REPORT #684

TAX SECTION

New York State Bar Association

Report on Proposed Subchapter S

One Class of Stock Regulations

Table of Contents

TAX SECTION
New York State Bar Association

March 6, 1991

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20024

Dear Commissioner Goldberg:

I enclose our report on the proposed subchapter S one class of stock regulations. The principal authors of the report are Roger J. Baneman and Philip R. West.

Although our report acknowledges certain positive aspects of the proposed regulations, we believe that the proposed regulations go beyond what is appropriate to implement the tax policies underlying the statute and will result in the termination of many S elections as a result of commonplace arrangements that are not tax motivated. Accordingly, we believe the proposed regulations should be re-proposed with substantial modifications.

The report suggests alternatives to the nonconforming distribution rules and the option rules in the proposed regulations, recommends elimination of the reasonable interest rate requirement of the straight debt safe harbor, recommends that the Portage Plastics line of cases continue to apply to debt outside of the straight debt safe harbor, suggests an approach for the effective date of the final regulations and makes various technical comments.

We would be pleased to discuss the report and its recommendations with your staff at their convenience.

Very truly yours,

James M. Peaslee
Chair

Enclosure

Identical letter to:

The Honorable Kenneth W. Gideon
Assistant Secretary of the Treasury
for Tax Policy
3120 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Abraham N.M. Shashy, Jr., Esq.
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3026
Washington, D.C. 20224

cc: Robert R. Wootton, Esq.
Tax Legislative Counsel
Department of the Treasury
3046 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Terrill A. Hyde, Esq.
Deputy Tax Legislative Counsel
for Regulatory Affairs
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Room 4206
Washington, D.C. 20220

Gregory J. Marich, Esq.
Associate Tax Legislative Counsel
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Room 4206
Washington, D.C. 20220

Thomas R. Hood, Esq.
Counsellor to the Commissioner
Internal Revenue Service
1111 Constitution Avenue
Room 3316
Washington, D.C. 20224

Mary L. Harmon, Esq.
Special Assistant to Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3034
Washington, D.C. 20224

David R. Haglund, Esq.
Attorney Advisor
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 5004
Washington, D.C. 20224

Tax Report #684

NEW YORK STATE BAR ASSOCIATION TAX SECTION

Report on Proposed Subchapter S

One Class of Stock Regulations

NEW YORK STATE BAR ASSOCIATION TAX SECTION

Report on Proposed Subchapter S One Class of Stock Regulations

This report[*] comments on regulations proposed on October 5, 1990, under Section 1361 of the Code (the "Proposed Regulations").[1] The Proposed Regulations address the "one class of stock" requirement under subchapter S.

Introduction

Congress enacted subchapter S in 1958 to minimize the effects of Federal income taxes on choices of the form of business organizations and to permit the incorporation and operation of certain small businesses without the incidence of income taxation at both the corporate and the shareholder level.[2] S corporations generally are not subject to Federal income tax. S corporation shareholders, however, are generally taxed directly

---

[*] The principal authors of the report are Roger J. Baneman and Philip R. West. Helpful comments were received from Mark Berg, Jeffrey Cole, John Corry, Peter Faber, Arthur Feder, Stuart Gross, Carolyn Ichel, Bruce Kayle, Richard Lieder, James Peaslee, Richard Reinhold, Stanley Rubenfeld, Deborah Schenk, Michael Schler and Eugene Vogel.

[1] 55 Fed. Reg. 40870.

[2] S. Rep. No. 1983, 85th Cong., 2d Sess. 87 (1958), reprinted in 1958-3 Cum. Bull. 922, 1008 (hereinafter the "1958 Senate Report")

on corporate profits whether or not distributed.

A corporation will not be an S corporation (and, hence, will not be eligible for taxation under subchapter S) if, among other things, it has more than one class of stock.[3] The Proposed Regulations address this “one class of stock” requirement.

Some of the principal provisions of the Proposed Regulations are summarized in the next section. Our major comments on the Proposed Regulations and technical comments then follow.

Summary of Regulations

Shares treated as second class of stock. The Proposed Regulations treat a corporation as having more than one class of stock if all of its outstanding shares do not - confer identical rights to distribution and liquidation proceeds, regardless of whether such differences in rights occur pursuant to the charter, articles or bylaws, by operation of state law, by administrative action, or by agreement. However, buy-sell agreements among shareholders and restrictions on the transferability of stock are

[3] Code Section 1361(b)(1)(D). In determining whether a corporation has more than one class of stock, differences in voting rights are disregarded. Code Section 1361(c)(4).

disregarded in determining whether a corporation has more than one class of stock. Agreements to redeem shares of stock are disregarded for purposes of the one class of stock requirement unless the agreement either restricts the right of the holders of the stock to share in liquidation proceeds or provides for so-called “nonconforming distributions” as described below.

Nonconforming distributions. Regardless of whether a corporation's outstanding shares confer identical rights to distribution and liquidation proceeds by their terms, the Proposed Regulations treat a corporation as having more than one class of stock if the corporation makes “nonconforming distributions”. Nonconforming distributions are distributions that differ with respect to timing or amount with respect to each outstanding share of stock unless the distributions come within one of two narrow exceptions. Under the first exception, distributions that differ in timing are not treated as nonconforming distributions if (i) the timing differences are unintentional and the distributions are pro rata with respect to all outstanding shares taking into account the entire taxable year or (ii) the distributions are made within a three-month period and the aggregate distributions during this three-month period are pro rata with respect to all outstanding shares. Under the second exception, distributions treated as payment in exchange for stock under Section 302(a) or 303(a) are not treated as nonconforming distributions. A distribution treated as a Section 301 distribution pursuant to Section 302(d) is generally also not treated as a nonconforming distribution.

According to the preamble to the Proposed Regulations, transfers by a corporation to a shareholder that are characterized as distributions under general principles of Federal tax law (presumably, constructive dividends) or under Code sections such as section 7872 are considered distributions with respect to stock for purposes of the Proposed Regulations, including the nonconforming distribution provisions.

Debt reclassified as equity. The Proposed Regulations provide that debt instruments treated as equity under general principles of Federal tax law constitute a second class of stock unless they are within the straight debt safe harbor (discussed below) (the "Equity Equals Second Class of Stock Rule"). The Proposed Regulations take the view that cases such as Portage Plastics Co., Inc. v. U.S., 486 F.2d 632 (7th Cir. 1973) (en banc); Stinnett v. C.I.R., 54 T.C. 221 (1970); Shores Realty Co., Inc. v. U.S., 468 F.2d 572 (5th Cir. 1972); and Gamman v. C.I.R., 46 T.C. 1 (1966)--holding that purported debt instruments, even if they constituted equity for tax purposes, were not a second class of stock for subchapter S purposes--were legislatively overruled by the enactment of the straight debt safe harbor in the Subchapter S Revision Act of 1982 (the "1982 Act").

Straight debt. An instrument issued by an S corporation that satisfies the definition of "straight debt" under the Proposed Regulations ("Straight Debt") is not treated as outstanding stock for purposes of the "one class of stock" requirement regardless of whether it is treated as equity under general tax principles. Straight Debt is generally defined as a written unconditional obligation to pay a sum certain on demand, or on a specified due date, which:

(i) does not provide for an interest rate or payment dates that are contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock, or similar factors;

(ii) bears a reasonable interest rate;

(iii) is not convertible (directly or indirectly) into stock of the corporation; and

(iv) is held by an individual (other than a non-resident alien), an estate, or a trust described in Section 1361(c)(2).

Unlike the other three factors, the requirement that Straight Debt bear a “reasonable interest rate” does not appear in the Code. The Proposed Regulations provide “safe harbor” reasonable interest rates and generally allow interest-free loans if their term is one year or less.

Call options and warrants. A call option, warrant or similar instrument (collectively “call option”) is treated as a second class of stock under the Proposed Regulations if the call option is “substantially certain to be exercised” when it is issued, materially modified or transferred. This rule applies regardless of whether the call option holder is treated as the owner of the underlying stock under general principles of tax law.

There are two exceptions to the general rule relating to call options. First, call options issued to certain institutional lenders in connection with loans are not treated as a second class of stock if the call options are exercisable only on default in repayment of the loan. Second, a call option issued to an employee in connection with the performance of services is not treated as a second class of stock if it is not transferable under Regulation Section 1.83-3(d) and does not have a readily ascertainable fair market value under Regulation Section 1.83-7(b) at the time of grant.

The Proposed Regulations provide a safe harbor for a call option whose strike price on the date it is issued, materially modified or transferred is at least 90% of the fair market value of the underlying stock at that time.

Restricted stock. Stock that is substantially non-vested (within the meaning of Regulations Section 1.83-3(b)) is not treated as outstanding stock of the corporation and the holder of such stock is not treated as a shareholder, unless the holder makes an election under Section 83(b). If such an election is made, the stock is treated as outstanding and the holder of the stock is treated as a shareholder for subchapter S purposes.

Deferred compensation plans. An instrument, obligation, or arrangement that does not convey the right to vote, is not property under Section 1.83-3 of the Proposed Regulations and is issued to an employee by a corporation in connection with the performance of services under a plan with respect to which the employee is not taxed currently on income is not treated as outstanding stock for purposes of the “one class of stock” requirement.

Effective date. By their terms, the Proposed Regulations were generally effective for taxable years beginning on or after January 1, 1983, with a modified prospective effective date in three situations:

> (1) The Equity Equals Second Class of Stock Rule applied to instruments designated as debt that were in existence on October 5, 1990 and have been held proportionately to the nominal stock of the corporation, for taxable years beginning on or after the date ninety days after publication of final regulations (the "Ninety Day Date");
>
> (2) The reasonable interest rate requirement applied to instruments meeting the straight debt safe harbor as set forth in Code Section 1361(c)(5) that were in existence on October 5, 1990, for taxable years beginning on or after the Ninety Day Date; and
>
> (3) The provisions in the Proposed Regulations relating to call options applied to call options in existence on October 5, 1990, for taxable years beginning on or after the Ninety Day Date.

However, on February 12, 1991, the IRS announced that the Proposed Regulations will be revised "to provide for a prospective effective date".[4]

Major Comments

At the outset, we would like to put our comments on the

[4] IR—91—25 (February 12, 1991).

Proposed Regulations in context. We have serious criticisms of the Proposed Regulations which are set forth at length in the balance of this report. However, we also wish to acknowledge their positive features. The Proposed Regulation are concise and clearly written. The provisions relating to restricted stock, shareholders agreements, call options issued to employees, and treatment of “straight debt” for general tax purposes are responsive to practical taxpayer concerns and indeed are generally favorable to taxpayers. Even as to the portions of the Proposed Regulations with which we and other commentators have serious disagreements, public statements by Treasury and IRS officials have indicated that Treasury and the IRS will be responsive and will endeavor to fashion rules that will avoid unnecessary terminations of S elections. We note the recent IRS announcement to the effect that the final regulations will be prospective as a positive indication along these lines. Accordingly, although in our view the Proposed Regulations require substantial revisions, we acknowledge their positive aspects and we are confident that Treasury and the IRS will endeavor in good faith to make the final product responsive to legitimate taxpayers concerns.

Turning now to our critical analysis of the Proposed Regulations, it is clearly appropriate for Treasury and the IRS to issue regulations to clarify the application of the “one class of stock” requirement and to prevent abuses in this area. However, we believe that the Proposed Regulations, in attempting to prevent abuses, go too far and will inappropriately and unfairly cause the termination of many S elections.

1. General approach. The threshold problem with the Proposed Regulations is their harsh and overly technical approach considering that (i) subchapter S is targeted to smaller businesses with less access to sophisticated tax advice, (ii) the purpose of the "one class of stock" requirement appears to be quite narrow and (iii) the consequences of a finding that this requirement has not been met are drastically adverse to the taxpayer.

First, subchapter S was enacted in 1958 to aid and benefit certain small businesses, as a way of expanding taxpayer options, not limiting them.[5] The 1982 Act emphasized the goal of simplifying Subchapter S by removing traps for the unwary.[6] Thus the legislative purpose is clearly to provide "user friendly" provisions.

Second, the available evidence of legislative intent suggests that the purpose of the "one class of stock" requirement is to avoid the complexity which would arise if a corporation's profits were passed through to preferred and common stock

---

[5] See 1958 Senate Report at 87.

[6] See H.R. Rep. No. 97-826, 97th Cong., 2d Sess. 1 (1982) (hereinafter the "1982 House Report"); S. Rep. No. 97-640, 97th Cong., 2d Sess. 1 (1982) (hereinafter the "1982 Senate Report").

shareholders with tiered claims to such corporate profits.[7] This purpose might be expressed more generally as a desire to avoid partnership-style allocations with their attendant complexity.[8]

Third, if an S corporation is found to have a second class of stock, its S election is terminated. Moreover, given the timing of the audit cycle, the year under audit would typically be several years in the past. Thus, the termination would effectively be retroactive by several years, multiplying its adverse impact on the taxpayer.

---

[7] The committee reports accompanying the reported bills in 1958 do not discuss the purpose of the "one class of stock" requirement. However, a forerunner to subchapter S was introduced in 1954 which would have permitted certain corporations to elect to be taxed as partnerships. This forerunner had a "one class of stock" requirement and the Senate report accompanying the proposed legislation discussed this requirement as follows:

> The corporation may have only one class of stock outstanding. No class of stock may be preferred over another as to either-dividends, distributions, or voting rights. If this requirement were not made, undistributed current earnings could not be taxed to the shareholders without great complications. In a year when preferred stock dividends were paid in an amount exceeding the corporation's current earnings, it would be possible for preferred shareholders to receive income previously taxed to common shareholders, and the same earnings would be - taxed twice unless a deduction for the earnings previously taxed were allowed to the common shareholders. Such an adjustment, however, would be extremely difficult where there had been a transfer of common stock in the interim.

S. Rep. No. 1622, 83d Cong., 2d Sess. 453-54 (1954). This passage was quoted in a discussion of Congressional objectives with regard to the one class of stock requirement in Shores Realty Co., Inc. v. U.S., 468 F.2d at 575; see also Portage Plastics Co., Inc. v. U.S., 486 F.2d at 637.

[8] Another purpose may have been to limit the availability of flow-through treatment to small or simple corporations, with a single class of stock being viewed as a rough identifier of small size or simplicity. See S. Rep. No. 830, 88th Cong., 2d Sess. 146 (1964). However, it would be difficult for Treasury to further this purpose in the regulations, particularly because more stringent or technical rules would tend to fall most heavily on taxpayers with less access to professional tax guidance, which would typically be the smaller corporation that Congress had in mind for the benefits of subchapter S.

In view of these considerations, we believe that an appropriate approach would be to find the prohibited second class of stock only where such a finding is truly necessary to carry out the purpose of the "one class of stock" requirement or to preserve the integrity of the subchapter S provisions. The provisions in the Proposed Regulations relating to nonconforming distributions, the exclusivity of the straight debt safe harbor, and the treatment of call options as a second class of stock (all discussed in more detail below) are overly rigid and go beyond what is necessary to achieve these policy goals.[9] Moreover, because of their broad sweep, these provisions (particularly those relating to nonconforming distributions) will have the practical effect of jeopardizing the S elections of a great many corporations, as a result of commonplace arrangements that are not tax-motivated.[10]

2. Nonconforming distributions. We believe the provisions in the Proposed Regulations relating to nonconforming distributions should be substantially revised as described below.

---

9 We acknowledge that Treasury has a legitimate interest in crafting rules to prevent abuses such as (i) shifting an S corporation's taxable income and loss to persons who do not have the economic benefit or burden of such income or loss or (ii) giving a person or entity which is not a permissible S corporation shareholder (such as a corporation) a disguised stock interest (i.e., an interest not stock in form but economically identical to a stock interest). However, as noted in various places in the report, we do not believe that these provisions can be justified as necessary on these grounds.

10 If the IRS determines that the termination of a corporation's S election was inadvertent, it may waive the termination under Section 1362(f). See 1982 Senate Report at 12-13 (may be appropriate to waive breach of "one class of stock" requirement). However, the possibility of such discretionary relief does not justify the existence of overbroad substantive rules. Moreover, from an IRS caseload management viewpoint, it does not make sense to adopt rules that will predictably generate thousands of claims for Section 1362(f) relief that will have to be processed administratively.

We believe that these provisions are conceptually wrong as a means of policing abuses, at least in cases where the nonconforming distributions are not part of a legally binding arrangement. Moreover, inadvertent violations of these provisions will cause myriad terminations of existing S corporation elections without significantly furthering the purpose of the "one class of stock" requirement.

Conceptually, the scheme of subchapter S is that a corporation's items of income, loss, deduction and credit are included by its shareholders pursuant to section 1366(a) in proportion to their shareholdings, with concomitant adjustments to the shareholders' stock basis. Distributions to the shareholders in accordance with the terms of their stock generally reduce their stock basis. If a corporation's shareholders purposefully cause it to make distributions with respect to its shares that diverge from the terms of the shares, then, except as discussed below, we believe the correct re-characterization is not to treat the corporation as having two classes of stock but, rather, to treat the corporation as having made a distribution according to the actual terms of the stock followed by transfers or loans among shareholders.

For example, suppose that Father and Son each own 50% of the stock of an S corporation and the S corporation makes a $100 distribution to Son and no distribution to Father. In this case, the diverging distributions were presumably a means of effectuating a gift from Father to Son. Therefore, the correct re-characterization is to treat Father and Son as each having received $50 of distributions followed by a $50 gift from Father to Son. This re-characterization is consistent with the fact that Father and Son each include 50% of the corporation's income under Section 1366(a). In substance Father and Son have not changed the terms of the corporation's stock and created two classes of stock, the result reached by the Proposed Regulations; they have merely shifted assets between themselves.

By contrast, if shareholders enter into a legally binding side agreement that has the effect of amending the distribution or liquidation rights of the stock, it may be appropriate to view the side agreement as altering the actual terms of the stock and therefore creating a second class of stock. But, if the side agreement is a mere plan or intention which is not legally binding, then the two-step analysis set forth in the preceding paragraphs should apply.

For example, suppose that C and D each own 50% of the stock of an S corporation, with C having started the corporation with his own efforts and D having come in later as an investor for $100,000 in cash. If C and D were to enter into a binding agreement to the effect that, upon liquidation, D would receive the first $100,000 of liquidation proceeds, C would receive the next $100,000 of liquidation proceeds and the balance would be divided equally between them, then the agreement is a de facto amendment of the terms of the stock and the corporation therefore has more than one class of stock. However, if there were a plan between C and D to this effect but the plan was not legally binding on C, then the correct re-characterization is to treat the corporation as having a single class of stock and, if in fact C diverts some of his liquidation proceeds to D (perhaps to retain D's good will for future investments), C would be treated as having received such proceeds and as having made a payment of such proceeds to D.[11]

We acknowledge that a test based on legal enforceability does not provide as bright a line as might appear at first glance. Oral agreements may, of course, be legally binding, and arrangements between shareholders of closely held entities are notorious for their informality. With this in mind, it may be appropriate to provide a rebuttable presumption that a series of distributions over a period of years that do not conform to the terms of the outstanding stock are presumed to constitute a legally binding arrangement--and therefore a de facto amendment of the stock terms resulting in a second class of stock. However, the shareholders should be permitted to rebut the presumption by proving the absence of a legally binding arrangement, provided that the collateral shareholder-level consequences of the arrangement (e.g., gift, compensation, or loan treatment) are given full effect.

Apart from the conceptual problems posed by the Proposed Regulations' treatment of purposeful nonconforming distributions, there are two basic practical problems with technical rules such as the nonconforming distribution rules. First, S corporations are often small businesses with shareholders who are informal about interim uses of cash because they assume that they will

---

[11] In applying the binding agreement rule, we do not intend that an agreement relating to a particular distribution that is made contemporaneously with the distribution would be viewed as an agreement affecting the terms of the stock. Instead, such an agreement is more properly viewed as a means of disposing of the particular distribution. Thus, the facts in Example 2 below would not cause a finding of a second class of stock even if B's agreement to let A receive a non-pro rata distribution were legally enforceable.

"settle up" later, often after the end of the year when the corporation's books and tax returns are prepared. Second, a very small constructive dividend can cause the termination of the S election. It is extraordinarily harsh to terminate an S election because of timing differences in dividend payments or small constructive dividends.

The following examples illustrate the overbroad application of the nonconforming distribution provisions. In each example, assume that A and B each owns 50% of the stock of X, an S corporation.

> Example 1. X's clerical employee inadvertently causes X to make a smaller quarterly dividend distribution to A than to B. The error is discovered by X's accountant after the end of the taxable year when he is preparing financial statements and tax returns for the corporation. When the error is pointed out to the shareholders, an adjusting distribution is made to A.

> Example 2. A needs money to pay unexpected bills. B agrees to let A draw against the corporation's profits in mid-year to meet these bills. B takes an equalizing distribution within the same taxable year but six months later.

> Example 3. A uses an automobile owned by X primarily in furtherance of X's business. On audit, the IRS determines that A has used the automobile for personal purposes on several occasions during the taxable year and therefore considers A in receipt of a constructive dividend equal to the value of such personal use.

In each of these situations, X’s election under subchapter S would be terminated under the nonconforming distribution provisions, an obviously inappropriate result.

The constructive dividend issue is a difficult one and warrants additional discussion. On the one hand, small or isolated constructive dividends should not result in termination of an S election. On the other hand, a long-term compensation agreement or lease of property between an S corporation and a shareholder which is not on arm's length terms may constitute a de facto amendment of the terms of the stock, appropriately resulting in a second class of stock. On balance, we recommend that (i) constructive dividends (particularly small, isolated or unintentional constructive dividends) generally should not be treated as creating more than one class of stock but (ii) constructive dividends arising under a multi-year legally-binding contract between an S corporation and a shareholder should generally be treated as de facto amendments of the terms of the corporation's stock unless the amounts of the constructive dividends are small in relation to the payments generally under the contract or the parties can show that they made a good faith effort to set the contract terms on an arm's length basis.

In sum, we urge the substantial revision of the rules on nonconforming distributions. We recommend that these rules be revised along the following lines:

(1) Generally, distributions not in accordance with the terms of the S corporation's stock (whether intentional or unintentional) should be re-characterized as having been made in accordance with the terms of the stock followed by subsequent transfers or loans between shareholders (and

therefore should not result in a finding of more than one class of stock);

(2) If the shareholders enter into a legally binding side agreement that has the effect of amending the distribution or liquidation rights of the stock, the side agreement should be treated as altering the actual terms of the stock and therefore creating a second class of stock. It may be appropriate to provide a rebuttable presumption that a series of nonconforming distributions over a period of years is presumed to constitute a legally binding arrangement;

(3) Constructive dividends should be treated as described in the preceding paragraph.

If, contrary to our recommendation, it is decided to retain the substance of the nonconforming distribution provisions, we recommend (i) extending the correction period until the tax return filing date for the relevant taxable year, including extensions, and (ii) making it clear that small, isolated or unintentional constructive dividends will not give rise to nonconforming distributions.

3. Instruments outside straight debt safe harbor. If a purported debt instrument is treated as equity for Federal income tax purposes, we believe it should not automatically be classified as a second class of stock if it is not within the straight debt safe harbor. The legislative history of the 1982 Act offers insufficient evidence of congressional intent to overrule the Portage Plastics line of cases and policy considerations do not require that these cases be overruled.

Cases decided before the 1982 Act declared two versions of regulations on this issue invalid as applied to the factual situations under consideration. The original version of Regulation Section 1.1371-1(g) provided that "if an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock". In Gamman,[12] these regulations were declared invalid as applied to purported debt held by the shareholders in direct proportion to their shareholdings. The IRS then revised Regulation Section 1.1371-1(g) to provide that purported debt which is actually equity will be treated as a second class of stock unless the debt is held in the same proportions as the nominal stock. These revised regulations were held invalid as applied to purported debt not held in the same proportion as the nominal stock.[13] The IRS then issued Technical Information Release 1248 in 1973, stating that it would not litigate the second class of stock issue in cases "factually similar" to the decided cases and that it would revise the regulations.[14]

In 1982, a statutory provision was added as part of the 1982 Act which allowed specified instruments to be insulated from attack as a second class of stock. This "straight debt" safe harbor evolved as follows.

On September 16, 1982, the initial bill that ultimately became the 1982 Act, H.R. 6055, was reported out of the Ways and Means Committee to the full House, amended to include the straight debt safe harbor. The bill did not contain any language

---

[12] Gamman v. C.I.R., 46 T.C. 1 (1966).

[13] Portage Plastics Co., Inc. v. U.S., 486 F.2d 632 (7th Cir. 1973) (en-banc); Stinnett v. C.I.R., 54 T.C. 221 (1970).

[14] T.I.R. 1248 (July 27, 1973).

concerning the treatment of debt not falling within the safe harbor.

The Ways and Means report accompanying the bill states generally that the intent of the bill was to simplify and modify subchapter S by, in part, removing eligibility restrictions that appear unnecessary.[15] The report also adds an observation in the "Reasons for Change" section that then-current law contained many traps for the unwary, including unintentional violation of the eligibility rules, resulting in retroactive terminations of elections.

The report explained the straight debt safe harbor as follows:

> In order to insure that the corporation's election will not terminate in certain situations where the existence of a purported debt instrument (that otherwise would be classified as stock) may not lead to tax avoidance and does not cause undue complexity, the bill provides that an instrument which is straight debt will not be treated as a second class of stock . . . and therefore cannot disqualify a subchapter S election.[16]

The report goes on to state that "[the] classification of an instrument outside the safe harbor rules as stock or debt will be made under usual tax law classification principals [sic]".[17] The Senate report contains the identical statement.[18]

---

15 see 1982 House Report at 1.

16 Id. at 8.

17 Id.

18 1982 Senate Report at 8. The Senate Report is identical to the House Report in all material respects.

On October 15, 1982, the staff of the Joint Committee released a description of the Act.[19] The summary of the straight debt safe harbor included in the Joint Committee staff description contains the following statement: “The classification of instruments outside the safe harbor rule as stock or debt will be made under usual tax law classification principles applicable to subchapter S corporations.”[20]

The Treasury and IRS view--that purported debt treated as stock for Federal income tax purposes should be automatically treated as a second class of stock unless it comes within the straight debt safe harbor--is presumably based on the above-based on the above-referenced statements in the House and Senate Reports to the effect that instruments outside the safe harbor will be classified under the usual tax law classification principles.[21] The Treasury and IRS apparently infer from this statement that Congress intended that an instrument treated as equity under usual (i.e., non-subchapter S-specific) tax law classification principles should be treated as a second class of stock.[22]

---

19 JCS-37-82, 87th Cong., 2d Sess. (1982).

20 Id. at 14 (emphasis supplied).

21 Clearly, it would have been necessary to overrule prior case law to implement the Treasury view, since some of the pre-1982 cases involved instruments that would not qualify under the safe harbor. For example, Portage Plastics involved an instrument that paid interest calculated by reference to the issuer's net profits.

22 At least one Treasury official has stated publicly that Treasury and the IRS also base their view on a portion of the oral testimony of David Glickman, then Deputy Assistant Secretary of the Treasury for Tax Policy, during hearings on the 1982 Act. However, it is uncertain how much weight should be given to Mr. Glickman's oral testimony and we note that even Mr. Glickman's testimony did not include an express statement that the Portage Plastics line of cases should be overruled.

There are two principal difficulties with this inference. First, if Congress focused on this issue and intended to overrule a line of cases which invalidated two different versions of an IRS regulation, one would expect the legislative history to be more explicit and state that the cases are intended to be overruled.[23] Second, the congressional intent assumed by the IRS is contradicted by the Joint Committee Staff print on the Act, which states that debt instruments outside the safe harbor should continue to be governed by the classification rules theretofore applicable to subchapter S corporations--which would include the Portage Plastics line of cases.

Moreover, from a policy viewpoint, we do not believe it is necessary to overrule the Portage Plastics line of cases to prevent the abusive utilization of purported debt to circumvent the "one class of stock" requirement. These decisions were based on the specific facts before the courts which did not appear to involve a tax avoidance motivation.[24] However, the case where the taxpayer uses purported debt to achieve noneconomic sharing of an S corporation's taxable income or loss or to avoid the

---

[23] See Estate of Wood v. C.I.R., 909 F.2d 1155, 1160 (8th Cir. 1990).

[24] See Portage Plastics Co., Inc. v. U.S., 486 F.2d at 638; Amory Cotton Oil Company v. U.S., 468 F.2d 1046, 1050 (5th Cir. 1972); Shores Realty Company, Inc. v. U.S., 468 F.2d at 577 note 6; Brendan v. O'Donnell, 322 F.Supp. 1069, 1073 (N.D. Ala. 1971). In Shores Realty, a corporation did hold some of the purported debt. However, the court did not discuss this fact.

The legislative history of the 1982 Act notes that the pre-1982 case law is based on the absence of tax avoidance: "Under present law, the courts have ruled that certain purported debt instruments are permissible where their existence offered no tax avoidance possibilities, notwithstanding that under traditional tax concepts these instruments would have normally been considered stock for tax purposes. . . ." 1982 House Report at 7; 1982 Senate Report at 7.

limitations on permissible S corporation shareholders was not before the courts and a court may well, consistent with these cases, find purported debt to be a second class of stock in such a case. Thus, we do not read the Portage Plastics line of cases to be inconsistent with Treasury's policy goals with respect to the “one class of stock” requirement.

The Proposed Regulations provide that debt within the straight debt safe harbor will be treated as debt for all Federal income tax purposes, unless the Commissioner determines that a principal purpose for issuing the debt is tax avoidance. Thus, under the Proposed Regulations, a taxpayer could never create a situation for tax avoidance purposes in which an S corporation has outstanding debt that is re-characterized as stock for Federal income tax purposes and the S election is preserved. By contrast, if the Portage Plastics line of cases remains intact, there may be situations where purported debt will be reclassified as equity for general tax purposes without terminating an S election. One of the objectives of Treasury in seeking to overrule the pre-1982 case law may have been to eliminate this possibility.

We recognize that the proper income tax treatment of reclassified debt that is issued by a corporation with a valid S election may pose problems. For example, the corporation's taxable income and loss would have to be passed through to both the actual shareholders and the holder of the reclassified debt and there is no statutory guidance as to how this should be done. We believe, however, that the potential for unwarranted tax results for debt holders or actual shareholders is one of the factors that would appropriately be considered by a court in determining whether the presence of debt that would be reclassified as stock under general tax principles ought to terminate an S election. The concern over this issue is not sufficient to warrant an ironclad rule that would always terminate an S election where debt is re-characterized for general tax purposes, even in situations where debt holders or actual shareholders have not attempted to take advantage of the re-characterization of debt in determining their own tax treatment.

In summary, given the paucity of literal support in the legislative history for overruling the Portage Plastics line of cases and the fact that these cases are not inconsistent with Treasury's policy goals, we believe that the Proposed Regulations should not take the position that these cases have been overruled.

4. Straight debt safe harbor. We believe that the straight debt safe harbor should not add the requirement that the debt instrument bear a “reasonable interest rate”, a requirement which does not appear in the statute.

The JRS's authority to add to the requirements of the straight debt safe harbor is questionable. Section 1361(c)(5)(C) grants authority to the IRS to issue regulations “that may be necessary or appropriate to provide for the proper treatment of straight debt under this Subchapter and for the coordination of such treatment with other provisions of this title”. However, this grant of regulatory authority is intended to permit the IRS to coordinate the straight debt safe harbor with other Code provisions within and without subchapter S (e.g., the limitation on deductibility of investment interest under Section 163(d)) and to deal with debt within the straight debt safe harbor in the event a corporation is converting from a C corporation to an S corporation.[25] The statute does not confer authority to issue regulations on the definition of straight debt. Further, there is no indication in Section 1361(c)(5) or the legislative history that the list of requirements in Section 1361(c)(5) is not intended to be complete. Moreover, it is questionable whether the Service's general authority to issue "interpretive" Regulations under Section 7805 empowers it to add a substantive requirement that the debt bear a reasonable interest rate.

As a matter of policy, the advisability of adding this requirement is also subject to question. To be sure, for taxpayers aware of the requirement, the reasonable interest rate requirement is easy to comply with; the safe harbor rates provided are adequate for this purpose. However, the existence of the reasonable interest rate requirement is a trap for S corporations without ready access to sophisticated tax advice. Moreover, the reasonable interest rate requirement is not necessary from a policy viewpoint. Straight debt that is non-proportionate will likely be treated as debt under the case law. If proportionately-held straight debt bears inadequate or excessive interest, there are more appropriate and better-tailored tools available to the IRS to deal with these problems than termination of an S election. These include Section 1366(e), Section 7872 and Section 482. Terminating an S election because of inadequate or excessive interest is simply too drastic a consequence.

To illustrate how these other sections might be applied, suppose that the rate of interest charged on a shareholder loan is less than the applicable Federal rate. In that event, section 7872 would generally treat the transaction as a loan bearing interest at the applicable Federal rate, together with a payment

[25] See 1982 House Report at 8.

equal to the foregone interest by the lender to the corporation. Thus, section 7872 would seem always to provide a rate falling within the safe harbors set forth in the Proposed Regulations, and we do not see why the deemed payment by the lender to the corporation would itself cause the creation of a second class of stock. On the other hand, if interest were charged at a clearly excessive rate, then the excessive interest could be treated, under general tax principles or possibly under section 482, as a constructive distribution. Such distribution would be subject to any rules that are finally adopted for treating constructive distributions as nonconforming distributions.

5. Options. The Proposed Regulations provide that call options substantially certain to be exercised at the time of their issuance, material modification or transfer are treated as a second class of stock in all cases. We believe that the treatment of call options under the Proposed Regulations is inappropriate and should be changed.

First, we question whether a call option that is substantially certain to be exercised should be treated as a second class of stock in all cases. A better approach might be to treat the option as the underlying stock but not necessarily as a second class of stock. Analyzing the call option as stock, if the holder of the call option will, through exercise, obtain the same right to distribution and liquidation proceeds as the actual shareholders and if any differences in distributions prior to exercise would not create a second class of stock under regulations dealing with the effect of non-pro rata distributions, then second-class-of-stock treatment would not be appropriate. The holder of the call option could be treated as an actual shareholder for purposes of the inclusion of the corporation's items of income, loss, deduction and credit pursuant to Section 1366(a). Thus, the corporation's income could be allocated among its shareholders (both actual and deemed) and the purpose of the second class of stock requirement (avoiding complex allocations of corporate income and loss among different tiers of shareholders) would not require a finding of a second class of stock. Moreover, the collateral goals of the Treasury--preventing allocations of income and loss for tax purposes without economic substance and preventing impermissible shareholders of S corporations from having interests that are economically identical to those of shareholders--would be achieved by treating call options that are substantially certain to be exercised as the underlying stock.

To illustrate our approach, if a dividend were distributed to the actual shareholders but not to the option holder, the dividend would be analyzed as a non-pro rata distribution. Thus, if the option holder could have obtained his pro rata share of the distribution by exercising the option, then, as discussed supra at pages 13-16, the distribution might be treated as pro rata (including the option holder for this purpose), followed by a payment by the option holder to the actual shareholders.[26] On the other hand, if the option is not exercisable say for five years, and it is expected that there will be distributions on stock during that period, then the difference in distributions on stock and to the option holder could result in more than one class of stock under the rule we proposed for non-pro rata distributions arising under legally binding agreements. These rules would, of course, apply only if an option was substantially certain to be exercised.

---

26 If the option holder does not exercise the option in order to receive the dividend, this may tend to indicate that the option was not substantially certain to be exercised.

Second, consideration should also be given to the adoption of a more limited rule under which call options that are substantially certain to be exercised would be treated as the underlying stock only if they are issued with a principal purpose of avoiding taxes by shifting taxable income or loss. Under this approach, a call option would generally be treated as an option (and not as the underlying stock) even if the call option were substantially certain to be exercised. Thus, the corporation's items of income, loss, deduction and credit would be allocated only to the actual shareholders (and not to the holders of call options), subject to the anti-abuse rule referred to above. This approach would have the advantage of eliminating the practical uncertainty involved in determining whether a call option is in fact substantially certain to be exercised. Since S corporations are always closely held (because of the limitation on the number of shareholders), there is no market mechanism for determining the value of an S corporation's shares and thus, as a practical matter, in many cases it will be quite difficult to ascertain with any degree of confidence whether a call option is substantially certain to be exercised.[27] In particular, this approach avoids the problem of a potential termination of a corporation's S election solely because an option it has issued to an impermissible shareholder (such as a corporation) may be considered “substantially certain to be exercised”. There appears to be no important tax policy reason to terminate the S election in this situation if there is no intention to avoid tax through income or loss shifting and no taxable income or loss is passed through to the option holder.

---

[27] Although the safe harbor for call options with a strike price of at least 90% of fair market value might be useful if there were a contemporaneous issuance of stock to third parties, in many cases the value of an S corporation's shares is not readily determinable, and thus the safe harbor does not solve the uncertainty problem. If the approach set forth in this paragraph is not adopted, the 90% figure in the safe harbor should be reduced in order to lessen the uncertainty.

Third, we note that there are issues concerning the "substantially certain to be exercised" standard itself. The Proposed Regulations provide that the standard applies "regardless of whether the owner of the call option is treated as the owner of the underlying stock under general principles of tax law". As a conceptual matter, it is not clear why the ownership of stock of an S corporation which is the subject of an option should be governed by different rules than those governing the ownership of property generally for Federal income tax purposes. On a more practical level, there may be situations where an option that is substantially certain to be exercised should not be treated as the underlying stock. For example, in situations where the exercise price of an option is at or near fair market value but circumstances unrelated to exercise price make it substantially certain that the option will be exercised, (e.g., family considerations or the desire to eliminate minority ownership), it may not be appropriate to treat the option as the underlying stock. Perhaps this could be dealt with by specifying that the option must be substantially certain to be exercised for reasons relating to the exercise price in order for the option to be treated as the underlying stock.

Finally, in view of the thorny issues involved in articulating a comprehensive rule on the question of when an option should be treated as a second class of stock, Treasury could leave the entire issue to be addressed by the case law. This would permit the courts to address a particular factual situation--and to weigh the economic likelihood of exercise, the presence or absence of business or tax motivation for the option, and the appropriateness of terminating the corporation's S election in the particular situation--without the need to articulate a comprehensive doctrine. In this way, a body of case law for options, analogous to the Portage Plastics line of cases for purported debt instruments, could develop.

On balance, we believe that the best approach would be to treat a call option substantially certain to be exercised for reasons relating to exercise price as the underlying stock (with a safe harbor exercise price at somewhat less than 90% of fair market value) and to assess whether, treated as the underlying stock, the call option has the attributes of a second class of stock.

6. Effective date. We believe the Proposed Regulations should be re-proposed and, when final regulations are ultimately adopted, we believe consistent with the recent IRS announcement in IR-91-25 that such final regulations should apply prospectively only.

Treasury will face two basic administrative alternatives after it makes its modifications to the Proposed Regulations: it can re-propose the regulations or it can issue them in final form. In view of the controversy generated by the Proposed Regulations and the extensive modifications which we consider advisable, we believe that the regulations should be re-proposed. Given that taxpayers and the government have been operating without regulations on the one-class-of-stock issue since the issuance of T.I.R. 1248 in 1973 and the significant legislative modifications enacted in 1982, the benefit of providing an opportunity for public comment on re-proposed regulations would appear to outweigh any detriment from the delay caused by such a re-proposal.

As to the effective date for the ultimate final regulations, we suggest that final regulations, when adopted, should generally apply for taxable years beginning after the Ninety Day Date, but should not apply to debt instruments or call options issued before the date the final regulations are promulgated.

Our proposed effective date rule would make it unnecessary for pre-existing debt instruments and call options to be changed for taxable years subsequent to issuance of the final regulations. We believe this approach is appropriate for two reasons. First, taxpayers may have no reason to consult their tax advisors to determine whether their pre-existing arrangements were affected and thus the application of the new rules to pre-existing debt instruments and call options would be a “trap for the unwary”. Second, even if taxpayers were aware of the applicability of the new rules, their applicability to pre-existing debt instruments and call options held by third parties such as lenders could require a difficult renegotiation of existing financing arrangements, precisely what prospective rules are supposed to prevent.

Technical Comments

Section 1.1361-1(b)(3), -1(1)(2)(i). These sections provide, inter alia, that substantially non-vested stock with respect to which a section 83(b) election has been made is treated as outstanding stock for purposes of the “one class of stock” requirement and that such stock is treated as a second class of stock unless it confers rights to distribution and liquidation proceeds identical to those conferred by the other outstanding shares.

Non-vested stock as to which a section 83(b) election has been made ("section 83(b) stock") does not, by virtue of such election, cease to have the features that made it non-vested, i.e., it remains forfeitable (or subject to a fixed price buyback) and non-transferable. Under the Proposed Regulations, it is not clear whether the forfeitability (or fixed price buyback) will cause the stock to be considered to have rights to distribution and liquidation proceeds that differ from the other outstanding shares. Presumably the drafters intended that forfeitability (or a fixed price buyback) will not cause section 83(b) stock to be considered a second class of stock (otherwise all section 83(b) stock would be a second class of stock). It would be helpful if the Proposed Regulations would make this point explicitly.

Section 1.1361-1(b)(4). This section in effect provides a definition of a deferred compensation plan that will not be considered a second class of stock. We believe the definition should be expanded to encompass a plan where the income is taxable currently to the recipient, as well as a plan where the income is deferred, so long as the initial receipt of rights under the plan is not taxed currently to the recipient. For example, if an employee of an S corporation is entitled to additional annual compensation equal to 2% of the corporation's net earnings, such entitlement should not be treated as a second class of stock merely because the 2% of net earnings is taxed to the employee currently, rather than being taxed on a deferred basis. To reflect this point and several non-substantive clarifying changes, we suggest that the section be revised to read as follows:

"4) Treatment of Deferred Compensation Plans. For purposes of subchapter S, the issuance by a corporation of an instrument or obligation, or the entering into an arrangement by a corporation, that does not convey the right to vote, that does not itself produce a transfer of property under section 1.83-3 of the regulations, and that is issued or entered into with an employee in connection with the performance of services under a plan with respect to which the employee is not taxed currently on income with respect to such issuance or the entering into of such an arrangement (regardless of whether the employee is taxed currently on income from the arrangement), shall not be treated as creating outstanding stock." (changes are underlined)

Section 1.1361-1(1)(2)(i). This section includes a provision to the effect that agreements to redeem stock are disregarded in determining whether a corporation has more than one class of stock unless the agreement, inter alia, restricts the right of the holders of the subject stock to share in liquidation proceeds. We presume that if a shareholders agreement grants a corporation a call right to redeem shares of a shareholder at an appraised value or at a formula price, for example upon a shareholder's death or his leaving the employ of the corporation, such call right would not be considered a restriction on the shareholder's right to share in liquidation proceeds for this purpose. The Proposed Regulations should so state.

Section 1.1361-1(1)(2)(ii)(B). The pro rata distribution exception to the general rule on nonconforming distributions provides different correction periods (during the same taxable year or within a 3-month period) depending on whether the timing differences in the distributions are "unintentional". The Proposed Regulations do not state whose state of mind is relevant in deciding whether the timing difference was unintentional, e.g., one or more shareholders, officers, other employees, etc. In addition, it is not clear what level of intent is required, e.g., the intent to pay money, the intent to make a dividend distribution, or the intent to make a non-pro rata dividend distribution. Rather than attempt to sort through this thicket of issues, we suggest that the correction period ought to be the same regardless of whether the timing difference was "unintentional".

Section 1.1361-1(1)(2)(ii)(C). The second sentence of this section provides that a distribution treated as a section 301 distribution pursuant to section 302(d) is not treated as a nonconforming distribution unless made pursuant to a plan providing for "a series of distributions to the shareholders of the S corporation that would result in the shareholders owning substantially the same proportionate interest in the corporation that they had before the series of distributions". Presumably, the quoted language is intended to apply to a situation illustrated by the following example:

Example 1. A, B and C each own 100 of the 300 outstanding shares of X, an S corporation. As part of a plan, X redeems 10 of A's shares in January 1991 for $10, 10 of B‘s shares in December 1991 for $10 and 10 of C's shares in June 1992 for $10.

The intended result under the Proposed Regulations is presumably to treat the three $10 distributions under the nonconforming distribution rules without regard to the fact that they were structured in form as redemptions. On the other hand, the following example is presumably a case where the nonconforming distribution rules would not apply:

Example 2. Father and Son each own 50 of the 100 outstanding shares of Y, an S corporation. In an isolated transaction, Y redeems 10 shares from Father for $100. The Proposed Regulations should clarify, by further explanation or example, that this is the intended meaning of the language quoted above.[28]

Section 1.1361-1(1)(3)(iii)(A). After stating generally that a call option substantially certain to be exercised is treated as a second class of stock[29], this section goes on

[28] Our technical comments on the nonconforming distribution provisions are subject to our more general discussion of these provisions at pp. 13-20 supra.

[29] Our discussion about treating options as a second class of stock and about the “substantially certain to be exercised” standard appears supra at pp. 30-36.

to state “thus, for example” a corporation that issues or has outstanding a call option with a strike price substantially below the market price of the underlying stock on the date the call option is issued, transferred, or materially modified is treated as having more than one class of stock. This “example” may be inconsistent with the “substantially certain to be exercised” standard. By definition, an S corporation has a limited number of shareholders and thus there is unlikely to be a ready market for its shares. Therefore, even if a call option has a strike price substantially below market (in the sense of being substantially below the price that shareholders contemporaneously paid for their shares), there may be no buyer for the stock if the call option holder exercises his option. Accordingly, the call option holder may not be substantially certain to exercise his option. Because the “example” may thus be inconsistent with the general rule, it should be eliminated from the Proposed Regulations. If a call option has a strike price substantially below the market price of the underlying stock and this does cause the option to be substantially certain to be exercised, then the general rule would cause the call option to be treated as stock.

Section 1.1361-1(1)(3)(iii)(B). The exception to the general rule on call options for certain options issued to lenders and exercisable only upon a loan repayment default is of relatively limited utility. An option exercisable only in the event of a default is not a true option in the ordinary sense of the word. A true option is designed to give the holder a participation in the “upside” if the issuing corporation does well. An option exercisable upon default will not be of value to the holder if the corporation does well. Thus, for example, the exception does not apply to an option issued to a lender as a “kicker”. It is not clear whether this exception was intended to be so narrow.

The exception to the call option rules for certain employee options is extremely useful. It would seem consistent with its purpose to extend it to any person performing services and not just to employees.

Section 1.1361-1(l)(4)(ii)(C). Although we disagree with the decision to add the "reasonable interest rate" requirement to the straight debt safe harbor, we believe that the reasonable interest rate safe harbors are very reasonable and well designed. However, we believe that, to aid those not thoroughly versed in the original issue discount rules, the Proposed Regulations should state that a loan which bears interest currently at one of the safe harbor interest rates (either fixed or variable) is treated as bearing a reasonable interest rate.

Section 1.1361-1(l)(5), Example 5. This example, relating to an exception to the rules on nonconforming distributions, is confusing because the distributions in the example are exactly 3 months apart. Presumably the example would reach the same result if the correcting payment were to be made on December 1 rather than June 1 and we suggest that the example be changed to so provide.