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# A Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary: Part XVII – A Brief Stop at an Important Destination – Code Section 1361(b)(1)(D)

By Larry Brant on 8.26.25 | Posted in Internal Revenue Code, Tax Laws, Tax Planning

I have feverishly been reporting about provisions of the One Big Beautiful Bill Act and have left my multi-part series on Subchapter S adrift at sea. Accordingly, I want to sneak in one more article in this Subchapter S series before turning my attention back to the Act.

**Single-Class-of-Stock Requirement**

In accordance with Code § 1361(b)(1)(D), an S corporation may not have greater than one class of stock. The key to only having one class of stock is generally to make sure that all outstanding shares have identical rights to distribution and liquidation proceeds. That concept, however, may be easily said, but it may be difficult to fully grasp, implement and monitor. In this blog post, I aim to synthesize the complexities of this monumental rule of Subchapter S into an understandable set of guidelines.

**Voting Rights**

As a starting point in this primer, it is important to note Code § 1361(c)(4). This is a provision that is often forgotten or overlooked by tax practitioners. In the Subchapter S context, it identifies an important rule –

**Differences in voting rights alone will not create a second class of stock.**

This rule can act as a friend to corporate attorneys who are creating the corporate governance documents. Multiple voting rights permit greater latitude in structuring management control and in shifting ownership for legacy planning purposes. If the shares have identical rights to distribution and liquidation proceeds, differences in voting rights alone will not create a second class of stock. Treasury Regulation § 1.1361-1. Therefore, S corporations can attract outside capital and/or provide key employees with a proprietary interest without diluting control. Likewise, for the same reason, the use of non-voting shares can be an intricate part of estate planning (i.e., making gifts of shares to the next generation without loss of control).

For example, an S corporation may have shares that are entitled to vote on all corporate matters, including the election of officers and directors, operating distributions, liquidation, etc., and shares that may not vote on any corporate matters. Likewise, an S corporation may have shares that may only vote on specific corporate matters and shares that may vote on all corporate matters (i.e., shares that may vote on all corporate matters and shares that may not vote on the election of directors or officers, or operating distributions, but may vote on all other corporate matters). Of course, it is key that the Articles of Incorporation expressly permit any differences in the shares of the corporation.

**EXAMPLE 1:** Corporation desires to make an S election. It is otherwise eligible to make an S election. Corporation issues voting stock to management/shareholders and nonvoting stock to outside investors/shareholders, all of whom are eligible S corporation shareholders. The Articles of Incorporation authorize the issuance of the non-voting stock. Corporation remains eligible to make an S election.

**EXAMPLE 2:** The sole shareholder of Corporation, an S corporation, gifts his or her annual gift tax exclusion amount or all or part of his or her lifetime estate/gift exclusion amount in the form of non-voting stock to each of his or her children, thereby shifting value without giving up control. Assuming the Articles of Incorporation authorize the issuance of the non-voting stock, and the children are otherwise eligible S corporation shareholders, the gifts will not impact the S election of Corporation.

**Distributions Preferences**

Shares of an S corporation may not have dividend or liquidation preferences that impact the economic rights of the shareholders. Such will create a second class of stock. *See* PLR 8528049; Treasury Regulation § 1.1371-1(g) (adopted under former IRC § 1371).

**EXAMPLE:** Corporation desires to make an S election. The founder is its sole shareholder. Corporation issues shares to its management team that, in the aggregate, amount to 10% of the outstanding shares. The Articles of Incorporation were amended to provide that the management shares are entitled to receive a pro-rata share of all distributions (operating and liquidating) but only after the founder receives $10M in distributions. Corporation is not eligible to make an S election. It has two classes of stock. The shares do not confer identical rights to distribution and liquidation proceeds.

**Redemption Rights**

Redemption rights contained in the corporation's Bylaws or Shareholder Agreement will generally not create a second class as long as the restrictions attached thereto do not affect the rights of holders in the corporation's profits and assets during their terms as shareholders.

See PLR 8528049; PLR 8407011; PLR 8506114; see also, Blau, Rohman & Lemons, *Shareholder Agreements and the Single Class of Stock Requirement*, Journal of Taxation, 238 (April 1988).

There have been several cases and rulings in this area.[1] **Caution is advised.**

**Warrants**

Unless warrants, options and convertible debentures are disguised equity, they generally do not alone create a second class of stock.[2]

In a case criticized by some commentators, the District Court for the Northern District of California (*Santa Clara Housing Group, Inc., et al v. US*) ruled that warrants issued by Santa Clara Valley Housing Group, Inc. ("Santa Clara"), an S corporation formed in 2000, to its shareholders in connection with the shareholders' participation in a tax shelter constituted a second class of stock.

Santa Clara's stock was held by five family members (the "Schotts"). During the late 1990s, the Schotts were approached by a large accounting firm marketing a tax shelter product known as the S Corporation Charitable Contribution Strategy ("SC2"). (The SC2 was declared an abusive tax shelter in 2004.)

Pursuant to SC2, an S corporation's shareholders temporarily transfer most of the corporation's non-voting stock (constituting a majority interest) to a tax-exempt charitable entity via a "donation," rendering the corporation's income largely tax-free.

Meanwhile, the shareholders retain all the shares of voting stock. The non-voting shares remain "parked" in the charity for a predetermined period of time, during which distributions are minimized or avoided. After the period of time elapses, the charity sells the "donated" shares back to the original shareholders.

The accumulated income is then distributed to the original shareholders either tax-free or at favorable long-term capital gains rates. To protect against the possibility that the donee might refuse to sell its majority stock back to the original shareholders, warrants are issued to the shareholders prior to the "donation." The warrants allow the shareholders to purchase a large number of new shares in the corporation and effectively dilute the charity's interest.

Relying on the accounting firm's advice, and desiring to participate in SC2, the Schotts ensured they owned 1,000 shares of outstanding stock of Santa Clara: 100 voting shares and 900 non-voting shares. In June 2000, each of the shareholders was issued a warrant to purchase 10 shares of non-voting stock for every share of non-voting stock he or she actually held. The warrants were issued solely to protect the Schotts' equity interest in Santa Clara while they engaged in the SC2 strategy.

In July 2000, the Schotts collectively "donated" the 900 non-voting shares to the City of Los Angeles Safety Members Pension Plan ("LAPF"), with the understanding LAPF would sell the shares back to the Schotts after a certain period of time.

Over the next four years, Santa Clara reported more than $114 million in ordinary income, of which more than $100 million was attributed to LAPF. During the four-year period, LAPF paid no taxes on the income and only $202,500 in earnings (0.02% of the income allocated to LAPF) were distributed to it. In December 2004, LAPF sold the 900 non-voting shares back to the original shareholders for a total of $1,645,002. The warrants associated with the transfer in 2000 were cancelled in March of 2006.

The IRS audited Santa Clara and the Schotts and determined SC2 was an abusive tax shelter under two alternate theories: (i) the SC2 transaction lacked substance and should be disregarded or recharacterized for tax purposes (in which case the Schotts were liable for taxes on the income passing through to LAPF); or (ii) the warrants issued in connection with the SC2 transaction violated statutes and regulations governing S corporations and terminated Santa Clara's S status (in which case Santa Clara would be taxed as a C corporation on all income earned while LAPF was a shareholder).

Santa Clara and one of the Schott shareholders paid the resulting tax deficiencies assessed by the IRS. Then, they filed a lawsuit in the Federal District Court, seeking a refund.

The district court held that the warrants issued to the Schotts in connection with the SC2 constituted a second class of stock under Treasury Regulation §1.1361-1(l)(4)(ii), thus terminating Santa Clara's S election. The court reasoned that the warrants were designed to permit the Schott family to retain nominal ownership of approximately 90% of the corporation even though 90% of the actual shares had been "donated" to LAPF. If LAPF had refused to sell the shares back, the Schotts could have exercised the warrants, thereby diluting LAPF's 900 shares such that LAPF would go from owning 90% to approximately 10% of the outstanding shares. In effect, the warrants "constituted equity," and were intended to prevent LAPF from enjoying the rights of distribution or liquidation that ordinarily would accompany ownership of the stock. Therefore, because Santa Clara's S election was terminated upon issuance of the warrants, it was taxable as a C corporation and not entitled to a refund.[3]

The taxpayer asked the district court to reconsider its decision, citing Treasury Regulation § 1.1361-1(l)(4)(iii), which contains three safe harbors whereby warrants are not a second class of stock.

First, certain warrants issued to lenders (in the business of lending) in connection with commercially reasonable loans to a corporation are not a second class of stock.

Second, certain warrants issued to employees or independent contractors in connection with the performance of services to a corporation are not a second class of stock.

Lastly, warrants are not a second class of stock if the strike price is at least 90% of the stock's value on the date the warrants are issued, transferred from a person who is an eligible S shareholder to a person who is not an eligible shareholder, or materially modified. For this purpose, a good faith determination of fair market value is respected unless it can be shown that the value is substantially in error and was arrived at without reasonable diligence.

Santa Clara asserted that the last safe harbor applied to it. The court agreed to reconsider its ruling on the grounds that the safe harbor would apply if the warrants met the strike price requirement.

The reconsideration hearing was scheduled to be heard on August 9, 2012, but there is no record of a court ruling. It is quite possible that the government and the taxpayer resolved the case. Many commentators believe the court could have concluded that the entire SC2 arrangement itself was a second class of stock as it lacked economic substance. Such approach would have avoided the entire analysis of the warrants and the potential application of the safe harbor.

At any rate, *Santa Clara Valley Housing Group, Inc.* illustrates that warrants, absent meeting the requirements under one of the safe harbors in the regulations, could constitute a second class of stock. In other words, if warrants or any instrument is disguised stock it will violate the single-class-of-stock rule under Subchapter S. **Caution is required!**

**Debt**

Debt may be considered a second class of stock. The Service has consistently asserted that shareholder loans (i.e., loans from the corporation to a shareholder) are a second class of stock. The courts, however, have routinely rejected the Service's argument.[4]

Code § 1361(c)(5) provides a safe harbor for debt (the "straight debt safe harbor"). In order to be assured that debt does not create a second class of stock, the following requirements must be met:

- The debt instrument must be in writing;
- The debt instrument must contain an unconditioned promise of the debtor to pay the debt on demand or on a specific date;
- The debt must be a sum certain in money;

- The debt instrument must contain an interest rate and interest payment dates not contingent upon profits, the borrower's discretion or any similar factors;
- The debt may not be convertible directly or indirectly into stock; and
- The debt must be due to a creditor which would be a permitted shareholder, or (as added by the 1996 Act) a person actively and regularly engaged in the lending business.

Lawmakers gave the Secretary specific authority in IRC § 1361(c)(5)(C) to prescribe regulations as are necessary or appropriate to ensure the proper application of the straight debt safe harbor, as outlined immediately above. In fact, on May 28, 1992, the Secretary issued Final Treasury Regulations on the single-class-of-stock requirement.[5] These regulations generally apply to tax years of an S corporation beginning on or after May 28, 1992.[6]

The single-class-of-stock regulations do not apply to:

- An instrument, obligation or arrangement issued or entered into before May 28, 1992, and not materially modified after that date;
- A buy/sell agreement, redemption agreement or agreement restricting transferability of shares entered into before May 28, 1992, and not materially modified after that date; or
- A call option or similar instrument issued before May 28, 1992, and not materially modified after that date.

Corporations and their shareholders have the option of applying the Final Treasury Regulations on the single-class-of-stock requirement to prior years.[7]

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**PRACTICE ALERT:** The fact that a "straight debt" obligation is subordinated to other debt of the corporation does not prevent the obligation from coming within the purview of the "straight debt" safe harbor.[8]

**PRACTICE ALERT:** Treasury Regulation § 1.1371-1(g) (corresponding to old Code § 1371) provided that pro-rata shareholder debt does not constitute a disqualifying second class of stock even though the debt actually represents equity capital. The addition of Code § 1361(c)(5) (straight debt safe harbor) undoubtedly invalidates this regulation.

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**Distribution and Liquidation Proceeds**

Subject to limited exceptions, a corporation is treated as having only one class of stock if all outstanding shares of the corporation confer identical rights to distribution and liquidation proceeds.[9] The determination of whether all outstanding shares of a corporation confer identical rights to distribution and liquidation proceeds is a question of facts and circumstances. A review of the "governing provisions" and "commercial contractual agreements" is necessary.

A review of the corporation's Articles of Incorporation, the corporation's Bylaws, applicable state law and all binding agreements to which the corporation and its shareholders are parties relating to distribution and liquidation proceeds is necessary. These documents are collectively referred to in the Final Treasury Regulations as the "governing provisions."[10] If the review of a "governing provision" reveals that the outstanding shares of a corporation do not confer identical rights to distribution and liquidation proceeds, the corporation will be deemed to have greater than one class of stock.

A review of all commercial contractual agreements to which the corporation and its shareholders are parties, such as lease agreements, employment agreements and loan agreements, as well as the circumstances surrounding the execution of such documents, is necessary. Because these documents do not directly relate to distribution or liquidation proceeds, they are not considered to be "governing provisions." A commercial contractual agreement will only violate the single-class-of-stock rule if a principal purpose of the agreement is to circumvent the rule.[11]

Private Letter Ruling 200935018 is illustrative of the issue discussed above. The request for a ruling was submitted on behalf of an S corporation (X) regarding the status of its S corporation election.

X was incorporated in State 1. X had a written policy of making proportionate distributions to its shareholders in an amount necessary to cover their state-level taxes on the pro-rata pass-through of S corporation income. X took the position it did not have nexus with State 2 and did not file a tax return with, nor did it pay taxes to State 2. This position turned out to be incorrect. Later, following an audit and some jousting, X entered into a settlement agreement with State 2 and specifically agreed to make a lump sum payment for both its corporate excise taxes and the personal income taxes of its shareholders attributable to the activities of the S corporation for the two prior tax years.

As already discussed above, IRC § 1361(b)(1)(D) provides that an S corporation cannot have more than one class of stock. Treasury Regulation § 1.1361-1(l)(2)(i) expressly provides that the determination of whether all outstanding shares of stock confer identical rights to operating and liquidation proceeds is based on the governing provisions of a corporation. Such provisions include binding agreements relating to distribution and liquidation proceeds.

The Service concluded that a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical rights to operating and liquidating distributions. Because, pursuant to X's Bylaws, the shareholders were entitled to proportionate distributions, and X's constructive distributions for prior state income taxes of its shareholders were remedial in nature and consistent with what would have been distributed for the two prior tax years if the state taxes had been properly paid, the constructive distributions under the agreement with State 2 did not cause the termination of X's S corporation election.

**State Law**

The state law applicable to a corporation and its shareholders could create a second class of stock. So, a review of the applicable state law is necessary.

**EXAMPLE 1:** The law of State X requires that permission be obtained from the Corporation Commissioner before shares may be issued by a corporation. The Commissioner grants permission to Corporation Y to issue its shares subject to the restriction that any person who is issued shares in exchange for property, and not cash, must waive all rights to receive distributions until the shareholders who contributed cash for shares have received distributions in the amount of their cash contributions.

The Final Treasury Regulations provide that the condition imposed by the Corporation Commissioner pursuant to the law of State X alters the right to distribution and liquidation proceeds conferred by the outstanding shares of Corporation Y so that the rights to distribution and liquidation proceeds are not identical. Thus, Corporation Y in the above example is treated as having more than one class of stock.[12]

**EXAMPLE 2:** State X has an income tax. State X requires that corporations pay state income tax on behalf of their nonresident shareholders. The law of State X does not require corporations to pay state income tax on behalf of resident shareholders. Corporation Y has two resident shareholders and two nonresident shareholders. Corporation Y complies with state law and pays state income taxes on behalf of its two nonresident shareholders.

The payment of state income taxes by Corporation Y on behalf of its nonresident shareholders will be treated as constructive distributions to those shareholders. Provided the resident shareholders have the right (pursuant to a "governing provision") to distributions that take into account the payments made on behalf of nonresident shareholders, the shares would confer identical rights to distribution proceeds. If there is no distribution equalizing provision in a "governing provision," Corporation Y would be determined to have greater than one class of stock.[13]

**PRACTICE ALERT:** Use caution in this area; all shareholder agreements and like agreements need careful review.

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**Bylaws or Articles of Incorporation**

Bylaws and Articles of Incorporation are "governing provisions" and must be reviewed to determine whether a corporation has a second class of stock.

**EXAMPLE 1:** Corporation Y has two equal shareholders, A and B. Pursuant to Corporation V's Bylaws, A and B are entitled to equal distributions. Corporation A actually distributes $100,000 to A in the current year but does not distribute $100,000 to B until the next year. Since there are no circumstances that indicate that the difference in timing occurred by reason of a "governing provision" relating to distribution or liquidation proceeds, the timing difference will be ignored. Corporation Y only has one class of stock.[14] The below market loan provisions of IRC § 7872, however, may apply to this situation.

**EXAMPLE 2:** Corporation Y has two equal shareholders, A and B. Pursuant to Corporation Y's Bylaws, shareholder B will receive his or her distribution one year following the distribution to shareholder A. Since the timing difference occurred by reason of a "governing provision", Corporation Y will be treated as having more than one class of stock.[15]

**Employment Agreements**

The employment agreements of shareholders/employees must be reviewed to determine if the corporation has a second class of stock.

**EXAMPLE 1:** Corporation Y has two equal shareholders, A and B, who are also employed by Corporation Y and have binding employment agreements with the company. The compensation paid by Corporation Y to A under A's employment agreement is reasonable. The compensation paid to B under B's employment agreement, however, is found to be excessive.

Employment agreements are "commercially contractual agreements." They are not "governing provisions." Therefore, unless the facts and circumstances indicate that a principal purpose of the employment agreement is to circumvent the one-class-of-stock requirement, Corporation Y will be found to have only one class of stock. Treasury Regulation § 1.1361-1(1)(2)(v) Example 3. Facts to consider include when the agreement was entered into, the purpose of the agreement, the extent of the compensation difference between the shareholders/employees, the reason for the differences in compensation among the shareholders/employees, etc.

**CAVEAT**: Be careful in the compensation area.

**EXAMPLE 2:** Corporation Y is required under binding employment agreements to pay accident and health insurance premiums on behalf of certain shareholders/employees. Due to the varying number of dependents of each shareholder/employee, different premium amounts are paid by Corporation Y for each shareholder/employee.

As stated above, employment agreements are commercial contractual agreements. Accordingly, unless a principal purpose of an employment agreement is to circumvent the one-class-of-stock requirement, the agreement will not cause the corporation to have more than one class of stock. The above facts and circumstances do not reflect that a principal purpose of the agreement was to circumvent the one-class-of-stock rule. Thus, Corporation Y will not be determined to have more than one class of stock.[16]

In PLR 9248002, the Service held that a split-dollar life insurance agreement among an S corporation and its shareholders did not violate the single-class-of-stock rule. In that fact situation, the corporation paid 100% of premiums on existing insurance policies, less the term "insurance cost," which were purchased and owned by the shareholders/employees. The Service stated that the payments were fringe benefits to employees and not a vehicle for defeating the single-class-of-stock rule.

**Loan Agreements and Other Commercial Contractual Agreements**

As stated above, "commercial contractual agreements" are not "governing provisions." Thus, unless a principal purpose of such agreements is to circumvent the one-class-of-stock rule, such agreements will not cause a corporation to be determined to have more than one class of stock.

**EXAMPLE 1:** A is a shareholder of Corporation Y. Corporation Y makes a below-market loan to A.

The loan agreement, unless one of its principal purposes is to circumvent the one-class-of-stock rule, will not cause Corporation Y to have more than one class of stock. All facts and circumstances surrounding the agreement must be reviewed, including the amount of the loan, the repayment terms and the stated interest rate in comparison to the current market rate. If the amount of the loan were significant and the interest rate were extremely low, the Service could make a strong argument that a principal purpose of the loan was to circumvent the one-class-of-stock requirement.[17]

**EXAMPLE 2:** Corporation Y leases property from one of its shareholders. The lease agreement requires rental payments that are greatly in excess of fair market rent.

Since a lease agreement is not among the "governing provisions," it will not cause Corporation Y to be determined to have more than one class of stock unless one of the principal purposes of the lease is to circumvent the one-class-of-stock rule. Again, an analysis of the facts and circumstances must be undertaken. If the lease agreement is greatly in excess of current fair market value, a good argument may be made by the Service that a principal purpose of the lease is to violate the one-class-of-stock rule.

**EXAMPLE 3:** Corporation and its shareholders established an investment fund for the shareholders. Participation was voluntary. Shareholders were given the opportunity to invest a portion of their dividends in the fund. The fund was designed to serve as a savings and investment vehicle for the shareholders, and an asset that the shareholders could use to enhance the corporation's bonding capacity.

The Service was presented with this fact pattern in PLR 9330009. The Service determined that the investment fund was not a "governing provision." Thus, the investment fund, which did not alter the shareholder's rights to distribution and liquidation proceeds, did not have a principal purpose that was to circumvent the one-class-of-stock rule.

**Stock Issued in Return for Services**

Shares received in connection with the performance of services are not considered outstanding if the shares are substantially non-vested (i.e., subject to a substantial risk of forfeiture).[18]

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**PRACTICE ALERT:** If a holder of shares makes an IRC § 83(b) election (to include the value of the shares and income), the shares are considered outstanding. Thus, if an IRC § 83(b) election is in effect, an inquiry must be made as to whether the shares confer rights identical to the other outstanding shares with respect to distribution and liquidation proceeds.

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**Phantom Stock Plans**

Incentive compensation and other deferred compensation arrangements, such as phantom stock or stock appreciation plans, generally do not create a second class of stock for a corporation.

Four requirements must be met to avoid violating the single-class-of-stock rule:

- The arrangement may not convey voting rights;
- The arrangement must be unfunded and merely an unsecured promise to pay money or property in the future;
- The arrangement must be for employees or independent contractors offered in connection with the performance of services and may not be excessive in reference to the actual services performed; and
- The arrangement must be a plan with respect to which the employee or contractor is not currently taxed (i.e., no IRC § 83(b) election is in effect).[19]

**Other Instruments, Obligations and Arrangements**

Instruments, obligations or similar arrangements (whether or not designated as debt) issued by a corporation will be treated as a second class of stock if the following two requirements are met:

- The instrument, obligation or arrangement is equity or otherwise results in the holder being treated as the owner of shares under the general principles of the federal tax law; and
- A principal purpose of issuing or entering into the instrument, obligation or arrangement is to circumvent the rights of the outstanding shares with respect to distribution or liquidation proceeds, or to circumvent the limitations on eligible shareholders.[20]

Unwritten advances from a shareholder to the corporation that do not exceed $10,000 in the aggregate at any time during the tax year of the corporation are not treated as a second class of stock if two requirements are met:

- The advances are treated as debt by the parties; and
- The advances are expected to be repaid within a reasonable period of time.[21] The Final Treasury Regulations do not define the term "reasonable period of time." Presumably, a period less than 12 months is reasonable. To date, no case law or rulings on this particular issue exist.

The above safe harbor applies even though advances are considered equity under general principles of federal tax law. Also, the failure of an unwritten advance to meet the safe harbor will not result in the determination that a second class of stock exists unless the advance is considered equity and a principal purpose of the advance is to circumvent the rights of the outstanding shares to distribution or liquidation proceeds, or to circumvent the limitations on

eligible shareholders.

Obligations of the same class that are considered equity under general principles of federal tax law, but are owned solely by the owners of the outstanding shares of the corporation in proportion to their stock holdings are not automatically treated as a second class of stock unless a principal purpose of the obligations is to circumvent the rights of the outstanding shares with respect to distribution and liquidation proceeds, or the limitations on eligible shareholders.[22]

As a general rule, call options, warrants and similar instruments issued by a corporation generally will be treated as a second class of stock if, based upon all of the relevant facts and circumstances, it is substantially certain that the instrument will be exercised by the holder or a potential transferee; and the instrument has a strike price substantially below the fair market value of the underlying shares on the date the instrument is issued, the date the instrument is transferred by a person who is an eligible shareholder to a person who is an ineligible shareholder, or the date the instrument is materially modified. If an option is issued in connection with a loan and the time period for exercise of the option is extended consistent with a modification of the underlying loan, the extension will not be considered a material modification.[23] Other rules exist:

- A call option or similar instrument will not be treated as a second class of stock if it is issued by a corporation to a person actively and regularly engaged in the business of lending, in connection with the securing by the corporation of a commercially reasonable loan.[24] The exception for lenders will continue to apply even if the lender transfers the option and the underlying loan, or a portion thereof. If the lender transfers the option without a corresponding portion of the underlying loan, this lender exception ceases to exist.[25]
- A call option that is issued to an individual who is either an employee or independent contractor in connection with the performance of services for the corporation or a related corporation (assuming the option value is not excessive with reference to the services actually performed) will not be treated as a second class of stock if: the call option is non-transferable; and the call option does not have a readily ascertainable fair market value at the time the option is issued.

This exception for options issued to employees and independent contractors applies only if the services are performed for the issuing corporation or for a corporation, the shares of which are owned 50% or more by the issuing corporation. For purposes of determining the percentage of shares owned by the issuing corporation, both the number of voting shares and the value of the shares must be considered. This exception for options issued to employees and

independent contractors will not be affected by the termination of the employee or independent contractor after the issuance of the call option. If the call option becomes transferable, the exception ceases to apply.[26]

The Final Treasury Regulations specifically provide that the Commissioner may provide other exceptions by revenue ruling or other "published guidance."

A call option is not treated as a second class of stock if, on the date the call option is issued, the date it is transferred by a person who is an eligible shareholder to a person who is not an eligible shareholder, or the date it is materially modified, the strike price of the call option is at least 90% of the fair market value of the underlying shares on that date. A good-faith determination of value by the corporation will be respected unless it can be shown that the value is substantially in error and the determination of value is not performed with reasonable diligence to obtain a fair value. Failure of the option to meet this safe harbor, however, will not in and of itself result in the option being treated as a second class of stock.

**Shareholder Agreements**

Agreements among the shareholders of a corporation and agreements among the shareholders and the corporation restricting transferability of shares, and redemption agreements among the shareholders and the corporation are not "governing provisions." Rather, they are “commercial contractual agreements.” Such agreements will not create a second class of stock unless:

- A principal purpose of the agreement is to circumvent the one-class-of-stock rule; and
- The agreement establishes a purchase price for the shares which, at the time the agreement was entered into, was significantly in excess or below the fair market value of the shares.[27]

If the subject agreement provides for the redemption or purchase of shares at book value or at a purchase price between fair market value and book value, such purchase price will not be considered to be significantly in excess or below the fair market value of the shares.[28] A good faith determination of fair market value will be respected unless the value was substantially in error and the determination was not performed with reasonable diligence. [29]A determination of book value will be respected if it is determined in accordance with Generally Accepted Accounting Principles (including permitted optional adjustments) or it is the book value that is used by the corporation for a substantially non-tax purpose.[30]

Notwithstanding the general rule, bona-fide agreements to redeem or purchase shares at the time of a shareholder's death, divorce, disability or termination of employment will not create a second class of stock, regardless of the facts and circumstances surrounding the agreement or the purchase price set forth in the agreement.[31] The Commissioner is given specific authority in the Final Treasury Regulations to issue revenue rulings or other publications that extend this rule to other types of bona-fide agreements to redeem or purchase shares.[32]

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**PRACTICE ALERT:** All shareholder and buy/sell agreements for S corporations should contain the following savings clause: "Notwithstanding anything herein to the contrary, the parties intend that, in all circumstances, each share of corporation shall have equal rights to distribution and liquidation proceeds."

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The Service has routinely ruled that the single-class-of-stock rule has not been violated by a shareholder agreement or buy/sell agreement where the agreement has not altered the rights conferred by shares to distribution and liquidation proceeds.[33] Nevertheless, caution is advised. All shareholder agreements and buy/sell agreements should contain the above savings clause.

Shareholder agreements and buy/sell agreements should deal with several business and tax issues that should not be ignored.

A well-designed shareholder agreement or buy/sell agreement should deal with the following business issues:

- Provide for an orderly transfer of shares upon the death, retirement, disability and/or termination of employment of a shareholder;
- Establish a fair market value for the shares;
- Provide a method for funding the purchase of the shares (i.e., insurance);
- Provide for the continuance of the business upon the termination of a shareholder's interest in the corporation;
- Maintain shareholder liquidity;
- Provide a framework for the transfer of shares among shareholders and third parties, and, especially in the case of closely held corporations, prevention of transfers to outsiders without the approval of the other shareholders; and
- Deal with or minimize taxation upon receipt of insurance proceeds to fund the buy/sell and recognize the opportunity for surviving shareholder(s) to obtain a stock basis

increase due to the purchase of a departing or deceased shareholder's stock.

A well-designed shareholder agreement or buy/sell agreement should deal with the following S corporation tax issues:

- Preserve the S election (i.e., limit the number of shareholders, restrict transfers to ineligible shareholders and avoid violating the one-class-of-stock rule);
- Allocation of income and loss to a terminating shareholder's interest;
- Provide for the amount and timing of operating distributions during S corporation years and termination years;
- Provide for shareholder action upon termination of an S election (i.e., application to the Secretary for waiver for an inadvertent termination); and
- Agreement to revoke S status upon certain stated events.

In Private Letter Ruling 201017019, the shareholders of X, an S corporation, entered into a shareholder agreement with the corporation that required X to make payments to the shareholders, as distributions with respect to X's stock, in an amount based on each shareholder's pro rata share of X's taxable income for a given taxable period. The payments were intended to ensure X's shareholders had sufficient funds to pay the federal and state income tax liabilities resulting from their distributive share of X's income.

If X's taxable income increased or its creditable foreign taxes were decreased after X's original IRS Form 1120S was filed for a particular taxable year, the shareholder agreement allowed X to make distributions to the shareholders (with respect to the deficiency resulting from such increase or decrease) within a reasonable time (the "Discretionary Payment Provision"). This Discretionary Payment Provision was intended to allow X to assist its shareholders in paying any additional tax liability resulting from the tax return adjustment.

X believed it was more efficient and equitable to base distributions under the Discretionary Payment Provision on the shareholders' interests for the taxable period to which the adjustment relates, rather than the shareholders' interests at the time the additional distributions are actually made (as the shareholders' interests could change between these two distinct time periods). X proposed to amend the Discretionary Payment Provision to cover other post-filing adjustments to X's tax returns. The new provision would permit X to make a distribution to each person or entity that was a shareholder during the relevant taxable year if any item of X's taxable income, gain, loss, deduction, credit or the like, was adjusted or amended after X's original return for that taxable year had been filed.

Any such distributions:

- were to be made in accordance with the shareholders' interests in X's taxable income or loss for the taxable year;
- could take into account any interest, penalties or the like, attributable to the post-filing adjustment; and
- would be made at a time selected by X, but in any event, at a reasonable time after the relevant post-filing adjustment.

As discussed above, IRC § 1361(b)(1)(D) prohibits an S corporation from having more than one class of stock. Under Treasury Regulation § 1.1361-1(l)(1), subject to exceptions, 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.

Based on the foregoing facts, the Service ruled the Discretionary Payment Provision (including the proposed amendments) would **not** cause X to have more than one class of stock for purposes of IRC § 1361(b)(1)(D), and that distributions made pursuant to the Discretionary Payment Provision would not cause X to have more than one class of stock under the same provision. The rights to liquidation and distribution proceeds among shareholders were identical.

**Recent Tax Court Memo Case**

Last year, the U.S. Tax Court was presented with a case where the issue at hand was whether the taxpayer, an S corporation, had more than one class of stock. The case seems straightforward, but its facts are convoluted, and tax practitioners must be careful not to take the ruling out of context.

In *Maggard v. Commissioner* (T.C. Memo 2024-77), two of the three shareholders caused the S corporation to make disproportionate distributions. The court focused its analysis on Treasury Regulation § 1.1361-1(l)(2). It ultimately concluded that the determination of whether shares confer identical rights to distribution and liquidation proceeds requires a focus on the corporation's governing provisions (i.e., the Articles of Incorporation, Bylaws and other governing provisions), rather than how distributions are actually made to the shareholders.

In *Maggard*, the governing provisions expressly provided for only one class of stock giving all shares equal rights to distribution and liquidation proceeds. Based upon that fact, the court ultimately concluded that, despite many years of disproportionate distributions, no second class of stock existed. Accordingly, the corporation's S election was not terminated.

**PRACTICE ALERT:** *Maggard* does not stand for the proposition that disproportionate distributions will never terminate an S election. A detailed analysis of the case is warranted.

James Maggard co-founded an engineering firm with another individual. The business took the form of a corporation, and it made a timely S election. When his co-founder left the business, Maggard brought in two individuals as shareholders whom he thought were his friends. The friends proceeded to make unauthorized distributions to themselves that were well in excess of their proportionate share. Upon audit by the IRS, when Mr. Maggard was assessed tax on his proportionate share of the corporation's income (which was never distributed to him), he asserted that the disproportionate distributions created more than one class of stock, thereby terminating the corporation's S election. The Service ruled against Mr. Maggard on appeal. Consequently, he filed a petition in the U.S. Tax Court, asserting that the S election had been terminated and thus he should not have to pay income tax on distributions he never received. The case hinged on whether disproportionate distributions alone terminate an S election.

The facts of the case are interesting. Mr. Maggard and his friend Todd Schricker co-founded Schricker Engineering Group ("Schricker"), an engineering consulting partnership. A few years later, they incorporated Schricker in California and caused an S election to be made.

10,000 shares of stock were outstanding and owned equally by the two shareholders. Under California law, this entitled each owner to a *pro rata* share of any dividends as well as any distribution of its assets on liquidation. Cal. Corp. Code §§159, 400(b) (West 1975).

Pursuant to the Articles of Incorporation, the corporation was authorized to issue 10,000 common shares, all of which were of one class. The Bylaws did not mention more than one class of stock or make any allowance for disproportionate liquidation rights to its shareholders.

In July 2003, Todd Schricker sold his shares to Mr. Maggard. Mr. Maggard. in turn, sold a total of 6,000 shares in Schricker to two individuals, LL (4,000 shares) and WJ (2,000 shares).

LL and WJ joined Schricker's Board of Directors and took on executive roles of the corporation. Mr. Maggard remained the corporation's lead engineer, though he also helped in sales and business development.

Because LL had an accounting background and was an old family friend, Mr. Maggard allowed him to handle the corporation's accounting and finances. LL served as Schricker's CEO and CFO.

WJ became Schricker's corporate secretary.

The two new shareholders together oversaw day-to-day operations.

Pursuant to the corporation's governing provisions, each shareholder was entitled to a proportionate share of the corporation's distributions.

LL misappropriated funds by inflating reimbursements relating to his expense account. Additionally, LL and WJ caused the corporation to make disproportionate distributions of the corporation's earnings to themselves.

LL stopped causing the corporation to file corporate tax returns (IRS Form 1120S). Also, he failed to cause the corporation to issue IRS Schedules K-1 to shareholders.

Eventually, Mr. Maggard caught on to the misdeeds of both LL and WJ. He hired a CPA and asked him to reconcile the corporate books. It was ultimately discovered that LL overdistributed $160,800 to himself and underdistributed approximately $165,000 to Mr. Maggard. Eventually, Mr. Maggard accused LL and WJ of embezzling more than $1 million, including approximately $250,000 in 2012 and $300,000 in each of 2013, 2014 and 2015.

When Mr. Maggard confronted LL about the unauthorized distributions, LL denied wrongdoing. LL and WJ then eliminated Mr. Maggard's access to the corporation's books and records and froze him out of all business meetings.

Using their majority positions on the Board of Directors, LL and WJ voted to increase their salaries, vacation time and other employee benefits. They authorized payouts to themselves of roughly $325,000 based on retroactively increasing the amount of paid time off they had on the books of the corporation. Mr. Maggard received no such benefits.

LL and WJ went on the offensive, suing Mr. Maggard in California Superior Court, claiming (in addition to other claims) breach of contract and fraud. They also sought declaratory relief, asserting LL and WJ combined own 60 percent ownership of the corporation.

Mr. Maggard filed counterclaims, seeking rescission of the stock transfer to LL and WJ based on fraud and failure of consideration, conversion, breach of contract, and embezzlement. He also sought declaratory relief to invalidate LL's ownership of shares, as well as asking the court to order an accounting.

The court found that the corporation had overdistributed to LL and underdistributed to Mr. Maggard. The court also concluded found that Mr. Maggard had not authorized the disproportionate distributions. The court's judgment ordered the corporation to make a corrective distribution of $164,783 to Mr. Maggard.

Despite the court order, LL and WJ refused to pay. Instead, LL offered to buy Mr. Maggard's entire stake in the company for $1,262,500. Mr. Maggard accepted the offer.

The resulting settlement agreement included a covenant that Schricker wouldn't make any changes to the Schedule K-1s it finally issued to Mr. Maggard in 2018 for the 2012-17 tax years. From this point on, Mr. Maggard had no role — official or otherwise — in the company that he had cofounded.

After the settlement, Mr. Maggard contacted the IRS Commissioner's Whistleblower Office. After telling the story to the IRS, he was told that his whistleblower claim may cause the termination of the corporation's S corporation status, making Schricker a C corporation and, presumably, it would owe corporate taxes to which it was not previously subject. Additionally, it may mean that Mr. Maggard may not be required to include in his own taxable income money that he was entitled to, but had not received, from the corporation.

In 2018, the corporation caused its 2011-2016 IRS Forms 1120S to be prepared and filed, but no IRS Schedules K-1 were issued to Mr. Maggard. When his attorney contacted the corporation, asking where Mr. Maggard's IRS Schedules K-1 were, LL offered a single number written on a napkin: $300,000. This purportedly represented Mr. Maggard's *pro rata* portion of the corporation's losses for tax year 2014. Mr. Maggard and his spouse, filing jointly, claimed the $300,000 loss on their 2014 return (filed in 2018).

Mr. Maggard received another napkin with a single number on it for 2015 (a $50,000 loss). He and his spouse used that number on their late-filed 2015 return.

Without any information for 2016, Mr. Maggard and his spouse filed their 2016 return, reporting no income or loss from the corporation.

The corporation thereafter issued and filed IRS Schedules K-1 for 2014-2016. These IRS Schedules K-1 showed Mr. Maggard had, in fact, income for each of these tax years (rather than losses).

Upon audit of Mr. Maggard's tax returns, the IRS assessed taxes, interest and penalties against him and his spouse for underreporting their income associated with the corporation. After losing on appeal, Mr. Maggard and his spouse filed suit in the U.S. Tax Court, claiming that no tax is owing on their distributive share of the corporation's income because during the tax years at issue, it was a C corporation. They claimed the LL and WJ embezzlement constituted disproportionate distributions that terminated the corporation's S election.

The court quickly focused on Treasury Regulation § 1.1361-1(l)(1):

**"[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."**

Citing Revenue Procedure 2022-19, Section 3.03, 2022-41 IRB 282, 286, the court noted that the IRS has stated that it will not treat any disproportionate distributions made by a corporation as violating the single-class-of-stock requirement if the governing provisions provide for identical rights.

Mr. Maggard argued that LL and WJ embezzled from the corporation, resulting in unequal distributions. On the other hand, the IRS asserted that the embezzlement does not matter because the regulation tells us to focus on shareholder *rights* under a corporation's governing provisions, not what shareholders actually do in practice (unless, of course, it is due to a commercial contractual agreement that has a principal purpose to circumvent the single-class-of-stock rule).

On this point, the court sided with the IRS, reiterating the language out of the regulations:

**A corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights. . .**

The court went on to cite *Minton v. Commissioner*, 94 T.C.M. (CCH) 606, 607 (2007), *aff'd*, 562 F.3d 730 (5th Cir. 2009). In that case, the court ruled that a binding agreement among the shareholders allowing disproportionate distributions could terminate an S election if its principal purpose is to circumvent the single-class-of-stock requirement.

In the instant case, no governing provision authorized the disproportionate distributions resulting from the alleged embezzlement of LL and WJ. Further, there was no binding agreement, the principal purpose of which was to circumvent the single-class-of-stock requirement. The court stated:

**"Without that formal memorialization there was no formal change to Schricker's having only one class of stock. And this means that we cannot revoke Schricker's election to be an S corporation for disproportionate distributions under Treasury Regulation §1.1361-1(1)(2)."**

**Conclusion**

At first blush, the single-class-of-stock rules seem clear and simple to apply. Unfortunately, as the above discussion illustrates, the rule is far from simple. The terrain is full of traps for the unwary. I hope this article, however, helps tax practitioners avoid the traps and provides a good understanding of the single-class-of-stock requirement of Subchapter S.

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[1] Additional capital and loan obligations upheld. PLR 8506114. Buy/sell provision upheld. PLR 8627015; *see also* PLR 8650025. Liquidation preferences are not allowed. *Paige v. United States*, 580 F2d 960 (9th Cir. 1978). Transfer restrictions, formula price for stock repurchases, and dividend reinvestment provisions ruled not to constitute a second class of stock. *See* PLR 8407011; PLR 8528049; PLR 8506114; PLR 8907016.

[2] Rev. Rul. 67-269, 1967-2. CB 209.

[3] Meanwhile, the shareholder who filed a refund suit with Santa Clara was entitled to a refund of the deficiencies and penalties assessed against her based on the IRS's alternative theory that the income allocated to LAPF should be re-allocated to the Schotts.

[4] *See Shores Realty Co., Inc. v. United States*, 468 F2d 572 (5th Cir. 1972); *Portage Plastics Company, Inc.,* 486 F2d 632 (7th Cir. 1973).

[5] Treas. Reg. § 1.1361-1(1).

[6] Treas. Reg. § 1.1361-1(1)(7).

[7] *Id*.

[8] Treas. Reg. § 1.1361-1(1)(5).

[9] Treas. Reg. § 1.1361-1(1)(1).

[10] Treas. Reg. § 1.1361-1 (1)(2).

[11] *Id.*

[12] Treas. Reg. § 1.1361-1(1)(2)(v) Example 1.

[13] Treas. Reg. § 1.1361-1(l)(v) Example 7.

[14] Treas. Reg. § 1.1361-1(1)(2)(v) Example 2.

[15] *Id.*

[16] Treas. Reg. § 1.1361-1 (1)(2)(v) Example 4.

[17] Treas. Reg. § 1.1361-1(1)(2)(v). Example 5.

[18] Treas. Reg. § 1.1361-1(b)(3).

[19] Treas. Reg. § 1.1361-1(b)(4); *See*, *also* Rev. Rul. 67-269,1967-2 CB 298 (1967); PLR 9040035; 9032027 & 9109025.

[20] Treas. Reg. § 1.1361-1 (1)(4)(ii).

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

[22] Treas. Reg. § 1.1361-1(1)(4)(ii).

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

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

[25] *Id.*

[26] Treas. Reg. § 1.1361-1(1)(4)(B)(2).

[27] Treas. Reg. §1.1361-1(1)(2)(iii).

[28] *Id.*

[29] *Id.*

[30] *Id.*

[31] Treas. Reg. § 1.1361-1(1)(2)(iii)(B).

[32] *Id.*

[33] *See*, PLR 8937034, 8811061, 8627015 and 8528049.

**Tags:** A Journey Through Subchapter S, debt, distribution and liquidation proceeds, IRS, phantom stock, S corporation, shareholders, single-class-of-stock requirement, stock, U.S. Tax Court, voting rights, warrants