S Corporation Trap- The Second Class of Stock

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Take-Away: An S election by a corporation can be inadvertently terminated if there is a deemed second class of stock

Background: An S corporation is something of a hybrid between the asset protection afforded to a C corporation and the passthrough tax attribute benefits of a partnership. However, the benefits of an S corporation have to be balanced against the numerous eligibility requirements that have to be observed at all times. These technical requirements apply to both state-law corporations that have made an S election as well as to state-law LLCs that have elected to be characterized as an S corporation. However, the inadvertent termination of the entity's S corporate status can leave the business owner exposed to disastrous tax consequences. For example, if the S corporation was previously a C corporation before its S-election, the termination of the S corporation status would lead to the imposition of entity-level tax that dates back to the initial date of the S election termination, which could amount to years of unremitted income taxes. The problem is that many
S shareholders fail to understand the events that can cause an inadvertent termination of the S-election. A couple of the pitfalls that can lead to the inadvertent loss of an entity's S-election include the following.

1. Deemed Second Class of Stock: An S corporation may only maintain one class of stock, with some possible exceptions identified in the Regulations.[Regulation 1.1361-1.] The S corporations can, however, have both voting and non-voting stock interests, but nothing more. If the S corporation issues stock with varying liquidation preferences or dividend preferences, the entity will probably be deemed to possess multiple classes of stock, thus endangering its S corporate status. Consequently, in these instances, the S corporation can be deemed to have issued a second class of stock even when no issuance of separate shares occurs. There are two

common instances when a *second-class of phantom stock is deemed to have been issued:*

Debt: Under Treasury Regulations the issuance of debt in the form of a shareholder or related-party loan that lacks the typical indicia and characteristics of a *bona fide debt* instrument, like low or no stated interest rate, no maturity date, a thinly capitalized borrower, etc., that *debt* may be classified instead for U.S. federal income tax purposes as an issuance of stock. Accordingly, the debt may be treated as a second class of stock.

Unreasonable Compensation: A comparable analysis applies with respect to unreasonably high or *excessive* compensation of the entity executives, or with respect to preferential or improper distributions of property or cash to the business owner. Under these circumstances, the IRS might view these *excessive* distributions to the business owner as based on an informal underlying equity interest in the S corporation.

2. Too-Creative Governing Documents: Perhaps the most frequent cause to new business owners is the unintentional creation of a second class of stock that is caused by poorly drafted governing documents of the S corporation. Treasury Regulations authorize the IRS to look to the Corporation's governing instruments, e.g., Article of Incorporation or Organization and Bylaws, to determine if a second class of stock exists stemming from differing shareholder distribution or liquidation rights. Regulation 1.1361-1(l)(2).] An S corporation's bylaws/operating agreement must allocate income, deductions, or losses among shareholders in a manner that is consistent with the rules set forth in the Tax Code. [IRC 1366] That section requires that allocations be strictly proportional to each shareholder's ownership interest. The mistake sometimes made in the entity's governing documents and buy-sell agreements, while aiming to facilitate governance and profit-sharing arrangements, may inadvertently introduce partnership tax concepts like: (i) capital accounts; (ii) special allocations; or (iii) curative allocations. These types of provisions can inadvertently undermine the

S corporate status by inferring that distributions or liquidations may be made in a fashion that is inconsistent with the S corporate rules set-forth in the Tax Code and Regulations.

Practical Implications: The possibility of an inadvertent S-election termination can also cause headaches when the S shareholder tries to sell the entity. A potential buyer of the S corporation will always be concerned about the risk of a lurking second-class of stock, if the S shareholder seeks to sell the corporate entity, rather than the entity's assets; if the buyer acquires the S corporation, the potential income tax liabilities that stem from an historical S-election termination will inure to, and be the responsibility of, the buyer. Accordingly, the buyer will often insist that rigorous tax due diligence be performed to uncover any inadvertent S termination prior to acquiring the corporation. If the buyer identifies a potential second class of stock in the corporation it will either bargain for a lower purchase price or it will seek even greater indemnification from the selling shareholders. Consequently, the price received on the sale of the S corporation could be lower and/or the time required for the prospective buyer to conduct its due diligence could delay the ultimate sale.

Conclusion: The shareholders of an S corporation should proactively manage their corporation by always: (i) Continuously assess shareholder agreements to ensure that they comply with the S corporation rules (statute and Regulations;) (ii) Monitor the number, eligibility and compensation of S shareholders; (iii) Intentionally structure any shareholder or related-party loans to be consistent with the IRS's criteria for *bona fide* debt instruments; and (iv) periodically consult with tax professionals to ensure their ongoing compliance with the S corporation rules and with an eye toward identifying the risk of a second class of stock.