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IRAs, Absent Meeting A Narrow Exception, Are Not Eligible S Corporation Shareholders

By Larry Brant on 8.7.14 | Posted in Corporate Tax, S Corporations

Taproot Administrative Services v. Commissioner, 133 TC 202 (2009), 679 F3d 1109 (9th Cir. 2012), is an S corporation shareholder eligibility case. It was decided by the US Tax Court in 2009 and eventually made its way to the 9th Circuit Court of Appeals, where a decision was rendered in 2012.

Background

Prior to the enactment of the American Jobs Creation Act of 2004, only the following were eligible S corporation shareholders:

- US citizens and resident individuals;
- Estates;
- Tax-exempt 501(c) charities and 401(a) retirement plans; and
- Certain trusts, including QSSTs, ESBTs and grantor trusts

As a result of the lobbying efforts of family-owned rural banks, as of October 22, 2004 (the effective date of the American Jobs Creation Act), a new eligible shareholder was added to the list, IRAs, including Roth IRAs, provided two criteria are met:

- The S corporation must be a bank, as defined in Section 581 of the Code; and
- The shares must have been owned by the IRA on October 22, 2004, the enactment date of the American Jobs Creation Act.

As you might imagine, having an eligible IRA shareholder will be rare. The exception to the S corporation eligibility rules provided by the American Jobs Creation Act is quite narrow.

Taproot

The facts of the case are simple and straight forward. The taxpayer thought it was an S corporation. The tax year at issue was 2003. The taxpayer's sole shareholder was a custodial Roth IRA account held for the benefit of an individual (who was an eligible S corporation shareholder). The Service audited the S corporation and eventually issued a notice of deficiency for tax year 2003, determining, among other things, that the corporation was taxable as a C corporation because it had an ineligible shareholder. The taxpayer asserted, in somewhat of a convoluted and unintelligible manner, that an IRA was an eligible S corporation shareholder. After being unable to convince the auditor of this argument, the taxpayer appealed. Unfortunately for the taxpayer, the argument did not favorably resonate with the Appeals Officer. The law seems clear: no IRA (for tax year 2003 or earlier) is an eligible S corporation shareholder. After losing in the IRS Office of Appeals, the taxpayer filed a petition in the US Tax Court.

The tax year at issue, 2003, predates the American Jobs Creation Act by one year. Furthermore, the taxpayer was not a bank. So, even if the provisions of the American Jobs Creation Act were applicable, they would not save the day for Taproot Administrative Services ("Taproot").

Ruling against the taxpayer, the US Tax Court, citing Revenue Ruling 92-73, concluded:

"Unlike grantor trusts, traditional and Roth IRAs exist separate from their owners for Federal income tax purposes....Because the tax-free accrual of income and gains is one of the cornerstones of traditional and Roth IRAs, it would make no sense to treat IRAs as grantor trusts thereby ignoring one of their quintessential tax benefits. As it stands, an IRA—and not its grantor or beneficiary—owns the IRA's income and gains...."

The Tax Court also stated there was no indication Congress (prior to the American Jobs Creation Act) ever intended to allow IRAs to own S corporation stock. While it could have, it did not list IRAs as eligible S corporation shareholders in Code Section 1361. Had Congress intended to make IRAs eligible S corporation shareholders, it could have done so explicitly, as it had in the limited case of banks desiring to elect S corporation status. Consequently, the court concluded a Roth IRA is not eligible to own shares of an S corporation. The taxpayer was taxable as a C corporation.

Judge Holmes wrote a dissenting opinion. He pointed out that an IRA is owned by a custodian for the benefit of an individual. Judge Holmes asserted the individual, not the IRA, should be considered the shareholder for purposes of the analysis.

With its loss in the Tax Court, the taxpayer could have licked its wounds, packed up and returned home. Rather, Taproot appealed to the Ninth Circuit Court of Appeals. Jumping on Judge Holmes's dissenting opinion, the taxpayer argued the owner of an IRA, rather than the

IRA itself, should be considered the shareholder of the S corporation. An IRA is a custodial account, and with respect to custodial accounts, the person for whom the account is held is the owner of the shares held in the account. Put in the simplest terms, Taproot argued an IRA should be ignored; it is simply a custodial account. The only hope for this taxpayer was convincing the court that the proper analysis was to ignore the IRA and look at the beneficiary as the shareholder.

Unfortunately, the Ninth Circuit concluded that this argument lacked legal authority. If the assertion that we look through an IRA and look at the beneficiary to determine whether the S eligibility requirements are met was correct, why did Congress specifically have to amend Code Section 1361(c) (2) to allow IRAs to be eligible S corporation shareholders provided the corporation was a bank and the stock was owned by the IRA on October 22, 2004? Taproot's argument did not hold water. Consequently, it lost at the Ninth Circuit. The saga is over unless Congress amends Code Section 1361 to allow IRAs to be eligible S corporation shareholders.

Conclusion

There is one moral to this story: Even today, IRAs and Roth IRAs, absent meeting the narrow American Jobs Creation Act rural bank exception, are not eligible S corporation shareholders.

Tags: IRAs, S Corporations, Taproot