Income Tax—Subchapter S Corporations—A Voting Agreement Creating an Irrevocable Proxy Does Not Create a Second Class of Stock. *Parker Oil Co.*, 58 T.C. No. 95 (Sept. 21, 1972).

Parker Oil Company is a family-owned corporation whose original stock issue was one hundred shares of voting common. Forty shares were issued to Wilmer Parker, 10 shares to his wife, Annie, and 50 shares to Don W. Parker. On June 1, 1959, subsequent to the issuance of the shares, the company elected subchapter S tax treatment which allowed it to be taxed essentially as a partnership.[1] In 1961 Don Parker transferred five shares to Annie Parker, giving the Wilmer Parkers control of the corporation. When differences of opinion concerning managerial policies arose, Don Parker sued to recover the five shares. The suit was settled by an agreement on December 30, 1966, whereby Annie Parker reconveyed the five shares of stock to Don Parker. In return Don Parker executed an irrevocable proxy which gave M.N. Brown, a director, power to vote the five shares. Parker Oil's articles of incorporation which provided for only one class of stock were not amended to reflect the voting agreement.[2]

In a statutory notice of deficiency, the Commissioner informed Parker Oil that its subchapter S election had terminated during the taxable year ending June 30, 1967.[3] Under section 1371(a)[4] of the Internal Revenue Code, a small business corporation can have only one class

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1. Parker Oil Co., 58 T.C. No. 95, CCH TAX CT. REP. [Dec. 31, 544] at 3083 (Sept. 21, 1972). A small business corporation is defined as:

> [A] domestic corporation which is not a member of an affiliated group . . . and which does not—
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> (1) have more than 10 shareholders;
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> (2) have as a shareholder a person (other than an estate) who is not an individual;
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> (3) have a nonresident alien as a shareholder; and
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> (4) have more than one class of stock.

INT. REV. CODE OF 1954, § 1371(a).

When an election to be taxed under subchapter S is made by the small business corporation, the corporation is not subject to corporate income tax and all income, distributed or undistributed, is taxed to the shareholders. Also, corporate losses are passed through to the shareholders allowing them to offset these losses against other income. INT. REV. CODE OF 1954, §§ 1373-75; B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 6.01 (3d ed. 1971). Once an election has been made the corporation continues to be taxed under subchapter S unless it is terminated under INT. REV. CODE OF 1954, § 1372(e). Termination will occur if the corporation ceases to be a small business corporation as defined in § 1371(a). INT. REV. CODE OF 1954, § 1372(e)(3).

2. Parker Oil Co., 58 T.C. No. 95, CCH TAX CT. REP. [Dec. 31, 544] at 3083 (Sept. 21, 1972).

3. *Id.* Termination of subchapter S election is controlled by the INT. REV. CODE OF 1954, § 1372(e).

4. INT. REV. CODE OF 1954, § 1371(a).

of stock. The Commissioner contended that Parker Oil was no longer a small business corporation because he viewed the execution of the irrevocable proxy as creating, in substance, a second class of stock. Parker Oil was therefore disqualified from subchapter S treatment.[5]

The deficiency assessment was challenged before the Tax Court in *Parker Oil Co.*[6] The Commissioner contended that the deficiency assessment was supported by Treasury Regulation section 1.1371-1(g)[7] and Revenue Ruling 63-226[8] which state that a difference in voting rights of the outstanding shares creates a second class of stock. The Commissioner also contended that *Pollack v. Commissioner*[9] which denied a subchapter S status to a corporation whose stock had unequal voting rights was support for the deficiency assessment. In a split decision the Tax Court found, however, that the promulgations of the regulation and ruling on different voting rights did not conform with the intent of Congress in limiting a small business corporation to one class of stock.[10]

The court stated that "the overriding purpose of the one class of stock requirement . . . [was] to avoid complexities in taxing income to shareholders with different preferences as to the distribution of profits."[11] Because the Parker Oil stock had identical dividend and liquidation rights, the difference in voting power did not affect the distribution of profits. The court, therefore, held that, in situations where the differ-

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5. There could be no second class of stock in form because it was expressly forbidden by the articles of incorporation. Parker Oil Co., 58 T.C. No. 95, CCH TAX CT. REP. [Dec. 31, 544] at 3083 (Sept. 21, 1972).

6. *Id.* The case is currently on appeal. 7 CCH 1973 STAND. FED. TAX REP. 70, 656 (1973).

7. Treas. Reg. § 1.1371-1(g) (1959) provides in part:

> (g) Classes of stock. A corporation having more than one class of stock does not qualify as a small business corporation. . . . If the outstanding shares of stock of the corporation are not identical with respect to the rights and interest which they convey in the control, profits, and assets of the corporation, then the corporation is considered to have more than one class of stock. Thus, a difference as to voting rights, dividend rights, or liquidation preferences of outstanding stock will disqualify a corporation.

8. Rev. Rul. 226, 1963-2 CUM. BULL. 341 provides in part:

> [I]n the event that the outstanding stock of a corporation is subject to any other type of voting control device or arrangement, such as a pooling or voting agreement or a charter provision granting certain shares a veto power or the like, which has the effect of modifying the voting rights of part of the stock so that particular shares possess disproportionate voting power as compared to the dividend rights or liquidation rights of those shares and as compared to the voting, dividend, and liquidation rights of the other shares of stock of the corporation outstanding, the corporation will be deemed to have more than one class of stock. Accordingly, the corporation does not qualify as a small business corporation.

9. 392 F.2d 409 (5th Cir. 1968).

10. Parker Oil Co., 58 T.C. No. 95, CCH TAX CT. REP. [Dec. 31, 544] at 3083 (Sept. 21, 1972).

11. *Id.* at 3086-87; *accord*, W.C. Gamman, 46 T.C. 1, 7-8 (1966); S. REP. No. 830, 88th Cong., 2d Sess. 146 (1964).

ence in voting rights does not affect the allocation of income, Treasury Regulation section 1.1371-1(g) and Revenue Ruling 63-226 were invalid.[12]

The court also distinguished *Pollack*. There the articles of incorporation originally established one class of stock, but were subsequently amended to divide the original stock into four groups with an unequal number of shares in each group. Because each group of stock could elect one director, the stock had unequal voting rights. The *Parker* court, however, did not interpret the *Pollack* opinion as based on the different voting rights; rather it considered the determinative fact in *Pollack* was that four classes of stock were expressly created by the amended articles of incorporation, thereby coming within the specific provision of section 1371(a) which prohibits more than one class of stock.[13] *Pollack* did not support the Commissioner's position in *Parker* because Parker Oil's articles of incorporation established only one class of stock.[14]

Although the concurring judges[15] agreed that *Pollack* did not support the Commissioner's position, that Revenue Ruling 63-226[16] was invalid, and that the irrevocable proxy did not terminate Parker Oil's subchapter S election, they disagreed on the validity of Treasury Regulation section 1.1371-1(g).[17] Pointing out that the regulation does not specifically hold a voting agreement creates a second class of stock, they would construe it narrowly to apply only to a situation where the stock's

12. Parker Oil Co., 58 T.C. No. 95, CCH TAX CT. REP. [Dec. 31, 544] at 3083 (Sept. 21, 1972); *accord*, A. & N. Furniture & Appliance Co. v. United States, 271 F. Supp. 40 (S.D. Ohio 1967). In *A. & N. Furniture* the court held that a voting trust agreement in which three shareholders surrendered their voting rights to a fourth shareholder did not create a second class of stock. *But see* Portage Plastics Co. v. United States, ___ F.2d ___, CCH STAND. FED. TAX REP., U.S. TAX CAS. (72-2 at 85, 325), ¶ 9567 (7th Cir. July 18, 1972). *Portage* is a debt versus equity, one class of stock case, in which the court upheld Treas. Reg. § 1.1371-1(g) (1959). In Amory Cotton Oil Co. v. United States, 468 F.2d 1046 (5th Cir. 1972) & Shores Realty Co. v. United States, 468 F.2d 572 (5th Cir. 1972), the regulation as it applies to debt versus equity, however, was held invalid.

13. The Tax Court implied that the result in *Pollack* may have been different if it had been argued that Treas. Reg. § 1.1371-1(g) (1959) and Rev. Rul. 226, 1963-2 CUM. BULL. 341 did not reflect congressional intent.

Barnes Motor & Parts Co. v. United States, 309 F. Supp. 298 (E.D. N.C. 1970), is a case similar to *Pollack*. In *Barnes* the corporation had issued voting and nonvoting common stock. The court held that there were two classes of stock with unequal voting rights; therefore, the corporation was precluded from subchapter S election.

14. Parker Oil Co., 58 T.C. No. 95, CCH TAX CT. REP. [Dec. 31, 544] at 3087 (Sept. 21, 1972).

15. Five judges concurred and three judges dissented in *Parker*. Both the concurring and dissenting opinions held Treas. Reg. § 1.1371-1(g) valid. Since eight judges out of sixteen (assuming all judges sat) held Treas. Reg. § 1.1371-1(g) valid, the concurring and dissenting opinions are significant and are discussed in the text.

16. Rev. Rul. 226, 1963-2 CUM. BULL. 341.

17. Treas. Reg. § 1.1371-1(g) (1959).

different voting rights are defined in the articles of incorporation. Because a voting agreement does not change the voting rights given to the stock in the articles of incorporation, the concurring judges did not consider the regulation applicable. They considered *Pollack* illustrative of a situation where voting rights were defined in the articles of incorporation and where the regulation would be applicable.[18]

The dissent argued that *Pollack* supported the Commissioner's position because the voting agreement in *Parker* created stock with greater differences in voting rights than the stock in *Pollack*. The owner in *Pollack* retained the right to vote the stock although it had different weight in electing directors. In *Parker*, however, the owner of the five shares was irrevocably denied the right to vote them in any manner. Hence, the Parker stock had a greater voting disability than the stock in *Pollack*.[19]

An examination of the historical development of subchapter S provides support for the majority view that the regulation and ruling are invalid as to different voting rights. Subchapter S was initially proposed in 1954 as subchapter R,[20] but was enacted as subchapter S in 1958.[21] Subchapter S does not define the one class of stock requirement.[22] Moreover, the 1958 Senate Report[23] is void of any language concerning differences of voting rights.

A restriction on different voting rights is found, however, in the 1954 Senate Report[24] which states, "No class of stock may be preferred over another as to either dividends, distributions, or voting rights."[25] The only explanation for this restriction on voting rights given by the 1954 Senate Finance Committee was that it would enable the Internal Revenue Service to determine without difficulty the allocation of undistributed income to the shareholders.[26] Because undistributed income of a subchapter S corporation is allocated to the shareholders at the end of the corporate year in the same manner as if it was distributed, a difference in voting rights alone, however, would present no problems in the allocation of undistributed income.[27]

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18. Parker Oil Co., 58 T.C. No. 95, CCH TAX CT. REP. [Dec. 31, 544] at 3087 (Sept. 21, 1972) (concurring opinion).

19. *Id.* at 3089 (dissenting opinion).

20. S. REP. NO. 1622, 83d Cong., 2d Sess. 452 (1954).

21. INT. REV. CODE OF 1954, §§ 1371-79.

22. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 6.02 (3d ed. 1971).

23. S. REP. NO. 1983, 85th Cong., 2d Sess. 88 (1958).

24. S. REP. NO. 1622, 83d Cong., 2d Sess. 452 (1954).

25. *Id.* at 453.

26. *Id.*

27. INT. REV. CODE OF 1954, § 1373; *see* Landon, *An Approach to Legislative Revision of*

A more probable basis for the Committee's restriction on different voting rights is a further requirement of the 1954 subchapter R proposal that all shareholders of the corporation occupy a managerial position.[28] Because it was the intent of the Committee in proposing subchapter R to tax electing corporations as partnerships,[29] the Committee probably intended subchapter R corporations to closely resemble partnerships.[30] In a partnership all partners have rights of management,[31] and the partners must have voting power to facilitate these managerial rights. Hence, the Committee probably required all stock to have equal voting rights to insure that all shareholders would have a voice in management so that the corporation would maintain characteristics of a general partnership.[32] The requirement that all shareholders be managers was, however, eliminated from the 1958 version that became law.[33] If that requirement was the reason for the voting rights restriction, it is doubtful that the 1954 Senate Report[34] supports the regulation and the ruling. Hence, the court's conclusion that the legislative history did not support the regulation or the ruling is reasonable.

Further support for the majority view is found in the 1969 Tax Reform Studies and Proposals[35] prepared by a joint committee of the American Bar Association and the Treasury Department. The committee's objective was to clarify the governing rules of subchapter S, to remove undesirable restrictions and complications, and to prevent unintended hardships.[36] Restriction on voting rights was an undesirable restriction the committee sought to remove. The committee, therefore, recommended to Congress that different voting rights should not be interpreted as creating a second class of stock.[37] Although none of the proposals were enacted by Congress because of problems in drafting the revisions,[38] the Treasury Department has recognized contrary to the

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Subchapter S, 26 TAX L. REV. 799, 807 (1971).

28. S. REP. NO. 1622, 83d Cong., 2d Sess. 453 (1954).

29. *Id.* at 452.

30. *See id.* at 119.

31. UNIFORM PARTNERSHIP ACT § 18(e).

32. *See* Weinstein, *Stockholder Agreements and Subchapter S Corporations*, 19 TAX. L. REV. 391, 396 (1964).

33. *See* INT. REV. CODE OF 1954, § 1371.

34. S. REP. NO. 1622, 83d Cong., 2d Sess. 452 (1954).

35. HOUSE COMM. ON WAYS & MEANS & SENATE COMM. ON FINANCE, TAX REFORM STUDIES & PROPOSALS (pt. 2, 1969).

36. *Id.* at 271.

37. *Id.*

38. For a discussion of why none of the proposals on subchapter S were enacted see Landon, *An Approach to Legislative Revision of Subchapter S*, 26 TAX L. REV. 799, 800 (1971).

regulation that voting agreements, such as the one in *Parker*, should not be considered as creating a second class of stock.[39]

The legislative history of subchapter S and the recommendation of the 1969 Tax Reform Studies and Proposals indicate that the *Parker* court reached the most equitable result. The *Parker* holding prevents the severe financial hardships to the shareholders that would result from termination. For example, the Commissioner in *Parker* determined that for the taxable year when subchapter S status terminated, an additional tax of $56,985.10 was due[40] because the corporation would be subject to the regular corporate tax rate.[41] Furthermore, the shareholders would have lost their right to the tax free distribution of accumulated income.[42] Because the shareholders would have already paid personal tax on the accumulated income when it was earned, they would incur a double tax if it was later distributed. The Treasury Department has recommended that such financial hardships should not occur,[43] and the *Parker* court has implemented that recommendation.

The *Parker* decision will now allow the use of voting agreements in small business corporations without termination of subchapter S status and the resulting financial hardships. Congress, in enacting subchapter S, sought to benefit small businesses by permitting them to incorporate without incurring the normal corporate tax burdens.[44] Many businessmen, however, do not desire to incorporate without providing for control of the business after incorporation.[45] Prior to *Parker*, the use of a voting agreement resulted in denial of subchapter S treatment.[46] Businessmen, therefore, were confronted with a dilemma. If they accepted the favorable tax treatment of subchapter S they could not retain control of the business with voting agreements. Hence, many businesses that Congress sought to benefit chose not to accept the benefits of subchapter S.[47] The *Parker* decision will now permit these businesses to

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39. *See* note 35 *supra*.

40. Parker Oil Co., 58 T.C. No. 95, CCH TAX CT. REP. [Dec. 31, 544] at 3084 (Sept. 21, 1972).

41. INT. REV. CODE OF 1954, § 1372(e)(3).

42. *See* INT. REV. CODE OF 1954, § 1375(f)(1); Landon, *An Approach to Legislative Revision of Subchapter S*, 26 TAX L. REV. 799, 814 (1971).

43. *See* note 35 *supra*.

44. S. REP. NO. 1983, 85th Cong., 2d Sess. 87 (1958).

45. Many states have provided for control after incorporation by allowing the use of voting agreements. *E.g.*, TEX. BUS. CORP. ACT. ANN. art. 2.30B (Supp. 1972).

46. Treas. Reg. § 1.1371-1(g) (1959); Rev. Rul. 226, 1963-2 CUM. BULL. 341. Since the ruling specifically states a voting agreement will create a second class of stock, fear of litigation would make many businesses hesitant to elect subchapter S.

47. *Cf.* Weinstein, *Stockholder Agreements and Subchapter S Corporations*, 19 TAX L. REV. 391, 399 (1964).

enjoy the tax benefits of subchapter S while also retaining control of the business.

Some two hundred thousand corporations have already elected subchapter S status despite complex governing rules.[48] Because subchapter S is used by such a large number of corporations, every effort should be made to clarify the governing rules to prevent hardships to the shareholders. The *Parker* decision has made the initial step by clarifying the role of voting agreements in small business corporations. The Commissioner should now acquiesce to *Parker* and revise the one class of stock requirement to permit the use of voting agreements.

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48. *Supra* note 35. Since this is a 1969 statistic, the figure is probably greater at present.