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Termination of Status as S Corporation Shareholder

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The tax treatment of an S corporation as a pass-through entity, with respect to which items of income, gain, loss, and deduction do not generally result in a corporate tax obligation, but, instead, are passed through to shareholders, may become burdensome to those shareholders. A shareholder may not be receiving distributions sufficient to pay taxes attributable to inclusion of the shareholder's share of these items in taxable income; the corporation and its other shareholders may be excluding that shareholder from involvement in the business of the corporation; the shareholder may have reason to believe that corporate profits are being distributed in a manner not proportionate to stock ownership, such that the shareholder is taxed on profits the shareholder did not receive; or information regarding the shareholder's share of tax items, required to be set forth on the shareholder's Schedule K-1, may not be made available to the shareholder.

In such situations, a shareholder may be inclined to take the position, on the shareholder's personal income tax returns, that the corporation is no longer an S corporation or that the shareholder no longer owns stock of the corporation. Two recent Tax Court cases, *Maggard v. Commissioner* (TC Memo 2024-77) and *Veeraswamy v. Commissioner* (TC Memo 2024-83), discussed below, underscore that such a position is likely to fail where the shareholder has not clearly abandoned or otherwise transferred the shareholder's stock, and no action has been taken that causes the corporation to cease to qualify as an S corporation.

Maggard

James Maggard ("Maggard") and another individual co-founded an engineering consulting firm that was incorporated in 2002. An S corporation election was made for the corporation. In 2003, the other co-founder sold his stock to Maggard, and Maggard then sold 60% of the stock of the corporation to two other individuals.

The two new shareholders (referenced in the opinion and below as LL and WJ) oversaw the accounting and records of the corporation and its day-to-day management. Maggard alleged that they misappropriated funds through disproportionate distributions to themselves at the expense of Maggard, that LL claimed inflated reimbursements of expenses, and that LL caused the corporation to cease to timely file tax returns on Form 1120S and to provide Schedules K-1 to the shareholders. After Maggard confronted the other shareholders in 2012 regarding the unauthorized distributions, they terminated his access to the books of the corporation, prevented him from fully participating as a director and shareholder of the corporation, and otherwise made his position untenable.

Litigation ensued between the shareholders. Ultimately, under a settlement signed in 2018, Maggard sold his stock in the corporation to LL.

Forms 1120S were ultimately filed in 2018 for the corporation with respect to six years, including 2014 through 2016, and the Schedules K-1 for those years allocated income to Maggard that had not been reported on his tax returns. Following an audit, the IRS asserted deficiencies attributable to Maggard's share of income of the corporation.

Maggard asserted that the unauthorized and disproportionate distributions to LL and WJ caused the corporation to be considered to have multiple classes of stock. Because an S corporation cannot have more than one class of stock (IRC § 1361(b)(1)(D)), Maggard argued that the actions of LL and WJ caused the corporation to cease to be an S corporation, and that its income for the years under audit therefore did not pass through to him.

The Commissioner disagreed, and cited a regulation under IRC section 1361 to the effect that whether or not shares provide identical rights to distributions and liquidation proceeds (as required to comply with the one-class-of-stock limitation) is determined by reference to the corporation's "governing provisions," consisting of "the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds" (Reg. § 1.1361-1(l)(2)(i)). Because there was no evidence that the disproportionate distributions were authorized by any such governing provision, the Commissioner argued that those distributions, even if made, did not result in a proscribed second class of stock.

The court, after discussing the regulation and cases involving somewhat similar circumstances, agreed that the disproportionate distributions did not result in a second class of stock.

The court further rejected Maggard's argument that the failure of LL and WJ to respect his rights as a shareholder and board member and to provide timely and accurate information to him with respect to his share of tax items relating to the corporation warranted termination of the corporation's status as an S corporation, and found that these circumstances did not terminate the corporation's status as an S corporation.

Veeraswamy

Karen Veeraswamy ("Veeraswamy") and her spouse formed a corporation in 2000 with respect to which an S corporation election was made, and the corporation acquired an apartment building in 2005. Initially, both Veeraswamy and her spouse were involved in the operation of the property.

Thereafter, Veeraswamy began to be abused by her spouse, and she filed for divorce in 2011. She was then isolated from the business by her spouse. The corporation ceased to make timely payments on its debt, and, in 2013, her spouse caused it to file for bankruptcy. In the bankruptcy proceedings, her spouse represented to the court that he was the sole owner of the corporation.

The apartment building owned by the corporation was sold in 2014, with net proceeds to the corporation of almost $2 million after the payment of its debts. Contemporaneously, Veeraswamy filed a claim in bankruptcy court seeking payment of unpaid support obligations of her spouse, but without any assertion that she was a shareholder. That claim was denied, but the net proceeds were deposited in escrow at the time of the final decree in the corporate bankruptcy, pending resolution of the divorce proceedings.

Veeraswamy's spouse filed for bankruptcy in 2018, reporting unpaid Federal tax and domestic support obligations, and died in 2019. Thereafter, Veeraswamy filed an amended claim in her deceased spouse's bankruptcy proceeding that asserted that she was a 50% shareholder of the corporation, and also sought to reopen the bankruptcy of the corporation. The Federal government objected to her claims as a shareholder, arguing that she should be estopped from pursuing them by reason of having not raised them earlier in the corporate bankruptcy proceeding.

Ultimately, a settlement of the personal bankruptcy proceeding was negotiated, in which Veeraswamy received $480,000 in domestic support and $486,038 in satisfaction of her claims as a shareholder.

Veeraswamy did not file a personal income tax return for 2014. The Commissioner prepared a substitute return for Veeraswamy that reflected one-half of the corporation's net rental income and capital gain from the property sale in 2014 and asserted a tax deficiency on that basis.

Veeraswamy filed a petition in Tax Court for review of the deficiency and argued that she was not a 50% shareholder of the corporation in 2014. However, it was apparently undisputed that she was a shareholder of the corporation when it was formed, and the court found no evidence that she took any express action to abandon her stock in the corporation -- and concluded, therefore, that she remained a shareholder in 2014.

Veeraswamy argued that the government should be estopped, under the doctrines of equitable estoppel and collateral estoppel, from arguing that she was a shareholder, given its inconsistent position in the bankruptcy proceedings of her deceased spouse.

The court found that the conditions for application of equitable estoppel were not met, noting that the government's position during her husband's bankruptcy were taken in good faith based on the information available to the government at that time, that Veeraswamy was not ignorant of the true facts relating to her stock ownership, and that there was no evidence that she incurred a detriment by reason of the government's prior position.

The court also found that the conditions for application of the doctrine of collateral estoppel (also known as "issue preclusion") were not met, because the bankruptcy court did not issue a final judgment on the stock ownership issue in either the corporate or personal bankruptcy proceedings. The tax deficiency asserted by the Government against Veeraswamy was therefore sustained.

The Government's assertion of additions to tax under section 6651(a) for failure to timely file a return and to pay tax for 2014 were also sustained. Veeraswamy (who appeared *pro se*) did not argue that she had reasonable cause for failure to file a return. The court also noted that, although Veeraswamy consulted with an accountant during the bankruptcy proceedings, there was no evidence that the accountant advised her that she did not have an obligation to file a return for 2014.

Observations

Given the facts of the two cases discussed above, it is not surprising that the Tax Court concluded that each petitioner remained a shareholder of an S corporation. The apparent skepticism of the IRS and the courts to the arguments of these petitioners should be kept in mind by taxpayers and their advisers in dealing with similarly contentious circumstances, although other arguments and theories, not raised in these cases, may be available to similarly oppressed taxpayers.

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