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IRAs Barred From Owning Stock in S Corporation

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Corporations are generally subject to Federal income tax on their taxable income, when earned, and shareholders are generally subject to Federal income tax on the receipt of dividend distributions from corporations, but only when such distributions are actually made. In the case of a corporation meeting certain criteria, the Internal Revenue Code (the "Code") offers the option of electing "S corporation" status, under which the corporation is generally not subject to Federal income tax, but the shareholders are subject to tax on a "pass-through" basis at the time the corporation earns income, regardless of whether the income is distributed to them. The income of an S corporation is thus generally taxed currently to all of its shareholders, including qualified pension trusts and charitable organizations that would otherwise be exempt from income tax.

The rules governing what sorts of trusts are—and are not—permitted to be shareholders of an S corporation are extremely detailed. As noted above, qualified pension trusts and charitable organizations are also specifically permitted to be S corporation shareholders. In a recent reviewed decision, the Tax Court held (with four judges dissenting), that a Roth individual retirement account ("Roth IRA") is not a permitted shareholder of a S corporation and, therefore, that a corporation in which a Roth IRA held shares could not qualify as an S corporation, but, rather, was fully taxable as a "C corporation."[1]

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The Tax Court's holding is consistent with the position taken by the IRS in a ruling published in 1992,[2] and more recently by regulation,[3] and appears to reflect a sensible interpretation of the relevant provisions of the Code. The journey taken in the court's opinion through provisions of the Code and Regulations and the history of legislative action relating to this issue is worthy of note, as are legislative and administrative developments over the past twenty years or so regarding the categories of persons who may own stock in an S corporation.

Background

In order for a corporation to be eligible to make an S corporation election, it must be a domestic corporation meeting various requirements, including: a limitation on the number of shareholders (generally not more than 100); a requirement that the corporation not have more than one class of stock (with very limited exceptions); and the requirements that the corporation not have a nonresident alien as a shareholder and that each non-individual shareholder fit within certain other categories. These categories have been significantly expanded over the years, but there remain significant limitations, specifically, that each non-individual shareholder be an estate, a trust of one of the sorts described below, or a qualified pension trust or charitable organization.

Trusts that are permitted by the Code to be shareholders of an S corporations include: (i) a trust all of the property of which is treated, under the "grantor trust" rules of the Code as owned by one U.S. individual (whether or not the grantor of the trust); (ii) a voting trust, the beneficial owners of which are treated under the grantor trust rules as the owners of their respective shares of the trust; (iii) a "qualified subchapter S trust" (generally a trust that distributes all of its income currently to one individual who is a U.S. citizen or resident); and (iv) an "electing small business trust," each beneficiary of which must be an individual, estate, or one of several types of charitable organizations.

Individual retirement arrangements are not included on the Code's list of trusts that may be S corporation shareholders. However, a trust that constitutes an individual retirement account under Code section 408(a) (including a Roth IRA) is explicitly permitted as a shareholder of an S corporation that is also a "bank," but only to the extent of the stock held by the trust on October 22, 2004 (the date of enactment of this special provision). If this provision applies, the individual for whose benefit the IRA was created is treated as the shareholder for purposes of S corporation rules.

'Taproot'

Taproot Administrative Services Inc. (the petitioner) was a Nevada corporation that attempted to elect to be an S corporation. It filed a Form 1120S Federal tax return for 2003, indicating an effective date for its S election of October 2, 2002.

The sole shareholder of the petitioner during 2003 was the First Trust Co. of Onaga (First Trust), acting in the capacity of custodian for Paul DiMundo, an individual, under an arrangement apparently intended to constitute a Roth IRA, a type of "individual retirement plan" with respect to which contributions are non-deductible. [4] (There is no suggestion in the opinion that the arrangement did not qualify as a Roth IRA).

Income earned by a Roth IRA is generally not subject to income tax at any time. Such income is not taxed at the time it is earned, and it is also not taxed at the time it is distributed to a permitted beneficiary in a qualified distribution.[5] The use of Roth IRA's is expected to increase with the upcoming easing (pursuant to recently enacted legislative changes scheduled to take effect after 2009) of certain contribution limitations imposed by current law.

The IRS issued a notice of deficiency to the petitioner reflecting a determination that it was taxable as a C corporation for 2003 because it had an ineligible shareholder during that year. The petitioner filed for review of the tax deficiency by the Tax Court, and the Commissioner moved for partial summary judgment on the issue of whether the petitioner was an S corporation for 2003.

Discussion

The petitioner made two arguments in support of its position that a Roth IRA was a permissible shareholder of an S corporation. First, the petitioner argued that, because the stock of the petitioner was held in a custodial account for the benefit of one individual, that individual should be viewed as the shareholder, at least for purposes of determining whether the petitioner was eligible to make an S election.

In support of that argument, the petitioner cited a statement in the Regulations under subchapter S to the effect that, for specified purposes, "[t]he person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation."[6] This statement is consistent with earlier IRS rulings holding that stock held in a custodial account for the benefit of a disabled person, or in a Uniform Gift to Minors Act account for a child, is treated for tax purposes as held by the disabled person or child.

The Commissioner responded that the custodial account and similar arrangements addressed in the earlier rulings all involved situations in which the income earned by the account was taxable on a current basis to the beneficiary of the arrangement. By contrast, the key purpose of the transfer of property to an IRA is to achieve tax benefits, including deferral of (or, in some cases, complete exemption from) Federal income tax on the income, tax benefits that would not be available if the property were treated for tax purposes as held directly by the beneficiary.

The petitioner also argued that an IRA is—or, at least, could be—a trust with respect to which the owner has powers that cause the trust to come within the scope of the "grantor trust" rules. (A "grantor trust" for the benefit of a U.S. citizen or resident is a permissible shareholder of an S corporation.) However, the IRA at issue in *Taproot* was not a trust in form, and the opinion of the court appears to question whether an IRA could be established that reserved rights to the contributor in a manner that would suffice to meet the requirements for qualifying as a "grantor trust." Moreover, even if a trust described in the grantor trust rules could also meet the IRA requirements, it seems apparent (and the petitioner did not appear to argue to the contrary) that, where applicable, the IRA regime would preclude the imposition of tax on a current basis on income attributable to property held in the IRA.[7] By contrast, the items of income, deduction, and credit attributable to property held by a grantor trust are supposed to be taken into account on a current basis in determining the tax liability of the grantor or other person treated as the owner of the trust.

Thus, the petitioner's argument was internally inconsistent, in trying to claim the benefit of grantor trust treatment of the IRA as a permissible shareholder of an S corporation, without accepting (with respect to the IRA's beneficiary) the income tax treatment imposed by the Code upon a person treated as the owner of a grantor trust.

The opinion further noted that, in 2004, Congress amended the S corporation provisions to authorize the election of S corporation status by closely held banks, even if they had one or more IRA's as shareholders. That amendment, by permitting such an election, but only in circumstances where stock of the corporation was held by an IRA as of the date of enactment in 2004, implicitly confirmed that Congress interpreted the Code as generally precluding a corporation with an IRA shareholder from electing to be an S corporation. Had Congress believed IRA's to be permitted shareholders of S corporations, a special rule permitting IRA shareholders for bank corporations would have been unnecessary.

Accordingly, the court concluded that the petitioner was not a S corporation in 2003 and granted summary judgment for the Commissioner.

The circumstances before the court did not involve a "traditional" (non-Roth) IRA, with respect to which contributions may be deductible, but distributions are generally taxable to the recipient.[8] It seems reasonably clear, however, that this court would also conclude that a traditional IRA is not a permissible shareholder of an S corporation.

Somewhat surprisingly, this case provoked a lengthy dissent. The dissenters believed that the petitioner's IRA shareholder should not have precluded treatment of the petitioner as an S corporation, on the rationale that the beneficial owner of the stock of the petitioner—that is, the person who would ultimately reap the benefits and bear the

burdens of stock ownership of the corporation—was the individual beneficiary of the IRA, and that this individual should be viewed as the shareholder at least for purposes of determining eligibility for S status.

The dissenters further argued that the concerns expressed by the IRS, to the effect that interpreting the relevant IRA and S corporation provisions as desired by the petitioner would provide a tax windfall—by permitting S corporations owned by RA's to avoid the current income tax otherwise imposed at the corporate or shareholder level (or both) with respect to profits of businesses conducted by corporations—would be adequately addressed by the tax imposed by the Code on the "unrelated business taxable income" of IRA's.[9]

Observations

Taproot represents, in a sense, only the latest addition to an ever-expanding—but not wholly consistent—body of law that seeks to determine, when provisions of the Code confer a favorable tax status on a business entity only if it is owned solely by certain categories of persons, whether it is the identity of the owners, under local law, of interests in the entity or that of the person(s) ultimately entitled to the benefits and burdens of ownership that should be determinative of whether the desired status is available. More broadly, the decision may have the indirect consequence of focusing more attention by taxpayers and by the IRS on potential tax benefits that may be sought through creative use of a traditional or Roth IRA as an owner of an interest in a pass-through entity, such as a partnership or limited liability company.

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[1] *Taproot Administrative Services, Inc. v. Commissioner*, 133 T.C. No. 9 (Sept. 29, 2009). A very narrow statutory exception relating to certain corporations in the banking business is discussed below.

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

[3] Treasury Regulation section 1.1361-1(h)(1)(vii).

[4] An "individual retirement account" is defined in Code section 408(a) as a trust for the benefit of an individual or the individual's beneficiaries that meets certain requirements. Under section 408(h), a custodial account meeting certain requirements may be treated as a trust for purposes of section 408.

[5] See Code sections 408, 408A. As further discussed below, however, a Roth IRA, like a traditional (non-Roth) IRA, is potentially subject to the tax on "unrelated business taxable income" (or "UBTI") imposed by Code section 511.

[6] Treasury Regulation section 1.1361-1(e)(1).

[7] Code section 512(e) specifically provides that a qualified pension trust or charitable organization that is a shareholder of an S corporation is subject to income tax on its share of the income of the S corporation, as though that share constituted "unrelated business taxable income" (commonly called "UBTI" or "UBIT"). However, nothing in section 512(e) would make that provision applicable to IRA's, even though they (like pension trusts) are generally taxable on their UBIT, and there does not seem to be any other provision in the Code that would explicitly achieve a similar result (although Code section 1366 might be interpreted to require that result).

[8] Code sections 219 and 408.

[9] Code section 511. As noted above, however, there does not appear to be any provision of the Code that states explicitly that an IRA's share of the income of a corporation would be treated as "unrelated business taxable income" for purposes of the section 511 tax.

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