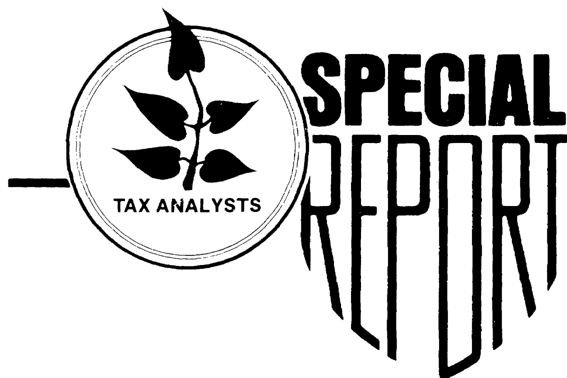

THE NEW SUBCHAPTER S ONE CLASS OF STOCK PROPOSED REGULATION: MUCH BETTER, BUT STILL NOT AWFULLY GOOD

by Martin D. Ginsburg
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In this article, the authors discuss the new, completely revised subchapter S one class of stock proposed regulation (July 1991). The earlier (October 1990) proposed regulation, now withdrawn, would likely have disqualified an extraordinary number of S corporations, retroactive to January 1, 1983, and not surprisingly was universally condemned. The authors conclude that while the July 1991 proposed regulation is greatly superior to its predecessor, in one major and a number of minor respects it remains flawed. Most importantly, after propounding a salutary series of exemptive and objective rules crafted to avoid a disqualifying second class of stock, the drafters of the proposed regulation felt impelled to restore uncertainty and the risk of S disqualification by withdrawing the exemption where "an [arrangement] is entered into to circumvent the one class of stock [or the eligible shareholder] requirement."

The authors address a number of discrete problems in the proposed regulation, many of them apparently inadvertent, and point out ways in which nearly all of these problems can be avoided through the careful structuring of instruments and agreements. More broadly, the authors suggest revisions that would eliminate many of the uncertainties and pitfalls for the inadequately advised that now inhere in the July 1991 proposed regulation.

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Table of Contents

I. October 1990 Proposed Regulation 82

II. 1991 Proposed Legislation and Proposed Regulation 83
- A. Identical Rights to Distribution and Liquidation Proceeds 83
- B. Nonidentical Dividend Payments 85
- C. Distributions Reflecting Changes in Shareholdings 85
- D. Below-Market Loans, Unreasonable Compensation, and Other Constructive Dividends 86
- E. Section 83 Restricted Stock 87
- F. Buy-Sell and Redemption Agreements and Transfer Restrictions 88
- G. Treatment of Deferred Compensation Plans 90
- H. Debt and Other Instruments 90
- I. Options, Warrants, Convertible Debt, or Similar Instruments 91
- J. Effective Date 95

III. Conclusion 95

In October 1990, Treasury brought forth its first proposed regulation designed to add flesh and meaning to subchapter S' terse one class of stock eligibility requirement. The October 1990 pronouncement may have been the least sensible regulatory proposal of our time, and deserved the near-universal condemnation that descended upon it.

Lesson absorbed if not thoroughly learned, at the end of July 1991 Treasury delivered up a new subchapter S one class of stock proposed regulation. This second version is much better than the first version. That is hardly a surprise. Sadly, the new July 1991 proposed regulation still is not awfully good. If we may misquote slightly a former first lady, the persistent difficulty resides in the Treasury's staggering inability to "Just Say Yes."

In this article, we begin with the statute as it was interpreted by judicial decisions and IRS rulings prior to the October 1990 proposed regulation. After a brief comment on that pronouncement's short tenure, we pass to the 1991 legislative proposals attracted by the October 1990 proposed regulation, and then proffer, with abundant illustrations, a detailed deconstruction of the July 1991 proposed regulation.

(Continued on next page.)

An S corporation—more exactly, a domestic corporation that is "a small business corporation for which an election under [Code Section] 1362(a) is in effect"—may not have outstanding more than one class of stock. Section 1361(a)(1) and (b)(1)(D). Differences in voting rights among the outstanding shares do not, however, create different classes of stock. Section 1361(c)(4). A principal purpose of the one class of stock limitation is to avoid in subchapter S the complexities of special allocations that are manifest in the partnership arena, especially in the regulations under 704(b). *See,* e.g., *Parker Oil Co. v. Commissioner,* 58 T.C. 985, 990 (1972).

Tax litigation initiated prior to enactment of the Subchapter S Revision Act of 1982 had made abundantly clear the reluctance of the courts to find a disqualifying second class of stock when all of the corporation's outstanding shares conferred, on their face, identical rights to distributions and liquidation proceeds.[1] The 1982 legislation, as it was generally understood at the time, with Treasury's full accord adopted and extended this judicial wisdom by initiating the "differences in voting rights are permissible" rule of section 1361(c)(4) and the "straight debt" safe harbor of section 1361(c)(5), discussed below at II(H).

Between 1982 and fall 1990, the IRS generally followed a sensible course. Buy-sell agreements among SCo's shareholders or redemption agreements between SCo and its shareholders (containing, e.g., options for SCo or its other shareholders to purchase outstanding stock, perhaps at termination of the holder's employment, at book value, or at a formula price) were held not to violate the one class of stock requirement, even where some shareholders were bound by the agreement and others were not. Rev. Rul. 85-161, 1985-2 C.B. 191.

The IRS had flatly ruled that the mere issuance by SCo of options, warrants, and convertible debentures . . . would not adversely affect SCo qualification.

At an early date, the IRS had flatly ruled that the mere issuance by SCo of options, warrants, and convertible debentures, (instruments having none of the attributes of immediate stock ownership because they did not carry the right to vote as a stockholder or the right to receive dividends), would not adversely affect SCo qualification. Rev. Rul. 67-269, 1967-2 C.B. 298. It was thus well understood that SCo could issue to a person not eligible to be an SCo shareholder (e.g., a corporation or a partnership) convertible debt or debt with warrants attached.[2] As an illustration, a pleasantly liberal 1988 private ruling demonstrates, in some circumstances at least, IRS recognition that an SCo may issue warrants to a lender without the debt and warrants being recharacterized as a second class of stock. LTR 8811061, 12/23/87.

The IRS, however, also espoused the view that if on the particular facts convertible debt or a debt-and-warrants package really is stock in disguise (perhaps because the conversion or exercise price is substantially in the money), recharacterization would follow.[3] While these IRS pronouncements involve C corporations, there was a concern that recharacterization could extend to SCos, certainly to find stock (without regard to class) in the hands of an ineligible shareholder and possibly to identify a second class of stock, in either case to disqualify the issuer as an SCo.

Without further parsing the details, it seems fair to say that from 1983 through September 1990, the one class of stock eligibility requirement in subchapter S occasioned little dispute. The rules were not in all respects precise, some of the margins were fuzzy, but practitioners and revenue agents were in general accord and exhibited rare harmony. There thus was no perceptible need for reexamination or extensive further guidance. Good sense urged that the qualification requirement be left alone.

I. October 1990 Proposed Regulation

Good sense did not carry the day. On October 5, 1990, Treasury and the IRS published a lengthy proposed regulation under section 1361 (PS-4-73) propounding what was, to say the least, an exciting new antitaxpayer interpretation of the one class of stock requirement, which, if it had been adopted, would generally have been retroactively applicable to taxable years beginning on or after January 1, 1983. The carefully implemented goals of the October 1990 proposed regulation seemed to be three: (1) make it as difficult as possible for ordinary taxpayers to use subchapter S, (2) disqualify as many SCos as possible, and (3) insure that the disqualifications are as retroactive as possible (preferably January 1, 1983 for calendar year S corporations, i.e., the effective date of the Subchapter S Revision Act of 1982).

As ever, the IRS solicited comments on the proposed one class of stock regulation. Initial comments were critical but restrained. Later comments, as taxpayers and their representatives more fully appreciated the mischievous nature of the regulatory proposal, were critical and intemperate. *See,* e.g., 50 *Tax Notes* 195 (January 14, 1991), reprinting the submission made to the IRS on January 3, 1991 by one of your authors. The first positive IRS response to the universal criticism was the announcement, on February 13, 1991 (IR-91-25), that any "regulations on this subject will be revised to provide for

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[1] *See,* e.g., *Portage Plastics Co. v. United States,* 486 F.2d 632 (7th Cir. 1973), rejecting IRS attempt to characterize purported debt as a disqualifying second class of stock. But *cf. Paige v. United States,* 580 F.2d 960 (9th Cir. 1978) (California Commissioner of Corporations, as a condition of allowing corporations to issue common stock, required that shareholders who contributed cash for their stock be afforded a liquidation preference in the amount of their cash contributions if, on liquidation, the corporation were unable to repay in full initial cash and property contributions; *held* to create a second class of stock); Rev. Rul. 71-522, 1971-2 C.B. 316 (similar).

[2] Later conversion or exercise would, however, terminate S corporation status at that time if the exercising holder were an ineligible shareholder. Additionally, as discussed below, convertibility may increase the risk that a debt obligation will, at the time of issuance, be treated for tax purposes as equity.

[3] *See,* e.g., Rev. Rul. 82-150, 1982-2 C.B. 110. The holder of a deep-in-the-money option was treated as owning stock and therefore was required to recognize as income a share of the corporation's undistributed foreign personal holding company income.

a prospective effective date." An even more positive IRS response later followed: after a condemnatory hearing and the introduction in Congress of many bills designed to restore what generally had been understood to be pre-1990 law,[4] the IRS and Treasury on July 25, 1991 withdrew the October 5, 1990 proposed regulation and issued the new, far better, but still imperfect proposed regulation discussed below.[5]

II. 1991 PROPOSED LEGISLATION AND PROPOSED REGULATION

The IRS and Treasury published under section 1361(c) (4) a new and more sensible proposed regulation on July 25, 1991 (PS-4-73). In general, the 1991, proposed regulation applies only to SCo taxable years beginning on or after January 1, 1992. Prop. Reg. section 1.1361-1(l)(7).

Important in fathoming the 1991 proposed regulation is a fair appreciation of the legislative activity that preceded its publication. Introduced on June 26, 1991, as H.R. 2777, S. 1394, the Tax Simplification Act of 1991 proposed, with retroactive effect to taxable years beginning after 1982, that section 1361(c)(4) be amended to read as follows:

> ***Determination of Whether Corporation Has One Class of Stock.***—For purposes of subsection (b)(1)(D), a corporation shall be treated as having one class of stock if all outstanding shares of stock of the corporation confer identical rights to distributions and liquidation proceeds. The preceding sentence shall apply whether or not there are differences in voting rights among such shares.

The technical explanation accompanying the legislative language expands (pages 71-72):

> The bill provides that 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. Applicable State law, determined by taking into account legally enforceable rights under the corporate charter, articles, or bylaws, administrative action, and any agreements, determines whether the outstanding shares confer different rights to distribution or liquidation proceeds.
>
> Where an S corporation in fact makes distributions which differ as to timing or amount, the bill in no way limits the Internal Revenue Service from properly characterizing the transaction for tax purposes. For example, if a distribution is properly characterized as compensation, the Service could require it to be so treated for tax purposes. Similarly, if a payment should be properly characterized as a distribution, the Service could require it to be so treated for tax purposes.

The July 25, 1991 proposed regulation in effect presumes enactment of the Tax Simplification Act of 1991: explicitly, enactment of revised section 1361(c)(4), quoted above, and adoption of the two paragraphs from the technical explanation quoted immediately above.

In the end, the proposed regulation casts a cloud of uncertainty over what could and should have been straightforward and reliable.

The legislative objective is to make it terribly difficult to disqualify an S corporation on grounds of a second class of stock, provided (i) the corporation has not purported to issue shares of different classes (ignoring differences in voting power) and (ii) state corporate law does not impose nonidentical rights to distributions or liquidation proceeds. The July 1991 proposed regulation at first seems to exemplify that spirit, but a careful reading discloses that the drafters could not bring themselves to embrace solely objective criteria vigorously. Thus, in the end, the proposed regulation casts a cloud of uncertainty over what could and should have been straightforward and reliable. After first announcing that particular kinds of routine commercial agreements, e.g., a lease or employment agreement, would not be treated as a second class of stock, the IRS/Treasury drafters felt impelled to restore uncertainty by adding "unless such an agreement is entered into to circumvent the one class of stock requirement."[6]

A. Identical Rights to Distribution and Liquidation Proceeds

As proposed to be amended by the Tax Simplification Act of 1991, section 1361(c)(4) confirms that SCo will be treated as having one class of stock if all outstanding shares "confer identical rights to distributions and liquidation proceeds." The July 1991 proposed regulation employs the same formula.[7] The proposed regulation embellishes the uncomplicated statutory formulation, announcing that the determination of identical rights is made based on (i) the corporate charter, (ii) articles of incorporation, (iii) bylaws, (iv) applicable state law, and (v) "binding agreements relating to distribution and liquidation proceeds." Prop. Reg. section 1.1361-1(l)(2)(i).

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[4]The last but most important being the Tax Simplification Act of 1991, 401(a) of which, discussed below, would, if enacted, amend and clarify section 1361(c)(4) retroactive to taxable years beginning after December 31, 1982.

[5]Because the new regulatory proposal to a large extent is an inversion of the October 1990 proposal and a response to the criticism that first proposal attracted, an understanding of the practical and conceptual problems engendered by the October 1990 proposal remains useful. A detailed analysis of the October 1990 proposed regulation is preserved and available in Levin & Stoffregen, "New 'S' Second-Class-of-Stock Proposed Regulation—A Gigantic Trap," 51 *Tax Notes* 641 (February 11, 1991).

[6]*See* Prop. Reg. section 1.1361-1(l)(2)(i), (iii)(A), (v) examples 3, 4, and 5.

[7]Prop. Reg. section 1.1361-1(l)(1) which, however, refers to "distribution" in the singular while amended section 1361(c)(4) uses "distributions" in the plural. There may be a distinction, or possibly a typographical error, but not a difference.

Collectively, the proposed regulation refers to the five as the "governing provisions."

> **Example (1):** A and B form SCo, with A contributing $100 cash for 100 shares and B contributing property worth $100 for 100 shares. Although the 200 shares are identical on their face, the state commissioner of corporations for the state in which SCo is incorporated requires the parties to agree that SCo will not make distributions to B (who contributed property) until A (who contributed cash) has received distributions totalling $100. In light of this provision of applicable state law, under the proposed regulation SCo will be deemed to have two classes of stock outstanding and is disqualified as an S corporation.[8]

A new and important concept in the 1991 proposed regulation is a "binding agreement relating to distribution and liquidation proceeds." It is clear that an arrangement may be a "binding agreement" without "relating to distribution and liquidation proceeds." Explicitly, the proposed regulation states that "[a] routine commercial contractual arrangement, 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 such agreement is entered into to circumvent the one class of stock requirement.*"[9] Prop. Reg. section 1.1361-1(l)(2)(i) [emphasis added].

> **Example (2):** SCo has two equal shareholders, A and B, who are each employed by SCo and have binding employment agreements with SCo. The compensation paid by SCo to A under A's employment agreement is reasonable. The compensation paid by SCo to B under B's employment agreement, however, is found to be excessive.

These are exactly the threshold facts in example 3 of Prop. Reg. section 1.1361-1(l)(2)(v), which then goes on to state as a fact that SCo and B "did not enter into [B's] employment agreement to circumvent the one class of stock requirement" of section 1361(b)(1)(D). Therefore, IRS announces, SCo is not treated as having more than one class of stock, although SCo "is not allowed a deduction for the excessive compensation paid to [B]."

Now suppose that after much dispute and extensive litigation, a court concludes that SCo and B did enter into B's employment agreement to circumvent the one class of stock requirement? If you think a dispute of this sort unlikely, think harder: If this regulation is adopted without change, you may well expect revenue agents asserting excessive compensation by an SCo rather routinely to assert "circumvention" as well. The revenue agent, after all, has nothing to lose and much to gain in the way of leverage in the negotiation, and it is after all the taxpayer's burden to prove that the employment agreement, or the lease or the loan agreement or other "routine commercial contractual arrangement," was not "entered into to circumvent the one class of stock requirement." Moreover, because the proposed regulation suggests *no* standards for applying this "circumvention" rule, the taxpayer's ability to carry the burden of proof by demonstrating lack of intent-to-circumvent seems uncertain at best.

Much else in the proposed regulation turns on a finding of bad intent. Prop. Reg. section 1.1361-1(l)(2)(iii) grants absolution to buy-sell, redemption, and similar agreements not "entered into to circumvent the one class of stock requirement." A below-market loan *from* SCo to a shareholder, triggering a deemed distribution under section 7872, is not disqualifying provided the "loan was not entered into to circumvent the one class of stock requirement." Prop. Reg. section 1.1361-1(l)(2)(v) example 5. A variety of debt and other instruments that would constitute equity or otherwise result "in the holder being treated as the owner of stock under general principles of federal tax law" are not disqualifying provided they are not "used to contravene the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to contravene the limitation on eligible shareholders" contained in section 1361(b)(1). Prop. Reg. section 1.1361-1(l)(4)(ii)(2). *See also* Prop. Reg. section 1.1361-1(l)(4)(iv)(A) (similar rule for convertible debt).

What is the source of this intense IRS/Treasury concentration on evil motive? Certainly it is not experience. Subchapter S entered the code in 1958. More than one-third of a century has produced not a single reported case in which the IRS asserted, let alone demonstrated, that miscreants had entered into routine commercial contractual arrangements or buy-sell agreements, or had acquired convertible debt or any other instrument, "to circumvent the one class of stock requirement" or "to contravene the limitation on eligible shareholders."

What is the source of this intense IRS/Treasury concentration on evil motive? Certainly it is not experience.

Is there any conceivable set of circumstances in which the sin of evil intent is inadequately punished by standard remedies, deduction disallowance and the like, and ought in addition to attract the extreme prejudice of subchapter S disqualification? We doubt it.

But if the IRS and Treasury, perceiving an imbalance of risk and remedy that escapes us, believe there must be an intent-specific disqualification rule, we urge that it be sharply narrowed and tailored to those circumstances in which there is a special reason to believe standard remedies may lack sufficient bite. Explicitly, focus upon the unusual case in which the other party to the bad intentioned arrangement with SCo is not taxable on the income distributed or deflected.

> **Example (3):** B, a tax-exempt institution, holds SCo convertible debt. The terms of the convertible debt and the surrounding circumstances are such that, under general principles of federal tax law, the instrument would be deemed stock of SCo. Whether distributions to B from SCo are treated as interest or as dividends, by virtue of its tax-exempt status B is not taxable on those distributions, nor is B taxable on any gain realized by it on disposition of the SCo convertible debt.

[8] *See* Prop. Reg. section 1.1361-1(l)(v) example 1. The result was the same under the pre-1982 version of subchapter S in *Paige v. United States,* 580 F.2d 960 (9th Cir. 1978). *See* n.1 *supra.*

[9] If an agreement is not a "governing provision," it is not taken into account under the proposed regulation in determining whether all outstanding shares confer identical rights to distribution and liquidation proceeds.

Motive to the side, SCo will be denied an interest deduction. If the entity's status as an SCo is preserved, the current tax liability of its shareholders (on the SCo's taxable income) will increase. If, because SCo and B were ill-intentioned, S status is lost and the entity becomes a C corporation, corporate tax liability will increase. We would have thought increased shareholder tax liability to be punishment both appropriate and sufficient, but the single advantage of adopting a two-prong test (evil motive plus tax-insulated contracting party) is clear enough: there would be very few arrangements to which this disqualification rule could apply.

Example (4): Same as example (3), except that B is a lending institution that is not tax-exempt. Assume that the arrangement was entered into both to circumvent the one class of stock requirement and to contravene the limitation on eligible shareholders.

Under a narrowed disqualification rule, because B will include current distributions in gross income while SCo will be denied a deduction for those distributions, SCo will not be disqualified as an S corporation notwithstanding the parties' awful intentions. Special considerations relating to S corporation "debt" instruments are reviewed at II(H) and in Ginsburg & Levin, *Mergers, Acquisitions & Leveraged Buyouts*, para. 1104.02 (CCH Tax Transactions Library).

B. Nonidentical Dividend Payments

The October 1990 proposed regulation had announced that even where SCo has only one homogenous class of stock outstanding, and no shareholder agreement varies the shareholders' rights to receive equal distributions, SCo nevertheless would be deemed to have more than one class of stock outstanding if in fact SCo made distributions to shareholders that varied in time or amount (i.e., nonconforming distributions). There was, however, an extremely narrow exception in the October 1990 proposed regulation, for nonconforming distributions equalized before the end of SCo's taxable year, provided the timing differences either were unintentional or were quickly reversed.

The July 1991 proposed regulation contains no similar disqualification rule. To the contrary, if the "governing provisions" provide for identical distribution and liquidation rights, SCo "is not treated as having more than one class of stock" and "any distribution (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." Prop. Reg. section 1.1361-1(l)(2)(i).

The 1991 proposed regulation recognizes that state laws may require that SCo pay or withhold state income taxes on behalf of some or all of its shareholders, and announces that such state tax laws do not impact adversely on one class of stock qualification "provided that, when the constructive distributions resulting from the payment or withholding of taxes by [SCo] are taken into account, the outstanding shares confer identical rights to distribution and liquidation proceeds." Prop. Reg. section 1.1361-1(l)(2)(ii). Differences in timing between constructive distributions to some shareholders and actual, equalizing distributions to the other shareholders explicitly do not create a second class of stock.

Example (5): SCo has two equal shareholders, A and B, who under SCo's governing provisions are entitled to equal distributions. In year-one SCo distributes $50,000 more to A than to B; B receives an equalizing $50,000 distribution in year-two. The difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds.[10] The difference in timing of distributions to A and B does not cause SCo 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."[11]

Example (6): SCo is organized and operates in State X which requires corporations to pay state income taxes on behalf of nonresident shareholders but not on behalf of resident shareholders. A and B each own 50 percent of SCo's outstanding shares. A is a resident of State X, but B is a resident of State Z. Under X state law or an SCo governing provision, A is entitled to distributions that take into account the payments to State X that SCo makes on behalf of B. Payments by SCo of State X income taxes on behalf of B are disregarded in determining whether SCo has more than one class of stock. Prop. Reg. section 1.1361-1(l)(2)(v) example 7.

Example (7): A and B each own 50 percent of SCo's outstanding shares. A is a resident of State X, and B is a resident of State Z. State X does not require SCo to pay State X income taxes on behalf of nonresident shareholder B. However, the aggregate X plus Z state tax burden on B, with respect to his share of SCo income, is higher than the aggregate X state tax burden borne by A. SCo executes a binding agreement with its shareholders under which SCo, rather than making equal distributions to A and B, will make grossed-up distributions to B in amounts that will give A and B equal after-state-tax distributions. Because the binding agreement "relates to distribution or liquidation proceeds," it is a governing provision and alters the equal distribution rights conferred by SCo's outstanding stock so that those rights are not in fact equal. Accordingly, SCo is treated as having more than one class of stock and is disqualified as an S corporation. Prop. Reg. section 1.1361-1(l)(2)(v) example 6.

C. Distributions Reflecting Changes in Shareholdings

Frequently, an SCo pays a cash dividend shortly after the end of its taxable year, allocating the distribution among the shareholders based on the amount of SCo's taxable income allocable to each shareholder for the taxable year (i.e., based on the K-1 amount allocated to

[10] *See* Prop. Reg. section 1.1361-1(l)(2)(v) example 2. That is, the "governing provisions" which include any such "binding agreement relating to distribution or liquidation proceeds" require equal distributions and do not contemplate that such distributions will be made to the shareholders at different times. The cited example in the proposed regulation certainly suggests, although it does not hold, that if there were a binding agreement requiring substantial differences in the timing of distributions (other than in response to state law requirements for payment and withholding of state income tax), the IRS might assert a disqualifying second class of stock.

[11] *Id.*

each shareholder). An SCo may distribute (1) 100 percent of SCo's taxable income for the recently ended year, (2) a uniform percentage (e.g., 33 percent) of SCo's taxable income designed to permit each shareholder to pay his federal and state income tax on the amount of SCo's taxable income for the recently ended year allocated to such shareholder, or (3) an amount somewhere between (1) and (2). This distribution is often paid shortly after SCo's accountants complete the K-1s for the recently ended year (frequently approximately March 15 of the next year).

Under code sections 1366 and 1377(a), the amount of an SCo's taxable income or loss allocable to each shareholder (on his K-1) is generally determined by assigning an equal portion of each tax item to each day of the taxable year and then dividing the portion so allocated to each day pro rata among the shares outstanding on that day (i.e., a daily prorate system).

Thus, where there is a change in the relative stockholdings of SCo's shareholders during the tax year (or after the end of the tax year but before SCo pays the year-end distribution), such a year-end cash distribution based on the amount of SCo's taxable income allocated to each shareholder will *not* be proportionate to SCo's stockholdings at the time of the dividend.

Example (8): SCo has $100,000 of taxable income for its 1991 calendar taxable year. On January 1, 1991, A owns all 100 shares of SCo's outstanding stock. On July 1, 1991 (halfway through 1991) A sells 50 of his SCo shares to B, so that for the last half of 1991, A and B each own 50 percent of SCo. The result would be the same if A keeps all 100 of his SCo shares but on July 1, 1991, B buys 100 newly issued shares from SCo.

Under the code, SCo's 1991 taxable income is allocated on a daily prorate basis—$75,000 to A (who owned 100 percent of SCo's stock for half the year and 50 percent for the other half) and $25,000 to B (who owned half of SCo's stock for half the year).

On March 15, 1992 (the day after SCo's accountants complete SCo's tax return), SCo declares and immediately pays a $50,000 dividend, i.e., 50 percent of its 1991 taxable income.[12] In accordance with a shareholders' agreement (*or* a long-standing oral policy *or* a provision in SCo's corporate charter), the cash dividend is paid 75 percent to A and 25 percent to B, i.e., proportionate to the 1991 K-1 allocation of taxable income. The cash dividend is *not* paid 50 percent each to A and B, although at the time of the dividend they each own 50 percent of SCo's stock.

Example (9): Same facts as example (8), except that B purchases her 50-percent interest in SCo on January 1, 1992 (i.e., after the end of SCo's 1991 taxable year, but before the March 15, 1992, distribution of 50 percent of SCo's 1991 taxable income). Hence, under the code, 100 percent of SCo's 1991 taxable income is allocable to A, and under the shareholders' agreement (or the long-standing oral policy or the corporate charter), 100 percent of the March 15, 1992 cash dividend is paid to A.

Under the unfortunate October 1990 proposed regulation, it was not clear whether, in the immediately preceding two examples, distributions consonant with federal tax responsibility would be found violative of the one class of stock requirement. The July 1991 proposed regulation attempts a sensible clarification, and nearly succeeds.

"An agreement does not . . . alter the rights to liquidation and distribution proceeds conferred by an S corporation's stock merely because the agreement provides that, as a result of a change in stock ownership, distributions in one taxable year are to be made on the basis of the shareholders' varying interests in the S corporation's income in the immediately preceding taxable year."[13] Hence, in examples (8) and (9), if the described distributions are made in accordance with a shareholders' agreement (or a long-standing oral policy), there is no risk of a disqualifying second class of stock.

But suppose, as examples (8) and (9) alternatively posit, the "agreement" to distribute on the basis of the shareholders' varying stock interests is embodied in the corporate charter (or the corporate by-laws), a location selected by SCo's careful corporate counsel "out of an abundance of caution, to be sure future shareholders are on binding constructive notice"? Of course, in a rational tax world it *should* be alright, since the corporate charter or the by-laws are merely another format for evidencing an agreement among SCo and all its shareholders. But whether, absent a further clarifying change in the proposed regulation, an IRS agent, on audit, may dispute this conclusion is another matter. Hence, an experienced tax practitioner, in her own "excess of caution," may for the present use agreements separate from the corporate charter, articles of incorporation, or bylaws

D. Below-Market Loans, Unreasonable Compensation, and Other Constructive Dividends

Under the October 1990 proposed regulation, any constructive distribution from an SCo to a shareholder, unless pro rata with respect to all shareholders, was labeled a nonconforming distribution and terminated the S election.[14] Of all the foolish pronouncements in the October 1990 proposed regulation, the one addressing nonconforming distribution rules was by a wide margin the most foolish and it was universally condemned.

Under the July 1991 proposed regulation, agreements and arrangements—generically, "routine commercial con-

[12]The result would be the same if SCo distributed $100,000 (i.e., 100 percent of its 1991 taxable income) or $33,000 (i.e., the estimated amount necessary to permit its shareholders to pay 31-percent federal income tax plus state income tax on their $100,000 K-1 taxable income).

[13]Prop. Reg. section 1.1361-1(l)(2)(iv). The proposed regulation goes on to state that if distributions pursuant to the agreement are not made within a reasonable time after the close of the taxable year in which the varying interests occur, "the distributions may be recharacterized depending on the facts and circumstances, but will not result in a second class of stock."

[14]*See* Treasury Department release accompanying October 1990 Prop. Reg. section 1.1361-1. Thus, a loan by SCo to a shareholder with a below-market (i.e., below AFR) interest rate, because under section 7872 it gives rise to a phantom interest payment from the shareholder to SCo and an equal phantom distribution by SCo to the shareholder, under the October 1990 pronouncement produced a nonconforming distribution and S disqualification.

tractual arrangements" as exemplified by a lease, employment agreement, or loan agreement—which, if mispriced, may give rise to a non-pro-rata constructive distribution, presumptively do not give rise to a disqualifying second class of stock. The litany of the 1991 proposed regulation, already exposed in II(A), runs like this (Prop. Reg. section 1.1361-1(l)(2)(i)):

- Only a "governing provision" can create a second class of stock;
- A "binding agreement relating to distribution and liquidation proceeds" is a governing provision, but other binding agreements are not governing provisions;
- A "routine commercial contractual arrangement, such as a lease, employment agreement, or loan agreement," although a binding agreement, is not a governing provision because it is not a "binding agreement relating to distribution and liquidation proceeds";
- Thus below-market loans, unreasonable compensation employment agreements, and other constructive dividend generators ordinarily do not create a risk of subchapter S disqualification.

But, as discussed in some detail in II(A), there is unfortunately in the July 1991 proposed regulation a vague and potentially important exception. Under Prop. Reg. section 1.1361-1(l)(2)(i) a routine commercial contractual arrangement is a "governing provision," and thus can disqualify SCo, if "such an agreement is entered into to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this [Prop. Reg. section 1.1361-1(l)]."

E. Section 83 Restricted Stock

Under the July 1991 proposed regulation, SCo stock that is subject to a substantial risk of forfeiture (an "SRF"), as defined in section 83, but as to which the holder has made a timely section 83(b) election, is treated as outstanding and constitutes a second class of stock if the stock does not confer rights to distribution and liquidation proceeds that are identical to the rights conferred by the other outstanding shares of SCo stock. Prop. Reg. section 1.1361-1(b)(3), -1(l)(3).

Example (10): SCo's stock is owned by A. SCo issues new stock to its president, B, for $1 a share, under an agreement pursuant to which SCo can buy the stock back for $1 a share if B ceases to be employed by SCo at any time during the next five years. Notwithstanding the SRF, B's SCo stock is, during the five-year SRF period, entitled to a full share of any dividends paid by SCo and of any liquidation proceeds paid out by SCo. B makes a section 83(b) election with respect to his SCo stock.

Because B made a section 83(b) election, the SCo stock held by B is treated as outstanding SCo stock, but because B's rights to dividend and liquidation proceeds are identical to the rights of all other holders of SCo stock, B's SCo stock is not treated as a second class of stock.

Example (11): Same facts as example (10), except that (a) if SCo liquidates during the five-year SRF period, B is entitled to receive only $1 as a liquidating distribution, or (b) if SCo pays any dividends during the five-year SRF period, B is not entitled to receive such dividends, or (c) B is subject to both of the restrictions in (a) and (b).

Because B made a section 83(b) election, B's SCo stock is treated as outstanding, but because B's rights to dividend and/or liquidation proceeds are not identical to the rights of all other holders of SCo stock, B's SCo stock constitutes a second class of stock. Hence SCo's S election is terminated.

If SCo has outstanding stock subject to an SRF as to which a section 83(b) election has been made—so that such stock is treated as outstanding for purposes of subchapter S—such stock is, by definition, subject to a redemption or cross purchase agreement (i.e., the SRF agreement). Whether the existence of such redemption or cross purchase agreement causes the stock to be treated as a second class depends on rules 1, 2, and 3 discussed in II(F) (as illustrated by examples (12) through (17)).

SCo stock that is subject to an SRF but with respect to which the holder has not made a timely section 83(b) election would not be treated as outstanding SCo stock under the July 1991 proposed regulation. Hence such nonsection 83(b) SRF stock could not be a second class of stock and could not terminate SCo's S status. Prop. Reg. section 1.1361-1(b)(3). Moreover, because such SRF stock is not treated as outstanding (until the SRF expires), it is not allocated any portion of SCo's taxable income or loss, and SCo's other shareholders (i.e., those owning stock not subject to an SRF or owning SRF stock as to which a timely section 83(b) election was made) are allocated all of SCo's taxable income or loss.

There is, however, a transitional exception in the July 1991 proposed regulation to the general rule that nonsection 83(b) SRF stock is not treated as outstanding SCo stock. Nonsection 83(b) SRF stock issued on or before August 8, 1991, "that has been treated [although wrongly] as outstanding" stock by SCo (even though substantially nonvested) is to be treated as outstanding for purposes of subchapter S, and the fact that it is substantially nonvested and that no section 83(b) election has been made with respect to the stock will not, under the proposed regulation, cause the stock to be treated as a second class of stock. Prop. Reg. section 1.1361-1(b)(6) (termed a "special effective date provision" in the proposed regulation).

Certainly 'treated as outstanding' does not mean stock so treated under relevant state corporate law.

How is the taxpayer to determine, in applying the special effective date provision, whether nonsection 83(b) SRF stock issued on or before August 8, 1991, "has been treated as outstanding by the corporation (even though it is substantially nonvested)"? Certainly "treated as outstanding" does not mean stock so treated under relevant state corporate law. Sensibly, the test must be whether SCo treated nonsection 83(b) SRF stock as outstanding for federal income tax purposes. Explicitly, when SCo calculated section 1366(a) income, loss, deductions, and credits passing through to its shareholders, did SCo count as shareholders the holders of its nonsection 83(b) SRF stock? To be practical about it, did SCo issue the SRF stockholder a K-1? Indeed the preamble to the pro-

posed regulation (PS-4-73) states, as the reason for adopting the special effective date provision, that "some S corporations have treated substantially nonvested stock for which no section 83(b) election has been made as outstanding stock *for purposes of the income allocation provisions*" (emphasis added).

If the correct test is whether the corporation has treated the stock as outstanding for SCo income allocation purposes, as we believe, then in its coverage of SRF stock "issued on or before August 8, 1991," the proposed regulation is puzzling. If SCo issued nonsection 83(b) SRF stock after December 30, 1990, SCo will generally not have treated that stock as either outstanding or not outstanding until SCo makes its 1991 tax computations and prepares its 1991 K-1s in or around March 1992.[15] Is SCo therefore obliged to treat nonsection 83(b) SRF stock issued in 1991 (but before August 9, 1991) as not outstanding, on the grounds that having never filed a K-1 with respect to that stock before August 9, 1991, the stock "has [not previously been affirmatively] treated as outstanding" by SCo prior to August 9, 1991? On the other hand, if SCo had (prior to 1991) issued some nonsection 83(b) SRF stock which it treated as outstanding (by issuing 1990 K-1s with respect to such stock), must SCo automatically treat as outstanding the nonsection 83(b) SRF stock issued in 1991 (but before August 9, 1991), on the ground that having previously treated some nonsection 83(b) SRF stock as outstanding, SCo must treat all such stock as outstanding? Clarification in the final regulation would be helpful.

Clarification in the final regulation would be helpful.

The proposed regulation does not deal with the situation where all of SCo's stock is subject to an SRF and no timely section 83(b) election has been made with respect to any of SCo's stock. Logically, there are two choices: either (i) SCo could be treated as having no stock outstanding, in which case it would presumably not qualify as an SCo, would be taxed as a C corporation, and would owe corporate-level tax on all of its earnings or (ii) all the SRF stock could be treated as outstanding, in which case SCo would qualify for SCo status if all shares of stock had identical rights to dividend and liquidation proceeds and were held by qualified stockholders. The second alternative is clearly the more reasonable.

F. Buy-Sell and Redemption Agreements and Transfer Restrictions

Rule 1: Under the July 1991 proposed regulation, "bona fide agreements to redeem or purchase [SCo] stock at the time of [the shareholder's] death, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights." Prop. Reg. section 1.1361-1(l)(2)(iii).

Rule 1 apparently applies regardless of the price, unlike rules 2 and 3 discussed below. However, we think rule 1 applies to a stock redemption or purchase agreement only if "death, disability, or termination of employment" are the exclusive events which, under the agreement, trigger redemption or purchase. If, for example, a buy-sell agreement provides that stock shall be redeemed at the time of shareholder B's death, disability, or termination of employment or the merger of SCo with and into any other corporation, we believe Rule 1 does not apply and the practitioner must consult rules 2 and 3 discussed below.

Rule 2: Less sweepingly, the July 1991 proposed regulation provides that "bona fide buy-sell agreements among shareholders, agreements restricting the transferability of [SCo] stock (but not providing for redemption by the corporation), and 'general' redemption agreements are also disregarded in determining whether [SCo's] outstanding shares confer identical . . . rights."[16] Rule 2, however, applies "*unless* (a) the agreement is entered into to circumvent the one class of stock requirement, *and* (b) the agreement establishes a purchase price that, *at the time the agreement is entered into,* is significantly in excess of or below the fair-market value (FMV) of the stock."[17]

Thus, rule 2 does not apply if both (a) and (b) above are present, although we can think of no reason why rule 2 should contain these qualifications while far more rational rule 1 does not.

Rule 3: Even less sweepingly, the July 1991 proposed regulation provides that "redemption agreements that are not 'general' redemption agreements [i.e., an agreement that does not cover substantially all SCo's outstanding shares] are disregarded [and thus do not jeopardize S corporation qualification] *unless* the agreement establishes a purchase price that, *at the time the agreement is entered into,* is significantly in excess of or below the fair-market value of the stock."[18]

Thus, rule 3 does not apply if this single circumstance is present, i.e., a mispriced redemption agreement that is not a "general" redemption agreement jeopardizes S qualification even if the agreement was not entered into to circumvent the one class of stock requirement. We can think of no reason why this distinction makes any sense at all, that is, why rule 3 should be more restrictive than rule 2.

For purposes of rule 2 and rule 3, a buy-sell or redemption agreement, whether "general" or otherwise, will not be considered to establish a purchase or redemption price too far above or below FMV—i.e., will not raise the specter of a second class of stock—if the purchase or redemption price is pegged "at book value or at a price between fair-market value and book value." Prop. Reg. section 1.1361-1(l)(2)(iii). Further, "a good faith determination of fair-market value will be respected unless it can be shown that the value was substantially in error or

[15] SCo might have earlier "treated [the SCo stock] as outstanding" for purposes of subchapter S income allocation, if there were an early termination of SCo's 1991 tax year for some reason, e.g., a March 1, 1991 merger of SCo into another corporation. However, this hardly seems a standard case on which the drafters of the proposed regulation might have focused.

[16] Prop. Reg. section 1.1361-1(l)(2)(iii) defines a "general" redemption agreement as one that "applies to substantially all the outstanding shares of the corporation and that provides that, upon the occurrence of an event that triggers redemption, substantially all the shares of a shareholder will be redeemed at a price that is uniform for all shares subject to the agreement."

[17] *Id.* (emphasis added).

[18] *Id.* (emphasis added).

the determination of the value was not performed with reasonable diligence."[19]

The protective rules set out in the preceding paragraph can be employed to advantage. If, for example, the agreement's pricing provision announces that in no event shall the purchase price be less than book value when, as almost inevitably is the case in a profitable corporation, FMV is above book value, the price cannot be "too far below" FMV. That is, even if the parties intend a purchase or redemption price substantially below FMV, as long as the price cannot fall below book value they do not risk a disqualifying second class of stock. Prop. Reg. section 1.1361-1(l)(2)(v) example 8.

If, on the other hand, the parties intend a high (but not an outlandish) price, certainly well above book value, the requisite showing of good faith, reasonable diligence, and error not too substantial can be made concentrating on the pricing procedure called for by the agreement. If SCo is youthful and expanding, for example, a valuation formula that awards predominant weight to discounted future earnings (or cash flow) is likely to yield a share price at the high end of the FMV range. Discounted future earnings (or cash flow) is a well-recognized, well-accepted technique for valuing a closely held business. It would seem beyond controversy that the valuation method can be adopted and applied in good faith and with reasonable diligence, and it would not seem easy to show that the value so determined is "substantially in error."[20]

It would seem beyond controversy that the valuation method can be adopted and applied in good faith and with reasonable diligence.

In sum, as a practical matter, for the well-advised SCo, a buy-sell or redemption agreement or an agreement restricting share transfers should not pose a risk of S disqualification under the July 1991 proposed regulation, with one possible exception discussed in example (15) below.

Example (12): All 500 of SCo's shares are owned by A. SCo hires a new executive, B, and SCo sells B 100 newly issued shares for $1 each (approximately FMV), pursuant to an agreement which restricts transfers by B and grants SCo an option to repurchase B's 100 shares at cost ($1 each) if B ceases to be employed by SCo within three years. B makes a section 83(b) election, so that his 100 shares are treated as outstanding (*see* II(E)). However, because B's shares are entitled to receive the same dividend and liquidating distributions as A's shares, they are not a second class of stock, unless the redemption agreement causes B's shares to be so treated.

B ceases to be employed by SCo 30 months later when each SCo share has an FMV of $10. SCo exercises the option to repurchase B's shares for $1 each (i.e., cost).

The redemption agreement between B and SCo falls within rule 1 because it is triggered only by B's death, disability, or termination of employment. Hence the purchase price is not relevant, and the redemption agreement does not create a second class of stock.

Moreover, even if the purchase price were relevant, the $1 price per share was not significantly different from FMV "at the time the agreement [was] entered into."

Example (13): Same as example (12), except that, at the time B purchased the 100 shares of SCo stock for $1 each, the book value and FMV were each $5 per share.

B recognizes ordinary income upon making the section 83(b) election, but there is no second class of stock, because rule 1 does not require a redemption price between book value and FMV at the time the agreement was entered into.

Example (14): Same as example (12) (i.e., B purchased the stock at $1, which was FMV, and the redemption price was $1), except that SCo's option to repurchase B's 100 shares is triggered not by B's termination of employment but rather by SCo's failure to reach certain performance goals by the third anniversary of B's employment. SCo fails to reach the goals, and SCo redeems B's stock for $1 per share.

Rule 1 does not apply because the option is not triggered solely by B's death, disability, or termination of employment. Rule 2 does not apply because the option is not a "general redemption agreement" (because it does not cover A's 500 shares). However, rule 3 applies because the nongeneral redemption agreement established a price that was not significantly different from FMV "at the time the agreement [was] entered into." Hence the redemption option does not create a second class of stock.

Example (15): Same as example (13) (i.e., B purchased the stock at $1 although book value and FMV were each $5, and the redemption price was $1), except that SCo's option to repurchase B's 100 shares is triggered not by B's termination of employment but rather by SCo's failure to reach certain performance goals by the third anniversary of B's employment. SCo fails to reach the goals, and SCo redeems B's stock for $1 per share.

Neither rule 1 nor 2 applies for the reasons stated in example (14). Nor does rule 3 apply, because the redemption price ($1 cost) was significantly below both book value and FMV "at the time the agreement [was] entered into." Hence B's shares appear to create a second class of stock, regardless of whether the agree-

[19] *Id.* In referring to "the fair-market value of the stock" that is subject to a buy-sell or redemption agreement, Prop. Reg. section 1.1361-1(l)(2)(iii) is ambiguous. Stock covered by a buy-sell or redemption agreement usually is restricted in various ways, i.e., (a) a forfeiture (SRF) restriction, (b) a restriction which by its terms will never lapse, or (c) both. *See* section 83 and Reg. section 1.83-3(b) and (h) (defining forfeiture and nonlapse restrictions). As used in Prop. Reg. section 1.1361-1(l)(2)(iii), does "fair-market value" mean (1) FMV ignoring all restrictions, (2) FMV ignoring forfeiture restrictions but taking into account nonlapse restrictions, or (3) FMV ignoring no restrictions, i.e., taking into account all restrictions? We think the drafters intended, or perhaps assumed, the first, FMV ignoring all restrictions. Clarification in the final regulation would be welcome.

[20] In general, *see* S. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies,* Dow Jones-Irwin (2d ed. 1989); W. Klein and J. Coffee, *Business Organization and Finance,* Foundation Press (4th ed. 1990).

ment was entered into with a "circumvent" motive, because the "circumvent" qualification appears to be relevant only to rule 2, not rule 3.

There are, we believe, at least two ways the reasonable commercial arrangement described in example (15) might be structured to avoid the risk of S disqualification that is exposed in that example. The simpler way avoids resorting to any of the three rules, by causing the SCo stock subject to the redemption or purchase agreement never to be treated as "outstanding" SCo stock, as illustrated in example (16) below. An alternative way is to wrap example (15)'s performance vesting arrangement into a "TARSAP" (time-accelerated restricted stock award plan) arrangement[21] and thereby qualify the agreement under rule 1, as illustrated in example (17) below.

Example (16): Same as example (15) (i.e., B purchased the stock at $1 although book value and FMV were each $5, and the redemption price was $1), and SCo's option to repurchase B's 100 shares is triggered by SCo's failure to timely reach certain performance goals. However, B does not make a section 83(b) election because the agreement with SCo forbids B from making a section 83(b) election with respect to the shares. In this case, the SCo shares acquired by B are nonsection 83(b) SRF stock, hence they are not treated as outstanding, and under Prop. Reg. section 1.1361-1(b)(3) they are not a second class of stock and cannot terminate SCo's S status. *See* II(E).[22]

Example (17): Same as example (15), including B's making of a section 83(b) election, but the vesting and forfeiture provisions read as follows:

(a) B's SCo shares will be redeemed (at $1 per share) at the time of B's death, disability, or termination of employment unless (i) the shares have earlier vested (i.e., are no longer SRF stock) by virtue of SCo having reached the performance goals described in (b) below *or* (ii) B's death, disability, or termination of employment has not occurred before the seventh anniversary of B's employment.

(b) If SCo reaches certain performance goals by the third anniversary of B's employment, the 100 SCo shares vest in B's hands and are no longer SRF stock.

(c) Under its employment agreement with B, SCo can, without penalty, terminate B's employment during a several-month period prior to the seventh anniversary of the commencement of B's employment. It is SCo's intention and B's expectation that if SCo fails to reach the performance goals by the third anniversary of B's employment, SCo will discharge B before the seventh anniversary and will redeem B's stock at that time for $1 per share.

This arrangement wraps the performance goals trigger within a TARSAP structure (i.e., successful performance accelerates from the end of year seven to the end of year three the vesting of B's full ownership in the SCo stock) and, we believe, without significantly altering the parties' commercial deal enables them to fit the arrangement under favorable rule 1.[23]

G. Treatment of Deferred Compensation Plans

Under the July 1991 proposed regulation, an agreement by SCo to pay deferred compensation, in connection with the performance of services to SCo, to an SCo employee or independent contractor would not constitute a second class of stock provided that the obligation or agreement does not convey the right to vote and is not "property" within the meaning of the section 83 regulations, i.e., it is merely an unfunded and unsecured promise to pay money or property in the future. Prop. Reg. section 1.1361-1(b)(4).

Example (18): SCo issues a stock appreciation right (an "SAR") to its president, A. The SAR provides that SCo will pay to A on a specified future date an amount equal to the then FMV of a share of SCo stock less $1 (which is the current FMV of a share of SCo stock). SCo's obligation is not funded or secured and does not convey the right to vote. The SAR does not constitute a second class of SCo stock.

The proposed regulation addresses only SARs issued as deferred compensation in return for services provided SCo by an employee or an independent contractor such as an outside consultant. Suppose an SAR is issued by SCo to a person other than a service provider, for example to a lender in partial compensation for monies advanced. The proposed regulation is silent and hence there is at least a question as to whether that SAR may constitute a second class of stock. As described below, the answer will turn on a dual finding, that the SAR (a) constitutes equity under general tax principles and (b) is being used to contravene the one class of stock or the eligible shareholder requirement. Normally a right to such an SAR would not constitute stock under general tax principles. *But see* the *Farley Realty* case discussed in Ginsburg & Levin, Mergers, *Acquisitions & Leveraged Buyouts,* para. 203.067 (CCH Tax Transactions Library).

H. Debt and Other Instruments

Under the July 1991 proposed regulation, "any instrument, obligation, or arrangement" of SCo, unless otherwise excepted as described below, is treated as a second class of SCo stock if it (i) "constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of federal tax law, and (ii) is used to contravene the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to contravene the limitation on eligible shareholders con-

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[21]The TARSAP approach is discussed, with respect to its potentially favorable financial accounting effect in various circumstances, in Ginsburg & Levin, *Mergers, Acquisitions & Leveraged Buyouts,* para. 1311.016 (CCH Tax Transactions Library).

[22]If performance goals are later achieved and B's SCo stock vests, under section 83(a) B will be charged with gross income equal to the spread at that time and SCo will be awarded a deduction under section 83(h). The parties likely will wish to negotiate a tax indemnification agreement (i.e., bonus compensation to be paid to B by SCo) to rebalance the tax detriment and tax benefits.

[23]These conclusions assume, as ordinarily would be the case, that employee B does not control SCo's board of directors. If B did control SCo's board of directors, it is not likely that B in year seven would vote in favor of his own discharge, and hence the other parties to this arrangement might not find it acceptable.

tained in [Prop. Reg. section 1.1361-1(b)(1)]." Prop. Reg. section 1.1361-1(l)(4)(ii)(A).[24]

To the proposed regulation's dual test, disguised equity plus improper intent, there is a statutory safe-harbor exemption and, in the proposed regulation itself, additional safe harbors and exemptions.

Section 1361(c)(5) contains the statutory safe-harbor exemption for "straight debt"—i.e., a written unconditional obligation which (i) is held by a person who could qualify as a shareholder of an SCo, (ii) has a fixed principal amount payable on demand or at a specified time, (iii) bears interest at a fixed rate (or a rate which floats based on an objective index), and (iv) has no convertibility feature. Under section 1361(c)(5), such "straight debt" will be classified as debt for S purposes even if it might be classified as equity in a C corporation.[25] The proposed regulation would clarify several points regarding this statutory safe harbor:

1. An SCo obligation may qualify as "straight debt" even though it is subordinate to other SCo debt.

2. The "straight debt" tests are applied at each of three events: (a) issuance of the debt, (b) material modification of the debt, and (c) transfer of the debt to a third party who is not an eligible SCo shareholder. Prop. Reg. section 1.1361-1(l)(4)(iii) and (iv).

3. The debt of a C corporation which meets the definition of "straight debt" will be treated as "straight debt" if the C corporation thereafter makes an S election. Prop. Reg. section 1.1361-1(l)(4)(vi).

The July 1991 proposed regulation contains five nonstatutory safe harbors and other exemptions:

1. Proportionally held debt obligations. Obligations of the same class owned solely by the owners of, and in the same proportion as, SCo's outstanding stock are not treated as a second class of stock whether or not such obligations are considered equity under general principles of federal tax law.[26] The proposed regulation explicitly notes that an obligation owned by SCo's sole shareholder is always "held proportionately."

2. No contravention intent. An instrument, obligation, or arrangement that is equity under general tax principles and does not meet the proportionately held safe harbor or any other safe harbor will nonetheless not result in a second class of stock unless it is used to contravene the rights of outstanding SCo shares or the limitation on eligible SCo shareholders.

3. Short-term unwritten advances. Unwritten advances from a shareholder to an SCo that do not exceed $10,000 in the aggregate at any time, that are treated as debt by the parties, and that are "expected to be repaid within a reasonable time," will not be treated as a second class of stock whether or not considered equity under general tax principles.[27]

4. Deferred compensation plans. As described in II(G), deferred compensation plans do not constitute a second class of stock.

5. Warrants, options, and the like. While many warrants, options, and the like are at risk of second class of stock designation, many such instruments will qualify for safe-harbor exemption as described in II(I) immediately below. However, it appears that a warrant or like instrument which flunks the rules discussed in II(I) immediately below will automatically be treated as a second class of stock without regard to the "contravention" bad-intent test applied to other types of instruments.

I. Options, Warrants, Convertible Debt, or Similar Instruments

Before it began proposing one class of stock regulations, it was the IRS' published position that the mere issuance by SCo of a normal form option, warrant, or convertible debenture would not adversely affect SCo qualification.[28] That simple sensible approach, under which a call option, warrant, or similar instrument (collectively, a "call option") issued by SCo was apparently

[24]It appears, however, from a careful reading of the proposed regulation, that a warrant, option, or similar instrument is not covered by this test, but rather is covered solely by the tests described in II(I) below (which do not contain a "contravention" bad-intent requirement), so that such an instrument will automatically be treated as a second class of stock if it flunks the rules described in II(I) without regard to intent. Prop. Reg. section 1.1361-1(l)(4)(i) and (iii).

[25]While such straight debt will not constitute a second class of stock disqualifying the S election, it appears that (absent a regulation to the contrary) such straight debt might be treated as equity for other purposes of the code, e.g., application of section 302 to a redemption. However, the proposed regulation contains a somewhat Delphic sentence on this topic: A straight debt obligation "considered equity under general principles of federal tax law . . . is generally treated as debt and when so treated is subject to the applicable rules governing indebtedness for other purposes of the Code." Prop. Reg. section 1.1361-1(l)(5)(iv) (second sentence). While the rule so enunciated is far from clear, it appears that the IRS will "generally" not assert that such straight debt is equity for purposes of the code other than the one class of stock rule.

Moreover, this proposed regulation goes on to state that if a straight debt obligation bears an unreasonably high rate of interest, "an appropriate portion of the interest may be recharacterized and treated as a payment that is not interest, [but that] recharacterization does not result in a second class of stock." Subject only to that "excessive interest" recharacterization possibility, interest paid or accrued on straight debt will be treated as interest by SCo and the recipient and will not constitute a distribution to which section 1368 applies.

[26]Prop. Reg. section 1.1361-1(l)(4)(ii)(B)(2). The July 1991 proposed regulation thus embraces the doctrine of *Portage Plastics Co. v. United States,* 486 F.2d 632 (7th Cir. 1973).

[27]Prop. Reg. section 1.1361-1(l)(4)(ii)(B)(1). The proposed regulation reiterates that unwritten advances which fail to meet this safe harbor still do not result in a second class of stock absent the combination of equity characterization under general tax principles plus intent to contravene the one class of stock or eligible shareholder limitations.

[28]Rev. Rul. 67-269, 1967-2 C.B. 298. Under the straightforward IRS pronouncement it was not relevant whether the option was or was not deep in the money.

never treated as a second class of SCo stock, is for the future cast aside by the July 1991 proposed regulation.[29]

Under the July 1991 proposed regulation, a call option issued by SCo is automatically treated as a second class of SCo stock—i.e., automatically disqualifies SCo status without regard to any "contravention" bad-intent test—if the call option (a) meets two tests (respectively "certainty of exercise" and "substantially in the money"), and (b) meets both of these tests on any of three occasions (respectively the time of issuance, transfer to an ineligible holder, or material modification). Those terms are explained more fully immediately below, followed by an identification of the proposed regulation's exceptions and safe harbors.

A dispassionate analyst might well conclude that if the call option satisfies the second test . . . it automatically will satisfy the first test.

Certainty of exercise. The proposed regulation's first test is whether, taking into account all the facts and circumstances, the call option is "substantially certain to be exercised (by the holder or a potential transferee)."

Substantially in the money. The proposed regulation's second test is whether, taking into account all the facts and circumstances, the call option has a strike price substantially below the FMV of the underlying stock.[30]

The call option becomes a disqualifying second class of stock if the option meets both these tests. The likelihood that a call option will be exercised is of course increased as the strike price declines relative to FMV, and a dispassionate analyst might well conclude that if the call option satisfies the second test (strike price substantially below FMV), it automatically will satisfy the first test (substantially certain to be exercised). The drafters of the July 1991 proposed regulation, however, either disagree or perceive a class of cases in which satisfaction of the substantially in the money test does not assure satisfaction of the certainty of exercise test as well. We suspect the answer is the latter—i.e., there will be many cases in which "substantially in the money" does assure "certainty of exercise"—and hazard these suggestions of cases in which certainty of exercise is not assured:

- The call option may not be currently exercisable and, taking into account all the facts and circumstances, it is not substantially certain that the holder will elect to exercise when the right to do so later matures (i.e., at that later date the option may no longer be in the money).
  Although the call option is currently exercisable, the SCo shares, when acquired, will be subject to a buy-sell or equivalent shareholder agreement under which redemption or resale price is set at a substantial discount from FMV (e.g., book value).

The dual tests, certainty of exercise and substantially in the money, under the proposed regulation are applied at each of three events:

(a) at the time the call option is issued,

(b) at the time of any subsequent transfer of the call option to a person who is not an eligible shareholder of SCo (e.g., because the transferee is an entity or nonresident alien or because SCo already has 35 shareholders) (*see* Prop. Reg. section 1.1361-1(l)(4)(v) example 1); and

(c) at the time of any material modification of the call option (Prop. Reg. section 1.1361-1(l)(4)(iii)(A)).

Importantly, if a call option is issued in connection with a loan and the time period in which the option can be exercised is extended in connection with (and consistent with) a modification of the terms of the loan, the extension of the time period in which the call option may be exercised is not considered a material modification of the option.

The notion that a call option must be retested, for likelihood of exercise and FMV/strike price relationship, on the date the call option is "transferred to a person who is not an eligible shareholder" seems to us pernicious. At the least, the regulation should disregard any such transfer of a call option by a person who was not an eligible SCo shareholder. If the transferring holder is an ineligible person, why should substitution of a different ineligible holder be an event so cosmic as to attract the extreme penalty of SCo disqualification?

The proposed regulation furnishes three exceptions (one, more accurately, is a safe harbor) to the rules under which a call option may be held a second class of stock:

1. "If [a call option] is issued by a corporation to a person that is actively and regularly engaged in the business of lending and is issued in connection with a loan to the corporation that is commercially reasonable," the call option will not be treated as a second class of stock. Prop. Reg. section 1.1361-1(l)(4)(iii)(B)(1). This exception applies even though the call option is substantially in the money.[31]

Example (19): Bank A makes a commercially reasonable $200,000 five-year loan to SCo. In con-

[29]The new, more onerous, less sensible call option rules of July 1991 Prop. Reg. section 1.1361-1(l)(4)(iii) do not apply to instruments, obligations, or arrangements issued or entered into on or before August 8, 1991. *See* Prop. Reg. section 1.1361-1(l)(7). Under Rev. Rul. 67-269, *supra,* call options issued by SCo prior to August 9, 1991 (provided they are not "materially modified" after that date) should pose no second class of stock risk.

[30]A call option will not be deemed to have a strike price substantially below FMV (without regard to what the strike price may be at the time of issuance or other testing date) if, under the terms of the instrument, the strike price at the time of exercise cannot be substantially below the FMV of the underlying stock. *See* Prop. Reg. section 1.1361-1(l)(4)(iii)(A).

[31]Query, however, if absolution for a substantially in the money call option extends to the extreme case in which the strike price is excessively low (e.g., one cent per share) and the stock's FMV on the date of grant is not excessively low. Might the IRS claim that the holder should be treated as owning the underlying stock from inception? *See* Rev. Rul. 82-150, 1982-2 C.B. 110 (involving a C corporation) and, in general, Ginsburg & Levin, *Mergers, Acquisitions & Leveraged Buyouts,* para. 1311.012 (CCH Tax Transactions Library). We believe that when the issue is SCo disqualification, the answer ought to be "no," i.e., the exception described in text should apply even though the call option is very substantially in the money (that is, even though the strike price is nominal), but confirmation in the final regulation would be welcome.

nection with that loan, SCo grants to A a divisible warrant to purchase 2,000 SCo shares at $10 per share. On the date the warrant is issued, SCo shares have an FMV of $20 per share. Shortly thereafter, when values have not changed, Bank A syndicates the loan by selling to Bank B for $100,000 one-half the SCo loan plus one-half the SCo warrant.

The notion that a call option must be retested . . . seems to us pernicious.

In the hands of Bank A the warrant is protected from second class of stock treatment by the active lender exception. However, when consistent with standard banking practice, Bank A syndicates the SCo loan and warrant, it is not clear whether the benefit of the active lender exception is thereby lost. The concern is initiated by the proposed regulation's unfortunate requirement that a call option be retested (for certainty of exercise and FMV/strike price relationship) at the time of any subsequent transfer of the call option to a person who is not an eligible shareholder of SCo, a requirement of retesting that the proposed regulation apparently imposes even if the transferor was itself an ineligible shareholder. To this concern there are at least three possible answers:

a. One possible answer is that once a call option (warrant) has been "issued by a corporation to a person that is actively and regularly engaged in the business of lending," the "call option is [forever] not treated as a second class of stock," regardless of the holder, i.e., even if Bank A transferred the exempted deep-in-the-money warrant to a person not in the lending business, it would not become a second class of stock.

b. A second possible answer is that a transferee like Bank B which is itself "actively and regularly engaged in the business of lending" can lay claim to the active lender exception.

c. The third, and least rational approach, is that the active lender exception covers only a lender who receives the original issuance of a call option and does not cover transferee Bank B, so that the transfer to Bank B creates a second class of stock.

The language of the proposed regulation is somewhat ambiguous, stating that "A call option is not treated as a second class of stock . . . if it is issued by a corporation to a person that is actively and regularly engaged in the business of lending." Hence, it can be read as permanently exempting a call option which was originally issued to an active and regular lender (regardless of the nature of a subsequent transferee) or as exempting a transfer (i.e., a reissuance by SCo) to a transferee active and regular lender.

We think that the third interpretation, terminating the exception if the original lender syndicates the loan package to another lender, makes no sense. And, moving from policy to technicality, we note that the parallel exception for a compensatory option (described immediately below) explicitly conditions the benefit of that exception upon nontransferability of the call option and further explicitly states that "If the [compensatory] call option becomes transferable, this [exception] . . . ceases to apply." The proposed regulation's drafters, it is clear, know how to limit the benefit of the exception to a first holder when that was their objective.

2. A compensatory option for services is not treated as a second class of stock if, as is normal, the call option is issued by SCo to an individual who is an employee or an independent contractor in connection with the performance of services, is not "excessive by reference to the services performed," is nontransferable (under Reg. section 1.83-3(d)), and does not have a readily ascertainable FMV (under Reg. section 1.83-7(b)) at the time the option is issued.[32] This exception applies even though the call option is substantially in the money.[33]

3. If on the testing date—i.e., the time of issuance, transfer to an ineligible holder, or material modification—the strike price of the call option is at least 90 percent of the underlying stock's FMV on that date, the option has found a safe harbor and is not treated as a second class of stock. Prop. Reg. section 1.1361-1(l)(4)(ii)(C). SCo's good faith determination of FMV "will be respected unless it can be shown that the value was substantially in error or the determination of the value was not performed with reasonable diligence to obtain a fair value." *Id.* The proposed regulation explicitly notes that failure of an option to meet this safe harbor "will not necessarily result in the option being treated as a second class of stock."

Example (20): All of SCo's stock (100 shares) is owned by individual A and is worth $1 million ($10,000 per share). B, a corporation that is not a lending institution, loans SCo $250,000 for a term of three years at an interest rate equal to two percent above the AFR. SCo simultaneously grants B an option to purchase 25 newly issued SCo shares at a strike price of $140,000 ($7,000 per share), which strike price is less than 90 percent of FMV on the date the call option is issued to B. If, taking into account all the facts and circumstances, it appears that the call option is substantially certain to be exercised (either by B or a potential transferee), because the strike price is 30 percent below FMV

[32]Prop. Reg. section 1.1361-1(l)(4)(iii)(B)(2). If and when the call option later becomes transferable, the compensatory option exception ceases to apply and the dual test for determining a second class of stock will be applied if (and when) the call option thereafter is either materially modified or transferred to a new holder who is ineligible to be an SCo shareholder. *See* Prop. Reg. section 1.1361-1(l)(4)(v) example 2.

[33]Query, however, if absolution for a substantially in the money call option extends to the extreme case in which the strike price is excessively low (e.g., one cent per share) and the stock's FMV on the date of grant is not excessively low. Might the IRS claim that the holder should be treated as owning the underlying stock from inception? *See Rev. Rul. 82-150*, 1982-2 C.B. 110 (involving a C corporation) and, in general, Ginsburg & Levin, *Mergers, Acquisitions & Leveraged Buyouts*, para. 1311.012 (CCH Tax Transactions Library). We believe that when the issue is SCo disqualification, the answer ought to be "no," i.e., the exception described in text should apply even though the call option is very substantially in the money (that is, even though the strike price is nominal), but confirmation in the final regulation would be welcome.

(which likely will be found to be "substantially below" FMV), the call option will be treated as a disqualifying second class of stock.

Example (21): Same as example (20), except that the call option also provides that in no event shall it be exercisable for a price that is below 90 percent of an SCo share's FMV determined on the date of exercise. The call option is not a second class of stock because it is not treated as having a strike price substantially below FMV.

Example (22): Same as example (20), except that B is actively and regularly engaged in the business of lending and its $250,000 loan to SCo is "commercially reasonable." The call option is not a second class of stock because the arrangement fits the exception accorded lending institutions.

Example (23): Same as example (20), except that SCo does not issue the call option to B corporation. Instead, to induce B to loan $250,000 to SCo, A grants B a call option to purchase directly from A 20 percent of SCo's outstanding stock at a strike price that is substantially below FMV. Whether or not, taking into account all the facts and circumstances, the call option is substantially certain to be exercised by B (or a potential transferee), the call option is not a second class of stock under the "call option" provision of the proposed regulation, since that provision applies only to a call option issued by SCo. However, the arrangement may give rise to a disqualifying second class of stock under rules 1, 2, and 3, applicable to buy-sell, redemption, and transfer restriction agreements, as described in II(F).

Example (24): In connection with a loan to SCo, SCo issues a call option to entity B which is neither an employee of SCo, an independent contractor furnishing services to SCo, nor a person actively and regularly engaged in the business of lending. On the date the call option is granted to B, SCo shares have an FMV of $100 each. The strike price under the call option is also $100. However, the option instrument states that SCo contemplates a public offering of $25 million of its stock within three years and further states that if the public offering is delayed, the strike price under the option will decline to $80 after 36 months, $70 after 42 months, $60 after 48 months, and finally $50 after 54 months. The described arrangement is not unique and accords with well established commercial practice. It is unclear whether this option qualifies for the benefit of the 90-percent safe-harbor exception of Prop. Reg. section 1.1361-1(l)(4)(ii)(C).

A convertible debt instrument issued by SCo will be considered a second class of stock in either of two circumstances: (a) The convertible debt is treated as equity under general "debt/equity" tax principles and is used to "contravene the rights to distribution or liquidation proceeds conferred by [SCo's] stock or to contravene the limitation on eligible shareholders contained in [subchapter S]," or (b) The convertible debt "embodies rights equivalent to those of a call option that is substantially certain to be exercised and [the] . . . conversion price . . . is substantially below the fair-market value of the underlying stock" on the testing date (i.e., date of issuance, transfer to a person who is not an eligible SCo shareholder, or material modification). Prop. Reg. section 1.1361-1(l)(4)(iv).

It is noteworthy, and in our view unfortunate, that under the proposed regulation a convertible debt instrument will be considered a second class of SCo stock in two cases in which an investment unit consisting of a nonconvertible debt plus a warrant would not give rise to a second class of SCo stock under the call option rules reviewed above. One case arises because the convertible debt rule (explicitly, test (b) in the preceding paragraph) does not incorporate the exceptions (e.g., active lender and compensation for services) that apply to call options under Prop. Reg. section 1.1361-1(l)(4)(iii)(B). The second case arises (under test (a) in the preceding paragraph) when a convertible debt instrument is treated as equity under general "debt/equity" tax principles, but an otherwise equivalent nonconvertible debt would not be treated as equity under general "debt/equity" tax principles.[34] These differences in tax treatment are illustrated in the following examples.

Example (25): SCo borrows $100,000 from Bank A on a five-year subordinated note bearing annually payable interest at a rate equal to the AFR plus two percent. The note is convertible at the holder's option into 2,000 SCo shares ($50 per share). On the date the convertible note is issued, SCo shares have an FMV of $100 per share. Since the conversion price is substantially below FMV on the date the convertible note is issued, under test (b) the convertible note will be considered a second class of SCo stock if it is concluded, as too likely it will be concluded, that the conversion right "is substantially certain to be exercised." Further, if the SCo convertible note passes test (b) (i.e., it is concluded that the conversion feature is not substantially certain to be exercised), to avoid second class of stock disqualification the convertible note also must pass test (a) (i.e., it must be concluded that either the convertible note is not equity under general tax principles or that the convertible note was not used to contravene the equal distribution or eligible shareholder requirements).

[34]Thus, under the convertible debt rules of Prop. Reg. section 1.1361-1(l)(4)(iv) summarized in the preceding text paragraph, SCo's convertible debt will be considered a second class of stock in either of two circumstances (test (a), which includes "equity under general tax principles," and test (b), essentially the test applied to call options but without certain exceptions that the proposed regulation applies to call options). A call option (including a warrant), however, is not subjected to any disqualification rule similar to convertible debt test (a) and is subject to the equivalent of convertible debt test (b) but with the benefit of exceptions that are not accorded convertible debt. The nonconvertible debt portion of an investment unit (debt plus warrant) is, as explored in II(H), subjected to a variation of test (a) that incorporates one statutory and several nonstatutory exemptions so that, as a practical matter, it is very difficult for nonconvertible debt to give rise to a second class of SCo stock. For a nonconvertible debt to be treated as a second class of stock, it must fall outside of the various exemptions and there must be an extraordinarily high debt-equity ratio, activity by the nonconvertible debt holder inconsistent with his position as a creditor, or some other dramatic fact.

Example (26): Same as example (25), except that instead of a convertible note Bank A receives as an investment unit a nonconvertible $100,000 note and a warrant to purchase 2,000 SCo shares at $50 per share. In this circumstance there is little or no risk of a disqualifying second class of stock while the instruments are in A's hands, absent highly unusual facts seldom, if ever, present with a bank lender (e.g., extraordinarily high debt-equity ratio, activity by A inconsistent with its position as a creditor, etc.). Convertible debt test (a) is inapplicable because the SCo note is not convertible. Because A is a person "actively and regularly engaged in the business of lending" and the warrant is issued in connection with a loan to SCo that is commercially reasonable, the warrant, even though substantially in the money, is not a second class of SCo stock. The nonconvertible SCo note, because it is not stock under general principles of federal tax law, will not be treated as a second class of SCo stock. Prop. Reg. section 1.1361-1(l)(4)(ii)(A).

As illustrated, under the proposed regulation's call option and convertible debt classification rules, arrangements that essentially are economically equivalent[35] receive potentially quite different treatment. It would make more sense, we think, if Prop. Reg. section 1.1361-1(l)(4)(iv), the convertible debt provision, were revised so that a commercial arrangement that does not risk second class of stock characterization when embodied in a debt/warrant investment unit will not risk second class of stock classification when embodied in a convertible debt instrument.

That notion of uniform evaluation of a convertible debt and a debt/warrant investment unit is fully consistent with the preamble to the July 1991 proposed regulation (PS-4-73) which states, "If a convertible debt instrument embodies rights equivalent to those of a call option, it is evaluated both as debt and as a call option under the proposed regulations." Unfortunately the actual language of the proposed regulation does not live up to the standard stated in the preamble.

Unfortunately the actual language of the proposed regulation does not live up to the standard stated in the preamble.

Finally, we close this discussion of call options and equivalent instruments (including convertible debt) on a comforting note. If the call option survives the tests set out above—it is not substantially certain to be exercised or it is not substantially in the money or it finds an exception or safe harbor—and hence is not treated as a second class of SCo stock, collateral arrangements designed to maximize future SCo stock value (and thus to maximize the likelihood of option exercise) should not place at risk the favorable, no second class of stock, conclusion. In particular, we have in mind the following quite common commercial arrangement.[36]

Example (27): SCo borrows money from Bank A on a five-year, subordinated, variable rate note. SCo simultaneously sells a call option to Bank A entitling the holder to purchase a specified number of SCo common shares for a specified price. The loan agreement and the call option agreement prohibit SCo from making distributions to its shareholders except to pay taxes on SCo's earnings taxed to the shareholders (in general, a prohibition against dividends in excess of 31 percent plus the applicable state rate times SCo's net income). If SCo operates profitably, the dividend restriction assures a continuing increase in per-share book value and, presumably, FMV as well. The conclusion, that this arrangement for continuous accumulation does not create a second class of stock risk, is eminently sensible.

J. Effective Date

The July 1991 proposed regulation announces (Prop. Reg. section 1.1361-1(l)(7)) that its one class of stock rules generally apply to taxable years of SCo beginning on or after January 1, 1992. However, the rules of Prop. Reg. section 1.1361-1(l)(4)—covering call options, convertible debt, and a variety of other instruments, obligations, or arrangements that constitute equity under general tax principals and are used to contravene the single class of stock or eligible shareholder requirements (*see* II(H) and (I))—do not apply to instruments, obligations, or arrangements issued or entered into on or before August 8, 1991.

In addition, the proposed regulation also indicates that the rules concerning inadvertent termination of SCo status (section 1362(f)) apply to violations of the one class of stock rules of the proposed regulation. Prop. Reg. section 1.1361-1(l)(6). Thus, it may be possible to avoid loss of S status by correcting the rule violation and then promptly applying to the IRS for a ruling that the violation was inadvertent.

III. CONCLUSION

The July 1991 version of the one class of stock proposed regulation is an enormous improvement over the October 1990 version. It could hardly have proved otherwise. But the July 1991 pronouncement still is not awfully good. The silence of earlier days, we believe, was better.

The effective date provision of Prop. Reg. section 1.1361-1(l)(7) is instructive. The new, detailed and intricate rules applicable to call options, convertible debt, and a great variety of other instruments, obligations, and arrangements do not apply to call options, convertible debt, instruments, obligations, and arrangements issued or entered into prior to August 9, 1991. Since subchapter S entered the Internal Revenue Code in 1958, we are speaking of instruments issued and arrangements

[35]A convertible debt and a nonconvertible debt/warrant package are not in all respects economically equivalent because the holder of convertible debt must surrender the interest-bearing instrument in order to obtain the underlying stock, while the holder of an investment unit can obtain the underlying stock (by exercising the warrant for cash) while retaining the interest-bearing debt instrument. But in terms of SCo second class of stock *vel non,* that economic difference hardly seems relevant.

[36]*See,* e.g., LTR 8811061, December 23, 1987, discussed in Ginsburg & Levin, *Mergers, Acquisitions & Leveraged Buyouts,* para. 1104.024 (CCH Tax Transactions Library).

entered into during one-third of a century. In that one-third of a century the "silent rules" worked marvelously well, just as they will continue to work marvelously well in the future for the vast number of pre-August 9, 1991, instruments and arrangements that continue in force.

We perceive no good reason of tax or any other policy why an unexercised call option, whatever the strike price and whoever the holder, should ever be treated as a second class of stock for purposes of the subchapter S qualification rules. We see no impelling reason to adopt any of the proposed regulation's rules that key disqualification to a revenue agent's notion of evil or improper motive. We are very much concerned that if the July 1991 proposed regulation is adopted in its present form, the opportunity for and reality of substantially increased controversy will, to no sensible purpose, be amply realized.

Perhaps Congress can be induced to amend its proposed Tax Simplification Act of 1991 to make it even clearer that "one class of stock" means simply that.