E. Harl*

Almost from the day of enactment of Subchapter S of the Internal Revenue Code in 1958,1 the single class of stock requirement has generated questions that have led to extensive litigation,2 repeated attempts to address the issues by regulation3 and numerous rulings in an effort to resolve the issues involved.4 The major area of concern has been the line between debt securities and equity interests, particularly where the debt securities represented shareholder loans.

Original IRS position

The Internal Revenue Service took the position soon after enactment of Subchapter S that if an instrument purporting to be a debt obligation had many of the characteristics of equity capital, it might be considered a second class of stock.5 Generally, outstanding stock of an S corporation had to be identical with respect to rights in the control, income and assets of the corporation.6 However, the regulation was declared invalid to the extent the regulations held that a second class of stock was created when all shares were identical as to voting rights.7 The Internal Revenue Service then agreed that disproportionate voting rights arising by agreement among the shareholders and not involving the corporation’s formal ownership structure did not create a second class of stock.8

Under a 1966 amendment to the regulations, shareholder loans made in the same proportion as stock ownership would not jeopardize the S corporation election.9 In a split decision, the Tax Court invalidated the regulations for a second time.10 IRS then announced that amendments to the regulations would be proposed.11

1992 Regulations

The Subchapter S Revision Act of 198212 specified that differences in voting rights in common stock were permissible and did not violate the requirement of a single class of stock.13 Under regulations that became final effective May 28, 1992, the Department of the Treasury has now provided guidance on the single class of stock requirement.14

General rule. Under the regulations, a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds and if the corporation has not issued any instrument or obligation, or entered into any arrangement, that is treated as a second class of stock.15 Several exceptions are specified to the general rule —

• Agreements to redeem or purchase stock at death, disability or termination of employment are disregarded in determining whether a corporation’s outstanding shares of stock confer identical distribution and liquidation rights.16

• Bona fide buy-sell agreements among shareholders, agreements to restrict the transferability of stock and certain redemption agreements are disregarded when — (1) the agreement is entered into to circumvent the one class of stock requirement and (2) the agreement establishes a redemption or purchase price significantly in excess of or below the fair market value of the stock.17

Debt as second class of stock. As for debt as a second class of stock, an obligation (whether or not designated as debt) is not treated as a second class of stock unless two conditions are met — (1) the obligation constitutes equity or otherwise results in the holder being treated as the owner of stock under the general principles of federal tax law and (2) a principal purpose of the arrangement is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders.18 The regulations contain safe harbors for obligations issued by a corporation —

• Unwritten advances from a shareholder not exceeding $10,000 in the aggregate at any time, that are treated as debt by the parties and are expected to be repaid within a reasonable time, are not treated as a second class of stock even if considered to be equity under general principles of federal tax law.19

• Proportionately-held obligations are not treated as a second class of stock.20

The failure of an obligation to meet either of the above safe harbors does not necessarily result in a second class of stock unless the obligation is considered to be equity and contravenes the rights of the outstanding stock or the limitation on eligible shareholders.21

"Straight debt." Obligations treated as "straight debt" are not considered to be a second class of stock even if it would otherwise be treated as equity under general principles of federal tax law.22 Straight debt means a written,
unconditional obligation, regardless of whether embodied in a formal note, to pay a sum certain on demand or on a specified date which —

• Does not provide for an interest rate or payment dates that are contingent on profits, the borrower’s discretion, the payment of dividends with respect to common stock or similar factors.
• Is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation, and
• Is held by an individual (other than a nonresident alien), an estate or a trust described in I.R.C. § 1361(c)(2).

The fact that an obligation is subordinated to other debt does not prevent the obligation from qualifying as straight debt.23

An obligation that originally qualifies as straight debt ceases to so qualify if the obligation — (1) is materially modified so that it no longer satisfies the definition of straight debt or (2) is transferred to a third party who is not an eligible shareholder.24

FOOTNOTES
2 E.g., Parker Oil Co. v. Comm’r, 58 T.C. 985 (1972).
6 Treas. Reg. § 1.1361-(g).
7 Parker Oil Co. v. Comm’r, 58 T.C. 985 (1972).
10 Stinnett v. Comm’r, 54 T.C. 221 (1970) (installment notes did not give rise to second class of stock even though disproportionate to shareholdings).
13 I.R.C. § 1361(c)(4). E.g., Ltr. Rul. 8405077, Nov. 2, 1983 (all shares had identical rights to dividends and to assets on liquidation; acceptable to have different restrictions on stock transfer).
16 Treas. Reg. § 1.1361-1(l)(2)(iii). Id.

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

POSSESSION. In 1951, the defendant purchased by deed the disputed 9.58 acres which were split by a road from another land in the same purchase. The defendant posted the property, sold timber from the property, allowed hunting on the property and paid all taxes due on the property. The plaintiffs purchased the land in an escheat sale and discovered the true boundaries from a survey. The court held that the defendant’s use of the land under color of title was sufficient to support a finding of adverse possession. Maynard v. Hibble, 418 S.E.2d 871 (Va. 1992).

BANKRUPTCY

GENERAL

AVOIDABLE TRANSFERS. Two creditors, the Commodity Credit Corporation (CCC) and the National Dairy Promotion and Research Board (NDPRB) had received what would otherwise constitute avoidable prepetition transfers from the debtor and had filed additional claims in the case. The unsecured creditor committee failed to file an avoidance action within two years after the transfers and such an action would be barred by Section 549(d). The committee argued that the CCC and NDPRB claims were disallowed under Section 502(d) because neither had returned the avoidable transfers. The CCC and NDPRB argued that a prepetition transfer was no longer avoidable for purposes of Section 502(d) after the time limit of Section 549(d). The court held that in order to further the policy of equitable distribution of estate property, Section 549 was to be interpreted to include in the definition of "avoidable transfers" transfers which could not be avoided because of the time limitation. Therefore, creditors who receive pre-petition avoidable transfers and do not return (either voluntarily or by an avoidance action) the transferred property are not allowed their bankruptcy claims or returning the transferred property and having their claims allowed in the bankruptcy case. Thus, such creditors have the choice of keeping the avoidable transfers and losing their bankruptcy claims or returning the transferred property and having their claims allowed in the case. In re KF Dairies, Inc., 143 B.R. 734 (Bankr. 9th Cir. 1992).

ESTATE PROPERTY. Within 180 days after the debtor filed bankruptcy, the debtor’s aunt died leaving the debtor a bequest of real and personal property. The estate was not admitted to probate until after 180 days following the bankruptcy petition and the debtor argued that under state law, the debtor was not entitled to the bequests until after the will was admitted to probate. The court held that the