



Class Warfare in the Family
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S Corporation Family Warfare

This podcast deals with an interesting case that illustrates issues related to the single class of stock requirements for S corporations and the danger of failing to have restrictions on the transfer of shares of S corporation stock when shareholder disputes break out. The case in question is the one of *Minton v. Commissioner*, T.C. Memo 2007-372.

Single Class of Stock Requirement

The key issue in question in the case is whether an agreement between the corporation and its founder when his children obtained interests in the corporation created a second class of stock, a prohibited situation for an S corporation—and, therefore, would terminate the S election. The interesting point in this case is that it is the *taxpayer* and not the IRS that is arguing for the second class of stock, apparently as a bit of bargaining point in a related non-tax bit of litigation.

The general requirements for a corporation to be eligible to elect treatment as an S

corporation are found at §1361(b)(1) which provides:

(1) In general

For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not--

(A) have more than 100 shareholders,

(B) have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual,

(C) have a nonresident alien as a shareholder, and

(D) have more than 1 class of stock.

The question of what constitutes a single class of stock is discussed in more detail at Reg. §1.361-1(l)(2)(i) which provides:

(i) In general.

The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l). Although 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, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Note that the regulation places the emphasis on state law rights to distributions rather than looking at actual distributions though, as noted in the final sentence, such distributions are going to be given "appropriate tax effect" which can be taken to mean the IRS reserves the right to determine they represent some other (likely taxable) transaction. But we have had letter rulings just this past year that noted that disproportionate distributions by themselves don't trigger a second class of stock (see LTRs 200730009 and 200723025 that were referenced in the *Current Federal Tax Developments* manual from Mares Nichols CPE, Inc. I used in two presentations back in mid-December).

The Family Business and the S Corporation

LPP was an S corporation that was incorporated by Julian E. Long (now deceased) in 1975. Shortly after it was incorporated, the corporation elected S status. Julian E.'s children, Julian W. Long (his son) and Linda Minton (his daughter) worked for the corporation.

In the mid-1980s Julian E. ceased to be involved in the day to day operation of the business and became a consultant. He was never paid any amount that was labeled salary by the corporation, but he did take distributions from time to time to pay living expenses for himself and his spouse.

Although exactly how many shares were distributed and when was in dispute in another case, no one disputed that various shares were transferred to the children from Julian E (and perhaps his wife as community property via her estate). Julian E.'s remaining interests was sold in equal parts to each child in September 1996, and he ceased to be shareholder as of that date, leaving the siblings as the remaining shareholders controlling 100% of the stock. However, not all was well between the siblings and litigation ensued between the parties. That litigation lead to the question of whether, in fact, LPP was an S corporation.

The Agreement

In the state court litigation, Linda's attorney uncovered some information that lead Linda to take the position that the S corporation election had been effectively terminated in 1986. The court explains the situation this way in its opinion:

During the course of litigation in the Louisiana State courts instituted by petitioner against LPP, Julian E., Julian W., and others with respect to the number of LPP shares owned by her (the first Louisiana litigation),⁶ petitioner discovered an audio tape of a purported 1986 LPP shareholders/directors meeting attended by Julian E., Julian W., and Alma. Her attorney, who is also her counsel in this case, after listening to the tape and having it transcribed, advised her that the participants at the meeting, by providing for a fixed level of distributions to Julian E., had created a second class of stock in LPP, thereby negating LPP's S corporation status.

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⁶In an unpublished opinion, *Minton v. Long's Preferred Prods., Inc.*, 829 So. 2d 669 (La. Ct. App. 2002), the court of appeal held in petitioner's favor in that litigation and confirmed that she (1) purchased 19 shares of LPP stock in 1986 and (2) owned 50 shares (or 50 percent) of that stock as of 1996, not 40.5 shares (or 40.5 percent) as had been alleged by Julian E. and Julian W. and reported on the 1998 Schedule K-1, Shareholder's Share of Income, Credits, Deductions, etc., issued to her by LPP.

Linda, having now come to the conclusion that there was no longer an S corporation, removed the income from the S corporation from her returns for open years as noted below:

Consistent with that position, petitioner, on her 1998 Form 1040, U.S. Individual Income Tax Return, which she filed on or about November 15, 1999, omitted \$229,292 of ordinary income and other pass-through items reported on the Schedule K-1, Shareholder's Share of Income, Credits, Deductions, etc., issued by LPP to her for 1998.⁷ Along with her 1998 return, petitioner submitted a Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR), which purported to justify that omission on the basis that the 1986 agreement created a second class of stock in LPP, thereby causing it to lose its S corporation status in 1986. Thereafter, petitioner filed amended 1996 and 1997 returns in which she took a position, vis-a-vis LPP's earnings, consistent with that taken in her 1998 return.

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⁷ Respondent's adjustment for petitioner's alleged omission of LPP income is \$283,077, based upon her ownership of 50 shares of LPP stock, whereas the 1998 Schedule K-1 issued to her by LPP reflects her ownership of only 40.5 shares, a position that was subsequently rejected by the Louisiana Court of Appeal. See supra note 6.

While her position was that the corporation had ceased to be an S corporation, she decided that "just in case" she'd insure the entity was not an S corporation by taking one additional step in the following year. The court notes:

On June 7, 1999, petitioner contributed one share of her LPP stock to H.C. Chemicals, Inc. (HCC), which had been incorporated by her daughter, Heather Minton Fuller (Heather), on June 4, 1999. Heather became the president and sole shareholder of HCC, the sole function of which has been to hold shares of LPP. LPP utilized June 7, 1999, as the date of termination of its S corporation status.

As noted, the corporation used that transfer as the event that terminated the S corporation's status pursuant to §1361(b)(1)(B) when it had a disqualified shareholder. Given that only a single share was transferred to the corporation, it certainly seems reasonable to assume the only reason the shares were transferred was to terminate the S status "just in case" it was still an S corporation—since had the election been found to be invalid, the corporation could not have elected S status again without Linda's consent.

Status of Corporation After 1986 Meeting

As noted, the key question is whether the S corporation status terminated in 1986 after the meeting or whether the status existed until June 7, 1999.

Linda's argument in favor of the 1986 termination was that:

Petitioner argues that (1) the 1986 agreement constituted a "binding agreement", within the meaning of section 1.1361-1(l)(2)(i), Income Tax Regs.,¹⁰ to make "guaranteed payments" to Julian E., beginning in 1986, in whatever monthly amounts would be necessary to cover his and Alma's living expenses, (2) those payments "were made over time, and accounted for properly as state law dividends", and (3) because "[n]o other shareholder received the monthly guaranteed payments that were received by Julian E. Long", LPP ceased to be an S corporation "from the moment that the agreement was made".

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¹⁰ We note that, pursuant to sec. 1.1361-1(l)(7), Income Tax Regs., "sec. 1.1361-1(l) does not apply to: an * * * arrangement * * * entered into before May 28, 1992, and not materially modified after that date". Sec. 1.1361-1(l)(7), Income Tax Regs., continues, however: "a corporation and its shareholders may apply this sec. 1.1361-1(l) to prior taxable years." We consider petitioner's 1998 return position and her reliance upon sec. 1.1361-1(l)(1) and (2)(i), Income Tax Regs., in this case as an election by petitioner, in her capacity as a shareholder of LPP, to apply sec. 1.1361-1(l), Income Tax Regs., to the 1986 agreement. Therefore, we shall apply that regulation in deciding whether the 1986 agreement created a second class of LPP stock.

Under that regulation, the key issue is whether there was such a binding agreement under state law that had the effect of creating a second class of stock—so the Court looked at the issue from that perspective and found Linda's arguments lacking.

The Court first addresses whether a truly binding agreement was entered into. The Court notes:

To begin with, petitioner has failed to establish that the 1986 agreement was in any way "binding". At best, petitioner testified that that agreement was nothing more than an informal, oral understanding among the board members/shareholders of LPP to have LPP make monthly distributions to Julian E. in whatever amounts he (and Alma) needed to cover their living expenses, a practice similar to that which prevailed prior to 1986. There is no evidence that the family members, in their capacity as directors and/or shareholders of LPP, took any formal corporate action to implement that understanding.¹¹

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¹¹ That absence of corporate action is inconsistent with what appears to have been the normal practice of LPP's shareholders/directors to keep written minutes of directors' and shareholders' meetings and of resolutions adopted at those meetings.

The Court specifically addresses what would need to have occurred to have a binding agreement under Louisiana law, at least as the Tax Court viewed it:

Louisiana corporation law specifically addresses the manner in which directors or shareholders of a Louisiana corporation shall act on behalf of the corporation. Petitioner has cited no provisions of Louisiana corporation law (and, therefore, no authority) in support of her position that LPP was bound by the 1986 agreement with the result that it might be said to constitute a "binding agreement" for purposes of section 1.13611(1)(2)(i), Income Tax Regs. Our own review of Louisiana corporation law leads us to conclude that the procedures required to (1) institute a board of directors' or shareholders' meeting and (2) adopt binding resolutions at such meetings are either governed by the articles of incorporation and/or the bylaws or by the Louisiana corporation law itself.¹²

LPP's articles of incorporation do not address the procedures for (1) instituting directors' or shareholders' meetings or (2) adopting binding resolutions at such meetings, and petitioner has failed to place LPP's bylaws into evidence. Nor has she demonstrated compliance with the provisions of Louisiana corporation law that pertain to those procedures in the absence of controlling articles or bylaws.

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¹² With regard to board of directors' meetings, see La. Rev. Stat. Ann. sec. 12:81C(6)(a) (1994):

[N]otice of meetings of the board shall be given as provided in the articles or bylaws. If not so provided:

- (i) Regular meetings of the board may be held without notice of the date, time, place, or purpose of the meeting, provided that the date, time, and place are fixed by the board or are determinable pursuant to the articles or by laws.
- (ii) Special meetings of the board shall be preceded by at least two days notice of the date, time, and place of the meeting.
- (iii) The notice of a special meeting of the board shall describe the purpose of the special meeting.

See also La. Rev. Stat. Ann. sec. 12:81C(9) (1994):

Any action which may be taken at a meeting of the board of directors * * * may be taken by a consent in writing signed by all of the directors * * * and filed with the records of proceedings of the board * * *.

With regard to shareholders' meetings, see La. Rev. Stat. Ann. sec. 12:73D (1994), which, in pertinent part, provides:

Unless otherwise provided in the articles or by-laws, and except as otherwise provided in this Chapter, the authorized person or persons calling a shareholders'

meeting shall cause written notice of the time, place and purpose of the meeting to be given to all shareholders entitled to vote at such meeting, at least ten days and not more than sixty days prior to the day fixed for the meeting. * * * Notice of any shareholders' meeting may be waived in writing by any shareholder at any time * * *

The Court found that, at best, all that was demonstrated was that “the most that can be said of the monthly distributions to Julian E. is that they, in effect, provided him with a timing benefit vis-a-vis LPP's distributable earnings, which, in total, have not been shown to belong to LPP's shareholders on other than a pro rata basis (in accordance with their respective stock ownership percentages).” The Court specifically pointed out that this wasn't fatal, as specifically allowed in Reg. §1.13611(l)(2)(vi), Example 2, cited below:

EXAMPLE 2. DISTRIBUTIONS THAT DIFFER IN TIMING. (i) S, a corporation, has two equal shareholders, A and B. Under S's bylaws, A and B are entitled to equal distributions. S distributes \$50,000 to A in the current year, but does not distribute \$50,000 to B until one year later. The circumstances indicate that the difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds.

(ii) Under paragraph (l)(2)(i) of this section, the difference in timing of the distributions to A and B does not cause S to be treated as having more than one class of stock. However, section 7872 or other recharacterization principles may apply to determine the appropriate tax consequences.

Inconsistent Positions in Litigation

The Court also notes that the only evidence supplied that the shareholders agreed to make distributions to her father and mother to cover their living expenses is her own testimony. But the Court notes that in the Louisiana court case, she made different claims as to the nature of those payments. In that case, Linda testified that her stock was paid for via distributions to her father made from the corporation to discharge her debt to purchase stock—the very payments Linda contended in Tax Court represented were distributions made on his stock, rather than in exchange for shares he held.

Combined with the previous analysis, the Court held Linda had fallen short of showing that, in fact, the corporation was no longer an S corporation and she didn't have to include its income on her return.

Having decided that it was still an S corporation in 1996, the Court did not have to deal with the question of whether duty of consistency would have required that Linda continue to respect the S status, given these facts.

Conclusions

Note that had the results might have been different if the IRS had been the party arguing

this matter—but this was again a taxpayer trying to take an inconsistent position for tax purposes once she found it was favorable to her in some manner. Having been aware of payments to her father for all of those years and only having the “revelation” that the S status had gone away in 1986 a decade later when she was in litigation, she was not in a strong position to persuade the court that it should recognize a second class of stock.

But had the IRS been raising the issue, it’s very possible a court would have been more sympathetic to the idea that this was a disguised agreement among the parties.

As well, it’s important to note that Linda was able to finally “kill” the S election by the transfer of shares to a corporation. While the Court doesn’t discuss why she wanted the S election to “go away” there are many reasons why she might want that, even when the other shareholders don’t. It’s important to note that, in some family disputes, the issue might simply be to “get even” for a perceived wrong by doing damage to the other party and not necessarily really improving the taxpayers’ position. Or it may simply have been that the “out” family member is now stuck with a passthrough entity interest which throws off income, but which is making no distributions with which to pay tax.

What is clear, however, is that a lack of proper agreements can allow situations like this to develop, with the underlying business and family left in ruins by actions of each side. The case should give us pause both to insure we have items like proper buy/sell agreements, restrictions on transfers and management agreements in place for an S corporation and to consider the potential complications when parents decide to leave or transfer a business evenly to their children—children who may not get along as time goes on.