# Viewpoint

## THE SUBCHAPTER S ONE-CLASS-OF-STOCK REGULATION.

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Ginsburg, Martin D., Levin, Jack S.

Martin D. Ginsburg, a professor of law at Georgetown University Law Center, and Jack S. Levin, senior partner of Kirkland & Ellis, Chicago, are co-authors of Mergers, Acquisitions, and Buyouts, published by Little, Brown & Company in July 1995 and revised semi- annually. Shorn of headings and footnotes, this article is excerpted from a chapter of the treatise.

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In October 1990 Treasury brought forth its first proposed regulation designed to add flesh and meaning to subchapter S's terse one-class-of-stock eligibility requirement. That 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 proved much better than the first version. That is hardly a surprise. Sadly, the 1991 proposed regulation still was not awfully good. If we may misquote slightly a former First Lady, the persistent difficulty resided in Treasury's staggering inability to Just Say Yes.

On May 28, 1992, Treasury published in the Federal Register T.D. 8419, 1992-2 C.B. 217, the final one-class-of-stock regulation effective (with exceptions) for taxable years of an S corporation beginning on or after May 28, 1992. While in large measure a republication of the 1991 proposed regulation, the 1992 final pronouncement incorporates a number of salutary changes that respond to a respectable number (although far from all) of the comments Treasury had received on the 1991 proposal. The final regulation, flawed but doubtless an improvement over the 1991 version and light years ahead of Treasury's 1990 disaster, has reached the A-minus grade level.

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 dissection of the May 1992 final one-class- of-stock regulation, noting, wherever

useful, changes from the 1991 proposed regulation.

An S corporation -- more exactly, a domestic corporation that is "a small business corporation for which an election under [section] 1362(a) is in effect" -- may not have outstanding more than one class of stock. Differences in voting rights among the outstanding shares do not, however, create different classes of stock. 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 section 704(b).

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. As it was generally understood at the time, the 1982 legislation, 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).

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 when some shareholders were bound by the agreement and others were not.

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. 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. 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.

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. While these IRS pronouncements involve C corporations, there was a concern that recharacterization could extend to SCos, certainty 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, and some of the margins were fuzzy, but practitioners and revenue agents were in general accord and exhibited rare

harmony. There was thus no perceptible need for reexamination or extensive further guidance. Good sense urged that the qualification requirement be let alone.

Good sense did not carry the day. On October 5, 1990, Treasury and IRS published a lengthy proposed regulation under section 1361, 1990-2 C.B. 864, propounding what was, to say the least, an exciting new anti-taxpayer interpretation of the one-class-of-stock requirement that, 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) ensure 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. The first positive IRS response to the universal criticism was the announcement, on February 12, 1991, that any "regulations on this subject will be revised to provide for 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, 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, which, as further revised and made final on May 28, 1992 is discussed below. In general, the 1991 proposed regulation was to apply only to SCo taxable years beginning on or after July 1, 1992.

Important in fathoming the 1991 proposed regulation (and in turn the 1992 final regulation) is a fair appreciation of the legislative activity that preceded its publication. Introduced on June 26, 1991, as H.R. 277, 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 1991 proposed regulation in effect presumed enactment of revised section 1361(c)(4), quoted above, and adoption of the two paragraphs from the technical explanation quoted immediately above.

The legislative objective is to make it terribly difficult to disqualify an S corporation on grounds of a second class of stock, provided (1) the corporation has not purported to issue shares of different classes (ignoring differences in voting power), and (2) state corporate law does not impose nonidentical rights to distributions or liquidation proceeds.

The July 1991 proposed regulation at first seemed to exemplify that spirit but a careful reading disclosed that the drafters could not bring themselves to embrace solely objective criteria. Thus, in the end, the proposed regulation cast a cloud of uncertainty over what could and should have been straightforward and reliable. After first announcing that particular kinds of "routine commercial contractual arrangements, such as a lease, employment agreement, or loan 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."

The 1992 final regulation reflects a modest -- and not completely successful -- attempt to reduce the uncertainty inflicted by the drafters of the 1991 proposed regulation (repair, for example, to the segment of the proposed regulation quoted immediately above). In the final regulation the qualifying (and confusing) adjective "routine" is deleted, the amorphous "arrangement" becomes the somewhat more precise "agreement" and -- more important -- a principal purpose standard is added. Under the final regulations a commercial contractual agreement cannot create a second class of stock "unless a principal purpose of the agreement is to circumvent the one class of stock requirement."

[The foregoing introduction is followed in the treatise by a detailed analysis of the 1992 final regulation, presented in 33 pages of text, 63 footnotes, and 31 examples, after which appears the following conclusion.]

The final May 28, 1992, version of the one-class-of-stock regulation is an enormous improvement over the October 1990 proposed version (it could hardly have proved otherwise) and a measurable improvement over the July 1991 version as well. But the

final pronouncement remains flawed. The silence of earlier days, we believe, was better.

The effective date provision of reg. section 1.1361-1(l)(7) is instructive. The new detailed and intricate rules applicable to buy- sell agreements, call options, convertible debt, and a great variety of other instruments, obligations, and arrangements do not apply to buy-sell agreements, call options, convertible debt, instruments, obligations, and arrangements issued or entered into prior to May 1992. Since subchapter S entered the Internal Revenue Code in 1958, we are speaking of instruments issued and arrangements 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-May 28, 1992, instruments and agreements 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 compelling reason to adopt any of the regulation's rules that key disqualification to a revenue agent's notion of evil or improper motive. We are very much concerned that, as a result of all this regulatory activity, the opportunity for and reality of substantially increased controversy will, to no sensible purpose, be amply realized.

Perhaps Congress can be induced, some day, to amend section 1361(c)(4) to make it even clearer that "one class of stock" means simply that.