HAVING YOUR CAKE AND EATING IT TOO: AVOIDING THE S CORPORATION SINGLE CLASS OF STOCK RULES WHILE GRANTING STOCK-LIKE INCENTIVE COMPENSATION

Cheryl Cruz
John Karayan
California State University, Los Angeles
Accounting

For many businesses, maintaining their election to be taxed as Subchapter S corporations is important. This is because S corporations enjoy all of the legal benefits of being incorporated (prime among them being limited legal liability for shareholder-investors) while avoiding a major tax cost of being incorporated: the specter of double taxation. Maintaining the election also is important because losing the election unexpectedly may trigger double taxation, and do so retroactively. How to keep S status -- which prohibits more than one class of stock -- while granting stock incentives to motivate employees -- which incentives can look like second classes of stock -- thus is an important tax planning puzzle.

Introduction

Using corporate stock as part of an employee's compensation in order to tie pay to company earnings is a highly regarded way to motivate key employees (Mellinger & Pluth, 1996). Quite often, a variety of legal, tax, and management concerns lead corporations to use special classes of stock (such as non-voting common or non-cumulative preferred) instead of common stock. Even more popular are stock equivalents, like restricted stock, phantom stock, incentive stock options, or stock appreciation rights (Dupee, 1990). In a regular corporation, it is simple to issue either stock or stock equivalents without unduly adverse effects. However, for a corporation which wants to maintain the special tax benefits of an S election, severely adverse effects may result. This article deals with ways special classes of stock and stock equivalents can be issued to employees as compensation without causing the loss of an S election.

The Choice of Entity Decision

An important first question ought to be: "what is an S election, and why is it important to keep it in the first place?" As suggested above, a regular corporation benefits shareholders by providing them a liability shield, but suffers the potential for double taxation. However, those corporations which meet a variety of stringent tests can elect, under Subchapter S of Chapter 1 of the *Internal Revenue Code,* to avoid double taxation. Once the election is made, it is very important to maintain it. This is because if an event disqualifies an S corporation, it becomes subject to double taxation again. This can be particularly disadvantageous if the disqualification is not anticipated. This normally is the case when an Internal Revenue Service ("IRS") auditor successfully determines that the company has violated one of the S corporation rules (*e.g.,* the single class of stock rules when issuing stock options to employees). Indeed, in such a case the disqualification is retroactive and thus can result in substantial unanticipated taxes.

The issue raised in the previous paragraph is part of a bigger question, *to wit*, "what is the optimal legal entity through which to operate a business?" Answering this question can be quite difficult, because it requires the balancing of many, often conflicting interests. Legal considerations usually (but not always) push the decision *toward* the corporate form, so shareholders not active in managing the business can benefit from the resulting liability shield. On the other hand, tax considerations usually (but not always) push the decision *away* from the corporate form, which potentially suffers from double taxation. A variety of tax planning techniques can mitigate the possible impact of double corporate taxation. However, using these techniques is costly and cannot always be done, particularly for small or start-up companies.

Given these tax considerations, a large number of taxpayers resort to the other basic forms of doing business -- the proprietorship for solely owned businesses, and the partnership for jointly owned businesses -- which avoid double taxation, but suffer from the potential for unlimited legal liability. There are a host of strategies to mitigate the potential for legal liability, too. One can use insurance (if it is available, and at reasonable cost), or rely on operating safely (or bank on the ultimate liability shield: bankruptcy). More sophisticated alternatives include operating through multiple legal entities (*e.g.,* a sales corporation dealing with the public, paired with partnership which owns most of the assets of the business), or hybrid entities, such as the master limited partnership. Again, using these techniques is costly and cannot always be done.

An S election is another alternative. The election allows a regular corporation to avoid double taxation merely by filing an election form with the IRS, provided a variety of complex rules are satisfied. Among these are restrictions on the number of shareholders (the limit currently is 75), the type of shareholders (there can be no non-resident alien shareholders), and the corporation's capital structure (there can be only one class of stock) (Carnes, Marshall, & Bolling, 1996).

The newest choice on the menu is the single taxed limited liability company ("LLC"), which rapidly is becoming the default for the choice of entity decision. (Woehlke, Kelliher, Schorr, & Primoff, 1995). After having first appeared in Wyoming in 1977, but being limited to only 4 states as late as 1992 (McCarthy & Albretsen, 1996), LLCs finally are coming into their own now that all 50 states have adopted the concept. (For an excellent treatise on LLCs, see C.E.B., 1996). However, there are rumblings in the U. S. Treasury about LLCs deteriorating the corporate tax base. That is, concerns are being raised that if LLCs are allowed to continue to avoid corporate taxes, soon only the largest businesses will remain as regular corporations paying the corporate tax. Because these rumblings are much like those which foreshadowed the stripping of special tax benefits from the previous addition to the menu, the master limited partnership, a decade ago, it is very possible that LLCs will lose their single tax status in the rough and tumble of the next wave of tax reform looming in Washington, D.C. There also are a variety of non-tax reasons -- high among them being corporate governance (*e.g.,* who elects officers, calls owner meetings, or approves buy out offers) -- mitigating against the use of LLCs in many circumstances (Jelsma, 1994). Finally, even if an LLC is the best choice for a new venture, it can be very costly for an existing corporation to convert to an LLC. Thus, they are not yet the perfect solution to the choice of entity problem.

In other words, S corporations are still a good choice of entity to use in many circumstances (Jordan & Kloepfer, 1994). Indeed, getting the best of both worlds -- single taxation coupled with limited legal liability -- is the very purpose for which Congress created S corporations in the late 1950s. S corporations have long been the favorite of many tax planners, but they are not the best in all situations. For example, S corporation status is limited to qualified businesses, a requirement which has prevented any foreign equity ownership. Rather than closing tax loopholes, restrictions like these can create tax traps for the unwary. Several changes were made to relax such rules by the various tax Acts signed into law during 1996, in particular the *Small Business Job Protection Act,* P. L. 104-188 (August 20, 1996). For example, the number of shareholders S corporations can have rose to 75 from the previous limit, 35.

However, the rule prohibiting S corporations from having more than one class of stock was not changed. This continues to present a formidable barrier to structuring incentive compensation arrangements involving anything but common stock. This is because a violation of the restrictions results in termination of the S status, which it turn typically triggers the very thing the election of S status is designed to avoid: double taxation. Therefore, those using S corporations have to look at more creative compensation devices in order to provide the benefits of stock incentive plans but not violate the rules governing S status.

The Single Class of Stock Rules

These restrictive rules are found in *Internal Revenue Code Section* (“§”) 1361. In particular, the final requirement of § 1361(b)(1)(D) states simply that a corporation making an S election can not have "more than 1 class of stock." This statement seems straightforward but, as with many issues in tax, it is not. For example, the next subsection, §1361(c)(4), provides that "a corporation shall not be treated as having more than 1 class of stock solely because there are differences in voting rights." In effect, this first qualification to the general rule allows an S corporation to have two distinct types of stock, voting and non-voting common, that are not treated as different classes for *tax purposes* even though they are separate classes *for other legal purposes*. This allows some flexibility in the capital structure of S corporations. Plus it is only one example of the exceptions and modifications which make up this ostensibly simple single class of stock requirement.

For example, an S corporation will be treated by the IRS as having only one class of stock if all outstanding instruments evidencing equity ownership confer identical rights to proceeds upon distribution and liquidation. *Treasury Regulations Section* (“Regs. §”) 1.1361-1(I)(1). Whether identical rights exist depends on the “realities” of the governing provisions of the corporation. These consist of the corporation’s charter, its articles of incorporation, its bylaws, applicable state law, and binding agreements not found in these sources. Regs. §1.1361-1(I)(2). Not only is legal structure on paper at issue, but also the intent behind the formation of equity interests. Because intent is a question of fact for a “jury” to decide, if a company issues anything resembling equity other than common stock, the owners can never be sure of whether these other obligations will destroy Subchapter S status. [For an excellent analysis of this issue, see Hamil (1995).]

Although the single class of stock rule applies to all the outstanding shares of stock of a corporation, the IRS has provided no definition of the term “outstanding stock”. There are examples, however, of what is *not* outstanding stock. The first exclusion from outstanding stock is restricted stock. Regs. §1.1361-1(I)(3). This is stock promised to an employee (or a non-employee such as a member of the Board of Directors, a retiree, or an independent consultant) but which is subject to a “substantial risk of forfeiture.” That is, the promise of the stock would disappear if the employee leaves the company before a certain date, underperforms, or some other contingency occurs. This risk of forfeiture shackles the employee with “golden handcuffs”. (Note that until the risk is eliminated, the employer gets no tax deduction for this compensation. However, the employee does not have to recognize any taxable compensation, but can elect to do so under §83(b).) So long as the risk remains and the employee does not make the §83(b) election, restricted stock is ignored by the IRS when determining whether the single class of stock rules have been violated.

The second exclusion concerns deferred compensation plans. Some plans are simple: compensation simply is not paid until a determinable future date. These plans are very much like typical defined contribution retirement plans, except that deferred compensation is not deductible by the employer until it is paid out. One difference is that contributions to qualified retirement plans are deductible when made, but qualified plans are subject to a variety of complex restrictions. For example, such plans must be currently funded, the funds must held in a trust separate from the employer, and the benefits withheld until retirement or a break in service. More importantly, qualified plans cannot be restricted to key employees, but must cover almost all long term, permanent employees.

Plain vanilla deferred compensation plans raise little risk of being recast as a second class of stock. So do some more exotic variants. For example, phantom stock plans are not considered a second class of stock, provided only employees are covered by the plan. Regs. §1.1361-1(b)(4). No stock is actually issued in a phantom stock plan. Instead, employees are treated as if they own stock. For example, they receive a payment equivalent to the dividends they would have earned had they actually received stock. Furthermore, employees can cash out of the plan by "selling" the imaginary stock back to the company. (A similar result applies to plans involving stock appreciation rights. In such plans, no phantom dividends are earned, and the amount received when cashing out is limited to the appreciation of the imaginary stock.)

The third exclusion exempts straight debt from being included as outstanding stock. Regs. §1.1361-1(b)(5). Straight debt is "a written unconditional obligation, regardless of whether embodied in a formal note, to pay a sum certain on demand, or on a specified due date." This exception is not trivial. The U.S. income tax system strongly favors the use of debt in capitalizing companies. Current return on debt -- interest -- typically is deductible, whereas current return on equity -- dividends -- is not. Similarly, repayment of debt rarely triggers tax, whereas repurchase of equity in a successful corporation typically does. Thus, entrepreneurs have strong incentives to disguise equity as debt. What actually is debt, and what is equity, suffers from a dearth of guidance from the IRS: although Congress laid down the basic rule by enacting §385 in 1969, the IRS has yet to issue final regulations interpreting it.

In order for even straight debt to be excluded from classification as a second class of stock, however, certain qualifications have to be met. First, the loan must not have interest rates or payment dates that are contingent upon profit. Second, the loan must not be convertible into stock or any other equity interest. Third, the debt must be held by an individual who is U.S. citizen or resident alien, an estate, or certain qualifying trusts. Although minor modifications to debt contracts will not cause a reclassification into a prohibited second class of stock, Regs. §1.1361-1(I)(5)(iii)(A), some modifications may. For example, transfer of debt to a third party who cannot be an S corporation shareholder can cause straight debt to be reclassified. Regs. §1.1361-1(I)(5)(iii)(B). However, most debt meets the requirements of the straight debt safe harbor unless the debt's principal purpose is to circumvent the single class of stock rule. Taken together, these rules fairly well show that a commercially reasonable loan will not trigger the loss of S corporation status.

Other Arrangements

Arrangements other than those discussed above can be treated as a second class of stock. For example, if they result in the holder being treated as the owner of stock under general principles of Federal tax law, S corporation status is lost unless there was no tax avoidance purpose to the arrangement. Regs. §1.1361-1(I)(4)(ii)(A). As with straight debt, there are safe harbors for such other arrangements, too. One is that the typical, small employee advance -- in effect, a short-term unwritten loan -- does not constitute a second class of stock. Even advances by a shareholder to the corporation are not a second class, provided they 1) do not exceed $10,000 in the aggregate at any time during taxable year, 2) are treated as debt by the parties, and 3) are expected to be repaid within a reasonable time. Regs. §1.1361-1(I)(4)(ii)(B)(1). Even if these conditions are not met, the advances will not be treated as a second class of stock unless the purpose of the advances was to circumvent the single class of stock rule (or the limitation on eligible shareholders).

Thus, short term advances do not destroy S corporation status. Nor do obligations that are proportionately held by the S shareholders, even when considered equity under other aspects of existing tax law. Again, there is the caveat that this is true only when the purpose is not to circumvent the single class of stock rule or the limitation on eligible shareholders. Note that when there is only one shareholder, debt would always be covered under this safe harbor. Reg §1.1361-1(I)(4)(ii)(B)(2).

Call options -- a term which includes not only traditional call options but also warrants and similar instruments -- can be considered a second class of stock, but generally are only if: 1) taking into account all the facts and circumstances the call option is substantially certain to be exercised, and 2) the stock has a strike price of less than 90% of its fair market value. These tests are applied on three different dates: the date the option is issued, the date it is transferred to a non-eligible shareholder, and the date it is materially modified. Regs. §1.1361-1(I)(4)(iii)(A).

Two exceptions apply to the call option rules. The first is when the option holder is actively or regularly engaged in the business of lending, and the option is issued in connection with a commercially reasonable loan to the corporation. This exception also applies in the case where the option is transferred along with the loan. If the option is not transferred with the loan, the preceding tests must be applied. The second exception to the general rules covering call options addresses the issue of call options issued as compensation to either independent contractors or employees. As long as the call options are not excessive compensation, they are not considered a second class of stock if they are nontransferable within the meaning of Regs. §1.83-3(d) and they do not have a readily ascertainable fair market value at issuance. Regs. §1.1361-1(l)(4)(iii)(B)(2).

Convertible debt can be considered a second class of stock, but only if it would be treated as a second class of stock under the general criteria for instruments, obligations, or arrangements treated as equity (*e.g.,* under §385), or if it grants rights equivalent to those of a call option. Because convertible debt has two ways to be classified as a second class of stock, S corporations should be careful in issuing any kind of convertible debt.

Having Your Cake, and Eating It Too

Now that the single class of stock rules have been fleshed out, attention can be focused on how to use special classes of stock or stock equivalents without running afoul of these rules. These uses, in turn, normally depend on the non-tax motivations for stock based incentive compensation. As alluded to above, there are many reasons why a corporation would want to compensate their employees with equity. It may be that the company feels that tying compensation to the company's financial performance will motivate employees to work harder. A company may want to keep or reward key employees by offering them restricted stock, stock options, or stock appreciation rights, which confer benefits parallel with those reaped by shareholders. A corporation also may be short of capital, and equity compensation may be a way to limit cash outflows.

One type of incentive, a restricted stock plan, offers a good way to structure equity compensation so that it does not violate the single class of stock rule. A restricted stock plan occurs when the stock being offered vests, if at all, based upon length of service or some performance criteria. This assures company control of the stock and maintains company loyalty. Another benefit of using a restricted stock plan is that the stock is not taxable until after the restrictions lapse, and is then taxed as ordinary income. This can allow people near retirement to defer income until their tax rate is better. If the employee wishes, he or she may opt for immediate taxation under §83(b), but this immediately makes the stock “outstanding stock” of the corporation under Regs. §1.1361-1(b)(3) and may lead to inadvertent termination of the S corporation, if the corporation is not careful.

A restricted stock plan offers a number of other benefits to S corporations. The plans are extremely flexible in that the restrictions can be based on various criteria including company performance, individual performance, or just overtime. Usually restricted plans terminate once the employee leaves. Thus, they can be an effective means of keeping key employees with the company. The cost of setting up the plan is usually low as there are not as many restrictions compared to other similar plans (*e.g.,* an incentive stock option plan).

The use of restricted stock, while allowed under the current S corporation Regulations, is dangerous for the S corporation. This is because it is easy to terminate the S election by violating the 75 maximum shareholder rule or by transferring the stock to ineligible shareholders. This would not be the case were all the employees covered under the plan were already shareholders and the corporation restricted the transfer of stock to eligible shareholders. The problems come when a company wants to include employees who either are not eligible or would increase the number of shareholders beyond the 75 maximum.

Another approach is to use stock options. However, their use can terminate the S election if the exercise of the option causes there to be either too many shareholders. In addition, while stock options are still attractive, there is always the risk that the transfer of a stock option to an ineligible stockholder could result in inadvertent termination.

Stock appreciation rights are another way in which to issue stock equivalents without violating either the single class of stock or ineligible shareholder rules. In *Private Letter Ruling ("PLR")* 9119041, the IRS ruled that a stock appreciation equivalency plan would not violate either the single class of stock rule or the number of shareholders limitation. Even though private letter rulings cannot be used as precedents, they provide insight as to senior IRS personnel's approval of the IRS the use of stock appreciation rights as compensation.

Conclusion

At least in these instances, the IRS has opened the door allowing employees of S corporations to share in the growth of their company without the company's owners having to worry about the single class of stock limitation. This should be welcome news to those organizations which can not, or should not, take advantage of the new limited liability company form of doing business (which has the tax advantages of S corporation without their restrictive rules). A caveat about using stock equivalents to circumvent the single class of stock rule is in order. In choosing an equity substitute, not only the structure but also the apparent intent must be considered. Because substance prevails over form, there are no certainties in tax planning in this areas, only probabilities. This can be the most unsettling part of planning to avoid the single class of stock rules.

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