A Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary: Part VIII - Shareholder Eligibility & The Peril of Having an Ineligible Shareholder Causing the Termination of the S Election

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Overview

In the S corporation arena, tax advisors and taxpayers generally do not focus a lot of attention on the S corporation shareholder eligibility rules other than at the time the S election is made. As we dive into shareholder eligibility rules in this Part VIII of my multi-part series on Subchapter S, it should become apparent that the eligibility rules can be complex and require that S corporations and their shareholders keep a close eye on shareholder eligibility after the S election is made.

Instances where S corporations and their shareholders may find the S election in peril for violating the shareholder eligibility rules include: (i) when a shareholder sells or otherwise transfers shares to a person or entity other than an existing eligible shareholder; (ii) when the corporation issues shares to a new shareholder; and (iii) when an existing shareholder transfers shares to a vehicle intended to be used for estate planning and/or creditor protection purposes. Failure to pay close attention to the eligibility rules can result in disastrous consequences to the S corporation and its shareholders.

The Code defines an S corporation as a "small business corporation" for which an election under IRC § 1362(a) is in effect.[1] A "small business corporation" is defined in § 1361 (b) as a domestic corporation that is not an ineligible corporation, and that does not:

- Have greater than one hundred (100) shareholders.

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- Have a shareholder that is not an individual, estate, specified type of trust or a specified type of tax-exempt organization.
- Have a nonresident alien as a shareholder.
- Have more than one class of stock.

Shareholder Eligibility

In accordance with Code § 1361(b), (c) and (d), all shareholders of an S corporation must be eligible shareholders. Several intricate rules accompany that requirement and are intertwined in many aspects of Subchapter S. The peril of having an ineligible shareholder is simple: the corporation's S election is terminated as of the first day the shares are held by the ineligible shareholder. So, an innocent transfer to an ineligible shareholder could result in a revocation.

Eligibility In General

Each shareholder must be an individual, a decedent's estate, a bankrupt's estate under Title 11 of the U.S. Code, a specified trust, a Code §§ 401(a) or 501(c)(3) organization, or a Code § 501(a) organization. Foreign trusts and nonresident aliens may not be shareholders of an S corporation.

Individuals

Individuals are eligible shareholders.[2] As stated above, however, nonresident aliens are ineligible shareholders.[3] For this purpose, an alien resident of Puerto Rico was held ineligible.[4]

PRACTICE ALERT: Be careful where community property laws apply. In *Ward v. United States*,[5] a shareholder's spouse (a citizen and resident of Mexico) who had a community property interest in the stock of an S corporation, caused the corporation to lose its S election. Even the "family" election under the provisions added to Subchapter S by the American Jobs Creation Act of 2004 ("AJCA") would not change this result.

PRACTICE ALERT: It is not clear whether "nonresident alien" applies only to individuals or whether it extends to alien estates.[6] The Code, however, specifically labels foreign trusts as ineligible.[7] **Caution is advised.**

Trusts

Limited types of trusts may be eligible shareholders.[8] Code § 1361(c)(2)(A) describes five (5) types of trusts that may own stock in a Subchapter S corporation.[9] They are as follows:

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- A trust that is treated under Code §§ 671-678 (Subpart E of Part I of Subchapter J) as totally owned by an individual who is a citizen or resident of the United States is an eligible Subchapter S corporation shareholder.[10]
- A trust meeting the requirements of paragraph one (described above) immediately before the death of the owner is an eligible Subchapter S corporation shareholder, but only for two (2) years post date of death.[11]
- A trust in which stock is transferred to it pursuant to the terms of a will is an eligible Subchapter S corporation shareholder, but only for two (2) years following the transfer.[12]
- A trust created primarily as a voting trust is an eligible Subchapter S corporation shareholder.[13] Treasury Regulation § 1.1361-1A(h)(3)(ii) requires that a voting trust be in writing, delegate the right to vote to the trustee, require all payments be made to or on behalf of the beneficial owners, require that title of the stock be delivered to the beneficial owners on termination, and must terminate by local law or by the agreement on or before a specific date or event.
- An Electing Small Business Trust ("ESBT"), provided that all beneficiaries must be individuals or estates. Prior to January 1, 1998, charitable organizations described in Code § 170(c)(2)-(5) could only hold contingent remainder interests. Thereafter, such beneficiaries are allowed to hold current income interests. No interest in such a trust may be acquired by "purchase." Unlike QSSTs, ESBTs may have more than one (1) current income beneficiary.

Subpart E Trusts

As stated above, pursuant to Code § 1361(c)(2)(A)(i), a trust treated under Code §§ 671-678 (Subpart E of Part I of Subchapter J) as totally owned by an individual who is a citizen or resident of the United States is an eligible Subchapter S corporation shareholder. The following is a general overview of the operative provisions contained in that subpart:

- Subject to several exceptions enumerated in Code § 673(b), for transfers in trust made on or before March 1, 1986, the grantor shall be treated as the owner of any portion of the trust in which he has a reversionary interest which, at the inception of that portion of the trust, is reasonably expected to take effect within ten years from the date of transfer to said trust.[14] The grantor, however, is not the owner of any portion of the trust where his or her reversionary interest in such portion is not to take effect until the death of the persons to whom income therefrom is payable.[15] For transfers made after March 1, 1986, the grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest which, at the inception of that portion of the trust, the value of such interest exceeds 5% of the value of such portion of the trust.[16] The grantor is not, however, treated as the owner where the beneficiary is a lineal descendant, holds all of the present interest in a portion of the trust, and the grantor retains a reversionary interest in said portion to take effect should the beneficiary die before attaining age 21.[17]

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- The grantor shall be treated as the owner of any portion of the trust in which the beneficiary's enjoyment of corpus or income is subject to a power of disposition, exercisable by the grantor or a non-adverse party (or both) without the approval of any adverse party (defined in Code § 672(2) as a party who has a substantial beneficial interest in the trust which would be affected by the exercise of the power).[18] A power of disposition includes, but is not limited to, a fiduciary power, or a power of appointment.[19] This rule does not apply to powers solely exercisable by a trustee, who is not a grantor or a spouse living with a grantor, to distribute, apportion or accumulate income if such person is limited by a reasonable standard set forth in the trust instrument.[20] Moreover, testamentary powers held by anyone other than the grantor are exempted from this rule. As well, if the trustee is not the grantor, sprinkle powers are likewise exempted.[21]
- A grantor shall be treated as the owner of any portion of a trust in which:
  - The grantor or non-adverse party (or both) without consent of an adverse party has a power to deal with corpus or income for less than full consideration;
  - The grantor or a non-adverse party (or both) have a power to borrow corpus or income without adequate provisions for security and interest;
  - The grantor has directly or indirectly borrowed trust funds and not completely repaid the loan; or
  - The grantor or other person, in a non-fiduciary role, has administrative powers to affect the trust corpus (e.g., vote stock, invest funds, or reacquire trust corpus by substituting property of equal value).
  - The grantor shall be treated as the owner of any portion of a trust in which there exists a power, exercisable by the grantor or a non-adverse party (or both), to re-vest title in the grantor.[22] For transfers occurring on or before March 1, 1986, if the power affects the beneficial enjoyment of income only after the expiration of ten years, said power will not make the grantor the owner of any portion of the trust.[23] For transfers occurring after March 1, 1986, if the power affects an interest, which at the inception of the trust, the value of such reversionary interest does not exceed 5% of the value of such portion of the trust, said power will not make the grantor the owner of any portion of the trust.[24]
  - In general, the grantor will be treated as the owner of any portion of a trust in which income is held, accumulated, or distributed for the benefit of the grantor or his spouse, or to pay life insurance premiums for the grantor or his spouse.[25]
  - Persons other than the grantor may be treated as the owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest corpus or income therefrom in himself; or such person has previously released or otherwise modified such power.[26]

Qualified Subchapter S Trusts

Code § 1361(d) provides that a QSST is also an eligible Subchapter S corporation shareholder. Pursuant to Code § 1361(d)(1)(A), a QSST is treated as a trust meeting the requisites of IRC § 1361(c)(2)(A)(i). These requisites are:

- The trust terms must require: (i) During the life of the current income beneficiary, there can only be one income beneficiary; (ii) Corpus distributions during the current income beneficiary's life can only be made

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to that beneficiary; (iii) The current income beneficiary's interest must terminate on the earlier of his or her death, or termination of the trust; and (iv) If the trust terminates during the current income beneficiary's life, all assets must be distributed to that beneficiary.[27]

- All of the trust's income (as defined under Code § 643(b)) must either be distributed or required to be distributed currently to an individual who is a citizen or a resident of the United States.[28] Section 643 defines "income" as the amount of trust income for the year determined under the Trust Agreement and local law.
- In order for a trust that meets the requisites of Code § 1361(e)(3) to qualify as a Subchapter S corporation shareholder, the current income beneficiary (or his legal representative) must file an election with the Internal Revenue Service.[29] The election is retroactive for up to 75 days prior to the filing.[30] It must be filed with the Service Center with which the corporation files its federal income tax returns. No particular type of form is required. A statement with the following information will suffice: Name, address, and taxpayer identification number of the current income beneficiary, the trust and the corporation; reference that the filing is an election under Code § 1361(d)(2); the date on which the election is to be effective; and information sufficient to show that the QSST requirements have been met.[31]
- The election, once made, can only be revoked with the Secretary's consent.[32] Moreover, the election must be made separately with respect to each Subchapter S corporation in which the trust holds stock.[33]
- Should a QSST fail to meet the requisites of Code § 1361(d)(3)(A) (described above) after an election becomes effective, it immediately loses its qualified status.[34] Should a QSST fail to meet the requisites of Code § 1361(d)(3)(B) (described above), however, it will not lose its qualified status until the first day of the first taxable year beginning after the tax year for which it failed to meet said requirements.[35]

Examples of trusts eligible to be QSSTs include: a QTIP marital deduction trust under Code § 2056(b)(7); a marital deduction trust under Code § 2056(b)(5), providing for all income for life with a power of appointment in the entire estate; a trust which will terminate when the beneficiary reaches a certain age; a trust which gives the beneficiary income for life;[36] and a revocable intervivos trust after the death of the trustor.[37]

A trust otherwise meeting the QSST requirements will not be invalidated solely because a court requires income distributions to greater than one (1) person. A voluntary current income payment to greater than one (1) person (e.g., payment to ex-spouse as alimony) will invalidate a QSST. For this purpose, spouses, if both are residents and file joint returns, are considered to be one (1) current income beneficiary (as long as they are married and file joint returns).

Examples of trusts that are ineligible to be QSSTs include: a foreign trust;[38] an irrevocable reversionary trust, Clifford Trusts[39] and certain retirement plan trusts.[40]

Electing Small Business Trusts

In 1996, Congress amended Code § 1361, adding an additional type of shareholder that is

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eligible to become an S corporation shareholder, the ESBT.[41] The ESBT was the first new entity to join the list of eligible S corporation shareholders in many years.

The ESBT is an interesting creature of statute. For reasons discussed below, its use is generally limited.

Originally, to qualify as an ESBT, all beneficiaries, current, contingent and remainder, had to be individuals or estates. Provided, however, charitable organizations described in Code § 170(c)(2) through (5) were initially allowed to hold contingent remainder interests. After December 31, 1997, such charitable organizations were allowed to hold current interests.[42] Additionally, an organization described in Code § 170(c)(1)[43] may hold a contingent interest in an ESBT, but it may not be a potential current beneficiary of the trust.[44]

No interest in an ESBT may have been acquired by "purchase." For this purpose, purchase means any acquisition if the basis of the property is determined under Code § 1012.[45] In other words, if a person acquires an interest in a trust, and any portion of the person's basis in the acquired interest in the trust is determined under Code § 1012, such interest is considered to be acquired by purchase.[46] This includes a net gift of a beneficial interest in the trust where the person acquiring the interest pays the gift tax.[47]

PRACTICE ALERT: The ESBT itself is not prohibited from acquiring S corporation stock or other property by purchase.[48]

An ESBT may not be a foreign trust.[49]

It also cannot be a Qualified Subchapter S Trust ("QSST") with respect to which an election under Code § 1361(d)(2) is in effect.[50]

Likewise, an ESBT cannot be a trust that is tax-exempt under Subtitle A of the Code.[51]

Last, an ESBT cannot be a charitable remainder annuity trust or a charitable remainder unitrust as defined in Code § 664(d).[52]

An ESBT must affirmatively elect to be treated as an ESBT.[53]

PRACTICE ALERT: The election is made by the trustee and is effective for the taxable year of the trust in which the election is made and all subsequent years unless the election is revoked with the Commissioner's consent.[54]

Each potential current beneficiary of the trust is treated as a shareholder of the S corporation.[55] Provided, however, if there is no potential current beneficiary during any period, the trust itself is treated as a shareholder of the corporation during that period.[56]

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"Potential current beneficiary" means any person who is entitled to, or at the discretion of the trustee may receive, a distribution of the income or principal of the trust.[57] No person is treated as a potential current beneficiary solely because that person holds a future interest in the trust.[58] Also, a person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (e.g., the death of the holder of a power of appointment) is not a potential current beneficiary until specified time or occurrence arises.[59]

The tax attributable to shares of an S corporation held by an ESBT is determined in accordance with special rules.[60] These rules are not very taxpayer friendly.

The portion of the trust holding S corporation stock is treated as a separate taxable trust. The tax on the separate trust is determined under normal rules applicable to trusts, with the addition and/or exception of the following:

- The highest individual tax rate is applied.
- The exemption amount under Code § 55(d) is zero.
- Capital losses are only allowed to the extent of capital gains.
- The only items of income, loss, deduction or credit taken into account are those items required to be taken into account under Code § 1366, any gain or loss from the disposition of the S corporation stock and (to the extent prescribed in Regulations) state/local taxes and administrative expenses.
- If the trust terminates, the loss carryovers or excess deductions are applied to the entire trust.

QUERY: Given the tax attributes and operating rules, all of which are discussed above, why would the trustee(s) of a trust ever want to make an ESBT election?

The answer appears to be that the ESBT may be a solution where the trust created or that springs into life on the death of the grantor does not meet the QSST requirements and holds the stock of an S corporation. In such instance, the trustee(s) may have no alternative without jeopardizing the S corporation election than making an ESBT election. The ESBT election, of course, comes with a tax cost (as illustrated above). That tax cost may, however, be much less than the cost of terminating the S corporation election.

PRACTICE ALERT: A QSST is usually preferable to an ESBT because the income flows through and is taxed directly to the beneficiary. An ESBT's taxable income is trapped within the trust for tax purposes, even if it is actually distributed out to the beneficiaries. The portion of an ESBT holding S corporation stock also gets taxed automatically at the highest individual income tax rate and is unable to take advantage of the graduated rate structure or the exemption allowed for trusts. This is a definite disadvantage for an ESBT that has very little or no other taxable income aside from the income from the part of the trust holding S corporation stock.

As discussed above, in accordance with Code § 1361(e)(3), each potential current beneficiary of an ESBT is

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treated as a shareholder of the S corporation. Consequently, since nonresident aliens are ineligible shareholders of an S corporation,[61] prior to the Tax Cuts and Jobs Act ("TCJA") (discussed below), they could not be potential current beneficiaries of an ESBT. Also, each potential current beneficiary is counted for purposes of complying with the 100 shareholder limitation contained in Code § 1361(b)(1)(A).

The TCJA expressly amended Code § 1361(c)(2)(B)(v) by adding a new sentence: "This clause shall not apply for purposes of subsection (b)(1)(C)."[62]

The result of this additional sentence is simple: Effective January 1, 2018, a nonresident alien may be a potential current beneficiary of an ESBT.

PRACTICE ALERT: Aside from being a potential current beneficiary of an ESBT, a nonresident alien still may not be a shareholder of an S corporation.[63] Additionally, a nonresident alien still may not be a beneficiary of a QSST.[64]

QUERY: Why does Congress care whether a nonresident alien is a shareholder of an S corporation or a QSST but finds is otherwise acceptable for a nonresident alien to be a potential current beneficiary of an ESBT?

A nonresident alien is a person who is neither a citizen of the United States nor a resident alien.[65] A person qualifies as a "resident alien" if the person is "a lawful permanent resident of the United States," fulfills the "substantial presence test" or fulfills the "first-year election" requirements.[66]

The fear of allowing nonresident aliens to be shareholders of S corporations or beneficiaries of QSSTs is obvious - nonresident aliens generally do not have to file income tax returns in the United States, which could allow corporations to distribute money without U.S. taxation. The fear does not exist in the case of ESBTs since the trust, not the beneficiary pays the tax resulting from the S corporation in which it holds shares.

PRACTICE ALERT: S corporations that wish to allow a nonresident alien to benefit from ownership of the corporation could use an ESBT to accomplish the goal. As mentioned above, however, there is a tax cost that comes with using an ESBT as an S corporation ownership vehicle.

PRACTICE ALERT: If a nonresident alien is a potential current beneficiary of an ESBT, extreme caution is required. If the stock of the S corporation is ever distributed (directly or constructively) to the nonresident alien beneficiary, the corporation's S election will be terminated as of the date of the distribution.[67] While the rules surrounding the eligibility of ESBT beneficiaries may have been liberalized, a new potential peril is added to the equation. **Extreme caution must be exercised.**

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An S corporation generally computes and reports to its shareholders, in addition to its non-separately computed income and loss, their pro-rata share of separately stated items of income (including tax exempt income), loss, deduction, loss and credit of the corporation.[68] The separately stated items include charitable contributions made by the S corporation. The ultimate tax treatment of charitable contributions made by the corporation, however, depends upon the tax status of each of the shareholders.

Prior to the TCJA, if a trust made a charitable contribution, the tax treatment of the charitable contribution and the corresponding deduction were handled one way, and if an individual made a charitable contribution, the tax treatment of the charitable contribution and the corresponding deduction were handled another way.

A trust is generally allowed a deduction for any amount of gross income, without limitation, which, pursuant to the terms of a governing instrument, is paid for a charitable purpose. No carryover of excess deductions is allowed. In contrast, the charitable contribution deduction applicable to individuals is limited to certain percentages of adjusted gross income[69] and excess deductions may generally be carried forward up to five years[70] and used in future years when adjusted gross income is sufficient to utilize the deductions.

The TCJA directly impacted ESBTs in another interesting manner. Prior to the enactment of the TCJA, the deduction for charitable contributions applicable to trusts, rather than the deduction applicable to individuals, applied to ESBTs.[71] So, an ESBT was allowed a charitable deduction for charity contributions (assuming the governing instrument so allowed the contribution) without a limitation pegged to adjusted gross income, but it did not have the ability to carryover unused charitable deductions due to insufficient income - the deductions were forever lost.

PRACTICE ALERT: For tax years beginning after December 31, 2017, the deduction for charitable contributions applicable to individuals applies to ESBTs. In particular, the rules applicable to individuals apply to the portion of an ESBT holding S stock for the purpose of determining and applying the deduction for charitable contributions made by the S corporation. So, the adjusted gross income limitations applicable to individuals now apply to the portion of ESBTs holding S corporation stock. Likewise, the ability to carry over excess charitable deductions for a period of five years is also available to the portion of ESBTs holding S corporation stock.

Under pre-AJCA law, an ESBT could hold stock of an S corporation. For the portion of an ESBT consisting of S corporation stock, the normal pass-through rules did not apply. Rather, the trust was taxed at a flat rate of thirty-five percent (35%) on its taxable ordinary income as specifically computed and its capital gains were taxed at the preferential rates that applied to individuals.

PRACTICE ALERT: For purposes of determining the maximum number of S corporation shareholders, each person who may have been entitled to receive a distribution from the trust (commonly referred to as a potential current beneficiary) was treated as a shareholder. To avoid disqualification after an ineligible

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shareholder became a potential current beneficiary of an ESBT, it had sixty (60) days to dispose of the S corporation stock.

PRACTICE ALERT: The AJCA eliminated some (but not all) of the tax traps for the unwary created by these rules.[72]

Beginning in 2005, for purposes of determining who the potential current beneficiaries of an ESBT are, all unexercised powers of appointment are ignored and disregarded.

The AJCA increased the period in which the ESBT can dispose of S corporation stock after an ineligible shareholder becomes a potential current beneficiary from sixty (60) days to one (1) year.

PRACTICE ALERT: Still, even after the AJCA, tax advisers need to be alert to the ESBT rules - although unexercised powers of appointment are disregarded, they need to take count of and evaluate all of the potential current beneficiaries of an ESBT. Further, they need to keep in mind the extended timeframe in which to dispose of S corporation stock in the event an ineligible shareholder becomes a potential current beneficiary of the trust (i.e., one year). The ESBT rules remain strict.

Estates

A decedent's estate is generally an eligible shareholder of an S corporation.[73]

PRACTICE ALERT: Unduly prolonged administration for purposes of Subchapter S may cause the estate to be converted into a testamentary trust and trigger the rules discussed above.[74]

A bankruptcy estate of an individual under Title 11 of the United States Code is an eligible shareholder.[75]

The status of a legal life estate or usufruct has been uncertain and subject to changing rules. Proposed Treasury Regulation § 1-1361-1A(f)(2) and (3), published on October 7, 1986, distinguished between such interests that were created before and after January 1, 1983. Under the proposed regulations, those legal life estates and usufruct interests created before January 1, 1983, were eligible shareholders. An interest created by a will executed before January 1, 1983, however, was only considered created before January 1, 1983, if the decedent died before January 1, 1986 and did not republish the will after December 31, 1982. Those legal life estates and usufruct interests created on or after January 1, 1983, were considered eligible shareholders provided: the interest was owned by only one individual who was a citizen or resident of the United States; the individual for whom the interest was created had not transferred the interest; and the interest terminated on the death of the individual for whom it was created.

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PRACTICE ALERT: The Treasury Regulations were finalized on July 20, 1995. These rules on legal life estate and usufruct interests were withdrawn. Accordingly, holders of these interests are not eligible shareholders any longer.

Corporations and Partnerships

Corporations and partnerships are ineligible S corporation shareholders.[76] With the exception in the case of a Qualified Subchapter S Subsidiary, corporations and partnerships are expressly excluded from the definition of an eligible shareholder. As mentioned above, a partnership may be able to hold shares as a nominee for its partners.

IRAs

Under pre-AJCA law, only U.S. citizens and resident individuals, estates, tax exempt charities and retirement plans, and certain types of trusts could be eligible S corporation shareholders. IRAs or Roth IRAs were not eligible S corporation shareholders.

Under the AJCA, an IRA or Roth IRA was given the right to hold shares of an S corporation in very limited circumstances and under stringent rules.

First, the S corporation must be a bank, as defined in IRC § 581.

Second, this carveout from previous law requires that the shares of the bank were held in an IRA or Roth IRA on the date of enactment of the AJCA.[77]

Third, where the shares of a bank are held by an IRA or Roth IRA, the individual beneficiary of the IRA or Roth IRA will be treated as the shareholder. Consequently, the individual beneficiary must be a U.S. citizen or resident.

PRACTICE ALERT: The exception created by the AJCA to the rule that an IRA and a Roth IRA are ineligible shareholders of an S corporation is limited to S corporation banks. The exception is further limited to shares held by an IRA or Roth IRA on the date of enactment of the AJCA (i.e., October 22, 2004).

So, the carveout from previous law only allows a limited number of banks, whose shareholders held their shares in IRAs or Roth IRAs on October 22, 2004, to elect S corporation status. This provision of the AJCA is likely the result of the lobbying efforts of family-owned rural banks. Its application is narrow.

Taproot Administrative Services, Inc. v. Commissioner, 133 T.C. 202 (9/29/09), 679 F.3d 1109 (9th Cir. 2012) illustrates the extent to which an IRA may be a shareholder of an S corporation.

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In *Taproot*, the taxpayer thought it was an S corporation. Its sole shareholder was a custodial Roth IRA established for the benefit of an individual. The Service issued the taxpayer a notice of deficiency for tax year 2003, determining, among other things, that the taxpayer was taxable as a C corporation because it had an ineligible shareholder. The taxpayer filed a petition with the Tax Court and moved for partial summary judgment regarding whether it was eligible for S corporation tax status because it had a Roth IRA as a shareholder.

The court reviewed the rules surrounding shareholder eligibility, noting that S corporation shareholder eligibility is limited to domestic individuals, estates, certain trusts and certain exemption organizations under Code §1361. However, in accordance with Treas. Reg. §1.1361-1(e)(1), a person whose S corporation stock is held by a nominee, guardian, custodian or agent, is deemed to be the S corporation shareholder. For tax year 2003, there was no statute or regulation prohibiting a traditional or Roth IRA from owning S corporation stock. (**Note:** Treas. Reg. §1.1361-1(h)(1)(vii) now includes such a prohibition unless the S corporation is a bank whose stock is held by an IRA or Roth IRA that meets the requirements created under the AJCA.) Instead, the only relevant legal authority at the time was Rev. Rul. 92-73, 1992-2 CB 224.

In Rev. Rul. 92-73, the Service determined that a trust qualifying as a traditional IRA is not a permitted shareholder of an S corporation because the beneficiary of a traditional IRA is not currently taxed on the IRA's share of the S corporation's income. By contrast, the beneficiaries of a permissible S corporation shareholder *grantor* trust are taxed currently on the trust's share of such income.

The Tax Court in *Taproot* found Rev. Rul. 92-73 persuasive. The court stated:

Unlike grantor trusts, traditional and Roth IRAs exist separate from their owners for federal income tax purposes. Because the tax-free accrual of income and gains is one of the cornerstones of traditional and Roth IRAs, it would make no sense to treat IRAs as grantor trusts thereby ignoring one of their quintessential tax benefits. As it stands, an IRA-and not its grantor or beneficiary-owns the IRA's income and gains....

The Tax Court also stated there was no indication Congress ever intended to allow IRAs to own S corporation stock. IRAs had not been explicitly listed as eligible S corporation shareholders. Had Congress intended to render IRAs eligible S corporation shareholders, it could have done so explicitly, as it had in the limited case of banks desiring to elect S status. Consequently, the Tax Court concluded a Roth IRA is not eligible to own shares of an S corporation. The taxpayer was taxable as a C corporation.

Judge Holmes wrote a dissenting opinion. He points out that an IRA is owned by a custodian for the benefit of an individual. Judge Holmes asserts the individual, not the IRA, should be considered the shareholder for purposes of the analysis.

With its loss in the Tax Court, the taxpayer could have licked its wounds, and packed up and returned home. Rather, Taproot appealed to the Ninth Circuit Court of Appeals. Jumping on Judge Holmes dissenting opinion, the taxpayer argued the owner of an IRA, rather than the IRA itself, should be

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considered the shareholder of the S corporation. An IRA is a custodial account, and with respect to custodial accounts, the person for whom the account is held is the owner of the shares the account owns. Put in the most simple terms, Taproot argued once again an IRA should be ignored; it is simply a custodial account.

The Ninth Circuit ultimately affirmed the Tax Court, holding a Roth IRA is not an eligible S corporation shareholder. Consequently, even after the AJCA, IRAs and Roth IRAs, absent meeting the limited rural bank exception, are not eligible S corporation shareholders.

Reasonable Safeguards

Several reasonable safeguards exist that can help prevent ineligible shareholders from putting the corporation's S election in peril. These safeguards include:

- Having a well drafted shareholder agreement in place that expressly prohibits the transfer of shares to an ineligible S corporation shareholder and renders any such attempted transfer void ab initio, and that requires any attempted transfer be reviewed and approved by the corporation's qualified tax adviser.
- Educating the shareholders relative to the S corporation shareholder eligibility rules.
- Routinely surveying the shareholders to ensure no share transfers have been attempted for any reason, including estate planning and/or creditor protection.
- Coordinating efforts with the shareholders' estate planning advisers and educating them on the S corporation eligibility rules.

Conclusion

As this blog post illustrates, the S corporation shareholder eligibility rules are complex. Failure to adhere to these numerous rules may result in the termination of the corporation's S election. If that is not an intended result, it could be unexpected and costly. Caution is advised.

I hope this blog post is helpful. I will continue this multi-part series on the not so obvious and the many traps that exist for the unwary in the world of S corporations. Stay tuned!

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[1] IRC § 1361(a)(1).

[2] Code § 1361(b).

[3] Code § 1361(b)(1)(c).

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[4] Rev. Rul. 73-478, 1973-2 CB 310.

[5] 661 F2d 226 (Ct. Cl. 1981).

[6] *See* Eustice & Kuntz, *Federal Income Taxation of S Corporations*, ¶ 3.03(2) (1985).

[7] Code § 1361(c)(2)(A).

[8] Code § 1361(c)(2).

[9] Amended by the 1996 Act.

[10] Code § 1361(c)(2)(A)(i).

[11] Amended by the 1996 Act. Also note the Service's ruling in PLR 20022603.

[12] *Id., see also,* Code § 1361(c)(2)(A)(iii).

[13] Code § 1361(c)(2)(A)(iv).

[14] Code § 673(a).

[15] Code § 673(c); Treas. Reg. §§ 1.673(a)1-(a)(1) and 1(b).

[16] Code § 673(a).

[17] Code § 673(b).

[18] Code § 674(a).

[19] Treas. Reg. § 1.674(a).

[20] Code § 674(d).

[21] Treas. Reg. § 1.674(a)-3.

[22] Code § 676(a).

[23] Code § 676(b).

[24] Code § 676(b).

[25] Code § 677.

[26] Code § 678.

[27] Code § 1361(d)(3)(A).

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[28] Code § 1361(d)(3)(B). *See also*, Treas. Reg. § 1.1361-1A(i)(1)(i); Rev. Rul. 86-110.

[29] Code § 1361(d)(2).

[30] Code § 1361(d)(2)(D). *See also,* House Committee Report on P.L. 98-369.

[31] Treas. Reg. § 1.1361-1A(i)(3).

[32] Code § 1361(d)(2)(C).

[33] Code § 1361(e)(2)(B).

[34] Code § 1361(d)(4)(A).

[35] Code § 1361(d)(4)(B).

[36] *See* PLR 860702; PLR 8424096; PLR 8336069.

[37] *See* PLR 8404086.

[38] Code § 1361(c)(2)(A).

[39] Code §§ 673 and 676.

[40] Prior to the 1996 Act, ESOPs were ineligible S corporation shareholders. § 1316(a)(1) of the 1996 Act amended IRC § 1361(b)(1)(B) so that certain tax-exempt organizations, including ESOPs, are eligible S corporation shareholders. The taxpayer selling shares of an S corporation to an ESOP does not get the tax deferred rollover benefit of IRC § 1042.

[41] §§ 1302 and 1317(a) of the 1996 Act. Code § 1361(e).

[42] Code § 1361(e) and §§ 1314 and 1302(c) of the 1996 Act.

[43] Code § 170(c)(1) organizations include states, possessions of the United States, or any political subdivision of the foregoing, the United States or the District of Columbia.

[44] Code § 1361(e)(1)(A)(i).

[45] Code § 1361 (e)(1)(C) and § 1302(c) of the 1996 Act.

[46] T. Reg. § 1.1361-1(m)(1)(iii).

[47] *Id.*

[48] *Id.*

[49] Code § 1361(c)(2)(A)(v).

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[50] Code § 1361(e)(1)(B)(i).

[51] Code § 1361(e)(1)(B)(ii).

[52] Code § 1361(e)(1)(B)(iii).

[53] Code § 1361(e)(3).

[54] *Id.*

[55] Code § 1361(e)(2).

[56] *Id.*

[57] *Id.*

[58] T. Reg. § 1.1361-1(m)(4)(i).

[59] T. Reg. § 1.1361-1(m)(4)(v).

[60] Code § 641(d) and § 1302(d) of the 1996 Act.

[61] Code § 1361(b)(1)(C).

[62] § 13541 of the TCJA. Public Law 115-97.

[63] Code § 1361(b)(1)(C).

[64] Code § 1361(d)(3)(B).

[65] Code § 7701(b)(1)(B).

[66] Code § 7701(b)(1)(A).

[67] Code §§ 1361(b)(1)(C) and 1362(d)(2).

[68] Code § 1366(a).

[69] Code § 170(d)(1)(A).

[70] *Id.* Qualified conversation contributions may be carried forward up to fifteen years. Code § 170(b)(1)(E)(ii).

[71] Code § 641(c) as cross referenced by Code § 1361(e)(4).

[72] § 234 of the AJCA. Public Law 108-357.

[73] Code § 1361(b)(1)(B). *See* Rev. Rul. 66-266, 1966-2 CB 356.

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[74] *See Old Virginia Brick Co.*, 367 F2d 276 (4th Cir. 1966), *aff'g* 44 TC 724 (1965); Treas. Reg. § 1.641(b)-3(a); *see also* Rev. Rul. 76-23, 1976-1 CB 264 (Estate kept open for 15 years); PLR 7951131 (Service may allow estate to be kept open pending completion of audit).

[75] Code § 1361(c)(3).

[76] *See* Treas. Reg. § 1.1361-1A(f)(1).

[77] § 233 of the AJCA. Public Law 108-357.

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