

Comments to the Internal Revenue Service in Response to
Anticipated Guidance Promulgated Under 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, and Sydney Traum. These comments were reviewed by Louis A. Mezzullo on behalf of the Division's Committee on Governmental Submissions.

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 would be 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 100. In addition, Code Sec. 1361 (c)(1)(A)(ii) was modified to permit a family to elect for all family members to be treated as one shareholder whether or not the family member holds the stock 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 generations removed from the youngest generation of shareholders who would be family members.

The statutory language does not limit the number of families that can elect to be treated as one shareholder. 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 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 be treated as one shareholder thus rendering the election unnecessary. In addition, any member of the family, presumably only shareholder family members, can make the election which should render the need to file an election obsolete.

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.

Despite this, Congress retained the election requirement and left it to the Service to add the details. We suggest that the Service make the election automatic. The common ancestor should be the oldest ancestor who is 6 generations away from the youngest shareholder in the family unit.

This proposal has several advantages. First, it will simplify the election by making it mandatory. Second, it makes clear that if a different family unit acquires an interest in the S corporation, the family unit will automatically be treated as a single shareholder thus reducing the need for multiple filings.

Because there does not appear to be any legitimate reason for a family to terminate the election, we suggest that the election continue until the termination of the S election, at which time the family election would also terminate.

In the alternative, if the Service determines that it is constrained by the statute to require an election, then the election should be indicated on the corporate income tax return (Form 1120S). A family member should make the election by filing a written statement with the corporation which must be kept part of the permanent corporate records. The corporation would then report the election on the S corporation's income tax return by "checking the box" which, presumably, would be a new box "H" on page one of Form 1120S.