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Excessive Compensation of S Corporation Shareholders Under IRS Private Letter Ruling 201607001

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INTRODUCTION

On February 12, 2016, the IRS published a private letter ruling, PLR 201607001 (hereafter, the Ruling) applying the one class of stock requirement for S corporations to potentially excessive compensation paid to an S corporation shareholder. The Ruling introduces five new developments in determining whether excessive compensation paid to S corporation shareholders complies with the requirement that it not have a principal purpose of circumventing the one class of stock requirement.

First, the IRS for the first time rules on the S corporation election consequences of payment of potentially excessive salary without an employment agreement. Second, the IRS for the first time rules on the application of Example 3 in the Treasury regulations concerning excessive compensation under an employment agreement to the payment of compensation without an agreement. Third, the IRS for the first time applies the principal purpose test to potentially excessive compensation paid to an S corporation shareholder without an employment agreement who does not appear to control shareholder distributions. Fourth, the IRS for the first time rules on the consequences for the S corporation election of potentially excessive compensation of a seemingly non-controlling shareholder, which was not incorporated into an employment agreement but was approved by the board of directors. Fifth, the IRS, without precedent, relies specifically on the no principal purpose representation by the taxpayer in ruling that the potentially excessive compensation did not violate the one class of stock rule. In this manner, the Ruling illuminates the requirements for meeting the principal purpose test and avoiding an S corporation election termination in the event of payment of excessive compensation to an S corporation shareholder.

This article focuses on deriving the principal purpose test applicable to salary, bonus or other current (as opposed to deferred or equity-based) compensation of S corporation shareholder-employees in light of the Ruling. This article discusses the application of the principal purpose test to three categories of S corporation shareholders: (1) shareholders in S corporations with multiple shareholders, who do not control shareholder distributions; (2) shareholders in S corporations with multiple shareholders who may control some aspect of corporate governance or corporate finance, but do not control shareholder distributions; and (3) shareholders in S corporations with multiple shareholders who control shareholder distributions and sole shareholders who also are the sole directors of their respective S corporations.

There is limited case law interpreting the Treasury regulations which set forth the principal purpose test for meeting the one class of stock rule. IRS guidance interpreting the regulations, first issued in 1992, is significantly redacted and may not recite all of the facts material to the particular ruling. The article at-

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tempts to find common elements in these redacted rulings, available case law, and the regulations to identify the meaning of the term ''principal purpose'' as it may apply to current, excessive compensation of S corporation shareholders in the view of the IRS. Unfunded, nonqualified deferred compensation arrangements, fringe benefits, restricted stock, stock options, and stock appreciation rights each are subject to special one class of stock rules in the regulations which do not necessarily involve meeting the principal purpose test.

The principal purpose test is meaningful in the context of seeking an inadvertent termination or other ruling once potentially excessive compensation has been discovered. However, deriving the principal purpose test also is valuable for identifying the steps that S corporation shareholders must take with respect to their compensation before payment in order to avoid a potential S corporation election termination if the compensation subsequently were deemed excessive.

BACKGROUND

Tax Attributes of S Corporations in General

Subchapter S of the Internal Revenue Code of 1986, as amended (I.R.C.), in §1361 to §1379,[2] sets forth the rules governing ''small business corporations'' or S corporations.[3] An S corporation, generally, must be a domestic corporation with a maximum of 100 shareholders,[4] which may be only individuals other than non-resident aliens,[5] estates, certain trusts, or tax-exempt entities.[6] The shareholders must affirmatively elect S corporation status, and consent of all shareholders is required.[7] Once the S corporation election is effective, it continues in effect until it is terminated with the consent of a majority of shareholders,[8] or automatically terminated due to failure to meet any statutory requirement.[9] If terminated, the S corporation would become a C corporation subject to corporate-level federal income tax.[10]

An S corporation, generally, is not subject to corporate-level federal income tax.[11] Income recognized by an S corporation passes through to its shareholders.[12] Losses of an S corporation likewise pass through to the shareholders, but only to the extent of each such shareholder's aggregate basis in his or her stock and debt of the S corporation.[13] Net taxable income and losses of an S corporation are generally allocated to the shareholders pro-rata on a per-share, per-day basis.[14] Therefore, generally, S corporation shareholders may not receive special allocations of income or loss items that otherwise would be permitted in partnership agreements subject to the Subchapter K regime.[15]

Section 162 Reasonable Compensation Deduction

Deductibility of Compensation Paid to S Corporation Shareholders in General

Various deductions may offset the income passed to S corporation shareholders.[16] S corporation shareholders generally may deduct their pro-rata shares of reasonable compensation paid by the S corporation that is intended to be a payment purely for services.[17] In general, compensation ordinarily paid for like services by like enterprises under like circumstances is reasonable.[18] Courts have established, and the IRS has employed, multi-factor tests to determine whether compensation is reasonable for purposes of the deduction allowed under §162.[19] However, a deduction would not apply for excessive compensation,[20] and excessive compensation may be recharacterized as a distribution of dividends if tied closely to stockholdings.[21]

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[2] Unless otherwise identified, all section references herein are to the I.R.C.

[3] §1361(a)(1).

[4] §1361(b)(1)(A).

[5] §1361(b)(1)(C).

[6] §1361(b)(1)(B).

[7] *See* §1361(a)(1), §1362(a).

[8] §1362(d)(1).

[9] *See* §1361(d)(2)(A).

[10] *See* §11 (tax imposed on taxable income of corporation), §1362(e)(1)(B) (short year beginning on first date for which termination is effective treated as short taxable year for which the corporation is C corporation).

[11] §1363(a).

[12] §1366(a)(1).

[13] §1366(a)(1), §1366(d)(1).

[14] §1377(a)(1).

[15] *See* §702(a) (taking into account distributive share of partner of partnership's items of income, gain, loss, deduction or credit), §704(a); Reg. §1.704-1(a) (allocation to partner of partnership items determined by partnership agreement unless otherwise provided under §704).

[16] §1366(a)(1)(A).

[17] §162(a)(1); Reg. §1.162-7(a) (reasonable allowance of deduction for salaries or other compensation for personal services actually rendered).

[18] Reg. §1.162-7(b)(3).

[19] *See, e.g., William E. Davis & Sons, Inc. v. Commissioner*, T.C. Memo 1975-229 (compensation of shareholder-employees of close corporation held reasonable; summarizing and applying factors examined by courts in determining whether compensation was reasonable, including but not limited to employee's qualifications and training; nature, extent, and scope of his duties; responsibilities and hours involved; size and complexity of business; results of employee's efforts; and prevailing rates for comparable employees in comparable businesses).

[20] Reg. §1.162-7(b)(1) (ostensible compensation not paid for actual services not deductible), §1.162-7(b)(3) (allowance of compensation may not exceed what is reasonable under all circumstances).

[21] *See* Reg. §1.162-7(b)(1) (''If in such a case the salaries are

ISSN 0747-8607

Why S Corporation Shareholders May Prefer Compensation to Dividends

Reasonable compensation issues most frequently arise in the context of closely held businesses, which often have an incentive for inflating owner/employee salaries in order to distribute profits as deductible compensation rather than nondeductible dividends. In the context of subchapter S corporations (where the tax attributes flow from the company to the owner) the incentive is typically the opposite — in addition to trying to shift income to family members at a lower tax bracket, the owners may attempt to recharacterize salaries as dividends rather than compensation in order to avoid FICA and other payroll obligations, and the taxing authorities may want to ensure that salaries are raised up to a reasonable level. However, some state or local jurisdictions penalize S corporations for failure to pay wages by subjecting the S corporation profits distributions to a state or local corporation tax.[22] Furthermore, S corporations may attempt to circumvent the 1-class of stock rule by disguising unequal dividend distributions as compensation. It is in this context that the reasonable compensation authorities discussed below become relevant.

Effect of Board Approval of Compensation on the Presumption of Its Reasonableness

A corporate taxpayer has a special burden of showing, by clear and convincing evidence, that amounts paid to its stockholders, officers, and directors, are reasonable compensation for services performed and not disguised dividends.[23] Under a judicially created ''independent investor test,'' there is a rebuttable presumption that salary paid to a shareholder-employee is reasonable, not a disguised dividend, and therefore is deductible.[24] For the presumption to apply, the payor must generate a higher percentage return on equity than its peers.[25] The independent investor test for compensation paid by a closely held S corporation to its shareholders could be substantiated by an independent third-party compensation analysis.

Even if such objective compensation analysis is not available, courts have said the action of the board of directors of a corporation in voting salaries for any given period is entitled to the presumption that such salaries are reasonable and proper.[26] However, courts have also held that the presumption is of no weight when the directors are the controlling shareholders and are setting their own salaries.[27] Also, courts have stated that compensation paid to the major shareholders of a corporation is subject to close scrutiny.[28] Thus, absent a presumption, procedures for determining and awarding compensation of S corporation shareholder-employees must be documented appropriately in employment or other agreements, board meeting minutes, and resolutions in order to provide evidence of compensatory intent and reasonableness for deductibility purposes.[29]

One Class of Stock

Regulations

An S corporation must have only one class of stock.[30] For purposes of this rule, a corporation shall not be treated as having more than one class of stock solely because there are differences in voting rights among the shares of common stock.[31] Under Treasury regulations, a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer *identical rights to distribution and liquidation proceeds*. Also, the corporation must not have issued any instrument or obligation, or entered into any arrangement, that is treated as a second class of stock.[32]

''The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is based on the corporate charter, articles of incorporation, bylaws, applicable

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in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock.''), §1.162-8 (providing that, ''in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stockholdings, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend'' includible in gross income of payee).

[22] *See, e.g.,* N.Y. Tax Law §209(1) (imposing general corporation tax on net income base of corporation, and not recognizing S corporations).

[23] *See, e.g., Griffin v. United States*, 182 Ct. Cl. 436, 449 (Ct. Cl. 1968).

[24] *See Exacto Spring Corp. v. Commissioner*, 196 F.3d 833, 839 (7th Cir. 1999), cited in *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*, 680 F.3d 867, 870 (7th Cir. 2012).

[25] *Mulcahy*, 680 F.3d at 870.

[26] *See Reppel Steel & Supply Co. v. Commissioner*, T.C. Memo 1976-86 (excessive compensation held to be, in substance, distribution of profits to each shareholder-employee).

[27] *See id.*

[28] *Young v. Commissioner*, T.C. Memo 1979-242 (employment agreement between corporate and sole stockholder approved by board consisting of shareholder, his wife and their accountant held reasonable based on consideration of: (1) employee's qualifications; (2) nature, extent and scope of employee's work; (3) the size and complexities of business; (4) comparison of salaries with gross and net income of business; (5) prevailing economic conditions; (6) dividend history of business; and (7) compensation paid for comparable services in comparable businesses). *See also Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115, 119 (6th Cir. 1949) (setting forth the reasonableness factors).

[29] *See Int'l Capital Holding Corp. v. Commissioner*, T.C. Memo 2002-109 (holding that substantial documentation, including board resolutions and consulting agreements evidenced parties' intent to treat payments as compensation for services and reasonableness of compensation for purposes of deductibility of payments under §162).

[30] §1361(b)(1)(D).

[31] §1361(c)(4).

[32] T.D. 8419, 1992-2 C.B. 217 (preamble to final regulations under §1361(b)(1)(D), §1361(c)(4), and §1361(c)(5), as added by the Subchapter S Revision Act of 1982, Pub. L. No. 97-354).

ISSN 0747-8607

state law, and any binding agreements relating to distribution or liquidation proceeds (collectively, the governing provisions).''[33] As an exception, employment agreements and other commercial contractual agreements are not binding agreements relating to distribution and liquidation proceeds.[34] However, to avoid the status of a binding agreement and, therefore, a governing provision, these agreements must not have a principal purpose to circumvent the one class of stock requirement under §1361(b)(1)(D) and the regulations.[35] Moreover, ''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.''[36] This is true even if the governing provisions are found to provide for identical distribution and liquidation rights.[37] The IRS did not provide additional guidance on the appropriate tax effects of distributions that differed in timing or amount because such tax effects were necessarily based on other I.R.C. provisions, general tax law principles, and facts and circumstances.[38]

Examples in the Regulations

Treasury and the IRS provided examples in the regulations applying this rule.[39] Example 2 described an S corporation with two equal shareholders who were entitled to equal distributions under the bylaws, where the second shareholder received a distribution a year later than the first shareholder.[40] In Example 2, the circumstances indicated that the difference in timing of the distributions was not by reason of a binding agreement related to distribution or liquidation proceeds, implying there was no principal purpose to circumvent the one class of stock rule.[41] Therefore, the timing of the distribution did not cause the S corporation to fail to meet the one class of stock requirement.[42] The Tax Court had said that Example 2 ''explains that distributions may be equalized within a period of time to avoid violating the one-class-of-stock provision.''[43] However, even if the payments were equalized, they could be recharacterized for tax purposes under §7872[44] or other I.R.C. provisions.[45]

In Example 3, Treasury and the IRS applied the above rule to a payment of excessive compensation to an S corporation shareholder.[46] In Example 3, two equal shareholders have binding employment agreements with the S corporation, and the compensation paid to one of the shareholders under the employment agreement is found to be excessive.[47] Furthermore, similar to Example 2, the facts and circumstances do not reflect that a principal purpose of the employment agreement is to circumvent the one class of stock requirement.[48]

Thus, the employment agreement is not a binding agreement relating to distribution and liquidation proceeds.[49] Therefore, the employment agreement is not one of the enumerated governing provisions, based on which the IRS would determine whether all outstanding shares of stock confer identical distribution and liquidation rights[50] and does not cause the S corporation to be treated as having more than one class of stock.[51]

PLR 201607001

Summary

In PLR 201607001 the IRS ruled on the application of the one class of stock requirement to payment of potentially excessive compensation absent a written compensation agreement by applying the situation described in Example 3. In the Ruling, the taxpayer represented that its governing provisions, including its charter, bylaws, and shareholder agreements, provided for identical distribution and liquidation rights. In addition, the board of directors of the taxpayer approved the compensation of all of the employees of the S corporation annually.

Given the redacted facts, the Ruling does not specifically provide that the shareholder in question was employed as of the date the taxpayer was incorporated or the date it elected S corporation status. The Ruling only notes that the shareholder was employed from ''Period.'' Thus, it is possible that the shareholder commenced employment after the incorporation or the election, potentially indicating that the taxpayer already may have had other existing shareholders. In addition, the Ruling refers to the employee as ''also a shareholder,'' suggesting further that there may have been more than one shareholder.

Moreover, the Ruling refers to the payee as an at-will employee, and says the board reviewed and ap-

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[33] T.D. 8419.

[34] §1361(b)(1)(D); Reg. §1.1361-1(*l*)(2)(i).

[35] Reg. §1.1361-1(*l*)(2)(i).

[36] T.D. 8419.

[37] *See id.*

[38] *Id.*

[39] *See* Reg. §1.1361-1(*l*)(2)(vi) *Exs.* 2, 3.

[40] Reg. §1.1361-1(*l*)(2)(vi) *Ex.* 2.

[41] *Id.*

[42] *Id.*

[43] *Miller v. Commissioner*, T.C. Memo 2011-189 (gift of stock by taxpayer, S corporation shareholder to his son; principal purpose or violation of one class of stock requirement not asserted by IRS; holding that distributions to taxpayer following gift of stock to his son exceeded adjusted basis of his remaining stock and therefore were includible in his gross income as long-term capital gains).

[44] §7872.

[45] Reg. §1.1361-1(*l*)(2)(i).

[46] Reg. §1.1361-1(*l*)(2)(vi) *Ex.* 3.

[47] *Id.*

[48] *Id.*

[49] *See* Reg. §1.1361-1(*l*)(2)(i).

[50] *See id.*

[51] Reg. §1.1361-1(*l*)(2)(vi) *Ex.* 3(ii).

ISSN 0747-8607

proved annually the compensation of all of its employees. This description suggests a possible distinction between the identities of the shareholder-employee, on the one hand, and the board on the other hand. By contrast to the Ruling, other IRS guidance on the issue addressed in the Ruling provides that the compensation was paid to a sole shareholder and CEO.[52] Thus, it is reasonable to conclude that the shareholder-employee (or shareholder) was not the sole shareholder of the S corporation.

The IRS did not cite any previous letter rulings in reaching its conclusion, citing only Example 3 demonstrating the effect of payment of excessive compensation to a shareholder under an employment agreement.[53] Analogous to that example, in the Ruling the IRS used the test of whether a principal purpose of the potentially excessive compensation was to circumvent the one class of stock requirement. To meet that test, the IRS explicitly relied on a representation by the taxpayer regarding the absence of such purpose.[54]

Thus, the IRS ruled that payment of any excessive compensation to the shareholder did not cause the S corporation to be treated as having more than one class of stock for purposes of §1361(b)(1)(D).[55] Accordingly, the IRS ruled that, under these circumstances, the S corporation election of the taxpayer did not terminate as a result of the compensation paid to the shareholder.[56]

Specific IRS Reliance on the Taxpayer No-Principal-Purpose Representation

Until the issuance of the Ruling, the IRS had never expressly ruled that a corporation did not violate the one class of stock requirement with respect to excessive compensation *specifically* based on the representation that the principal purpose of the payment was not to circumvent that rule.[57] It is unclear if this statement of specific reliance on the taxpayer representation is more than semantics and indicates a liberalization of the standard for issuance of guidance on the one class of stock rule.

As one of the requirements for requesting a letter ruling, a taxpayer must submit, among other things, complete facts and copies of all documents.[58] The Ruling may not have recited all facts submitted by the taxpayer that were material to the conclusion that the compensation would not have violated the one class of stock requirement, and some included facts were obscured due to redaction.[59] Thus, the language of specific reliance on the taxpayer representation of no principal purpose may not have been of consequence.

However, weeks later in 2015, the IRS issued PLR 201603015, in which it analyzed the one class of stock requirement with respect to non-compensatory and possibly disproportionate S corporation shareholder distributions. In that ruling, the IRS concluded that any S corporation election termination was inadvertent, provided corrective action was taken. The IRS said the ruling was based upon information and representations submitted by the taxpayer and accompanied by a penalties of perjury statement.[60]

However, in an apparent departure from the language in other rulings on the one class of stock issue, the IRS acknowledged that the Office of Chief Counsel had not verified any of the material submitted in support of the request for rulings, which the IRS said was subject to verification on examination. Although subject to penalty of perjury, a representation as to intent of not circumventing the one class of stock requirement may be relatively subjective. However, in this recent guidance, the IRS appeared to accord significant weight to the taxpayer's representation in issuing a favorable letter ruling.

Nevertheless, the IRS cautioned that a favorable letter ruling does not preclude further IRS scrutiny of the taxpayer having met the principal purpose test. Accordingly, practical compliance with the principal purpose test is imperative to retaining the S corporation status. The elements of this test with respect to shareholder compensation as gleaned from Treasury regulations, federal jurisprudence, and IRS guidance are the focus of the discussion below.

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[52] *See* PLR 9442007.

[53] *See* Reg. §1.1361-1(*l*)(2)(vi) *Ex.* 3; PLR 201607001.

[54] Stating that "Based solely on the facts submitted and representations made, we conclude that because X's governing provisions provide for identical distribution and liquidation rights *and because X represents that it was not a principal purpose to circumvent the one class of stock requirement through compensation paid to A*, any excessive compensation paid to A does not cause X to be treated as having more than one class of stock for purposes of section 1361(b)(1)(D)" (emphasis added).

[55] *Id.*

[56] *Id.*

[57] *See* PLR 201607001; *cf.*, PLR 9735006 (setting forth independent analysis of split-dollar life insurance arrangement as not altering distribution and liquidation proceeds in ruling that arrangement did not violate one class of stock rule); PLR 9803008 (determining that employment agreements were fringe benefits and were not vehicles to circumvent the one class of stock requirement without taxpayer representation as to principal purpose); PLR 9525035 (no representation with respect to vested stock as to principal purpose, only as to incentive for employee to accept employment; concluding agreement does not cause corporation to be treated as having more than one class of stock); PLR 9445019 (ruling restrictions disregarded on option shares in determining whether distribution and liquidation rights identical based solely on information and representations made, but not specifically on any principal purpose representation); *accord* PLR 9651017 (split-dollar life insurance not violating one class of stock rule), PLR 9803023 (ruling phantom stock plan will not create more than one class of stock), PLR 201218004 (representation regarding no principal purpose of redemption agreements), PLR 201326012 (representation of no principal purpose of debentures issued to employee IRA).

[58] *See* Rev. Proc. 2016-1, 2016-1 I.R.B. 1, §7.01(1), §7.01(2).

[59] *See* PLR 201607001.

[60] *See* Rev. Proc. 2016-1, §7.01(15) (requiring in request for a letter ruling, among other things, penalties of perjury statement from taxpayer).

ISSN 0747-8607

THE PRINCIPAL PURPOSE REQUIREMENT IN AVOIDING A SECOND CLASS OF STOCK

Principal Purpose in the Regulations

The regulations do not define the term ''principal purpose.''[61] This term is used in three provisions in the regulations. First, under the general rule, an agreement is a binding agreement if its *principal purpose* is to circumvent the one class of stock requirement.[62] The second provision applies to a buy-sell or a redemption agreement or an agreement otherwise restricting the transferability of stock.[63]

Subject to two requirements, such an agreement is disregarded in determining whether corporation stock shares confer identical distribution and liquidation rights. First, the buy-sell or redemption agreement must not have a *principal purpose* of circumventing the one class of stock rule.[64] In addition, the agreement must not establish a purchase price that deviates significantly from the fair market value of the stock.[65] Thus, a buy-sell or redemption agreement may have a principal purpose of circumventing the one class of stock requirement for the practical reason that such agreements inevitably would alter the distribution and liquidation rights of shareholders. Accordingly, this special rule is an exception to the principal purpose requirement of the general rule.[66]

The third provision relates to determining whether certain instruments, obligations, or arrangements are treated as a second class of stock and, by implication, fail to confer identical distribution and liquidation rights.[67] Generally, for such a determination, all stock shares are taken into account except for certain restricted stock, deferred compensation plans, and straight debt as set forth in the regulations.[68]

Debt instruments, obligations, or arrangements are not treated as a second class of stock unless they constitute certain subordinated, modified, or transferred straight debt.[69] Furthermore, debt instruments are never treated as a second class of stock if they constitute certain short-term unwritten advances and obligations, deferred compensation plans, non-vested compensatory options, certain non-compensatory options, or straight debt.[70] The regulations suggest that debt that does not fall within the straight debt safe harbor would be subject to the general one class of stock rule.[71] Accordingly, such debt must have a *principal purpose* to circumvent the one class of stock requirement in order to constitute a binding agreement.[72] Furthermore, the debt instrument must fail to provide identical rights to distribution and liquidation proceeds in order to constitute a second class of stock under the general rule.[73]

Another rule applies to equity instruments, which may include some vested compensatory options[74] that are not substantially certain to be exercised or are not discounted on the date of issuance, transfer, or material modification.[75] Unless these equity instruments are subject to exceptions, they are treated as a second

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[61] *See* Reg. §1.1361-1(*l*)(2)(i) through §1.1361-1(*l*)(2)(iii) (buy-sell and redemption agreements generally disregarded in determining whether outstanding shares of stock confer identical distribution and liquidation rights unless principal purpose to circumvent one class of stock requirement and purchase price deviates significantly from fair market value), §1.1361-1(l)(4)(ii) (any instrument, obligation or arrangement issued by corporation other than outstanding shares of stock not excepted under regulations treated as second class of stock if its holder is treated as the owner and principal purpose of issuing or entering into instrument, obligation or arrangement is to circumvent one class of stock requirement).

[62] *See* Reg. §1.1361-1(*l*)(2)(i).

[63] Reg. §1.1361-1(*l*)(2)(iii)(A).

[64] Reg. §1.1361-1(*l*)(2)(iii)(A)(1).

[65] Reg. §1.1361-1(*l*)(2)(iii)(A)(2).

[66] *See* Reg. §1.1361-1(*l*)(2)(i).

[67] Reg. §1.1361-1(*l*)(4). *See* Reg. §1.1361-1(*l*)(3).

[68] *See* Reg. §1.1361-1(*l*)(3). *See also* Reg. §1.1361-1(b)(3) (restricted stock), §1.1361-1(b)(4) (deferred compensation plans), §1.1361-1(b)(5) (straight debt).

[69] *See* Reg. §1.1361-1(*l*)(4)(i), §1.1361-1(*l*)(5)(ii) (subordination), §1.1361-1(*l*)(5)(iii) (modification or transfer).

[70] *See* Reg. §1.1361-1(*l*)(4)(i), §1.1361-1(*l*)(4)(ii)(B) (short-term unwritten advances), §1.1361-1(b)(4) (deferred compensation plans), §1.1361-1(*l*)(4)(iii)(B)(2) (compensatory options), §1.1361-1(*l*)(4)(iii)(B)(1) (call options), §1.1361-1(*l*)(4)(iii)(C) (call options under safe harbor), §1.1361-1(*l*)(5)(i) (straight debt under safe harbor).

[71] *See* Reg. §1.1361-1(*l*)(2)(i), §1.1361-1(*l*)(4)(i) (not stating specific rule for debt that does not fall under any exceptions, thereby applying default general rule to such debt to determine whether it constitutes second class of stock, which includes principal purpose test).

[72] *See* Reg. §1.1361-1(*l*)(2)(i), §1.1361-1(*l*)(4)(i) (''Instruments, obligations, or arrangements are not treated as a second class of stock for purposes of this paragraph [(*l*)] unless they are described in paragraph [(*l*)](5)(ii) or [(*l*)(5)(iii)] of this section,'' suggesting that described subordinated or modified debt character is only threshold to second class of stock treatment, for which principal purpose condition in general rule also must be met).

[73] *See* Reg. §1.1361-1(*l*)(2)(i).

[74] *See* Reg. §1.1361-1(*l*)(4)(iii)(B)(2) (special rule for options issued in connection with performance of services not applicable if option is vested).

[75] *See* Reg. §1.1361-1(*l*)(4)(iii)(A) (option generally treated as second class of stock if substantially certain to be exercised by holder or transferee and has strike price substantially below fair market value on issuance, transfer or material modification), §1.1361-1(*l*)(4)(ii)(B) (general rule for options treated as equity under general tax principles if other exceptions not applicable); *Santa Clara Valley Hous. Grp., Inc. v. United States*, No. 5:08-cv-05097-JF (HRL), 2011 BL 392644 (N.D. Cal. Sept. 21, 2011), *modified by*, rec'n *granted by*, Case No. 5:08-cv-05097-WHA, 2012 BL 15518 (N.D. Cal. Jan. 18, 2012) (Reg. §1.1361-1(*l*)(4)(ii) and §1.1361-1(*l*)(4)(iii) not in conflict, either rule may apply to instrument; holding that warrants used in tax shelter scheme were treated as second class of stock because they were equity and had principal purpose of circumventing one class of stock rule under Reg. §1.1361-1(*l*)(4)(ii)).

ISSN 0747-8607

class of stock if two conditions are present.[76] First, the holder of the instrument, obligation, or arrangement must be treated as the owner of the ''stock'' under Federal tax principles.[77] Second, the *principal purpose* of issuing such stock must be to circumvent the one class of stock or the 100-shareholder limit[78] requirement.[79] Thus, in contrast to debt instruments not subject to the straight debt safe harbor or other exceptions, if these two conditions are present, the equity issuance is treated as a second class of stock *per se*.

However, none of these three provisions explains the meaning of an agreement having a principal purpose of circumventing the one class of stock requirement. Based on the general rule,[80] the regulations inform only that the principal purpose must relate to circumventing the requirement for all of the outstanding shares of S corporation stock to confer identical distribution and liquidation rights. Examples in the regulations suggest that the principal purpose determination is based on facts and circumstances.[81]

Principal Purpose in Federal Jurisprudence

To date, two federal courts have applied the principal purpose test in the regulations.[82] In *Santa Clara Valley Hous. Grp., Inc. v. United States*,[83] the federal district court for the Northern District of California granted partial summary judgment to the U.S. government in an action for refund of taxes, penalties, and interest by an S corporation. The District Court held that warrants issued to S corporation shareholders in a transaction later declared a tax shelter by the IRS were equity and had a principal purpose of circumventing the one class of stock rule.[84]

If exercised, the warrants would dilute the stock held by the tax-exempt pension plan to which they were transferred to avoid tax on ordinary income, thereby allowing the original shareholders to retain their equity interest in the corporation even though the plan nominally was the majority shareholder. The District Court said that, ''[t]here is no evidence that the warrants were issued for any purpose other than to protect the Schott family's equity in Santa Clara for the period of time that the majority shares were 'parked' in'' the plan. The court also found that the warrants were intended to prevent the pension plan ''from enjoying the rights of distribution or liquidation that ordinarily would come with ownership of the majority of a successful company's shares.''

Thus, the warrants effectively altered the pro-rata distribution and liquidation rights of the pension plan, an ostensible shareholder, and had no purpose other than protection of family interests, which diminished plan rights. Accordingly, the court held that the warrants constituted a second class of stock, implying that the warrants had the prohibited principal purpose. Subsequently, the District Court granted in part a motion for reconsideration on the basis that it failed to consider whether the safe harbor for certain call options in the regulations applied to the warrants, but did not vacate its ruling under the principal purpose test.[85]

Therefore, payment of compensation with an objective that would result indirectly in violation of pro-rata distribution rights may be deemed as having a principal purpose of circumventing the one class of stock rule. However, this scenario is less likely to occur in the event of excessive current compensation than on payment of restricted stock, stock options, or rights, some of which may not be subject to the principal purpose test.

In *Minton v. Commissioner*,[86] the Fifth Circuit Court of Appeals affirmed a Tax Court memorandum decision that a recording of board meeting minutes, among other facts, failed to evidence a principal purpose of payments made to former shareholders of an S corporation who appeared to have transferred the stock to their children. Unlike *Santa Clara*, this decision is instructive on what does not constitute a principal purpose.

In *Minton*, taxpayer-petitioner had the burden of proof in arguing that the transaction created a second class of stock to avoid taxes on company profits in excess of actual distributions. The evidence suggested that the taxpayer's parents eventually sold all the shares to taxpayer and her brother, and that the monthly payments to the parents by the S corporation constituted consideration for the shares on behalf of the taxpayer and her brother.

The Fifth Circuit affirmed the Tax Court ruling that there was no binding agreement providing the father and brother with disproportionate distribution rights. Specifically, there was no evidence that the directors took any formal corporate action sufficient to bind the company in a manner that affected distribution and liquidation rights of the S corporation. Therefore, the payments did not create a second class of stock.

In the event of excessive compensation, S corporation shareholders could not argue that, analogous to the holding in *Minton*, the absence of an employment

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[76] Reg. §1.1361-1(*l*)(4)(ii)(A).

[77] Reg. §1.1361-1(*l*)(4)(ii)(A)(1).

[78] *See* §1361(b)(1)(A).

[79] Reg. §1.1361-1(*l*)(4)(ii)(A)(2).

[80] Reg. §1.1361-1(*l*)(2)(i).

[81] *See* Reg. §1.1361-1(*l*)(2)(vi) *Exs.* 3, 4, 5.

[82] *Santa Clara Valley Hous. Grp., Inc. v. United States*, No. 5:08-cv-05097-JF (HRL), 2011 BL 392644 (N.D. Cal. Sept. 21, 2011), *modified by*, rec'n *granted by*, Case No. 5:08-cv-05097-WHA, 2012 BL 15518 (N.D. Cal. Jan. 18, 2012) (warrants treated as a second class of stock); *Minton v. Commissioner*, 562 F.3d 730 (5th Cir. 2009), *aff'g* 94 T.C.M. 606 (2007) (no principal purpose of verbal agreement to purchase shares from former shareholders).

[83] No. 5:08-cv-05097-JF (HRL), 2011 BL 392644 (N.D. Cal. Sept. 21, 2011).

[84] *See* Reg. §1.1361-1(*l*)(4)(ii).

[85] *See* Reg. §1.1361-1(*l*)(4)(iii)(C) (safe harbor for call options).

[86] 562 F.3d 730 (5th Cir. 2009), *aff'g* 94 T.C.M. 606 (2007).

ISSN 0747-8607

agreement, board resolutions, or other writing evidencing the arrangement would indicate the absence of a principal purpose to circumvent the one class of stock rule. In excessive compensation situations, the S corporation would have the burden of proof in showing there was *no* principal purpose, unlike in *Minton*, where petitioner had the burden of proof in showing that there *was* a principal purpose. In sum, both decisions illustrate the application of the principal purpose test, but do not provide a singular authority defining the scope of the test for excessive compensation of S corporation shareholders.

Principal Purpose in IRS Guidance

The IRS has ruled regarding whether or not an S corporation violated the one class of stock requirement in several contexts, including the following issues. The IRS had ruled on whether compensation paid under an employment agreement or a deferred compensation plan met the one class of stock requirement.[87] The IRS also had ruled on whether or not an informal, unwritten employment agreement caused the corporation to have more than one class of stock.[88] In addition, the IRS had ruled on whether redemption of buy-sell agreements,[89] split-dollar life insurance agreements,[90] employment agreements providing registration rights,[91] debentures issued to an employee IRA,[92] or shareholder distributions not necessarily deemed as compensation[93] created more than one class of stock.

These rulings assist in identifying a trend of IRS reliance on the principal purpose representation by the taxpayer and in defining the scope of the principal purpose test. However, exceptions in the regulations apply to redemption agreements, NQDC plans,[94] options, restricted stock, and stock appreciation rights, which do not involve necessarily a principal purpose finding.

These rulings may be divided into two categories. In one set of rulings, the IRS was asked to advise, either prospectively or subsequently, on the propriety of

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[87] *See* PLR 201337001 (grant of traditional profits interests under equity-based compensation plan not creating more than one class of stock), PLR 201015017 (stock option plan and restricted stock plan not creating more than one class of stock), PLR 9840035 (plan for share appreciation rights and incentive stock option plan not treated as company stock, provided that units and options are not excessive), PLR 9803023 (provided stock issued under phantom stock plan is not excessive, plan not creating more than one class of stock), PLR 9626033 (bonus deferrals under incentive deferred compensation plan not treated as outstanding stock under Reg. §1.1361-1(b)(4); therefore, plan not treated as second class of stock); PLR 9525035 (agreement providing for issuance to employee of restricted stock in connection with performance of services does not cause S corporation to be treated as having more than one class of stock); PLR 9445019 (restrictions on incentive stock option shares disregarded in determining whether distribution and liquidation rights under option agreements are identical).

[88] PLR 200924019.

[89] *See, e.g.,* PLR 201218004 (taxpayer representation that redemption agreements do not have principal purpose of circumventing one class of stock requirement; ruling that agreements not treated as second class of stock), PLR 9508023 (taxpayer representation that redemption agreement does not have principal purpose of circumventing one class of stock requirement; ruling that agreement is disregarded in determining identical distribution and liquidation rights; no compensation arrangements at issue in ruling); *accord* PLR 9508022, PLR 9413023 (stating that buy-sell agreement with shareholder was result of arm's length business negotiations and purchase price reflected fair market value; no principal purpose representation by taxpayer; ruling, *inter alia*, that buy-sell agreement was disregarded in determining whether shares of stock confer identical distribution and liquidation rights; also ruling on compensation arrangements), PLR 9308006 (''principal purpose'' taxpayer representation with respect to shareholder buy-sell agreement among other agreements included in umbrella shareholder agreement, including employment and compensation agreements; ruling that buy-sell and other agreements do not constitute second class of stock).

[90] *See* PLR 9735006 (no taxpayer representation as to principal purpose of split-dollar life insurance agreements for S corporation shareholders but including independent IRS analysis of nature of agreements; ruling that agreements will not create more than one class of stock); *see also* PLR 9709027, PLR 9651017, PLR 9413023 (citing revenue ruling, providing that premiums under split-dollar life insurance agreement are fringe benefit to shareholder, not vehicle for circumvention of one class of stock requirement and therefore, disregarded in determining whether shares of stock confer identical distribution and liquidation rights), PLR 9331009, *supplementing* PLR 9309046 (shareholders must reimburse corporation to extent premium payments under split-dollar life insurance agreement confer economic benefit to shareholders; ruling that agreement does not alter distribution and liquidation rights and, therefore, will not create more than one class of stock; no taxpayer representation as to principal purpose); *accord* PLR 9318007.

[91] PLR 9720021 (ruling that amendments to shareholders' agreement and to certain employment and consulting agreements with each of shareholders providing, among other things, rights to demand registration of stock do not create second class of stock; no representation by taxpayer as to principal purpose of agreements).

[92] PLR 201326012 (taxpayer representation that debentures issued to an employee individual retirement account (IRA) were not issued with a principal purpose to circumvent the one class of stock requirement; ruling that issuance of debentures did not cause S corporation to have more than one class of stock). *See generally* §72(a) (setting forth general income inclusion rules for annuities), §408(a) (defining and setting forth requirements for an IRA), §408(d)(1) (setting forth tax treatment of IRA distributions as subject generally to §72).

[93] *See, e.g.,* PLR 201603015 (distributions to shareholders may have been disproportionate; taxpayer representations that form of transfers of funds to shareholders did not have as principal purpose circumvention of one class of stock requirement and under governing provisions shareholders had identical distribution and liquidation rights; no ruling on meeting one class of stock requirement; ruling that if S corporation election terminated, termination was inadvertent and S corporation treatment would continue, provided corrective distributions were made).

[94] *See, e.g.,* §409A(d)(1); Reg. §1.409A-1(a)(1) (defining a nonqualified deferred compensation plan generally for purposes of the restrictions on timing and form of payment under §409A).

ISSN 0747-8607

payments or arrangements in meeting the one class of stock requirement.[95] In the other set, the IRS was asked to rule on whether the termination of the S corporation election due to failure to meet the one class of stock requirement was inadvertent, thereby preserving S corporation status.[96] This distinction did not appear to affect the technical application of the principal purpose test.

HOW MAY EXCESSIVE COMPENSATION CREATE A SECOND CLASS OF S CORPORATION STOCK?

Applicability of the Principal Purpose Test to Distributions Without an Agreement

Principal Purpose of Compensation Without an Agreement in the Regulations

Under the general rule in the regulations, the principal purpose requirement applies explicitly only to contractual agreements.[97] The regulations do not say whether the principal purpose requirement applies to distributions not made pursuant to an agreement or whether payments that differ in timing or amount violate the one class of stock requirement *per se*. Thus, the regulations do not clarify whether disproportionate distributions or distributions that ''differ in timing or amount''[98] without an agreement, including an employment agreement, would be subject to the principal purpose test for complying with the one class of stock requirement.[99]

In Example 3, distributions that differ in amount due to payment to one of the shareholders of excessive compensation do not violate the one class of stock requirement.[100] In this example, the distributions are pursuant to an employment agreement. The facts and circumstances do not indicate a principal purpose of the employment agreement to circumvent the one class of stock rule. Thus, the discrepancies in the distributions do not violate the principal purpose test.

In Example 2, distributions to equal S corporation shareholders that differ in timing do not cause the corporation to be treated as having more than one class of stock.[101] By contrast to Example 3, this example does not specify whether there was any agreement related to the distributions. But, similar to Example 3, ''[t]he circumstances indicate that the difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds.''[102]

A binding agreement refers to an agreement with a principal purpose of circumventing the one class of stock requirement.[103] Because there is no binding agreement, and therefore, no principal purpose, the distributions in Example 2 are compliant with the principal purpose test. Therefore, neither example clarifies whether compensatory distributions without an agreement are subject to the principal purpose requirement.

Principal Purpose of Compensation Without an Agreement in IRS Guidance

In PLR 201603015, the IRS ruled on a situation where the S corporation election terminated, to determine whether the termination was inadvertent. The corporation made distributions to five S corporation shareholders, two of whom were owners or shareholders in two other entities, which themselves were two S corporation shareholders. The ruling did not mention the distributions were pursuant to any agreement.

Nevertheless, the taxpayer represented that the form of distributions did not have as a principal purpose the circumvention of the one class of stock requirement. The taxpayer also represented that its governing provisions provided for identical distribution and liquidation rights. Thus, by citing the principal purpose representation in the ruling, the IRS appeared to acknowledge that distributions without an agreement would meet the principal purpose requirement.

Similarly, in PLR 200924019, the corporation and two officers, presumably shareholders, entered into an ''informal unwritten employment agreement.'' Taxpayer represented that the circumvention of the one class of stock requirement was not a principal purpose of the agreement. Taxpayer also represented that the

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[95] *See, e.g.,* PLR 201326012 (ruling on past issuance of certain debentures to employee IRA), PLR 9840035 (ruling on proposed stock appreciation rights plan, incentive stock option plan and employee stock purchase agreement).

[96] *See* §1362(f)(2); Reg. §1.1361-1(*l*)(6) (cross-referencing §1362(f) concerning inadvertent terminations ''in cases where the one class of stock requirement has been inadvertently breached''); *see, e.g.,* PLR 200901011 (ruling that, where following reorganization, acquiror made S corporation election and target made QSub election, if failure of acquiror corporation to treat shares granted to certain directors and officers under restricted stock plan, some of whom made §83(b) elections, as outstanding shares of corporation or any corrective actions cause S corporation election to terminate, the termination was inadvertent and both parent and subsidiary would continue to be subject to Subchapter S if elections otherwise not terminated). *See also* §83(b) (requirements for making election to include in income of individual fair market value less purchase price of restricted property transferred in connection with performance of services at the time of transfer rather than at vesting), §1361(b)(3) (setting forth, in general, definition of, requirements for and tax treatment of qualified subchapter S subsidiary (QSub)), §1362(f) (setting forth requirements for failure to meet S corporation requirements or termination of S corporation election to be treated as inadvertent and as result for S corporation or QSub to be treated as such during period specified by IRS), PLR 201603015, PLR 201337001.

[97] Reg. §1.1361-1(*l*)(2)(i).

[98] *Id.*

[99] *See* PLR 201603015.

[100] Reg. §1.1361-1(*l*)(2)(vi) *Ex.* 3(i).

[101] *Id.*, *Ex.* 2.

[102] *Id.*

[103] Reg. §1.1361-1(*l*)(2)(i).

ISSN 0747-8607

shares conferred identical distribution and liquidation rights.

The IRS ruled that the employment agreement was not a governing provision and did not cause the corporation to have more than one class of stock. Here, although there was an informal agreement, it is unclear whether there was an employment agreement within the meaning of the general one class of stock rule in the regulations.[104] Therefore, the IRS appeared to acknowledge that the principal purpose test applies at a minimum to compensation paid without a written employment agreement.

In a 1997 Field Service Advice, the IRS said that a controlling shareholder redesignated distributions as salary and paid himself excessive compensation.[105] The IRS further noted that the facts and circumstances lent to a conclusion that the taxpayer suppressed equal distribution rights. Thus, the IRS deemed excessive compensation of the shareholder, who controlled distribution policies of the corporation, as paid pursuant to a *constructive* ''employment agreement'' which had a principal purpose of circumventing the one class of stock requirement.[106] Therefore, the IRS found an implied employment agreement and applied the principal purpose test to determine whether the potentially excessive compensation violated the one class of stock requirement.

Finally, in PLR 201607001, potentially excessive compensation was paid without an employment agreement, but with approval by the board. The taxpayer represented that the payment did not have a principal purpose. The IRS ruled that the compensation did not fail the principal purpose test.

On the other hand, in two 1998 rulings, the IRS concluded that, as long as certain deferred compensation under a plan was not excessive, the plan did not create more than one class of stock.[107] In PLR 9840035, the share appreciation rights plan was deemed subject to the exception for NQDC plans in the regulations.[108] The incentive stock option (ISO) plan was deemed subject to another exception in the regulations.[109]

The two exceptions treated the covered NQDC or options as non-outstanding stock *per se* rather than stock subject to the general identical rights rule and a threshold principal purpose requirement.[110] Both administrative exceptions required the NQDC plan and the ISO plan, respectively, not to be excessive by reference to the services performed.[111] Accordingly, the IRS ruled the share appreciation units and ISOs were not company stock, provided both forms of compensation were not excessive, by reference to the services performed by an employee.[112] Similarly, in PLR 9803023, a proposed phantom stock plan was deemed subject to the NQDC plan exception in the regulations. The IRS ruled that, provided that the stock issued was not excessive compensation, the plan would not create more than one class of stock.

Therefore, disproportionate distributions in the form of excessive salary or other current compensation without an agreement would not violate the one class of stock requirement if the payments did not have a principal purpose to circumvent that rule.[113] Accordingly, in the ensuing discussion, IRS guidance analyzing employment agreements will be useful in identifying the principal purpose requirements for current compensation without an agreement. By contrast, excessive NQDC or option grants that were deemed as disproportionate distributions could not comply with the one class of stock rule. Thus, they would be treated as creating a second class of stock *per se*.

Requirements for Current Compensation Under the Principal Purpose Test

Control of Distributions by a Shareholder. In a 1997 FSA, the IRS noted that the shareholder used his control to redesignate distributions as salary, arguably with the principal purpose of circumventing the one class of stock requirement.[114] The IRS found the potentially excessive compensation to be in derogation of true distribution rights. The IRS contrasted the facts to the situation in Example 3, which ''expressly postulates'' the employment agreement did not have a principal purpose of circumventing the one class of stock requirement.

The IRS concluded in the 1997 FSA that the payments could have resulted in the corporation having more than one class of stock. In addition, the IRS concluded the compensation could have been unreasonable. Therefore, the Office of Chief Counsel instructed the field to develop the facts.

Accordingly, the IRS set forth two principal purpose prongs in this guidance. First, using control over shareholder distribution policies to redesignate some of the distributions as compensation indicated intent or a principal purpose of circumventing the one class of stock requirement. Second, potentially excessive compensation violated the pro-rata distribution requirements, resulting in actual circumvention of the one class of stock rule.

Control of Distributions by the Sole Shareholder. In PLR 9442007, an employment agreement between an

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[104] *See* Reg. §1.1361-1(*l*)(2)(i).

[105] 1997 FSA LEXIS 177 (Mar. 6, 1997).

[106] *Id.*

[107] *See* PLR 9840035, PLR 9803023.

[108] *See* Reg. §1.1361-1(b)(4) (non-outstanding stock taken into account in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, and therefore, not subject to one class of stock rule).

[109] *See* Reg. §1.1361-1(*l*)(4)(iii)(B)(2) (options deemed stock that is taken into account in determining distribution and liquidation rights but under exception, treated as not second class of stock, bypassing principal purpose test under general one class of stock rule).

[110] *See* Reg. §1.1361-1(b)(4), §1.1361-1(*l*)(4)(iii)(B)(2).

[111] *Id.*; Reg. §1.1361-1(b)(4)(iii).

[112] PLR 9840035.

[113] *See* Reg. §1.1361-1(*l*)(2)(vi) *Ex.* 3; PLR 201607001.

[114] 1997 FSA LEXIS 177 (Mar. 6, 1997).

ISSN 0747-8607

S corporation and its sole shareholder and CEO provided for salary subject to cost-of-living adjustments (COLA), benefits, bonuses as the board of directors shall determine, and payments on change in control, death, or disability. Taxpayer represented that the principal purpose of the agreement was not to circumvent the one class of stock requirement. The IRS ruled, based solely on the facts submitted and the representations made, that the agreement and the payments made in accordance therewith would not violate the single class of stock requirement of subchapter S.

By contrast to the situation in the Field Service Advice, in this ruling the IRS did not appear to have been concerned with excessive compensation or other facts that could have indicated the presence of a principal purpose to circumvent the one class of stock requirement. Also, by contrast to the dearth of facts supporting reasonableness in the Field Service Advice, here, the board of directors of the corporation determined the amounts of the benefits and bonuses.

Furthermore, the shareholder received a salary with COLA increases. In addition, the shareholder served as CEO for the past five years, and the employment agreement was for an additional 10 years, suggesting that the services the CEO performed had been substantial and that the salary and benefits were more likely to be reasonable. Thus, the facts and a representation by the corporation and shareholder were sufficient for the IRS to rule that this employment agreement, and the compensation paid pursuant to it, did not violate the one class of stock rule. This ruling demonstrates that, unlike the 1997 guidance, control by the shareholder-employee of distribution policies does not necessarily result in finding a principal purpose to circumvent the one class of stock rule where compensation is not excessive.

It is unclear whether an employment agreement with a sole shareholder possibly could violate the one class of stock requirement. It would not be possible for distributions to differ in timing or amount from those of other shareholders. However, similar to the Field Service Advice reasoning, the IRS could find that excessive compensation of a sole shareholder derogated ''true'' distribution rights, possibly by defining distribution rights broadly. For example, such distribution rights of a sole shareholder could exclude rights to amounts resulting from excessive compensation. The regulations do not appear to sanction such a broad reading of distribution rights.[115]

Board Approval of Compensation. It is unclear whether approval of compensation by the board in PLR 9442007, which possibly was controlled by the sole shareholder, supported the conclusion that the one class of stock rule was met. In this ruling, board approval could have evidenced review and consideration of the compensation package, including its reasonableness. Such procedures may be distinguished from unapproved distributions that could have been excessive or in violation of the distribution rights, as the IRS might have averred in the 1997 Field Service Advice. But, even if PLR 9442007 did not indicate that board approval supported a finding of no principal purpose, its import may be limited for compensation paid by an S corporation with more than one shareholder.

By contrast to PLR 9442007, the facts in PLR 201607001 suggest that the shareholder-employee might not be the sole shareholder. The Ruling does not say whether that shareholder had any control over corporate governance or corporate finance, but it mentions that the board of directors of the corporation reviewed and approved all employee compensation annually, thereby indicating a lack of control by that shareholder over shareholder distributions. Under this interpretation, the Ruling is not contradicted by PLR 9442007 in suggesting that board approval of potentially excessive compensation is a contributing factor in demonstrating no principal purpose.

Similarly, in PLR 200807004, the corporation had six shareholders. The corporation appeared to have paid additional bonus compensation for four tax years to the deemed owner of a trust that was a shareholder. The board of directors approved all these bonuses retroactively in the subsequent tax year. The bonuses were meant to assist the shareholder in repayment of a loan from the corporation for purchase of its stock from other shareholders. Later, the corporation was advised that the bonus compensation was excessive and constituted constructive distributions to the individual shareholder.[116]

The corporation sought an inadvertent termination ruling from the IRS.[117] The corporation represented that it did not enter into the bonus compensation arrangement with a principal purpose of circumventing the one class of stock requirement. The corporation also represented that it did not intend to terminate the S corporation election and that it would make corrective distributions to other shareholders, and that the individual shareholder would repay some of the bonuses.

The IRS applied Example 2 in the regulations concerning distributions that differed in timing and were not made subject to a binding agreement.[118] The IRS likely ignored the initial classification of the transfers as bonus compensation and considered the payments constructive distributions. Notwithstanding, the distributions in Example 2 were subject to the principal purpose test.[119]

The IRS ruled, *inter alia*, based solely on the facts submitted and the representations made, that any termination due to excessive additional bonus compensation was inadvertent, and that the company would be treated as an S corporation from the date the board approved the bonuses. The IRS did not specify that, in the event of termination, the election would have

[115] *See* Reg. §1.1361-1(*l*)(2)(i), §1.1361-1(*l*)(2)(vi) *Ex.* 3.

[116] *See* §1361(c)(2)(B)(i) (deemed owner of a trust treated as the shareholder in meeting the requirements of §1361(b)).

[117] *See* §1362(f); Reg. §1.1361-1(*l*)(6).

[118] *See* Reg. §1.1361-1(*l*)(2)(vi) *Ex.* 2.

[119] *See id.*, *Exs.* 2, 3.

ISSN 0747-8607

been effective in the years in which the bonuses were paid, apparently prior to board approval. The S corporation election could have terminated in the year the disproportionate payments were made, not later, when they seemingly were approved.[120]

Therefore board approval of bonuses may have eliminated a principal purpose of the earlier payments to circumvent the one class of stock provision and been dispositive to an inadvertent termination ruling. If interpreted in this manner, PLR 200807004 would be consistent with the Ruling and not negated by PLR 9442007 in suggesting that board approval of compensation supported a finding of no principal purpose.

In PLR 201603015, the IRS took into account a taxpayer representation that any disproportionate distributions did not have a principal purpose. The IRS then ruled that any S corporation election termination was inadvertent. If the IRS found a principal purpose of the distributions, then any S corporation election termination may not have been inadvertent.[121] PLR 201603015 did not address board approval of the disproportionate distributions or excessive compensation, but PLR 201603015 was consistent with PLR 200807004 in that no principal purpose was found and therefore the distributions did not result in an inadvertent termination.

PLR 201603015, together with PLR 200807004 and the other rulings above, indicate that board approval of compensation by a corporation with multiple, non-controlling shareholders assists in negating a principal purpose. These rulings also support that board approval and a no-principal-purpose finding would be integral to a favorable inadvertent termination ruling for excessive compensation.

In PLR 200924019, the IRS took a more liberal approach than in the 1997 Field Service Advice or in the Ruling with respect to an informal unwritten employment agreement with two officers, possibly shareholder-employees. In this case, the taxpayer represented that the employment agreement did not have a principal purpose of circumventing the one class requirement; that all shareholder distributions were proportionate and all outstanding shares conferred identical distribution and liquidation rights.

The ruling did not provide that a board of directors approved the informal, unwritten agreement. But, in contrast to the 1997 Field Service Advice where the IRS was willing to imply an employment agreement for excessive compensation in derogation of true distribution rights, excessive compensation was not raised as an issue in this ruling.

Thus, the apparent lack of board approval did not preclude the IRS from ruling, based on the information submitted and the representations made, that the employment agreement was not a governing provision. Therefore, in this case, similar to PLR 9442007, board approval apparently would not have been dispositive to meeting the one class of stock requirement with respect to compensation without a written agreement. However, based on PLR 201607001, PLR 201603015 and PLR 200807004, board approval may be significant if not dispositive in negating a principal purpose of excessive compensation, and if applicable, obtaining a favorable inadvertent termination ruling.

Excessive Compensation Without an Agreement Under the One Class of Stock Rule. In a corporation with *multiple shareholders*, board approval of compensation of a shareholder-employee who does not control distribution policies appears to be sufficient to evidence that compensation, if later found excessive, did not have a principal purpose of circumventing the one class of stock rule. However, any other corporate documents that qualify as governing provisions must provide identical distribution and liquidation rights. Also, the S corporation shareholders would not be able to deduct their pro-rata shares of the excessive compensation, would have to amend their returns, and might be subject to penalties and interest assessed for understatement of tax.

Similarly, board approval may negate a principal purpose if the payee of excessive compensation is a *controlling shareholder*. However, to avoid a principal purpose of excessive compensation, a shareholder who controls at least some aspect of corporate governance or corporate finance may not also control the distribution policies of the corporation. The shareholders may evidence a bona fide restriction on control over distributions in the corporate charter, the bylaws, or any shareholder agreements. However, such documents must each comply with the applicable one class of stock requirements in all other respects. Also, an S corporation should document board approval of the compensation and benefits paid to such shareholder-employee in written and timely executed resolutions to support a finding of no principal purpose.

Akin to *shareholder controlling distributions*, the IRS might find a principal purpose if the compensation paid to a *sole shareholder* and director were excessive. Such controlling or sole shareholder would be unable to rely on other individuals to approve distributions unless the corporation had additional, independent directors who approved the compensation package. Thus, with respect to a sole shareholder-employee who also is the sole director or a co-shareholder controlling distributions, approval by a controlled board may assist only in determining that compensation was reasonable.

Accordingly, sole shareholder-directors and shareholders in control of corporate distributions of S corporations may find it necessary to assess the reasonableness of their compensation prior to approval or payment and document the basis for approval in board resolutions. Determining the amount of compensation based on an independent, third-party analysis may help support reasonableness. However, the findings in a compensation study would be rebuttable by the IRS

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[120] *See* §1362(D)(2)(B) (any termination for failing to qualify as S corporation effective on or after date of cessation); Reg. §1.1362-2(b)(2) ("If an election terminates because of a specific event that causes the corporation to fail to meet the definition of a small business corporation, the termination is effective as of the date on which the event occurs.").

[121] *See* §1362(f)(2).

ISSN 0747-8607

in assessing reasonableness of the compensation. For this reason, a written employment agreement setting forth the amount, timing, and other terms of the compensation and benefits payable to a sole or controlling shareholder-employee, which is timely and appropriately approved by the board, may provide additional protection from a potential principal purpose exposure.

These principles are consistent with the standards for establishing a presumption of reasonableness of compensation under §162. Both sets of rules address treatment of compensation as dividends. Under the reasonableness test, dividend reclassification precludes a deduction. Under the principal purpose test, such treatment may result in termination of the S corporation election. Therefore, board approval and substantiation of reasonableness bolster the case for integrating similar factors under the principal purpose test. Collectively, these steps would assist shareholders of S corporations in evidencing the absence of a principal purpose and avoiding a possible S corporation election termination for failing the one class of stock rule.

CONCLUSION

In sum, regulations and IRS guidance suggest that shareholder compensation, absent a written plan or agreement, is subject to the principal purpose requirement in determining whether an S corporation has one class of stock. Where the facts do not raise an excessive compensation issue, absent other violations, the IRS may not be concerned with a principal purpose of circumventing the one class of stock rule. However, if excessive compensation is an issue and the shareholder-employee controls the distributions, the IRS may determine that the payment had a principal purpose of circumventing the one class of stock requirement.

To avoid this scenario, S corporations should assess the reasonableness of any compensation and benefits paid to shareholder-employees and document approval of the amounts and terms of the remuneration in governing body resolutions. Where control of distributions by a specific shareholder-employee may be at issue, board resolutions may be insufficient for demonstrating the lack of a principal purpose. Thus, an independent third-party assessment of reasonableness, an employment agreement with the shareholder-employee setting forth the terms of the compensation and benefits package, and a written board approval may be instrumental in avoiding an S corporation election termination.

ISSN 0747-8607