

Comments for Technical Corrections to Internal Revenue Code Section 1361

The following comments are being submitted on behalf of the American Bar Association Section of Real Property, Probate and Trust Law. They have not been approved by the House of Delegates nor the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

The comments were prepared by members of the Business Planning Group of the Probate and Trust Division of the Real Property, Probate and Trust Law Section of the American Bar Association. Principal responsibility was exercised by Douglas W. Stein, of Barris, Sott, Denn & Driker, PLLC, Detroit, Michigan, a member of the Group, and by Steven B. Gorin, of Thompson Coburn LLP, St. Louis, Missouri, Chair of the Group. Also participating in the preparation of the comments were W. Birch Douglass, III, of McGuireWoods LLP, Richmond, Virginia, and Sydney S. Traum, of counsel to Levey, Airan, Shevin, et al, Coral Gables, Florida. Reviewing these comments on behalf of the Section's Committee on Governmental Submissions was Louis A. Mezzullo of McGuireWoods LLP, Richmond, Virginia.

Although members of the Business Planning Group of the Real Property, Probate and Trust Law Section of the American Bar Association who participated in preparing these comments and recommendations have clients who are affected by the federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments.

In 2004 Congress modified Code Sec. 1361(b)(1)(A) by increasing the number of shareholders an S corporation may have to one hundred (100). In addition, Code Sec. 1361 (c)(1)(A)(ii) was modified to permit any family member to elect for all family members to be treated as one shareholder whether or not the electing family member owns stock in the company either directly or is deemed to hold the stock by reason of being a beneficiary of a qualified Subchapter S trust or an electing small business trust.

Code Sec. 1361(c)(1)(B)(i) defines family members to include the common ancestor, lineal descendants of the common ancestor, and the spouses (or former spouses) of the lineal descendants or common ancestor. Code Sec. 1361(c)(1)(B)(ii) states an individual is not a common ancestor if, when the election to treat family members as one shareholder becomes effective, the individual is more than six (6) generations removed from the youngest generation of shareholders who are family members.

Election

The statutory language does not limit the number of families that can make the election. This is contrasted with other versions of S corporation reform, such as the

Subchapter S Modernization Bill of 2003 which limited this election to one family. Since only one family could elect S status in the Subchapter S Modernization Bill of 2003, the election was necessary. Congress clearly chose to expand the one family rule by allowing all families which are S corporation shareholders to make the election, thus rendering the election unnecessary. The election requirement should be removed and all descendants of a common ancestor should be treated as one person.

Congress sought to simplify the use and administration of S corporations. The retention of the election adds a level of complexity that is unwarranted in light of the broad definition of a family member and the ability of allowing any member of the family to make the election.

If Congress does not remove the election requirement, then the statute should be clarified to indicate which family member can make the election. As currently written, it appears that any family member, even a non-shareholder family member can make the election. Congress should make clear that only a shareholder family member can make the election under Code Sec. 1361.

Ambiguity

Due to the way the statute was drafted there are several ambiguities. For example, it is unclear whether all descendants of a common ancestor, no matter how far removed, can be treated as a single shareholder or if only those descendants who are no more than six (6) generations removed from a common ancestor are to be treated as a single shareholder. This ambiguity exists due to the use of the phrase “For purposes of this paragraph” as opposed to “For purposes of determining a common ancestor under subsection (C)(1)(B)(i)” in Code Sec. 1361(c)(1)(B)(ii). Congress should make the definition clear and implement congressional intent to treat all descendants of a common ancestor, no matter how far removed, as a single shareholder by revising Code Sec. 1361(c)(1)(B) to read as indicated below.

Under Code Sec. 1361(c)(1)(B)(ii) the date for identifying the common ancestor is tied to the latter of “the effective date of this paragraph” or the time of the S election. If the effective date language refers to the effective date of the legislation, the quoted language does not cover future shareholder families that first acquire stock after the S election is in place. The statute should refer to the date the family becomes subject to Code Sec. 1361(c)(1)(A)(ii).

The statute also fails to address whether trusts, which are ignored for income tax purposes (i.e., grantor trusts) or a trust in which the beneficiaries are members of the family can be treated as a member of the family. The legislative history makes this clear but the statute is silent on the matter. It is suggested that, for purposes of determining how many shareholders there are, a trust should be “looked through” and a determination should be made at the beneficiary level and not at the trust level. Thus, a trust in which all the beneficiaries who can benefit from the S corporation are members of the family will allow the trust to qualify as a member of the family. However, a trust in which some of the beneficiaries are not family members will not be treated as a member of the family.

Proposed Statute

We respectfully suggest that the statute be revised as described below.

Eliminate Election

If our suggestion to eliminate the election is adopted, we suggest that the statute read as follows:

“(c) Special rules for applying subsection (b):

(1) Members of family treated as 1 shareholder.

(A) In general. For purpose of subsection (b)(1)(A) all members of a family shall be treated as 1 shareholder.

(B) Members of the family. For purpose of subparagraph (A) -

(i) In general. The term “members of the family” means the common ancestor, all lineal descendants of the common ancestor, and the spouses (or former spouses) of such lineal descendants or common ancestor. Trusts in which all of beneficiaries, without regard to an unexercised power of appointment, are members of the family shall be treated as a member of the family.

(ii) Common ancestor. For purposes of determining a common ancestor under subsection (c)(1)(B)(i), an individual shall not be considered a common ancestor if, as of the date the individual’s family becomes subject to subsection (c)(1)(A), the individual is more than 6 generations removed from the youngest generation of shareholders who would (but for this clause) be members of the family. For purposes of the preceding sentence, a spouse (or former spouse) shall be treated as being of the same generation as the individual to which such spouse is (or was) married.

(C) Effect of adoption, etc. In determining whether any relationship specified in subparagraph (B) exists, the rules of section 152(b)(2) shall apply.”

With Election

If our suggestion to eliminate the election is not adopted, we suggest that the statute read as follows:

“(c) Special rules for applying subsection (b):

(1) Members of family treated as 1 shareholder.

(A) In general. For purpose of subsection (b)(1)(A)-

(i) unless an election is made under clause (ii), a husband and wife (and their trusts and estates) shall be treated as 1 shareholder, and

(ii) all members of the family shall be treated as 1 shareholder.

(B) Members of the family. For purpose of subparagraph (A)(ii) -

(i) In general. The term “members of the family” means the common ancestor, all lineal descendants of the common ancestor, and the spouses (or former spouses) of such lineal descendants or common ancestor. Trusts in which all of beneficiaries, without regard to an unexercised power of appointment, are members of the family shall be treated as a member of the family.

(ii) Common ancestor. For purposes of determining a common ancestor under subsection (C)(1)(B)(i), an individual shall not be considered a common ancestor if, as of the date the individual’s family becomes subject to subsection (c)(1)(A)(ii), the individual is more than 6 generations removed from the youngest generation of shareholders who would (but for this clause) be members of the family. For purposes of the preceding sentence, a spouse (or former spouse) shall be treated as being of the same generation as the individual to which such spouse is (or was) married.

(C) Effect of adoption, etc. In determining whether any relationship specified in subparagraph (B) exists, the rules of section 152(b)(2) shall apply.”

(D) Election. An election under subparagraph (A)(ii) -

(i) may, except as otherwise provided in regulations prescribed by the Secretary, be made by any member of the family who is a shareholder at the time, and

(ii) shall remain in effect until terminated as provided in regulations prescribed by the Secretary.