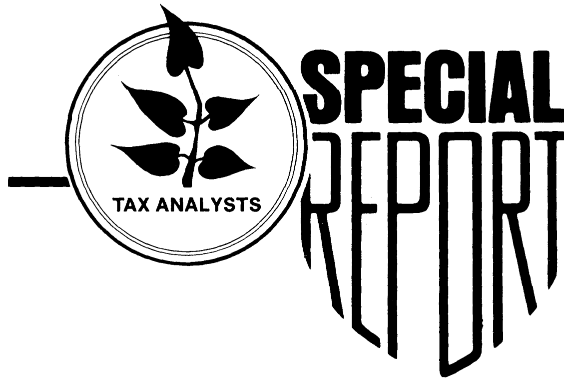

NEW "S" SECOND-CLASS-OF-STOCK PROPOSED REGULATION — A GIGANTIC TRAP

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In this article, Levin and Stoffregen analyze and critique the recently issued proposed regulation interpreting the code section 1361 prohibition against an S corporation having more than one class of stock outstanding. The authors conclude that the proposed regulation is inconsistent with the legislative purpose underlying the 1982 revision of subchapter S, because it creates an extraordinary number of technical traps for the unwary and proposes to make most of those traps retroactive to January 1, 1983. Hence, if adopted as drafted, the regulation would unfairly disqualify a countless number of S corporations, many of them retroactive to January 1, 1983.

The proposed regulation's highly technical approach, would make subchapter S extremely difficult to use without incurring inordinate legal monitoring fees, contrary to the original intent that subchapter S be available for small businesses. For example, an S corporation which advances the payment date for a cash dividend to one of its shareholders will frequently disqualify the S election. Similarly, any nonproportionate constructive distribution, such as unreasonable compensation to one shareholder, an unreasonable expense reimbursement, or a below market loan, would generally disqualify the election.

Finally, the proposed regulation is ambiguous in crucial respects, including the ability of an S corporation which has had a change in ownership during the year to pay a year-end cash dividend in proportion to the K-1 allocation of its taxable income (as opposed to the shareholdings at the time the dividend is paid).

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INTRODUCTION

To qualify as an S corporation ("SCo") and, hence, generally pay no federal income tax, a corporation may have no more than one class of stock outstanding (except for differences in voting rights, which are not deemed to create a second class for this purpose).[1]

In October 1990, the IRS issued a lengthy proposed regulation under code section 1361 interpreting the one-class-of-stock requirement. If and when adopted, the proposed regulation will generally be retroactive to taxable years beginning on or after January 1, 1983.[2]

Unfortunately, the proposed regulation creates an extraordinary number of traps for the unwary, so that the carefully implemented goals of the proposed regulation

[1]Code section 1361(b)(1)(D); code section 1361(c)(4).
[2]Prop. Reg. section 1.1361-1(l)(7).

appear to be as follows: (1) make it as difficult as possible for ordinary taxpayers to use subchapter S, (2) disqualify as many SCos as possible, and (3) make the disqualifications as retroactive as possible.

RIGHTS TO DISTRIBUTION/LIQUIDATION PROCEEDS

Code section 1361 states that an SCo will be treated as having more than one class of stock unless all outstanding shares of its stock "confer identical rights to distribution and liquidation proceeds." The proposed regulation embellishes on this statutory rule by clarifying that a second class of stock exists whether the difference in distribution or liquidation rights is caused by (1) the corporate charter, (2) the bylaws, (3) operation of state law, (4) administrative action, or (5) agreement among the shareholders.[3]

Example (1): SCo and its shareholders enter into a shareholders' agreement stating that all SCo dividends are to be state tax effected, so that each shareholder will retain the same amount after paying state income taxes. Hence, if any two shareholders reside in different states with different state income tax rates, they would receive a different amount per share as a dividend from SCo under the shareholders' agreement. In this case, SCo would be deemed to have two classes of stock outstanding and would lose its SCo status.

Example (2): A and B form SCo, with A contributing $100 cash for 100 shares and B contributing property for 100 shares. Although the 200 shares are identical on their face, the state commissioner of corporations for the state in which SCo is incorporated requires the parties to agree that SCo will not make distributions to B (who contributed property) until A (who contributed cash) has received a stated amount of distributions. SCo is deemed to have two classes of stock outstanding and loses its SCo status.

SCo will. . .be deemed to have more than one class of stock. . .if it. . .makes distributions to shareholders which vary in timing or amount. . . .

PRO RATA DIVIDEND REQUIREMENT

Surprisingly, the proposed regulation goes on to state that even where SCo has only one homogenous class of stock outstanding and no shareholders' agreement varies the shareholders' rights to receive equal distributions, SCo will nevertheless be deemed to have more than one class of stock outstanding if it in fact makes distributions to shareholders which vary in timing or amount (i.e., makes non-conforming distributions).[4]

There is, however, an excessively narrow relief provision: Nonconforming distributions that vary in timing will not be treated as creating a second class of stock if the distributions during SCo's taxable year (taken in the aggregate) are pro rata with respect to all outstanding shares (i.e., the distributions are equalized before the end of SCo's taxable year) *and* either (1) the differences in timing were unintentional, or (2) the distributions are equalized within a three-month period.[5]

Example (3): SCo has two shareholders, A and B, and uses a calendar tax year. On 12/15/90 SCo declares a dividend payable on 1/2/91. A requests that, as a favor, his portion of the dividend be paid to him on 12/31/90 and SCo complies. B's portion of the dividend is paid to him on 1/2/91 (i.e., on the regular dividend payment date, which is 3 days after the payment to A).

Payment of the dividend has no tax consequences to A or B because SCo has no C E&P (or if SCo has C E&P, because SCo has an AAA in excess of the amount of the dividend).

Taking into account both the 12/31/90 and the 1/2/91 payments, the total distribution by SCo is pro rata to shareholdings. Nevertheless (assuming that the proposed regulation is valid in this respect), the distribution is non-conforming and SCo loses its S status because all distributions during SCo's 1990 tax year were not pro rata.

DIVIDENDS AFTER CHANGED SHAREHOLDINGS

Frequently, an SCo pays a cash dividend shortly after the end of its taxable year, allocating the distribution among the shareholders based on the amount of SCo's taxable income allocable to each shareholder for the taxable year (i.e., based on the K-1 amount allocated to each shareholder). An SCo may distribute (1) 100 percent of SCo's taxable income for the recently-ended year, (2) a uniform percentage (e.g., 33 percent) of SCo's taxable income designed to permit each shareholder to pay his federal and state income tax on the amount of SCo's taxable income for the recently-ended year allocated to such shareholder, or (3) an amount somewhere between (1) and (2). This distribution is often paid shortly after SCo's accountants complete the K-1s for the recently-ended year (frequently approximately March 15 of the next year).

Under code sections 1366 and 1377(a), the amount of an SCo's taxable income or loss allocable to each shareholder (on his K-1) is generally determined by assigning an equal portion of each tax item to each day of the taxable year and then dividing the portion so allocated to each day pro rata among the shares outstanding on that day (i.e., a daily pro-rate system).[6]

Thus, where there is a change in the relative stockholdings of SCo's shareholders during the tax year (or after the end of the tax year but before SCo pays the year-end distribution), such a year-end cash distribution

[3]Prop. Reg. section 1.1361-1(l)(2)(i).

[4]Prop. Reg. section 1.1361-1(l)(2)(i)(A).

[5]Prop. Reg. section 1.1361-1(l)(2)(ii)(B).

[6]*See* M. Ginsburg and J. Levin, *Mergers, Acquisitions and Leveraged Buyouts*, paragraph 1103.02 (CCH Tax. Trans. Lib.) for an exception applicable to a terminating shareholder where all shareholders agree.

based on the amount of SCo's taxable income allocated to each shareholder will *not* be proportionate to SCo's stockholdings at the time of the dividend.

Example (4): SCo has $100,000 of taxable income for its 1991 calendar taxable year. On 1/1/91 A owns all 100 shares of SCo's outstanding stock. On 7/1/91 (halfway through 1991) A sells 50 of his SCo shares to B, so that for the last half of 1991 A and B each own 50 percent of SCo.[7]

Where there is a change in...stockholdings ...a...cash distribution based on...taxable income allocated to each shareholder will not be proportionate to SCo's stockholdings at the time of dividend.

Under the code, SCo's 1991 taxable income is allocated on a daily pro-rate basis $75,000 to A (who owned 100 percent of SCo's stock for half the year and 50 percent for the other half) and $25,000 to B (who owned half of SCo's stock for half the year).

On 3/15/92 (the day after SCo's accountants complete SCo's tax return), SCo declares and immediately pays a $50,000 dividend, i.e., 50 percent of its 1991 taxable income.[8] In accordance with a shareholders' agreement (*or* a long-standing oral policy *or* a provision in SCo's corporate charter), the cash dividend is paid 75 percent to A and 25 percent to B, i.e., proportionate to the 1991 K-1 allocation of taxable income. The cash dividend is *not* paid 50 percent each to A and B, although at the time of the dividend they each own 50 percent of SCo's stock.

Example (5): Same facts as example (4), except that B purchases her 50 percent interest in SCo on 1/1/92 (i.e., after the end of SCo's 1991 taxable year, but before the 3/15/92 distribution of 50 percent of SCo's 1991 taxable income). Hence, under the code, 100 percent of SCo's 1991 taxable income is allocable to A, and under the shareholder's agreement (*or* the long-standing oral policy *or* the corporate charter), 100 percent of the 3/15/92 cash dividend is paid to A.

The proposed regulation requires that "all...outstanding shares...confer identical rights to distribution and liquidation proceeds" and that distributions actually be paid identically on a share-for-share basis. However, the proposed regulation does not expressly address whether the "identical" distribution standard is applied by reference to (1) shares outstanding on the dividend record date[9] or (2) shares outstanding during the period the taxable income was earned (i.e., calculated on a daily pro-rate basis).

If the proposed regulation is read as requiring each dividend to be distributed identically to stock owned on the dividend record date, the unfortunate result would be the inadvertent termination of countless S elections (including those in Examples (4) and (5) above), i.e., whenever SCo experiences a change in stock ownership during its taxable year (or after year end but before the record date for the year-end distribution), its S election would be invalidated if (as SCos frequently do) the dividend is paid proportionate to the K-1 earnings allocations.

However, at least one 1984 private letter ruling (dealing with subchapter S subsequent to the 1982 Act) explicitly held that a shareholder agreement to pay dividends on a daily pro-rate basis did not violate the one-class-of-stock rule.[10] The ruling dealt with a shareholder agreement to pay "annual minimum distributions...equal to __ percent of [SCo's] taxable income to its shareholders, who divide said sum amongst themselves on a per-share, per-day basis" and concluded that this did "not create a second class of stock."

The proposed regulation does not...address whether the "identical" distribution standard is applied by reference to (1) shares outstanding on the dividend record date or (2) shares outstanding during the period the taxable income was earned....

Moreover, the 1982 Act's revision of the subchapter S rules was designed to move the taxation of SCo shareholders more toward the taxation of partners, to simplify the rules, and to eliminate traps which would disqualify S status. If the proposed regulation is read as rejecting the daily pro-rate distribution approach of the 1984 private letter ruling, it would create a tremendous trap for the unwary. The proposed regulation should be amended clearly to permit daily pro-rate distributions.

If (notwithstanding the above discussion) the IRS successfully takes the position that SCo dividends must be paid proportionate to stock ownership on the dividend record date, a well-advised SCo can take a number of (albeit cumbersome) planning steps to cure the problem.

[7]The result would be the same if A keeps all 100 of his SCo shares but on 7/1/91 B buys 100 newly-issued shares from SCo.

[8]The result would be the same if SCo distributed $100,000 (i.e., 100 percent of its 1991 taxable income) or $33,000 (i.e., the estimated amount necessary to permit its shareholders to pay 31 percent federal income tax plus state income tax on their $100,000 K-1 taxable income).

[9]If the proposed regulation is interpreted as adopting alternative (1) above, presumably shareholdings on the dividend record date would be determinative, rather than on the dividend declarations date or the dividend payment date. *See* Javaras letter to Treasury, *Highlights & Documents*, p. 899 (Jan. 28, 1991).

[10]LTR 8407011.

Example (6): On 1/1/91 A owns all 100 shares of SCo's outstanding stock. On 12/1/91 (11 months into SCo's 1991 calendar tax year) A sells 50 of his SCo shares to B. If permitted by the proposed regulation, SCo (a) would have paid a dividend equal to 40 percent of its taxable income, (b) would have waited until 3/15/92 (when SCo's accountants would complete its tax return) to determine the amount of and to pay the dividend, and (c) would have allocated the dividend between A and B on a daily pro-rate basis.

Assuming that the proposed regulation requires the dividend to be paid pro rata to SCo's stock ownership on the dividend record date, the alternatives include:

(a) On 11/30/91 (the day before A's 50 share sale to B), SCo estimates its 11 month earnings (from 1/1/91 to 11/30/91) and distributes 40 percent of such amount to A (who owns 100 percent of SCo's stock). Then, on 3/15/92, when SCo's actual 1991 earnings are known, it distributes 40 percent of the *excess of* (i) its actual 1991 earnings *over* (ii) the 11 month estimated earnings, with such distribution being made 50 percent to A and 50 percent to B (i.e., proportionate to SCo stockholdings on 3/15/92. This approach is unsatisfactory to the extent the 11/30/91 earnings estimate is wrong.

(b) On 11/30/91 (the day before A's 50 share sale to B), SCo declares a dividend to shareholders of record on 11/30/91 (when A owns 100 percent of SCo's stock). The dividend is a contingent amount, i.e., 40 percent of 11/12 of SCo's 1991 taxable income as finally determined. The dividend resolution states that it is payable as soon as SCo's 1991 taxable income is determined. Later, on 3/15/92 (when SCo's actual 1991 earnings are determined), SCo (i) pays the contingent dividend 100 percent to A (who owned 100 percent of SCo's stock on the record date for the contingent dividend) and (ii) declares and immediately pays a second dividend equal to 40 percent of 1/12 of its 1991 taxable income (50 percent to A and 50 percent to B, i.e., proportionate to SCo's stockholdings on 3/15/92). This approach runs into the problem that many state corporation statutes impose a limit (e.g., 60 days for Delaware) on the maximum time between a dividend record date and payment date.[11]

(c) SCo declares and pays (on 3/15/92) only one dividend which is equal to 40 percent of its entire 1991 taxable income, and makes such payment 50 percent to A and 50 percent to B (i.e., proportionate to SCo's stockholdings on 3/15/92), but at the time B buys his 50 shares from A (12/1/91), B agrees to pay A an additional contingent purchase price (in addition to the negotiated price) equal to the excess of the 3/15/92 dividend over 40 percent of B's K-1 allocation of SCo 1991 taxable income.

All of these needlessly complex arrangements could be avoided by a rational clarification of the proposed regulation to allow year-end distributions on a daily pro-rate basis.

CONSTRUCTIVE DIVIDENDS

Any transfer from an SCo to a shareholder that is characterized for tax purposes in whole or in part as a dividend distribution will be treated as a nonconforming distribution unless the constructive distribution is pro rata with respect to all SCo shareholders. For example, if SCo makes a loan to one of its shareholders with a below-market (i.e., below AFR) interest rate, the borrowing shareholder is treated (under code section 7872) as paying phantom interest to SCo (equal to the excess of interest at the AFR over the actual interest) and SCo is treated as paying an equal amount back to the borrowing shareholder *as a phantom distribution*. This nonconforming distribution will terminate the S election.[12]

Similarly, unreasonable compensation paid to one of SCo's shareholder-employees (as well as unreasonable expense reimbursements) would result in loss of subchapter S status. Hence an SCo that paid aggressively large salaries to shareholder-employees to zero out the SCo's *state* taxable income might now find its S status threatened by the retroactive reach of the proposed regulation, unless the unreasonable portion of the salaries was pro rata to stockholdings. The potential for inadvertent termination of subchapter S status is thus greatly increased by the proposed regulation for any SCo found to have made a non-pro rata constructive or deemed distribution.

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STOCK REDEMPTIONS

A redemption of SCo stock or an agreement to redeem SCo stock generally would not be treated as a nonconforming distribution (regardless of whether the redemption qualifies as a capital gain redemption under code sections 302(a) or 303 or is treated as a dividend under code section 302(d)), unless the redemption was part of a planned series of redemptions that resulted in the shareholders of SCo owning (after a series of redemptions) substantially the same proportionate interest in SCo as they held before the series of distributions.[13] This rule prevents SCo from circumventing the prohibition on nonconforming distributions by making a series of redemptions (e.g., a redemption from A on 12/31/90 and from B on 1/2/91) that are substantially equivalent to dividends.

[11]*See* Del. Gen. Corp. Law section 213(c).

[12]*See* Treasury Dept. release accompanying proposed Reg. section 1.1361-1.

[13]Prop. Reg. section 1.1361-1(l)(2)(ii)(C).

[14]Prop. Reg. section 1.1361-1(l)(2)(i).

VOTING RIGHTS AND SHAREHOLDER AGREEMENTS

Differences in voting rights, buy-sell agreements among shareholders, restrictions on stock transferability, and stock redemption agreements are disregarded in determining whether an SCo has more than one class of stock (so long as they do not restrict the shareholder's right to receive distribution and liquidation proceeds while he owns the SCo stock).[14]

CODE SECTION 83 RESTRICTED STOCK

Under the proposed regulation, SCo stock that is subject to a substantial risk of forfeiture (an "SRF"), as defined in code section 83, but as to which the holder *has* made a timely code section 83(b) election, is treated as outstanding and constitutes a second class of stock if the stock does not confer rights to distribution and liquidation proceeds that are identical to the rights conferred by the other outstanding shares of SCo stock.

Example (7): SCo issues stock to its president, A, for $1 a share, under an agreement pursuant to which SCo can buy the stock back for $1 a share if A ceases to be employed by SCo at any time during the next five years. Notwithstanding the SRF, A's SCo stock is, during the five-year SRF period, entitled to a full share of any dividends paid by SCo and of any liquidation proceeds paid out by SCo. A makes a code section 83(b) election with respect to his SCo stock.

The SCo stock held by A is treated as outstanding SCo stock, but because A's rights to dividend and liquidation proceeds are identical to the rights of all other holders of SCo stock, A's SCo stock is not treated as a second class of stock.

Example (8): Same facts as Example (7), except that (i) if SCo liquidates during the five-year SRF period, A is entitled to receive only $1 as a liquidating distribution, *or* (ii) if SCo pays any dividends during the five-year SRF period, A is not entitled to receive such dividends, *or* (iii) A is subject to both of the restrictions in (i) and (ii). A's SCo stock is a second class of stock, and SCo's S election is terminated.

SCo stock that is subject to an SRF but with respect to which the holder has *not* made a timely code section 83(b) election would not be treated as outstanding SCo stock. Hence such non-code section 83(b) SRF stock could not be a second class of stock and could not terminate the SCo's S status.[15] Moreover, because such SRF stock is not treated as outstanding (until the SRF expires), it is not allocated any portion of SCo's taxable income or loss, and SCo's other shareholders (i.e., those owning stock not subject to an SRF or owning SRF stock as to which a timely code section 83(b) election was made) are allocated all of SCo's taxable income or loss.

The proposed regulation does not deal with the situation where all of SCo's stock is subject to an SRF and no timely code section 83(b) election has been made with respect to any of SCo's stock. Logically, there are two choices: either (i) SCo could be treated as having no stock outstanding, in which case it would presumably not qualify as an SCo, would be taxed as a C corporation, and would owe corporate-level tax on all of its earnings; *or* (ii) all the SRF stock could be treated as outstanding, in which case SCo would qualify for SCo status if all shares of stock had identical rights to dividend and liquidation proceeds. The second alternative is clearly the more reasonable.

The proposed regulation does not deal with the situation where all of SCo's stock is subject to an SRF and no timely code section 83(b) election has been made. . . .

DEFERRED COMPENSATION PLANS

Under the proposed regulation, an agreement by SCo to pay deferred compensation to an SCo employee would not constitute a second class of stock provided that the obligation or agreement is merely an unfunded and unsecured promise to pay money or property in the future.

Example (9): SCo issues a stock appreciation right (an "SAR") to its president, A. The SAR provides that SCo will pay to A on a specified future date an amount equal to the then Fair-Market Value (FMV) of a share of SCo stock less $1 (which is the current FMV of a share of SCo stock). SCo's obligation is not funded or secured. The SAR does not constitute a second class of SCo stock.

The proposed regulation addresses only SARs issued to an employee as deferred compensation. Hence, there is some risk that an SAR issued to a person other than an employee (for example to an outside consultant or a lender) may constitute a second class of stock. As described below, this would turn on whether the non-employee SAR "constitutes equity or otherwise results in the owner being treated as the owner of stock under general principles of federal tax laws." Normally a right to such an SAR would not constitute stock under general tax principles.[16]

[15] Prop. Reg. section 1.1361-1(b)(3).

[16] *See* M. Ginsburg and J. Levin, *Mergers, Acquisitions and Leveraged Buyouts*, paragraph 203.067 (CCH Tax. Trans. Lib.); but see the *Farley Realty* case discussed at paragraph 203.067.

DEBT AND OTHER INSTRUMENTS

Under the proposed regulation, "any instrument, obligation, or arrangement" of SCo (except for "straight debt" as defined below) is treated as a second class of SCo stock if it "constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of federal tax law."[17]

Code section 1361(c)(5) contains a statutory exemption for "straight debt"—i.e., debt which (1) is held by a person who could qualify as a shareholder of an SCo, (2) has a fixed principal amount payable on demand or at a specified time, (3) bears interest at a fixed rate (or a rate which floats based on an objective index), and (4) has no convertibility feature. Under code section 1361(c)(5), such "straight debt" will be classified as debt for S purposes even if it might be classified as equity in a C corporation.[18]

The proposed regulation would add an additional requirement to the definition of "straight debt." Under the proposed regulation (in addition to the statutory requirements), debt with a maturity of more than one year will qualify as "straight debt" only if it bears a reasonable interest rate.[19] A variable interest rate based on an objective index, such as LIBOR, may qualify as a reasonable interest rate.[20] The proposed regulation provides a safe harbor interest rate for this purpose—an interest rate will be reasonable if it is at least equal to the AFR and is not more than five percentage points above the AFR.[21] Similarly, a variable rate tied to an objective index would qualify for the safe harbor if the interest rate resulting from the formula at the time of issuance was at least 100 percent of the AFR and not more than five percentage points above the AFR.[22]

The proposed regulation would clarify several points:

(1) An SCo obligation may qualify as "straight debt" even though it is subordinate to other SCo debt.

(2) The "straight debt" tests are applied at each of three events: issuance of the debt, material modification of the debt, and transfer of the debt.[23]

(3) Once debt meets the "straight debt" definition, it will be treated as debt for all federal tax purposes unless tax avoidance is a principal purpose of issuing the debt.[24]

(4) The debt of a C corporation which meets the definition of "straight debt" will be treated as "straight debt" if the C corporation thereafter makes an S election.[25]

[17]Prop. Reg. section 1.1361-1(l)(3)(ii). *See* M. Ginsburg and J. Levin, *Mergers, Acquisitions and Leveraged Buyouts*, paragraph 1303 (CCH Tax. Trans. Lib.) for a discussion of the common law debt-equity rules.

[18]While such straight debt will not constitute a second class of stock disqualifying the S election, it can (except as set forth in the proposed regulation as discussed below) be treated as equity for other purposes of the code, e.g., application of section 302 to a redemption.

[19]Prop. Reg. section 1.1361-1(l)(4)(i).

[20]Prop. Reg. section 1.1361-1(l)(4)(ii)(B).

[21]Prop. Reg. section 1.1361-1(l)(4)(ii)(C).

[22]Prop. Reg. section 1.1361-1(l)(4)(ii)(C)(1)-(3).

[23]Prop. Reg. section 1.1361-1(l)(4)(iii)and (iv).

[24]Prop. Reg. section 1.1361-1(l)(4)(v).

[25]Prop. Reg. section 1.1361-1(l)(4)(vi).

OPTIONS AND SIMILAR INSTRUMENTS

Under the proposed regulation, "a call option, warrant, or similar instrument" (collectively an "option") issued by an SCo is automatically treated as a second class of SCo stock if it is substantially certain to be exercised by the holder, even if the holder is not treated as the owner of the underlying SCo stock for other purposes under federal tax law. The proposed regulation makes clear that convertible debt would be a "similar instrument" for this purpose.[26] The determination whether an option is substantially certain to be exercised would be made on three occasions: (1) at the time of issuance; (2) at the time of any material modification of the instrument; and (3) at the time of any subsequent transfer to another holder (other than transfer by gift, at death, between spouses, or incident to a divorce).[27]

A call option, warrant, or similar instrument . . . is . . . treated as a second class of . . . stock if it is substantially certain to be exercised. . . .

Whether an option is substantially certain to be exercised generally turns on the extent to which the FMV of the underlying stock exceeds the exercise price of the option at the time of the determination. If the exercise price is "substantially below" FMV, the option is, according to the proposed regulation, "substantially certain to be exercised" and hence is a second class of stock.

If an option is "substantially certain to be exercised," it constitutes a second class of stock, even though the stock into which it is exercisable is identical to the SCo's other outstanding stock, presumably because the option is treated as stock which, prior to exercise, does not have a right to distribution and liquidation proceeds.

Three safe harbors from the rule treating options as SCo stock help to illustrate the option rule. *First*, an SCo option will not be treated as "substantially certain to be exercised" at the time of issuance, material modification or subsequent transfer to another holder, if the strike price of the option at the time of such event is at least 90 percent of the FMV of the underlying SCo stock.[28] If the strike price is less than 90 percent of the FMV of the underlying stock, the safe harbor will not apply, but the taxpayer may still be able to establish that the option is not substantially certain to be exercised.

Second, an SCo option issued to an employee in connection with the performance of services will not be treated as a second class of stock if, at the time of the grant, the option (1) is nontransferable (except upon death of the holder) or is only transferable subject to an SRF and (2) does not have a readily ascertainable FMV, i.e., is not actively traded in an established market. If the option thereafter becomes transferable, it ceases to qualify for the safe harbor.[29]

[26]Prop. Reg. section 1.1361-1(l)(5), example 2.

[27]Prop. Reg. section 1.1361-1(l)(3)(iii)(A).

[28]Prop. Reg. section 1.1361-1(l)(3)(iii)(C).

[29]Prop. Reg. section 1.1361-1(l)(3)(iii)(B)(2).

Third, an SCo option issued to a lender in connection with a loan to SCo is not treated as a second class of stock so long as the option is exercisable only if SCo defaults on the loan.[30] The safe harbor applies only if the lender is unrelated to SCo and is actively and regularly engaged in the business of lending (or the lender is related to SCo, is actively and regularly engaged in the business of lending, and the terms of the loan to SCo are commercially reasonable). This safe harbor obviously has limited practical significance, since most lender options are issued to give the lender an upside opportunity if SCo does well, not if SCo does badly and defaults.

EFFECTIVE DATE

If adopted in its present form, the proposed regulation will generally be retroactive to taxable years beginning on or after January 1, 1983. However, a delayed effective date would be provided for several provisions that substantially expand prior law. *First*, in the case of an SCo option (including a warrant, convertible debenture, or similar instrument) in existence on or before October 5, 1990, the final regulation will apply to a taxable year beginning on or after the date that is 90 days following publication of the final regulation. Under this delayed effective date provision, an SCo option issued prior to October 6, 1990, will not be treated as a separate class of stock by the new option rule of Prop. Reg. section 1.1361-1(l)(3)(iii) (until the SCo's taxable year beginning on or after 90 days following publication of the final regulation), even if it was substantially likely to be exercised when issued, modified, or transferred.

However, there is no delayed effective date for Prop. Reg. section 1.1361-1(l)(3)(ii) which treats "any instrument, obligation, or arrangement" of an SCo as a second class of stock if it "constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of federal tax law." Hence there may be circumstances where an option will so resemble stock as to be a second class under this proposed regulation even before the delayed effective date of Prop. Reg. section 1.1361-1(l)(3)(iii).

Moreover, this delayed effective date does not apply to any option issued after October 5, 1990.

Second, the new requirement that "straight debt" with a more than one year maturity bear a reasonable interest rate would not apply to instruments issued on or before October 5, 1990, until the SCo's taxable year beginning on or after 90 days following issuance of the final regulation.[31] However, this delayed effective date does not apply to any instrument issued after October 5, 1990.

Third, in the case of SCo debt that was in existence on or before October 5, 1990, and was held solely by the owners of (and in substantially the same proportion as) the stock of SCo, the proposed regulation states that the final regulation will apply to taxable years beginning on or after the date that is 90 days following the publication of the final regulation. In *Portage Plastics Co. v. United States*,[32] the Seventh Circuit concluded in 1973 that purported debt held solely by SCo's shareholders and in substantially the same proportion as they hold SCo's nominal stock will not be treated as a second class of stock even if it is treated as equity for other federal tax purposes. The special effective date provision for the proposed regulation continues in effect the *Portage Plastics* holding for purported debt issued on or before October 5, 1990, until the SCo's taxable year beginning on or after 90 days following publication of the final regulation. The scope of this delayed effective date rule appears to be quite narrow, because such purported debt will generally qualify as "straight debt," and hence will not be a second class of stock regardless of the delayed effective date provision, unless either (1) the debt is not evidenced by a written instrument or (2) the debt is convertible.

The rules concerning inadvertent termination of SCo status apply to violations of the one-class-of-stock rules of the proposed regulation. . . .

The proposed regulation also indicates that the rules concerning inadvertent termination of SCo status[33] apply to violations of the one-class-of-stock rules of the proposed regulation.[34] Thus, if prior to October 5, 1990, SCo violated one of the retroactive rules of the proposed regulation, it may be possible to avoid loss of SCo's S status by correcting the rule violation and then applying for a ruling that the violation was inadvertent.

CONCLUSION

The proposed regulation's highly technical approach and ambiguities, would make subchapter S extremely difficult to use without incurring inordinate legal monitoring fees, contrary to the original intent that subchapter S be available for small businesses.

[30]Prop. Reg. section 1.1361-1(l)(3)(iii)(B)(1).
[31]Prop. Reg. section 1.1361-1(l)(7).
[32]486 F.2d 632 (7th Cir. 1973).
[33]Code Section 1362(f).
[34]Prop. Reg. section 1.1361-1(l)(6).