COMMENTS CONCERNING PROPOSED REVENUE RULING UNDER SECTION 1361 OF THE INTERNAL REVENUE CODE REGARDING QUALIFYING DIRECTOR SHARES ISSUED BY S CORPORATION AND QUALIFIED SUBSIDIARY BANKS

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

The comments were prepared by members of the Committee on S Corporations of the Section of Taxation. Principal responsibility was exercised by Kevin D. Anderson. Substantive comments were made by Jeffry M. Blair and H. Grace Kim. The comments were reviewed by C. Wells Hall III of the Section’s Committee on Government Submissions and by Jerald D. August, Council Director for the Committee on S Corporations.

Although the members of the Section of Taxation who participated in preparing these Comments may have clients who would be affected by the federal income tax principles addressed by these Comments, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact person: Kevin D. Anderson
(202) 879-4959
KAnderson@deloitte.com

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Attached to these comments is a draft of a proposed revenue ruling that would, if issued, address an S corporation and/or qualified subchapter S subsidiary (“QSub”) qualification problem arising out of the requirement that directors of a national bank own stock in the bank. Arrangements designed to comply with the requirements and guidelines established by the Office of the Comptroller of the Currency raise questions about whether an S corporation national bank has a second class of stock outstanding, or whether a national bank that is a QSub meets the 100-percent stock ownership requirement.

A. Background

Applicable provisions of the National Bank Act (12 U.S.C. § 21 et seq.) require that an individual must own a specified amount of stock in a national bank, or in a corporation controlling the national bank, in order to be a director of that bank. See 12 U.S.C. § 72 (2003). Several states have similar requirements for state-chartered banks. These shares are usually called “qualifying shares” or “qualifying director shares.” The Office of the Comptroller of the Currency (the “OCC”), the federal regulatory agency for national banks, has approved certain arrangements that place legal title to national bank shares in the hands of the director without giving that individual the attributes of beneficial ownership normally associated with unrestricted ownership of such stock, i.e., the right to receive dividends and other distributions, to benefit from any increases in value of the stock, and to bear the burden of any decline in the value of the stock.

Under one such approach approved by the OCC, the director will acquire shares of stock with an aggregate value of $1,000 in exchange for the payment of $1,000 in cash. The shares are subject to an agreement with the bank pursuant to which the director is obligated to sell back to the bank, and the bank is obligated to repurchase, the shares for an amount equal to the original purchase price when the director ceases to be a director of the bank. The director further assigns all rights to dividends and other distributions with respect to the stock to the bank.

B. Existing IRS Guidance

To be best of our knowledge, only one such arrangement has been addressed by the Service in a public fashion. In Priv. Rul. 200217048 (Jan. 24, 2002), the Service was asked to rule on the consequences to a bank holding company involving an arrangement virtually identical to the OCC-approved arrangement described above. The taxpayer represented that it had the arrangement in place prior to making an S corporation election and, upon recognizing that the agreements could result in a second class of stock, it amended the agreements with its directors to permit the directors to keep the dividends and other restrictions, and to provide for the payment of fair market value for the stock when the director’s service as such was terminated.
The Service ruled that the arrangement was one of the governing provisions described in Treas. Reg. § 1.1361-1(f)(2)(i), and thus, that the corporation’s purported election was inadvertently invalid. The Service then gave the taxpayer relief from the consequences of the inadvertent termination under the authority of section 1362(f). It is our understanding that the Service did not consider the possibility that, under a traditional benefits-and-burdens analysis, the director would not even be considered the owner of the stock for federal tax purposes.

On January 2, 2003, the OCC issued an advisory letter (AL-2003-1) to all national banks, department and division heads, and all examining personnel discussing Priv. Rul. 200217048. In the advisory letter, the OCC cautioned national banks that, although a private letter ruling from the Service is expressly non-precedential and non-binding on the Service, national banks with arrangements similar to the one described in the private letter ruling may wish to consult competent tax counsel to ensure that their arrangements fully comply with all applicable federal tax requirements. The OCC letter has added to the concern of banks and bank holding companies that are S corporations as to whether their current arrangements would be viewed by the Service as creating a second class of stock.

The purpose of the proposed revenue ruling is to respectfully request that the Service and Treasury address the issues presented by these fact patterns along the lines of a more traditional benefits-and-burdens analysis. In so doing, the Service and Treasury could reasonably conclude that the purported seller of the stock retains ownership of the stock for federal tax purposes, and that the arrangement represents nothing more than a loan, in substance, from the director to the purported seller. If characterized in this way, the second class of stock issues would be eliminated entirely. A more complete analysis of the law in this area is set forth in the attached proposed revenue ruling.

C. Relevant Legislative Proposals

Various legislative proposals have been made in recent years to expand, modernize, and improve subchapter S. One of the most recent bills is H.R. 1896, the Subchapter S Modernization Act of 2003, introduced last year by Rep. E. Clay Shaw, Jr. (R-Fla.). In general, the bill would have treated qualifying director shares as not being a second class of stock and would not have treated the person holding qualifying director shares as a shareholder of an S corporation solely by reason of holding qualifying director shares. Under the bill, qualifying director shares were defined for the purposes of the S corporation rules as shares of stock in a bank (as defined in section 581) or a bank holding company registered as such with the Federal Reserve System (i) which are held by an individual solely by reason of status as a director of such bank or company or its controlled subsidiary and (ii) which are subject to an agreement pursuant to which the holder is required to dispose of the shares of stock upon termination of the holder’s status as a director at the same price as the individual acquired such shares of stock.

Under the proposed legislation, distributions by an S corporation on its qualifying director shares (other than distributions in exchange for the stock) would have been treated as ordinary income by the holder of the stock and deductible by the distributing corporation.

Similar provisions have appeared in other versions of S corporation proposed legislation. H.R. 1896 is only the most-recently introduced legislative proposal containing the relevant
provision. In a letter dated July 1, 2003, Herbert Beller, then Chair of the Section of Taxation, submitted the comments of the Section on the Subchapter S Modernization Act. The following sets forth the comments relating to the qualifying director shares proposal:

**General Explanation.** The Act would amend section 1361 to provide that “qualifying director shares” would not be treated as a second class of stock, and that no person shall be treated as a shareholder of the corporation by reason of holding qualifying director shares. Such shares would be defined as shares of stock in a bank or bank holding company which are held by an individual solely by reason of status as a director and which are subject to an agreement pursuant to which the holder is required to dispose of the shares of stock upon termination of the holder’s status as a director at the same price as the individual acquired such shares of stock. In a manner similar to the treatment of restricted stock under section 83, any dividend distributions with respect to qualifying director shares will be treated as ordinary income to the holder and deductible to the corporation. Because these shares would not be treated as outstanding, no allocations would be made with respect to such stock under section 1366(a).

**Comments.** It is not clear whether current law is inadequate to deal with the circumstance of an individual who is required to hold nominal title to shares of stock in a bank or bank holding company in order to serve as a director of that organization. Present law would apparently apply traditional benefits-and-burdens test to determine whether a director is the Federal tax owner of stock subject to the type of agreement described in the proposed legislation. In a case where the issuing bank or bank holding company, rather than the individual director, is the Federal tax owner of the stock, presumably the stock would not be treated as outstanding, and thus could not violate the single-class-of-stock requirement applicable to S corporations.

**Recommendations.** We recommend that the committee reports accompanying the bill specify whether the proposal is intended to be a safe-harbor provision or the exclusive means of avoiding a second-class-of-stock issue in this context.

Proposed section 1361(g)(1) would provide that the operative rules described above apply “[f]or purposes of this subchapter”, i.e., subchapter S. We recommend that further consideration of the scope of the operative rules should be undertaken. For example, it might be appropriate to cause these rules to be applicable for purposes of chapter 1 of the Code rather than solely subchapter S, so that qualifying director shares are not treated as stock for purposes of subchapter C.

Proposed section 1361(g)(2)(i) (which should be designated as section 1361(g)(2)(A)) would define “qualifying director shares” as shares of stock held by an individual “solely by reason of status as a director” of the bank, bank holding company, or its controlled subsidiary. We recommend that the definition be clarified so that it achieves its apparent purpose, e.g., shares “which are required to be held by an individual under applicable Federal or state law in order to permit such individual to serve as a director of such bank or company or its controlled subsidiary”.

We also recommend that, in appropriate committee reports or other legislative history, it
would be clarified that “qualifying director shares” will not be treated as outstanding for purposes of determining whether an S corporation holds 100 percent of the stock of a qualified subchapter S subsidiary. This conclusion may already be apparent from Treas. Reg. § 1.1361-2(b), but further clarification would be appropriate and helpful.

D. Analysis

We offer this proposed revenue ruling consistent with the comments made by the Section of Taxation in response to the proposed legislation described above. We believe that current law is adequate to deal with the problems raised by the presence of qualifying director shares, and the proposed ruling treats the transferor of the shares, rather than the director, as the federal tax owner of those shares. The proposed ruling uses a traditional benefits-and-burdens analysis to determine whether one party to the arrangement or the other should be treated as the tax owner of the stock subject to the arrangement. Inasmuch as the proposed ruling concludes that the director is not the tax owner of the stock, the arrangement does not constitute a second class of stock. Moreover, in those transactions where the issuer of the stock is the other party to the transactions, the benefits-and-burdens analysis would lead to the conclusion that the stock which is the subject of the transaction is not outstanding stock for federal tax purposes.

Because of the explicit regulatory link between the single-class-of-stock provisions for qualification as a small business corporation and the 100-percent stock ownership requirement for qualified subchapter S subsidiaries, the proposed revenue ruling also provides that the benefits-and-burdens analysis can be used to determine whether an S corporation holds all of the stock of a corporation which purports to be a qualified subchapter S subsidiary.

The proposed revenue ruling also addresses the implications of Treas. Reg. § 1.1361-1(l)(4)(ii) (regarding the treatment of instruments, obligations, and other arrangements that would be treated as equity under general principles of Federal tax law) in the event that the Service and Treasury are unable to conclude that a particular transaction cannot be treated as a loan, or otherwise disregarded, for Federal tax purposes. Under these circumstances, the Service and Treasury could reasonably conclude that the transaction does not have a principal purpose to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders. Such a conclusion would be in keeping with the Government’s substantial change in focus from the effect of an arrangement (as reflected in the single-class-of stock regulations proposed in 1990) to the purpose of the arrangement (as reflected in the regulations proposed—for the second time—in 1991 to replace the 1990 proposed regulations and adopted as final regulations in 1992).

E. Recommendation

We respectfully request that the Service and Treasury consider the issuance of this proposed revenue ruling. We believe that the issuance of a revenue ruling along the lines of the attached draft will eliminate an area of uncertainty for national banks that either are, or

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1 See Treas. Reg. § 1.1361-2(b).
contemplate becoming, S corporations or qualified subchapter S subsidiaries. We also believe that the issuance of such a ruling will obviate the need for proponents of S corporation reform and modernization legislation to continue to advocate the need for a legislative solution to the issue.

Attachment
Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 1361. S Corporation Defined

26 CFR 1.1361-1; 1.1361-2

Rev. Rul. 200X-XX

ISSUE

Under the circumstances described below, (a) does a corporation have more than one class of stock under § 1361(b)(1)(D) of the Internal Revenue Code, and (b) is all of the stock of a subsidiary corporation held by an S corporation under § 1361(b)(3)(B)(i)?

FACTS

Situation 1

X is a national bank organized under the National Bank Act (12 U.S.C. § 21 et seq.). X is a calendar year taxpayer. Except for the effect, if any, of the transaction described in this Situation 1, X is a small business corporation within the meaning of § 1361(b)(1) and has had an S corporation election in effect at all times since January 1, 2003. X has 75 shareholders, as determined pursuant to § 1361(c)(1) and (2)(B), not including one of its directors, A, an individual.

The National Bank Act provides that, among other qualifications, A may not be a director of X unless A directly owns stock in X with an aggregate par value of at least $1,000. In order to satisfy this requirement, X and A enter into an agreement pursuant to which X issues 10y shares of its own previously unissued capital stock to A in exchange for the payment by A of $1,000 to X. The agreement further provides that, when A ceases to be a director of X, A is required to sell the shares of X stock back to X, and X is required to purchase the shares from A, for an amount equal to the original purchase price. A further agreed to assign to X any and all rights to dividends and other distributions made by X to A with respect to its stock.

Situation 2

The facts are the same as in Situation 1, except that B, an individual, is also a director of X, and B holds no stock in X except as described in this Situation 2. B and C, one of the shareholders of X, enter into an agreement pursuant to which C sells 10y shares of the X stock that C previously owned, in exchange for the payment by B of $1,000 to C. The agreement between B and C contains the same essential terms as the agreement described in Situation 1, under which B is required to sell the shares of X stock back to C, and C is required to purchase the shares from B, for an amount equal to the original purchase price when B ceases to be a director of X. B further agreed to assign to C any and all rights to dividends and other
distributions made by X to B with respect to its stock. X has 75 shareholders, as determined pursuant to § 1361(c)(1) and (2)(B), not including its directors, A and B.

Situation 3

Y is a corporation organized under the laws of State P. Y is a calendar year taxpayer. Except for the effect, if any, of the transaction described in this Situation 3, Y owns all of the outstanding stock of Z, a national bank. Y has obtained the requisite approval of the Board of Governors of the Federal Reserve System to be a bank holding company under the Bank Holding Company Act (12 U.S.C. § 1841 et seq.). Y is a small business corporation within the meaning of § 1361(b)(1) and has had an S corporation election in effect at all times since January 1, 2003. Except for the effect, if any, of the transaction described in this Situation 3, Z is a qualified subchapter S subsidiary within the meaning of § 1361(b)(3)(B).

D, an individual, is one of the directors of Z. In order to comply with the requirements of the National Bank Act regarding the ownership of shares by directors, Z and D enter into an agreement that is in all material respects identical to the agreement described in Situation 1. Z issues 10y shares of its own previously unissued capital stock to D in exchange for the payment by D of $1,000 to Z. When D ceases to be a director of Z, D is required to sell the shares of Z stock back to Z, and Z is required to purchase the shares from D, for an amount equal to the original purchase price. D further agreed to assign to Z any and all rights to dividends and other distributions made by Z to D with respect to its stock.

Situation 4

The facts are the same as in Situation 3, except that E, an individual, is also a director of Z, and E and Y, the bank holding company owning all of the outstanding stock of Z, enter into an agreement pursuant to which Y sells 10y shares of the Z stock that Y previously owned, in exchange for the payment by E of $1,000 to Z. The agreement between E and Y contains the same essential terms as the agreement described in Situation 3, under which E is required to sell the shares of Z stock back to Y, and Y is required to purchase the shares from E, for an amount equal to the original purchase price when E ceases to be a director of Z. E further agreed to assign to Y any and all rights to dividends and other distributions made by Z to E with respect to its stock.

LAW AND ANALYSIS

Section 1361(a)(1) provides that, for purposes of the Internal Revenue Code, the term “S corporation” means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for the year.

Section 1361(b)(1)(D) provides that, for purposes of subchapter S, the term “small business corporation” means a domestic corporation that is not an ineligible corporation and that does not, among other things, have more than one class of stock.
Section 1361(b)(2)(A) provides that, for purposes of § 1361(b)(1), the term “ineligible corporation” means any corporation which is a financial institution which uses the reserve method of accounting for bad debts described in § 585.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that, except as provided in § 1.1361-1(l)(4), a corporation is generally treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

Section 1.1361-1(l)(2)(i) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the “governing provisions”). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement. Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Section 1.1361-1(l)(2)(iii)(A) provides that buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation’s outstanding shares of stock confer identical distribution and liquidation rights unless (1) a principal purpose of the agreement is to circumvent the one class of stock requirement of § 1361(b)(1)(D) and § 1.1361-1(l), and (2) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock. Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess or below the fair market value of the stock and, thus, are disregarded in determining whether the outstanding shares of stock confer identical rights.

Section 1.1361-1(l)(2)(iii)(B) provides that bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights.

Section 1.1361-1(l)(4)(i) provides that instruments, obligations, or arrangements are not treated as a second class of stock unless they are described in paragraph (l)(4)(ii) or (iii) of that section. Section 1.1361-1(l)(4)(i) further identifies other types of instruments, obligations, or arrangements that are not treated as a second class of stock pursuant to other provisions of § 1.1361-1.

Section 1.1361-1(l)(4)(ii) provides that, except as provided in § 1.1361-1(l)(4)(i), any instrument, obligation, or arrangement issued by a corporation (other than outstanding shares of
stock described in paragraph (l)(3) of that section), regardless of whether designated as debt, is treated as a second class of stock of the corporation if (1) the instrument, obligation, or arrangement constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law, and (2) a principal purpose of issuing or entering into the instrument, obligation, or arrangement is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders.

Section 1361(b)(3)(A) provides that, except as provided in regulations, for purposes of the Code, a qualified subchapter S subsidiary shall not be treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of the qualified subchapter S subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation.

Section 1361(b)(3)(B) defines the term “qualified subchapter S subsidiary” as a domestic corporation that is not an ineligible corporation, if 100 percent of the stock of the corporation is held by the S corporation, and the S corporation elects to treat the corporation as a qualified subchapter S subsidiary.

Section 1.1361-2(b) provides that, for purposes of satisfying the 100 percent stock ownership requirement in § 1361(b)(2)(B)(i), stock of a corporation is treated as held by an S corporation if the S corporation is the owner of that stock for Federal income tax purposes, and any outstanding instruments, obligations, or arrangements of the corporation which would not be considered stock for purposes of § 1361(b)(1)(D) if the corporation were an S corporation are not treated as outstanding stock of the qualified subchapter S subsidiary.

It has long been a principle of Federal tax law that the substance of a transaction and not its form will determine the Federal income tax consequences of the transaction. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Rev. Rul. 61-18, 1961-1 C.B. 5, 6-7. In form, in each of Situations 1, 2, 3, and 4, the individual directors (A, B, D, and E) acquired legal title to the shares of stock in the national bank. Stock, which represents the ownership or equity of a corporation, is a risk investment and to purchase stock means to assume the risks of an investor in equity. See John Kelley Co. v. Commissioner, 326 U.S. 521, 530 (1946); Zilkha and Sons, Inc. v. Commissioner, 52 T.C. 607, 613 (1969), acq., 1970-1 C.B. xvi. By obtaining only the right to receive a return of the purchase price upon ceasing to serve as a director of the bank, the individual director had only the risk of a lender to the purported seller of the stock. In each case, that seller has retained the risks of an investor in equity. In substance, the seller has received the funds as a loan from the director. Depending upon the success or failure of the bank, it is the seller’s investment, not that of the individual director, that will appreciate or depreciate. Because the seller has retained the benefits and burdens of the ownership of the bank stock, therefore, the purported sale of the bank stock to the individual director will be disregarded for Federal tax purposes. See Tennessee Natural Gas Lines, Inc. and Subsidiary v. Commissioner, 71 T.C. 74, 83 (1978), acq., 1979-2 C.B. 2. Cf. Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982).

The provisions of § 1.1361-1(l) do not apply to transactions in which the holder of legal title to stock of a corporation is not considered the owner of the stock for Federal tax purposes.
Instead, the provisions of § 1361(b)(1)(D) and § 1.1361-1(l) will be applied to the Federal tax owner of the stock to determine whether the corporation has more than one class of stock outstanding.

The provisions of § 1.1361-1(l)(4)(ii) (regarding instruments, obligations, and other arrangements that would be treated as equity under general principles of Federal tax law) will not be applied to transactions similar to the arrangements described in this ruling even if the holder of legal title to stock of a corporation is considered the owner of the stock for Federal tax purposes. In these circumstances, the arrangements are entered into for a substantial and bona fide purpose unrelated to Federal tax law. Thus, the arrangements will not be treated as having a principal purpose to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders.

HOLDING

In **Situation 1**, A is treated as having made a $1,000 loan to X. The X stock subject to the agreement between X and A is not treated as outstanding stock because, under general Federal tax principles, A is not treated as the owner of the stock. Thus, A is not a shareholder of X for Federal tax purposes, and X does not have more than 75 shareholders.

In **Situation 2**, B is treated as having made a $1,000 loan to C. Under general Federal tax principles, C, rather than B, is treated as the owner of the X stock subject to the agreement between B and C. Thus, B is not a shareholder of X for Federal tax purposes, and X does not have more than 75 shareholders. Because C is not subject to any governing provisions limiting C’s right to receive distributions and liquidation proceeds with respect to the X stock subject to the agreement, the stock does not represent a second class of stock.

In **Situation 3**, D is treated as having made a $1,000 loan to Z. The Z stock subject to the agreement between Z and D is not treated as outstanding stock because, under general Federal tax principles, D is not treated as the owner of the stock. Thus, for Federal tax purposes, D is not a shareholder of Z, and Y is the owner of 100 percent of the Z stock.

In **Situation 4**, E is treated as having made a $1,000 loan to Y. Under general Federal tax principles, Y, rather than E, is treated as the owner of the Z stock subject to the agreement between Y and E. Thus, for Federal tax purposes, E is not a shareholder of Z, and Y is the owner of 100 percent of the Z stock.

DRAFTING INFORMATION

For further information regarding this revenue ruling, contact __________________ of the Office of Associate Chief Counsel (Passthroughs and Special Industries) at (202) 622-____ (not a toll-free call).