



TAXPAYER LIABLE FOR TAXES ON S CORPORATION INCOME EMBEZZLED BY OTHER SHAREHOLDERS

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One of the requirements to be treated as an S corporation for federal income tax purposes is that the corporation can have only one class of stock. This requirement means that all of the outstanding stock must confer identical rights with respect to distribution and liquidation proceeds. The Treasury Regulations state that the determination of whether stock meets this requirement is based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (i.e., governing provisions). If the “one class of stock” rule is violated, the S corporation election and corresponding pass-through income tax treatment is terminated and the entity immediately converts into a C corporation subject to taxation at both the entity and shareholder-level.

In a recent Tax Court case, *Maggard v. Commissioner*, the court ruled that the S corporation election did not terminate when an S corporation made disproportionate distributions to two of its shareholders at the expense of the third shareholder and that the third shareholder remained liable for income tax on his proportionate share of S corporation income that he never received.

In the case, a founder of an engineering firm taxed as an S corporation for federal income tax purposes sold sixty percent (60%) of the company to two friends. During the next few years, the “friends” embezzled more than \$1 million of company funds by inflating their expense reimbursements and making disproportionate distributions of company earnings to themselves at the expense of the founder. As a result, the founder never received his proportionate share of company profits which he was owed. The IRS audited the founder and determined that he did not correctly report income from the corporation for the audit years.

The founder argued that the corporation’s S election terminated, and the corporation became a C corporation, because the disproportionate distributions violated the “one class of stock” requirement. The founder therefore asserted that the corporation was a C corporation rather than a pass-through entity for the audit years and that he should not be liable for any income tax on the corporation’s income for those years. The IRS argued that actual disproportionate distributions are irrelevant to the analysis because the Treasury Regulations focus on shareholder rights under the corporation’s governing documents and not what the shareholders actually do.

Relying on these Treasury Regulations, the Tax Court agreed with the IRS’s position that the S election for the corporation did not terminate as a result of the disproportionate distributions. This was because the corporation’s governing documents continued to provide for identical rights to distribution and liquidation proceeds and the corporation did not authorize or create a second class of stock by way of any formal action.

The holding of *Maggard* illustrates that absent an actual agreement among the shareholders to distribute corporation profits disproportionately, the shareholder rights provided in the corporation’s governing documents will

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control whether the “one class of stock” rule is violated regardless of what the corporation does in making its distributions. *Maggard* seems to also foreclose a shareholder argument that a continuous pattern of disproportionate distributions amounts to an implied agreement. The *Maggard* decision could be viewed as a taxpayer-friendly because it provides peace of mind that unequal distributions from an S corporation, whether accidental or purposeful, will not cause the corporation to lose its Subchapter S status so long as the corporation’s governing documents do not create a second class of stock. Unfortunately, the shareholder who does not receive his proportionate share of distributions may still be liable for taxes on those distributions.

If you have any questions regarding this alert, please contact your Cummings & Lockwood private clients attorney.