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## **'Deckard': Failure to Establish Stock Ownership Defeats S Corp Shareholder Treatment**

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Treatment of a corporation as a pass-through entity for Federal income tax purposes can sometimes be achieved through an S corporation election under section 1362(a) of the Internal Revenue Code ("Code"), with the effect, among others, that the shareholders of the corporation may be permitted to claim its losses on their individual tax returns. However, an irregularity in corporate form may invalidate an election and give rise to adverse consequences that become apparent only in the context of a tax audit years after the election was attempted. *Deckard v. Commissioner* (155 T.C. No. 8 (2020)) illustrates this point and highlights the need for careful attention to the details of stock ownership, especially where classification as an S corporation is desired as a result of circumstances not anticipated at the time the corporation was formed.

### **Facts in *Deckard***

Clinton Deckard caused Waterfront Fashion Week, Inc. ("Waterfront") to be organized in May 2012 to produce an event in Louisville, Kentucky, known as Waterfront Fashion Week. Waterfront was formed as a nonstock and nonprofit corporation under the Kentucky Nonprofit Corporations Act (the "Act"), rather than as an ordinary business corporation, because it was thought that a nonprofit entity to which contributions may be deductible for income tax purposes would more readily attract funding. However, Waterfront never took the critical step of applying to the IRS for recognition of its tax-exempt status, with the result that it was considered a taxable corporation, contributions to which were not deductible, for Federal income tax purposes.

Under Waterfront's articles of incorporation (the "Articles"), the purposes of the corporation included, in addition to purposes relating to the Waterfront Fashion Week event, raising money for the Waterfront Park in Louisville and providing economic development opportunities in the fashion industry. Deckard was the President of Waterfront and one of its three directors.

Ultimately, more than 85% of the expenditures of Waterfront were funded by contributions by Deckard, and the Waterfront Fashion Week event produced by Waterfront did not break even. Accordingly, there were no funds remaining to be contributed to the maintenance of the Waterfront Park. The record before the Tax Court did not show Waterfront as engaging in any other activity, and it was ultimately dissolved administratively by the Kentucky Secretary of State on September 30, 2014, for failure to file a required annual report.

In October 2014, Waterfront, by means of filing Form 2553 with the IRS, purported to elect to be classified as an S corporation retroactive to the date of its incorporation. (Although an S election must generally be made not later than the 15<sup>th</sup> day of the third month of the year for which it is to be effective, an IRS Revenue Procedure provides relief for a limited class of late elections and permits an S election to be made up to approximately three years after the intended effective date under specified circumstances, and no issue was raised in the Tax Court proceedings regarding the timeliness of the election.) Waterfront's Form 2553 recited that Deckard was then the sole shareholder of Waterfront, and that he had had a 100% ownership interest in the corporation on the date of its incorporation. Deckard signed the Form 2553 as President of Waterfront and also as its sole shareholder.

In 2015, Waterfront and Deckard filed untimely income tax returns for 2012 and 2013 showing the corporation as having net operating losses for those years and claiming that, by reason of Waterfront's status as an S corporation, those losses "passed through" to Deckard and could be used to offset other income on his individual returns. By notice of deficiency to Deckard, the IRS disallowed the losses on the alternative grounds that Waterfront had not made a valid S election and that Deckard was not a shareholder of the corporation in 2012 or 2013.

Before the Tax Court, the government moved for partial summary judgment on the issues of the validity of the S election and Deckard's status as a shareholder, and Deckard by cross-motion moved for summary judgment in his favor on these issues.

## **Discussion**

It was undisputed that Waterfront, as a nonprofit corporation, was not authorized to issue stock and had not issued stock. Deckard argued, however, that he was the beneficial owner of the corporation. In support of such ownership, he declared that: he hired the event planning company that organized the Fashion Week event, and the attorney who advised and effected the formation of an entity to conduct the event; the corporation was formed as a nonprofit corporation by the attorney and in accordance with the recommendation of the event planning company; Deckard acted as president of Waterfront and its sole decision maker; and that, once it became clear that the event planning company was not succeeding in recruiting sponsors and raising contributions to the extent needed to fund the event, Deckard terminated the agreement with the event planning company, assumed full control of the event, abandoned plans to obtain tax-exempt status, and provided more than 85% of the cost of the event as contributions to Waterfront.

The opinion observes that the meaning of "shareholder," for purposes of qualification and taxation of a corporation as an S corporation, is determined by Federal law. Under that law, beneficial ownership might suffice for purposes of being a shareholder of an S corporation, notwithstanding that an individual did not bear the title of "shareholder" under state law. However, this did not dispose of the matter. It was still necessary to determine whether Deckard was a beneficial owner, and, for purposes of making that determination, Deckard's rights under state law, if not the label that state law gave to those rights, were relevant.

The court noted that nonprofit corporations are not generally considered to have owners, because such corporations are prohibited from distributing profits to "insiders" in a position to exercise

control, such as members, officers, and directors. Kentucky law in particular provided that a nonprofit corporation cannot pay a dividend or otherwise distribute its income or profits to its members, directors, or officers, and is prohibited from issuing shares of stock.

Further, the Articles provided that, upon the dissolution of Waterfront, its assets were to be distributed for exempt purposes described in Code section 501(c)(3) or to a government entity established for a public purpose. That Deckard may have been in complete control of the corporation would not relieve him and the other directors of the corporation of their fiduciary obligations to use the assets of the corporation in accordance with the requirements of the Act and the Articles. Thus, the court concluded that Deckard did not have ownership rights equivalent to those of a shareholder for purposes of subchapter S.

Deckard also made a substance over form argument. He argued that the court should disregard Waterfront's status as a nonprofit corporation and instead treat it as a for-profit entity, because Deckard intended it to be a for-profit entity owned solely by him and operated the corporation in a manner consistent with that intent. The court's somewhat predictable response was that taxpayers are generally bound by the form that they select, and, further, that the record was clear that Waterfront was intentionally formed under the Act as a nonprofit corporation and existed at all times under the Act, relating to nonprofit corporations.

The court also dismissed Deckard's argument that the failure to obtain or apply for tax-exempt status for Federal income tax purposes required that its shareholders be identified. The opinion characterized that failure as having no bearing on the circumstance that the corporation was, under state law, a nonprofit corporation subject to the limitations on distributions imposed by the Act.

Thus, the court concluded that Deckard was not a shareholder of Waterfront. Given that result, the court did not consider the government's alternative argument that no valid S corporation election was made for Waterfront.

## Observations

The Tax Court itself determined in an earlier case (consistent with the position taken in that earlier case by the government) that a nonstock corporation formed under Delaware law for charitable purposes did have shareholders for taxable years at issue for purposes of the personal holding company tax imposed by Code section 541 (*Steven Bros. Foundation, Inc. v. Commissioner*, 39 TC 93 (1962)). In those years, however, Delaware law permitted a nonstock corporation to provide to its members rights to share in current or accumulated profits upon dissolution. *Steven Bros. Foundation* is not discussed in *Deckard*, and it is unclear whether the earlier case would have provided significant support for Deckard's position had it been brought to the court's attention.

As a planning matter, *Deckard* underscores the need to confirm, whenever an S corporation election is contemplated, that the issuance of stock of the corporation to the intended shareholder or shareholders is authorized under the articles of incorporation and applicable state law and has been effected by the beginning of the taxable year for which the S election is to be effective.