One Class of Stock Rules for S Corporations Finalized

Regulations dealing with the important one class of stock requirement for S corporations were proposed and reproposed. Now, within a remarkably quick time period, they have been finalized. The final rules, effective for taxable years beginning on or after May 28, 1992, contain some important differences from the most recently proposed rules. Several grandfather provisions are also contained in the release.

Like the proposed regulations, the final ones provide that a corporation is treated as having only one class of stock if all outstanding shares of its stock confer identical rights to distribution and liquidation proceeds, and if the corporation has not issued any instrument or obligation, or entered into any arrangement, that is treated as a second class of stock.

One of the big questions from the second set of proposed rules was whether contractual arrangements would be considered “governing provisions” so as to have to be taken into account in determining whether different shares of stock are entitled to identical rights to distribution and liquidation proceeds. The “governing provisions” include the corporation’s articles of incorporation, bylaws, local law and binding agreements. The final regulations delete the word “routine” from the description of contractual arrangements that are subject to this analysis.

More importantly, they provide that contractual arrangements are considered “governing provisions” only if they were entered into to circumvent the one-class-of-stock requirement. The injection of a “bad intent” frame of reference by which an S corporation’s contracts are to be evaluated viz-a-viz the one class of stock requirement should provide significant comfort to the many practitioners who had worried about an innocuous agreement’s potential for exploding a second class of stock bomb.

Section 83 and Outstanding Stock

As under the proposed regulations, all outstanding shares of stock are taken into account. But stock issued in connection with the performance of services that is substantially nonvested is not treated as outstanding unless the holder of it has made a section 83(b) election. Deferred compensation arrangements that do not involve section 83 property are not ordinarily treated as outstanding stock. The final regulations clarify that this rule applies even in cases in which the deferred compensation plan has a current compensation feature.

Redemption and Buy Sell Agreements

As under the proposed rules, the final rules provide that agreements to redeem or buy stock at the time of death, disability or termination of employment are disregarded in determining whether a corporation’s outstanding shares confer identical rights. Plus, agreements triggered by divorce are now added to the list.

Simplifying the proposed rules, the final regulations now state that all other buy-sell and redemption agreements are evaluated under a single standard. Such agreements are disregarded unless:

1. A principal purpose of the agreement is to circumvent the one class of stock rule; and
2. The agreement establishes a redemption or purchase price that is significantly in excess of or below the fair market value of the stock.

Debt Obligations

Regardless of how it is denominated, an obligation is not treated as a second class of stock unless two conditions are met:

1. The obligation constitutes equity or otherwise results in the holder being treated as the owner of stock under general federal tax principles; and
2. A principal purpose of the obligation is to circumvent the rights conferred by the corporation’s outstanding stock or to circumvent the limitation on eligible shareholders.

Like the proposed regulations, though, the final regulations provide two exceptions for call options. The first is for lenders and the second is for options issued to an employee or independent contractor in connection with the performance of services. The final rules clarify that the first exception for lenders continues to apply if a lender transfers an option and the accompanying loan.
The second exception applies if the services are performed either for the issuing corporation or for the corporation in which the issuing corporation owns more than 50% of the voting power and value of the stock.

**Effective Dates**

Although the final regulations are generally effective for taxable years beginning after May 28, 1992, they do not apply to instruments, obligations, or agreements entered into before May 28, 1992 that are not materially modified after that date. Nevertheless, taxpayers may choose to apply the final rules to prior tax years.