S Corporations, Limited Liability Companies, and Limited Partnerships—How to Avoid Costly Estate Planning Pitfalls When Making Stock Transfers and Recapitalizations Involving Nonvoting Stock

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S corporation shareholder agreements should be carefully crafted by legal counsel in order to avoid certain events that can imperil the company's S election. One important consideration is the language in the shareholder agreement related to nonvoting stock transfer restrictions. This issue is important because S corporations are not permitted to have a second class of stock. Such language, if properly drafted, can enable the private company owner to transfer more shares to the next generation at the appraised value of the gifted ownership interest. This discussion addresses how issues can arise in the course of estate planning or in the course of a private company sale, how to address such issues, and how a capital structure—including nonvoting shares—can reduce the private company's future tax liability. This discussion provides an example of an S corporation recapitalization involving both voting stock and nonvoting stock.[1]

Important Protections in S Corporation Shareholder Agreements

Legal counsel ("counsel") and valuation analysts ("analysts") often advise business owners that the terms set forth in an S corporation shareholder agreement should include a provision that the private company stock cannot be transferred to any person if such a transfer would make the corporation fail to be a "small business corporation" under Internal Revenue Code Section 1361(b)(1).[2] Because the federal income tax laws change over time, the stock transfer restriction should be as simple—and as broad—as the preceding sentence.

The S corporation shareholder agreement may define the term "transfer" as any event that causes the prevailing federal income tax law to treat ownership as having changed. Such a transfer may include

transfers to a trust that is no longer a wholly owned grantor trust[3] even though the S corporation shares have not changed hands.

Notwithstanding these protections in the shareholder agreement, problems may occur for the S corporation or for its shareholders. For example, problems may occur if the S corporation does not have a qualified tax adviser approve every stock transfer other than to an individual who is a U.S. citizen.

These issues are important because the income tax consequences of losing an S election are harsh[4] and include the following:

1. The loss of the AAA[5] account
2. The possible imposition of a built-in gains tax[6]

The legislative history to Section 1362(f) explains the following:[7]

> If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.
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> The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped that taxpayers and the government will work out agreements that protect the revenues without undue hardship to taxpayers. For example, if a corporation, in good faith, determined that it had no earnings and profits, but it is later determined on audit that its election terminated by reason of violating the passive income test for three consecutive years because the corporation in fact did have accumulated earnings, if the shareholders were to agree to treat the earnings as distributed and include the dividends in income, it may be appropriate to waive the terminating events, so that the election is treated as never terminated. Likewise, it may be appropriate to waive the terminating event when the one class of stock requirement was inadvertently breached, but no tax avoidance had resulted. It is expected that the waiver may be made retroactive for all years, or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.

Accordingly, the Internal Revenue Service (the "Service") provides retroactive relief, so long as the taxpayer cannot get some benefit that it would not have received had it not followed the rules. Therefore, the Service may require adjustments to avoid unfair benefits.[8]

By allowing retroactive reinstatement, the Service allows an S corporation to avoid corporate level income tax. It would not be difficult to imagine an S corporation shareholder disagreeing with the relief and refusing to pay tax on his or her Form K-1 income, whipsawing the Service for having allowed the S corporation to avoid income tax. To avoid such a whipsaw, everyone who may be affected by the relief must consent.

If caught and corrected soon enough (generally 3 years and 75 days after the stock transfer), the taxpayer can obtain automatic relief.[9]

Otherwise, the correction may require an expensive and potentially time-consuming private letter ruling.[10]

As described above, either relief has the stated requirement that all of the S corporation shareholders consent to the relief for an inadvertent termination. Obtaining such consent may be difficult, for example, if the owner is no longer a shareholder or is incapacitated, deceased, or simply uncooperative.

An S corporation shareholder agreement should grant the company an irrevocable[11] durable power of attorney to sign such consents.

The S corporation shareholder agreement should also prohibit any shareholder from intentionally revoking the S election unless a particular threshold vote is attained. Counsel may consider having the shareholder agreement not only address express revocations. That is, counsel may also consider having the shareholder agreement allow the corporation's S election to be terminated by excess passive income.

An S corporation shareholder agreement may also address allocations of income upon a change in ownership or a termination of the S election. Generally, S corporation allocations of income are pro rata, per-share, per-day. Such allocations can cause unexpected results if income (including from

a sale of the business) is not earned evenly throughout the year.

The Single Class of Stock Rule

S corporations cannot have more than one class of stock.[12]

Counsel should exercise extreme caution not to strip any partnership tax and accounting provisions from any operating agreement or partnership agreement forms if an unincorporated entity makes the election.[13]

Any preferred stock that was issued when an S election was made renders the election ineffective. However, the Service may grant relief retroactively if all defects are cured.[14] Similarly, preferred stock being issued after an S election is made can be cured.[15]

Issuing a "profits interest"[16] would violate the single class of stock rule, but it can qualify for inadvertent termination relief.[17] If a profits interest is desirable, then the S corporation should form a limited liability company ("LLC") subsidiary[18] and have the LLC issue profits interests.

Voting Stock and Nonvoting Stock

The issues considered in this discussion apply to C corporations as well as to S corporations, unless the discussion specifies otherwise.

Nonvoting Stock Permitted for S Corporations

Differences in stock voting rights do not by themselves create a second class of stock.[19] Generally, if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, a corporation is treated as having only one class of stock.[20]

Therefore, the corporation may issue voting and nonvoting stock, each of which confers identical rights to distribution and liquidation proceeds. Such a capital structure also avoids gift and estate tax problems under the Chapter 14 anti-freeze valuation rules.[21]

A shareholder being wrongfully shut out from participating in management did not cause the shareholder to lose status as a shareholder when the shareholder continued to enjoy the financial benefits of being a shareholder.[22]

Why Nonvoting Shares Are Needed for Estate Planning

The retention of the right to vote (directly or indirectly) the shares of stock of a "controlled corporation" causes the inclusion of the transferred stock into a decedent's estate.[23]

A corporation is a "controlled corporation" if, at any time after the transfer of the property and during the three-year period ending on the date of the decedent's death, the decedent owned (or was deemed to own under certain income tax family attribution rules)—or had the right (either alone or in conjunction with any person) to vote—stock possessing at least 20 percent of the total combined voting power of all classes of stock.

If the trustee consults with the grantor regarding how to vote the stock that the trust owns, the Service may take the position:

1. that the grantor has indirectly retained the right to vote in conjunction with the trustee and
2. that, therefore, the stock is includible in the grantor's estate for estate tax purposes.[24]

If the grantor is the trustee over transferred nonvoting stock, the fact that nonvoting stock can vote in extraordinary matters, such as mergers or liquidations, will not cause Section 2036 inclusion.[25]

However, if the grantor transfers nonvoting stock and retains the voting stock, then the transferred nonvoting stock will not be includible in the grantor's estate for estate tax purposes.[26]

Typically, the S corporation starts with one type of voting stock, and then it issues a stock dividend of nonvoting stock. The stock dividend does not constitute a taxable distribution.[27]

The tendency of this author is to distribute 19 shares of nonvoting stock for each share of voting stock. This procedure allows the voting stock to retain a significant portion, yet it allows the original owner to shift 95 percent of the distribution and liquidation rights when transferring the nonvoting stock to the next generation.

Cautions When Issuing Nonvoting Stock

The taxpayer should consider filing Form 8937 to report the issuance of nonvoting shares.[28] Form 8937 is due 45 days after issuing the shares or, if earlier, on January 15 following the calendar year of the issuance.[29]

> "If the stock issuance would increase the franchise tax, the S corporation should consider effecting a reverse stock split."

However, as it is stated in the instructions for Form 8937, "an S corporation can satisfy the reporting requirement for any organizational action that affects the basis if it reports the effect of the organizational action on a timely filed Schedule K-1 (Form 1120S) for each shareholder and timely gives a copy to all proper parties."[30]

These deadlines and exceptions are from the December 2011 instructions to Form 8937. The taxpayer should be careful to check the instructions, as well as the Service's website, for future developments regarding Form 8937.[31]

Issuing more shares may increase the S corporation's franchise tax. The S corporation should check both the state in which it was formed and each state in which the corporation registers to do business.

If the stock issuance would increase the franchise tax, the S corporation should consider effecting a reverse stock split. The purpose of such a reverse stock split is to decrease the number of shares before issuing the nonvoting stock.

The issuance of nonvoting shares will not annul grandfathering from Section 2703.[32]

If the corporation is a C corporation, then the stock issuance will not violate Section 1202 exclusion of gain on the sale of qualified small business stock.[33]

Reallocations between Voting Stock and Nonvoting Stock

Future reallocations between voting stock and nonvoting stock would not create income tax consequences.[34] However, to avoid a taxable gift, a swap of voting for nonvoting stock (or vice versa) should consider the disparity in their respective values.[35]

It is not unusual for even noncontrolling *voting* shares to be valued 3 to 5 percent higher than *nonvoting* shares, Therefore, the taxpayer may consider consulting a qualified appraiser when making a swap of voting for nonvoting stock (or vice versa).

A redemption plan will not cause second-class-of-stock issues when its purposes were:

1. to ensure that voting power and economic ownership between person A and person A's family and person B and person B's family remain approximately equal and
2. to prevent an individual shareholder from owning a disproportionate amount of voting versus nonvoting common stock.[36]

Example of Recapitalizing With Voting Stock and Nonvoting Stock

For example, let's assume that there are 100 shares outstanding (all voting shares), and the grantor gives 20 shares to a trust.

The procedures are summarized as follows:

1. Amend articles of incorporation to allow nonvoting stock
2. Give 19 shares of nonvoting stock for every share of voting stock, such that:
   a. the grantor has 80 voting shares and 1,520 nonvoting shares and
   b. the trust has 20 voting shares and 380 voting shares
3. The grantor transfers to the trust nonvoting shares pursuant to a formula[37] (which will likely be 21 shares) in exchange for all of the trust's 20 voting shares

Section 1036[38] allows the third procedure to be income-tax-free, even if the trust is not a grantor trust.

Adjustments to the Value of Shares for Transactions

Valuation Discounts when Redeeming Noncontrolling Shareholders

Citing Treasury Regulation 1.1361-1(l)(2)(iii)(A),[39] Letter Ruling 9433024 concluded that a certain stock redemption agreement, described below, would be "disregarded in determining whether X's shares of stock confer identical rights":

> X is a corporation organized under the laws of A. X filed a subchapter S election effective January 31, 1983. X's capital structure consists of a single class of common stock, 65% owned by the Majority Shareholder, Y, and 35% owned by 10 other shareholders (collectively, Minority Shareholders).
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> Presently, X is negotiating a sale of substantially all of its assets to an unrelated third party. In the event a sale takes place, it is represented that each minority shareholder, pursuant to a Redemption Agreement,

has agreed to allow X to purchase their stock at a price equal to the proportionate share of the net fair market value of X's assets attributable to their block of X stock, subject to a minority discount. However, the Redemption Agreement establishes a minimum purchase price equal to the book value of the minority shareholders' stock as of the date the agreement is entered into.

Adjustments to Post-Redemption or Post-Sale Share Price

Relying on Treasury Regulation 1.1361-1(l)(2)(iii)(A), Letter Ruling 201218004 allowed the stock redemption proceeds to be adjusted such that the redeemed shareholders would receive additional payments if the corporation engages in certain sales transactions specified in the redemption agreement.

Similarly, Letter Ruling 201309003 approved a clause that allows:

1. the value of a certain claim against a third party to benefit members who sold their interest if any recovery is made and allows a person to purchase the S corporation's stock without requiring the selling original shareholder and
2. the purchaser to reach an agreement on the value of the claim.

Adjustments for Section 338(h)(10) Sales

Treasury Regulation 1.1361-1(l)(2)(v), "Special rule for section 338(h)(10) elections," provides the following guidance:

> If the shareholders of an S corporation sell their stock in a transaction for which an election is made under section 338(h)(10) and § 1.338(h)(10)-1, the receipt of varying amounts per share by the shareholders will not cause the S corporation to have more than one class of stock, provided that the varying amounts are determined in arm's length negotiations with the purchaser.

See part II.Q.8.e.iii.(f) Internal Revenue Code Sections 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.

Straight Debt

Definition of Straight Debt

"Straight debt" does not constitute a second class of stock[40] (and it does not qualify as stock for purposes of subchapter S).[41] This rule applies notwithstanding the existence of debt classified under Treasury Regulation 1.1361-1(l)(5)(i).[42]

"Straight debt" means a written unconditional obligation, regardless of whether it is embodied in a formal note, to pay a sum certain on demand, or on a specified due date, if it:[43]

1. 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;
2. is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation; and
3. is held by an individual (other than a nonresident alien), an estate, or a trust described in Section 1361(c)(2).

Clause (3) above, omits another type of creditor who qualifies under Section 1361(c)(5)(B)(iii): "a person which is actively and regularly engaged in the business of lending money."

The regulation cited above was promulgated before the statute referred to commercial lenders. The legislative history suggests that commercial lender qualification not include individuals who are commercial lenders.[44]

Being subordinated to other debt does not prevent the obligation from qualifying as "straight debt."[45]

How Debt Can Lose Its Qualification as Straight Debt

An obligation can lose its "straight debt" qualification by being materially modified or transferred to a third party who is not an eligible S corporation shareholder.[46]

Being "considered equity under general principles of federal tax law"[47] does not disqualify the obligation from being straight debt under this rule.[48] Therefore, the interest on a straight debt obligation is generally treated as interest by the corporation and the recipient. It does not constitute a distribution.[49]

“The income tax consequences of losing an S election are costly, including the possible imposition of a built-in gain tax.”

However, if the interest rate is unreasonably high, then an appropriate portion of the interest may be recharacterized and treated as a payment that is not interest (without resulting in a second class of stock).[50]

A conversion from C corporation status to S corporation status is not treated as an exchange of debt for stock with respect to “straight debt” that is considered equity under general principles of federal income tax law.[51]

Debt Other than Straight Debt

Treasury Regulation 1.1361-1(l)(2)(i) provides a safe harbor for a:

> commercial contractual agreement, such as a . . . loan agreement, . . . unless a principal purpose of the agreement is to circumvent the one class of stock requirement.

However, debt is treated as a second class of stock of the corporation:

1. if it constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of federal income tax law and
2. if a principal purpose of creating the debt 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.[52]

This rule does not apply to unwritten advances from a shareholder that do not exceed $10,000 in the aggregate at any time during the taxable year of the corporation, are treated as debt by the parties, and are expected to be repaid within a reasonable time.[53]

This rule also does not apply to obligations of the same class that are owned solely by the owners of, and in the same proportion as, the outstanding stock of the corporation, and it is not treated as a second class of stock.[54]

Obligations that are considered equity that do not meet this safe harbor will not result in a second class of stock unless a principal purpose of the obligations is to circumvent:

1. the rights of the outstanding shares of stock or
2. the limitation on eligible shareholders.[55]

A provision for the conversion of debt to equity, using the stock’s value at the time the debt instrument is issued, does not render it a second class of stock.[56]

However, a convertible debt instrument is indeed considered a second class of stock if:

1. it would be treated as a second class of stock under provisions relating to instruments, obligations, or arrangements treated as equity under general principles or
2. it embodies rights equivalent to those of a call option that would be treated as a second class of stock under provisions relating to certain call options, warrants, and similar instruments.[57]

Summary and Conclusion

The bylaws for S corporations, operating agreements for LLCs, and partnership agreements for limited partnerships should include transfer restrictions that are simple and broad, like casting a wide net, to avoid jeopardizing their status as tax pass-through entities.

The income tax consequences of losing an S election are costly, including the possible imposition of a built-in gain tax.

S corporations may only have one class of stock and, to classify as such, may not have shares with a profits interest. They may have voting and nonvoting shares, but each class must have the same rights to distributions and liquidation proceeds.

A capital structure consisting of nonvoting stock can be beneficial for estate planning. Pursuant to Section 2036(b)(1), the retention of the right to vote (directly or indirectly) shares of stock of a “controlled corporation” causes the estate inclusion of the transferred stock.

Nonvoting shares may be created through the issuance of a stock dividend, which does not constitute a taxable distribution. The taxpayer should consider filing Form 8937 to report the issuance of nonvoting shares.

Although nonvoting shares of a corporation are not subject to Section 2036(b)(1), note that *Pierre v. Commissioner*[58] held that estate planning laws look to state law rights, so beware that this

protection from Section 2036(b)(1) might not apply to nonvoting interests in LLCs or partnerships that are taxed as S corporations.

When gifting shares to the next family generation, the valuation of nonvoting shares usually includes a higher discount for lack of control, which enables the grantor to gift more shares at a given total value of the gift.

To avoid a gift being taxable, a swap of voting for nonvoting stock (or vice versa) should consider the disparity in the values of the stock. The taxpayer should consider consulting a qualified appraiser (or have tax counsel do so) when making a swap of voting for nonvoting stock (or vice versa). Often, attorneys will appoint qualified appraisers with whom they have worked before and found to be competent.

Issuing more shares may increase the S corporation's franchise tax. The S corporation should check both the state in which it was formed and each state in which the corporation registers to do business.

If the stock issuance would increase the franchise tax, the S corporation should consider effecting a reverse stock split in order to decrease the number of shares before issuing the nonvoting stock.

"If the stock issuance would increase the franchise tax, the S corporation should consider effecting a reverse stock split in order to decrease the number of shares before issuing the nonvoting stock."

Notes:

1. This document is adapted from an excerpt of, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," a 2,800+ page PDF that discusses how federal income, employment and transfer taxes, and estate planning and trust administration considerations affect how one might structure a business and then transition the business through ownership changes, focusing on structural issues so that readers can plan the choice of entity or engage in estate planning with an eye towards eventual transfer of ownership in the business. The author sends a link to the most recent version in his free electronic newsletter (roughly quarterly), called *Gorin's Business Succession Solutions*. If you would like to receive the PDF and quarterly newsletter, please complete https://www.thompsoncoburn.com/forms/gorin-newsletter. All references in this discussion to a "part" are to the March 15, 2021, version of this PDF.
2. See part II.A.2.f Shareholders Eligible to Hold S Corporation Stock.
3. See part III.A.3.a Wholly Owned Grantor Trusts – How to Qualify, Risks, and Protective Measures.
4. See parts II.E.2.b Converting from S Corporation to C Corporation and II.P.3.d Conversion from S Corporation to C Corporation.
5. See parts II.Q.7.b Redemptions or Distributions Involving S Corporations and II.P.3.b.v Conversion from S Corporation then to C Corporation then Back to S Corporation.
6. See part II.P.3.b.ii Built-in Gain Tax on Former C Corporations under Section 1374.
7. Senate Explanation of the Subchapter S Revision Act, P.L. 97-354 (10/19/82), "(e) Inadvertent terminations (secs. 1362(f))."
8. Regulation 1.1362-4(d), "Adjustments," provides the following:

   > The Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation or QSub during the period specified by the Commissioner. In the case of stock held by an ineligible shareholder that causes an inadvertent termination or invalid election for an S corporation under section 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of the S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent the loss of any revenue due to the holding of stock by an ineligible shareholder (for example, a nonresident alien).

9. Rev. Proc. 2013-30, which is described in other parts of this document. The relevant Internal Revenue Service web page is https://www.irs.gov/businesses/small-businesses-self-employed/late-election-relief.
10. See parts II.A.2.e.ii Procedure for Making the S Election; Verifying the S Election; Relief for Certain Defects in Making the Election (and its companion parts II.A.2.e.iii Relief for Late S corporation Elections Within 3+ Years, II.A.2.e.iv Relief for Late QSub Elections, and II.A.2.e.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity) and III.A.3.c.iii.(a) General Description of Deadlines for QSST and ESBT Elections (and its companion, part III.A.3.c.iii.(b) Flowchart Showing Relief for Late QSST & ESBT Elections).
11. Generally, a principal may revoke a durable power of attorney. However, a power coupled

with an interest, such as in a shareholder agreement, may be irrevocable.

12. Section 1361(b)(1)(D).

13. Letter Ruling 200548021 refers to the operating agreement as a governing provision for purposes of Regulation 1.1361-1(l)(2)(i). Letter Rulings 201136004 and 201351017 allowed relief for inadvertent ineligibility to make an S election where perhaps the capital account partnership provisions had not been stripped out and were later caught; same with Letter Ruling 201528025, which definitely involved capital account partnership provisions that had not been stripped out and were later caught. Letter Ruling 201949009 involved not only partnership provisions but also issued profits interests that needed to be cured to cure the S election being ineffective due to those provisions. The Internal Revenue Service will not rule on whether a state law limited partnership violates the single class of stock rules. Rev. Proc. 2009-3, Section 3.01(100), which rule originated in Rev. Proc. 99-51.

14. Letter Rulings 201716009 and 201751007.

15. Letter Ruling 201949003, with the following fixes having occurred in addition to the usual representations of inadvertence and promise to make any adjustments the Service requires:

    > X represents that on or about Date 5 it became aware that the issuance of the preferred stock may have inadvertently terminated its S corporation election. X represents that on Date 6 it took corrective action and (1) converted the preferred stock to common stock, (2) voted to cancel and retire all preferred stock, and (3) amended and restated its Articles of Incorporation to authorize only a single class of stock. X represents that as of Date 6 all issued and outstanding shares of preferred stock have been cancelled and retired. X also represents that its shareholders have taken into account their pro rata shares of X's separately and non-separately computed items pursuant to Section 1366 and have made any adjustments to stock basis as required under Section 1367. Furthermore, X represents that its shareholders have accounted for any distributions made under Section 1368.

16. For profits interests, see part II.M.4.f Issuing a Profits Interest to a Service Provider.

17. In Letter Ruling 201949009, an LLC made an S election. Later:

    > On Date 3, X's Operating Agreement included provisions regarding partnerships. Section 4(j) of the Operating Agreement provides, in part, that it is intended that X will be treated as a partnership for federal income tax purposes and that each Member will be treated as a partner of a partnership for tax purposes. Section 4(a) provides, in part, that X shall have two (2) classes of Units: Class A Units and Profits Units. Sections, 4, 8, and 19 of the Operating Agreement state that a Profits Interest only shares in liquidation proceeds due to profits earned after the issuance of the Profit Unit. On Date 4 and Date 5, X issued Profits Interests.
    >
    > When X's shareholders discovered the effect of the partnership provisions and the issuance of the Profits Interests, X canceled the Profits Interests between Date 6 and Date 7. X amended its operating agreement on Date 8 to remove the partnership provisions and the Profits Interest provisions and to provide identical distribution and liquidation rights to X's shareholders.

    The ruling held:

    > Based solely on the facts submitted and representations made, we conclude that X's S corporation election terminated on Date 3 because X had more than one class of stock due to the provisions in the Operating Agreement. We also conclude that the termination of X's S corporation was inadvertent within the meaning of § 1362(f). Accordingly, under the provisions of § 1362(f), X will be treated as an S corporation from Date 3 until Date 9, provided that X's S corporation election was otherwise valid and not otherwise terminated under § 1362(d).

18. See part II.E.7.c.i Corporation Forms New LLC.

19. Section 1361(c)(4).

20. Regulation 1.1361-1(l)(1), which provides:

    > *General rule*. A corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in paragraph (*l*)(4) of this section (relating to instruments, obligations, or arrangements treated as a second class of stock), 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. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

21. Section 2701(a)(2)(C) provides that Section 2701 does not apply to such a capital structure.

22. Enis v. Commissioner, T.C. Memo. 2017-222, reasoning:

    In determining stock ownership for Federal income tax purposes, the Court must look to the beneficial ownership of shares, not mere legal title. See *Ragghianti v. Commissioner*, 71 T.C. 346, 349 (1978), aff'd, 652 F.2d 65 (9th Cir. 1981). Cases concluding that a shareholder did not have beneficial ownership have considered both agreements between shareholders that removed ownership and provisions in the corporation's governing articles affecting ownership rights. See *Dunne v. Commissioner*, 2008 WL 656496, at *9. Mere interference with a "shareholder's participation in the corporation as a result of a poor relationship between the shareholders . . . does not amount to a deprivation of the economic benefit of the shares." *Id*. (citing *Hightower v. Commissioner*, T.C. Memo. 2005-274, aff'd without published opinion, 266 F.App'x 646 (9th Cir. 2008)); *Kumar v. Commissioner*, T.C. Memo. 2013-184.

    Petitioners contend that while Mrs. Enis was issued NLS shares, the removal of her power to exercise shareholder rights, as well as the actions of Dr. Ginsburg, removed the beneficial ownership of her shares. Petitioners, therefore, assert that they are not required to include pro rata shares of NLS' income. Petitioners identified no agreement or provisions in the corporation's governing articles removing beneficial ownership. Kumar does not support their position that a violation of the shareholders agreement could deprive them of the beneficial ownership of their shares. In *Kumar* we found that in the absence of an agreement passing the taxpayer's rights to his stock to another shareholder, a poor relationship between shareholders does not deprive one shareholder of the economic benefit of his shares. *Kumar v. Commissioner*, at *3. We, therefore, held that the taxpayer retained beneficial ownership. *Id*.

    Further, petitioners cited no authority, nor are we aware of any, that allows shareholders to exclude their shares of an S corporation's income because of poor relationships with other shareholders. While the relationships among the shareholders of NLS deteriorated, those poor relationships did not deprive Mrs. Enis of the economic benefit of her NLS shares. Indeed, ultimately, she sold her shares in 2014 for $436,165.

23. Section 2036(b)(1).

24. Rev. Rul. 80-346. TAM 9515003 argued that a taxpayer could not invoke Rev. Rul. 80-346 to argue for estate inclusion of voting stock:

    As the court noted in *In re Steen v. United States*, supra, allowing a taxpayer to disavow the form of the transaction (in this case, the explicit terms of the trust instrument) under these circumstances, would encourage inappropriate tax planning and unwarranted litigation and places the Service in an untenable administrative position. Accordingly, we doubt that a court would allow a taxpayer to disavow the trust instrument under the circumstances presented here.[2]

    [2] We note that the Tax Court has held that a taxpayer is precluded from even arguing against the form of the transaction in the absence of strong proof. Other courts have adopted an even more restrictive rule. Estate of *Robinson v. Commissioner*, 101 T.C. 499, 513-514 (1993).

    The TAM concluded:

    However, we doubt that the decedent detrimentally "relied" on the revenue ruling and structured the transaction to ensure that the transferred stock would be includible in the gross estate on his death. On the contrary, the decedent was advised by counsel and, no doubt, created the trust in order to EXCLUDE the stock from his gross estate. If the intent was to ensure the stock was included in the gross estate, the trust instrument would have expressly provided for the decedent's retention of voting rights. Further, if the decedent had in some way relied on Rev. Rul. 80-346 in creating the trust, then consistency would require that the transfer be reported on the gift tax return as a transfer with a retained interest. This was not done.

    Finally, even though A, as executrix, followed the revenue ruling in including the stock in the gross estate, nonetheless, we do not believe that, as discussed above, the estate can gain a tax advantage by now disavowing the form of the transaction.

    For more about the TAM and arguing estate tax inclusion, see fn 5397 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Section 754 Election or Required Adjustment for Built-in Loss).

25. Proposed Regulation 20.2036-2(a) (concluding two sentences).

26. See Section2036(b) (transfers of voting stock in a controlled corporation can be included in the transferor's estate for estate tax purposes if the transferor retains strings such as voting rights), Rev. Rul. 80-346 (even informal strings on voting stock held in trust can bring it into the settlor's estate), and both Rev. Rul. 81-15 and Proposed Regulation 20.2036-2 (the settlor's retention of voting stock outside of a trust will not cause the

Section 2036(b) inclusion of nonvoting stock transferred in trust); *Boykin v. Commissioner*, T.C. Memo. 1987-134 (same conclusion as Rev. Rul. 81-15 but without citing it). Rev. Rul. 81-15 does not appear to recognize that even nonvoting stock has some limited voting rights; fortunately, Proposed Regulation 20.2036-2(a) seems to recognize and approve of such a retention, as mentioned in fn. 233. Given that estate tax definitions regarding business entities tend to be sparse, one might also look to income tax rules regarding when the right to vote is significant. For purposes of determining whether a corporation was eligible to file a consolidated return, which turned on the presence of voting stock, voting for directors constituted a critical part of the right to vote. *Alumax Inc. v. Commissioner*, 109 T.C. 133 (1197), aff'd 165 F.3d 822 (11th Cir. 1999).

27. Section 301(a) taxes only a distribution of property, and refers to the Section 317(a) definition of "property." Section 317(a) provides that "property" does not include stock in the corporation making the distribution.
28. Section 6045(g).
29. Instructions for Form 8937 (revised December 2011). See www.irs.gov/pub/irs-pdf/i8937.pdf.
30. Instructions for Form 8937 (revised December 2011). See www.irs.gov/pub/irs-pdf/i8937.pdf.
31. See www.irs.gov/form8937.
32. See part II.Q.4.h Establishing Estate Tax Values, especially fn. 4332.
33. See fn 4920 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
34. Section 1036. Voting trust certificates are also eligible for an income-tax-free swap. Letter Ruling 200618004.
35. Bosca v. Commissioner, T.C. Memo. 1998-251.
36. Letter Ruling 201506003.
37. Use the principles of part III.B.3.d Disclaimers, found in part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.
38. See fn 6365 in part III.B.2.h.iii Swap Power (Section 1036 generally) and fn 650 in part II.D.4.a.i Classifying an Investment Trust (voting trust certificates).
39. Regulation 1.1361-1(l)(2)(iii)(A) is reproduced in part II.A.2.i.iv Providing Equity-Type Incentives without Violating the Single Class of Stock Rules.
40. Regulation 1.1361-1(l)(5)(i).
41. Regulation 1.1361-1(b)(5) provides:

    > Treatment of straight debt. For purposes of subchapter S, an instrument or obligation that satisfies the definition of straight debt in paragraph (l)(5) of this section is not treated as outstanding stock.

    This is important for Reg. § 1.1361-1(l)(3), which is reproduced in fn 3541 in part II.M.4.e.i Issuing Stock to an Employee - Generally.
42. Regulation 1.1361-1(l)(5)(i).
43. Regulation 1.1361-1(l)(5)(i).
44. House Report 104-586 (5/20/1996) for P.L. 104-188 (the Small Business Job Protection Act of 1996) expressed an intent that this cover "creditors, other than individuals, that are actively and regularly engaged in the business of lending money."
45. Regulation 1.1361-1(l)(5)(ii).
46. Regulation 1.1361-1(l)(5)(iii).
47. See part II.G.21 Debt vs. Equity.
48. Regulation 1.1361-1(l)(5)(iv).
49. Regulation 1.1361-1(l)(5)(iv).
50. Regulation 1.1361-1(l)(5)(iv).
51. Regulation 1.1361-1(l)(5)(v).
52. Regulation 1.1361-1(l)(4)(ii)(A).
53. Regulation 1.1361-1(l)(4)(ii)(B)(1).
54. Regulation 1.1361-1(l)(4)(ii)(B)(2), which further provides:

    > Furthermore, an obligation or obligations owned by the sole shareholder of a corporation are always held proportionately to the corporation's outstanding stock.
55. Regulation 1.1361-1(l)(4)(ii)(B)(2).
56. Letter Ruling 201326012.
57. Regulation 1.1361-1(l)(4)(iv).
58. 133 T.C. 24 (reviewed opinion 2009).

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