Withdrawals by Shareholder Did Not Create Second Class of Stock

Cross References

- *Mowry,* T.C. Memo. 2018-105, July 5, 2018

The taxpayer and his brother incorporated their business as an S corporation. The taxpayer owned 49% of the stock, and his brother owned 51%. They agreed that distributions would be proportional to their ownership shares.

For a time, the taxpayer worked for the business as managing operations in the field, spending most of his working hours at jobsites. He received compensation as an employee of the S corporation. Schedules K-1 (Form 1120S) were issued to each shareholder reflecting their share of distributions received from the corporation. The taxpayer's wife was also employed by the business. She performed bookkeeping and payroll services.

In 2012, the taxpayer's wife went on bed rest and another employee took over her duties. The taxpayer began to examine more closely the administration of the company's business. He discovered that certain credit cards in his name were being used without his authorization to pay personal expenses of his brother's children. He then reviewed the company books and determined that numerous items, including handwritten checks drawn on the company's bank accounts, had not been entered into the accounting records. He also discovered that his brother had been making substantial check and ATM withdrawals from the company's bank accounts without his knowledge.

In the fall of 2012, the business began to struggle. Vendors called the taxpayer after unsuccessfully trying to contact his brother. The corporation had trouble paying its employees, and some company checks bounced. The taxpayer had multiple discussions with his brother and his brother's wife about the company's cash flow problems. They told him that they were working on getting more money into the business.

On November 19, 2012, the taxpayer sent his brother an email stating that if he would not help to try to fix the business, then the taxpayer would have no choice but to resign and sell his shares to his brother for $1. The brother accepted that offer effective immediately.

The taxpayer filed his joint federal income tax returns for 2011 and 2012, but did not include his distributive share of income from the S corporation. Instead, he filed Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR),* relating to his interest in the S corporation. On the Form 8082, he notified the IRS that he did not receive a Schedule K-1 from the S corporation.

The S corporation in fact had not filed Form 1120S or issued Schedules K-1 for 2011 or 2012. The IRS conducted an examination and prepared substitute returns for the S corporation using the bank deposit method to determine income. The IRS allocated 49% of the company's distributable net income as ordinary income to the taxpayer.

In court, the taxpayer argued that the S corporation's election to be treated as an S corporation was terminated in 2011 because it ceased to be an S corporation by creating a second class of stock. The brother withdrew large sums of money from the company bank accounts without the taxpayer's knowledge, and IRS computations show that the taxpayer and his brother received distributions that were not proportional to their stock ownership. The taxpayer argued that these substantially disproportionate distributions appear to create a preference in distributions and effectively a second class of stock. The taxpayer said the business should be treated as a C corporation and that the taxpayer should be taxed only on dividend distributions that he actually received.

The court said that in determining whether a corporation has more than one class of stock, it considers the rights granted to shareholders in the corporation's organizational documents and other binding agreements between shareholders. Regulations state that the determination of whether all outstanding shares of stock confer identical rights is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds. The court has previously ruled that evidence of distributions paid to one shareholder and not to others over the course of multiple years was insufficient on its own to establish that a separate class of stock was created.

The original operative agreement between the two brothers was that distribution rights for each of their shares would be identical [in proportion to their stock ownership]. The taxpayer never discussed with his brother changing the agreement regarding distributions. There is no evidence that the taxpayer's brother intended to act as the majority shareholder to grant himself new rights to disproportionate distributions. The taxpayer offered no evidence of any actions taken at the corporate level to redefine shareholders' rights or issue a new class of stock.

The taxpayer argued that the court should regard the substance of the actions taken by his brother as creating a second class of stock. The court said the shareholders chose to organize and operate the S corporation with one class of stock, and before the years in issue the company's and the shareholders' tax obligations were determined on the basis that the business had elected to be treated as an S corporation.

The court said taxpayers are bound by the form of the transaction that they choose unless they can provide strong proof that the parties intended a different transaction in substance. The brother's withdrawals during the years in issue do not establish that he held a different class of stock with disproportional distribution rights.