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IRAs as Shareholders in Subchapter S Corporations – Who Is An "Individual"?

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Overview

A majority of the full U.S. Tax Court has ruled[1] in a test case that a Roth IRA is not qualified to be a shareholder in an S corporation.[2] The case presents an interesting analysis of who is an "individual" for purposes of being an eligible S corporation shareholder,[3] with a majority of the Tax Court ultimately concluding that IRAs cannot be considered grantor trusts (which are eligible S corporation shareholders because the individual grantor is deemed to be the shareholder) in determining their eligibility as S corporation shareholders because the rules that apply to grantor trusts "are incompatible with the rules that apply to" IRAs. In reaching its conclusion, the majority focused heavily on an IRS Revenue Ruling, ignored an existing Treasury Regulation on the matter and provided some insight as to the level of weight and authority practitioners and taxpayers can attach to various IRS pronouncements.

S Corporation Basics

An S corporation is simply a corporation that has made an election to be treated for tax purposes under Subchapter S of the Internal Revenue Code.[4] To be able to elect S corporation status, the corporation must be a small business corporation[5] - that's a corporation that:

- Is a domestic corporation created under U.S. law;
- Is not a financial institution that uses a reserve method of accounting for bad debts;
- Is not taxable as an insurance company
- Is not a Domestic International Sales Corporation (DISC) or former DISC;
- Is not a taxable mortgage pool
- Has 100 or fewer shareholders (with all shareholders being individuals, decedent's estates, bankruptcy estates, trusts or I.R.C. §501(c)(3) charitable organizations[6]; and
- Has only a single class of stock

Eligibility of trusts. Only certain types of trusts can be S corporation shareholders. Trusts eligible to hold S corporation stock are the following:

- Grantor trusts;[7]
- I.R.C. §678 trusts;[8]
- Voting trusts;[9]
- Testamentary trusts;[10]
- Qualified Subchapter S trusts;[11]
- Electing small business trusts;[12]
- Tax-exempt I.R.C. §401(a) qualified plan trusts;[13]

2004 rule change. Until enactment of the American Jobs Creation Act of 2004 (AJCA),

the only authority concerning IRAs as shareholders of S corporations was a 1992 IRS Revenue Ruling (Rev. Rul. 92-73[14]) and a 1995 Treasury Regulation.[15] The Revenue Ruling specifically held that a *trust* that qualifies as an IRA is *not* a qualified shareholder of an S corporation. The Regulation provides that the *partners* of a partnership and the *beneficiaries* of trusts are treated as S corporation shareholders. In light of the Revenue Ruling and the Regulation, many commentators believed that IRAs could not be S corporation shareholders. AJCA, however, allows both traditional and Roth IRAs to own stock in banks that have made an S election, to the extent of the stock held by the IRAs in such banks as of the date of enactment of AJCA – October 22, 2004. AJCA also provides an exemption from prohibited treatment for the sale by an IRA to the IRA beneficiary of bank stock held by the IRA on the date of enactment of the provision if certain conditions are met – (1) the sale must be pursuant to an S corporation election by the bank; (2) the sale must be for fair market value (as established by an independent appraiser); (3) the IRA incurs no commissions, costs, or other expenses in connection with the sale; and (4) the stock must be sold in a single transaction for cash not later than 120 days after the S corporation election is made.

> **Note:** The AJCA provision concerning IRAs is a one-time provision that merely provided that an IRA that holds bank stock as of October 22, 2004, will not be a disqualifying shareholder as to shares held on that date. The individual for whose benefit the IRA holds the stock will be considered the shareholder. The provision does *not* apply to new IRAs or permit additional shares to be transferred to an IRA. In addition, the provision only applies to banks and not bank holding companies.[16]

Facts of *Taproot*[17]

The facts of the case are simple. The petitioner, Taproot Administrative Services, Inc. was Nevada S corporation whose sole shareholder during 2003 was a custodial Roth IRA account held by a bank in a small Kansas town on behalf of an individual. In early 2007, IRS issued a notice of deficiency on the basis that, for 2003, the petitioner was a C corporation because the Roth IRA was an ineligible shareholder. The petitioner moved for summary judgment on the issues of whether it was eligible for S corporation status and, if not, whether the petitioner should be treated as a C corporation for 2003.

Arguments of the Parties – Who Is The Shareholder?

The petitioner argued that a custodial account, to qualify as an IRA, must be treated as a trust[18] with the *beneficiary* considered as the S corporation's shareholder for purposes of I.R.C. §1361. As such, the petitioner argued that an IRA is a qualified shareholder as a grantor trust – it is treated as owned by the grantor.[19] The petitioner also pointed out that IRS had stated in 1985 that S corporation stock held in a custodial account for a disabled person or by a custodian under the Uniform Gifts to Minors Act is treated as held by the disabled person or minor.[20] IRS argued that the Roth IRA custodial account at issue was different from the custodial accounts that were the subject of the 1985 Private Letter Ruling. Those accounts were created for a person that could not legally hold property in their own name. That wasn't the situation in this case. In addition, IRS cited the 1992 Revenue Ruling[21] - the Ruling that held that a *trust* that qualifies as an IRA is *not* a qualified shareholder of an S corporation.

The Tax Court's Analysis

The majority opinion noted that, for the tax year at issue, neither the Internal Revenue Code nor the Treasury Regulations explicitly prohibited an IRA (Roth or otherwise) from being an S corporation shareholder.[22]

> **Note:** The majority opinion did not reference Treas. Reg. §1.1361-1(e)(1) which was issued in 1995. That Regulation provides that the *partners* of a partnership and the *beneficiaries* of trusts are treated as S corporation shareholders.

So, to the majority, the outcome of the case hinged on the validity of Rev. Rul. 92-73.

> **Note:** Interestingly, the majority stated that it was not bound by Revenue Rulings and that Revenue Rulings are not entitled to substantial deference. Instead, the majority stated, whatever weight they are given, if any, depends on "their persuasiveness and the consistency of the Commissioner's position over time."

As for the persuasiveness of Rev. Rul. 92-73, the court noted that it was straightforward and clearly distinguished IRAs from grantor trusts (which are specifically listed as eligible S corporation shareholders).[23] The fact that the Roth IRA at issue was a custodial account, the court stated, was immaterial. I.R.C. §408(h) provides that custodial account IRAs are treated as "trusts" for purposes of I.R.C. §408, but not for any other purpose (including the grantor trust rules). In addition, traditional and Roth IRAs, the court noted, exist separate from their owners for tax purposes – unlike grantor trusts. As a result, they are subject to the unrelated business income tax (UBIT). The court also noted that the Commissioner has consistently applied Rev. Rul. 92-73 to all IRAs, and that the Congress has never indicated a desire to allow IRAs to be an eligible S corporation shareholder. In addition, the court cited the Congressional history behind the AJCA which noted that "…an IRA cannot be a shareholder of an S corporation."[24] Combined, the court determined that compelling reasons existed (including public policy reasons) to sustain the IRS position set forth in Rev. Rul. 92-73.

> **Note:** To boil it down, the Tax Court believed the rationale of Rev. Rul. 92-73 was simple. IRAs do not qualify as S corporation shareholders because the IRA beneficiary does not incur tax currently on the IRA's share of the S corporation's income, but the beneficiaries of trusts that are eligible to be an S corporation shareholder (as noted above and listed in I.R.C. §1361(c)(2)(A)) are currently taxed on the trust's share of income.

The result, according to the majority, was that the Roth IRA was ineligible to own shares in the petitioner and, because it did, the petitioner was not a qualified S corporation in 2003, but rather a C corporation for federal income tax purposes in 2003.

The Dissent

A four-judge dissent (opinion by Holmes) focused on the requirement that an S corporation shareholder (with some exceptions) must be a "person" that is an "individual." For property that is held by a custodian for someone else's benefit the question, according to the dissent, was whether the holder, beneficiary or the account itself was an "individual person." The dissent noted that Treas. Reg. §1.1361-1(e) (which the majority only mentioned in a footnote) sets forth a general rule – "[t]he person for whom stock of a corporation is held by a … custodian … is considered to be the shareholder of the corporation...". Whether the IRA custodial account made the owner the "beneficial owner" (who had beneficial enjoyment of the account was the key, according to the dissent) depended, according to the dissent, on the terms of the owner's contract with the custodian and local law. The dissent then cited many cases and IRS rulings that all pointed to the conclusion that the beneficial owner of property held in a custodial IRA account is the owner of the IRA. As such, the individual owner would be deemed the shareholder of the S corporation stock – an eligible shareholder.

As for the majority's conclusion that IRAs must be separate entities because UBIT is imposed on them, the dissent pointed out that the Internal Revenue Code language imposing UBIT on IRAs was similar to the Code's excise tax provisions – neither of which provide assistance for defining the "person" that is liable for the tax. Instead, the dissent pointed out that the Code and Regulations define what "person" is liable for each of those taxes. In addition, the dissent pointed out that I.R.C. §7701 defines "persons" and that while I.R.C. §1361(b)(1)(B) requires that S corporation stock be held by an "individual person," Treas. Reg. §1.1361-1(e) clarifies who is an "individual person" when a person's property is held by a custodian. Thus, the dissent reasoned that the court should have focused on the Code and the validity of the governing Regulation, not the Revenue Ruling.[25]

> **Note:** The dissent pointed out that the Regulation was not challenged by either the majority or the IRS, and that it was not likely that such a challenge would be successful.

The dissent also pointed out that Rev. Rul. 92-73 was narrow in scope and only applied to trusts that qualify as IRAs. But, in this case, the account was *not* a trust – it was a custodial account.[26] Instead, the dissent noted, the case turned on the ambiguity of the term "individual" in I.R.C. §1361(b)(1)(B) and whether Treas. Reg. §1.1361-1(e) was a reasonable construction of that ambiguity. The dissent believed it was.

The Court of Appeals Decision[27]

On appeal, the Ninth Circuit adopted the Tax Court's reasoning.[28] The appeal concentrated primarily on the argument that IRAs and Roth IRAs lack the essential characteristics of separate taxpayers, so they are indistinguishable from their owners. Because of this, the Roth IRA at issue functioned merely as the form of the taxpayer's individual investment account, so the shares of the S Corporation were, in reality, owned by the taxpayer, who is an eligible shareholder under the statute.

The court, however, decided that, to define an individual, the simplest manner was best and relied on the dictionary when no definition could be found within the Internal Revenue Code. The court also found the reasoning behind the Rev. Rul. 92-73 was persuasive and contrary to the taxpayer's argument. The court highlighted that the distinguishing feature between the trusts permitted under I.R.C. § 1361(c)(2)(A)(i) is that they are taxed on the trust's share of the S Corporation income, but the beneficiary of an IRA does not pay taxes on income until distributions are made.

In addition, the court found persuasive that the I.R.S has applied its Revenue Ruling consistently since its adoption and has been cited in forty-two private letter rulings. This consistency demonstrated to the court that the weight given to the Revenue Ruling is supported by the agency's consistency.

The court then examined the legislative history behind the S corporation and found that Congress would not have crafted legislation that allowed shareholders to employ Roth IRAs to perpetually avoid taxation.

Conclusion

Perhaps the most troubling aspect of the case is that the majority of the Tax Court largely decided the case for the IRS on the basis of policy reasons rather than on the Code and the relevant Regulation. While a case can be made that the Tax Court majority reached the correct result,[29] the manner in which they chose to reach that result raises concerns for the analysis of future cases brought before the court. On appeal, the Ninth Circuit adopted the Tax Court's reasoning and added little more to the analysis. It is not known whether this issue will be taken up by the Supreme Court. If it is, the Ninth Circuit has the highest rate of reversal among the Circuit Courts at the Supreme Court.

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[1] Taproot Administrative Services, Inc. v. Comr., 133 T.C. No. 9 (2009).

[2] The case was one of almost one-hundred cases involving the issue. The parties to the cases settled them and opted to make the present case the test case.

[3] See I.R.C. §1361(b)(1)(B).

[4] I.R.C. §1361(a)(1).

[5] Id.

[6] An otherwise eligible S corporation can be wholly owned by another S corporation, and a partnership can hold S corporation stock as a nominee for an eligible shareholder. Treas. Reg. §1.1361-1)(e)(1). Also, no shareholder can be a nonresident alien or be married to a nonresident alien who has a current ownership interest in such person's stock under local law (unless an election is made under I.R.C. §6013(g) to be taxed as U.S. residents. Treas. Reg. §1.1361-1(g)(1).

[7] A grantor trust is a domestic trust that is treated as being owned by an individual who is a U.S. citizen or resident, during the period the trust holds the S corporation stock. The grantor, not the trust, is treated as the shareholder. I.R.C. §1361(c)(2)(A)(i); 1361(c)(2)(B)(i). After the grantor's death, the trust can remain as a shareholder for two years. I.R.C. §1361(c)(2)(A)(ii). Grantor trusts have been allowed to be S corporation shareholders since 1976. See Tax Reform Act of 1976, Pub. L. No. 94-455, Sec. 902(c)(2)(A), 90 Stat. 1609.

[8] This is a trust where a person other than the grantor is treated as the substantial owner of the trust, during the period the trust holds the S corporation stock. The deemed owner, who must be a U.S. citizen or resident, is treated as the shareholder. I.R.C. §1361(c)(2)(A)(i).

[9] I.R.C. §1361(c)(2)(A)(iv). Each beneficiary is treated as a separate shareholder.

[10] I.R.C. §1361(c)(2)(A)(iii). The trust is an eligible shareholder for two years beginning with the day when the stock is transferred to the trust under the decedent's will. I.R.C. §1361(c)(2)(A)(iii).

[11] I.R.C. §1361(d). The beneficiary must elect (via Form 2553) to be treated as the owner of the trust so that it is eligible to hold the stock and is treated as the shareholder.

[12] I.R.C. §1361(c)(2)(A)(v).

[13] I.R.C. §1361(c)(6).

[14] 1992-2 C.B. 224.

[15] Treas. Reg. §1.1361-1(e)(1).

[16] The AJCA did not change the rule that IRAs are subject to unrelated business income tax. See H.R. 4520 Conference Report, footnote 64, in which it is stated, "present-law rules treating S corporation stock held by a qualified retirement plan…as an interest in an unrelated trade or business apply to an IRA holding S corporation stock of a bank." But, as noted above, under the AJCA, IRA subchapter S shareholders can sell the IRA's stock to the IRA's beneficiaries if certain conditions are made.

[17] 133 T.C. No. 9 (2009).

[18] I.R.C. §408(h).

[19] I.R.C. §1362(c)(2)(A)(i).

[20] Priv. Ltr. Rul. 8605028 (Nov. 4, 1985).

[21] Rev. Rul. 92-73, 1992-2 C.B. 224.

[22] There is such a regulation now. See Treas. Reg. §1.1361-1(h)(1)(vii), effective Aug. 14, 2008.

[23] The court noted that a grantor of a grantor trust is taxed on trust income (the trust is merely a conduit which passes taxable income and gains through to the grantor), but earnings accrue tax-free in both traditional and Roth IRAs. Thus, the court reasoned, the tax relationship between a beneficiary and an IRA is not governed by the grantor trust provisions of I.R.C. §§671-679.

[24] H. Rept. 108-548 (Part 1), at 129 (2004).

[25] The dissent stressed that the court's focus should have been on the beneficial ownership of the stock held under a custodian's control in terms of who ultimately bears the benefits and risks of S corporation stock ownership. The dissent also pointed out that the majority's reliance on a 17-year old Revenue Ruling, rules relating to grantor trusts, congressional inaction and other various statements concerning the IRS's views on the matter are not controlling law.

[26] Custodial accounts are not true trusts. *See, e.g.*, Walsh v. Galloway, 308 Bankr. 709 (Bankr. W.D. Pa. 2001).

[27] Taproot Administrative Services, Inc. v. Comr., No. 10-70892, 2012 WL 933908 (9th Cir. Mar. 21, 2012).

[28] The parties agreed in this case the *Skidmore* analysis is the appropriate deference to be given to the revenue ruling. The court pointed out the standard of deference is an issue that was not settled in the 9th Circuit. The court declined, however, to settle the question of whether revenue rulings should be entitled to a more stringent *Skidmore* analysis or *Chevron* deference.

[29] An IRA is generally treated as an exempt trust (like a qualified plan) and is, arguably, not a qualifying trust. To decide otherwise would raise questions about the handling of S corporation distributions where the beneficiary is the owner, and the application of the passive loss rules.