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All in the Family as a Single Shareholder of an S Corporation

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Subject to a few exceptions, a corporation that has elected to be taxed under subchapter S of chapter 1 of subtitle A of title 26 of the United States tax code is not taxed on its net income. Instead, the income, deductions, credits, and other tax items of an S corporation pass through to its shareholders on a pro rata basis. To qualify for subchapter S treatment, an electing corporation must satisfy the requirements that are set forth in section 1361, one of which is that the corporation can have no more than 100 shareholders. One aspect of that requirement is the focus of this article.

While no stock attribution rules apply in determining the number of shareholders of an S corporation, section 1361(c)(1) in effect prescribes an indirect attribution regime when it provides that shareholders with a specified relationship to each other are combined and treated as one shareholder. In counting the number of a corporation’s shareholders, a husband and wife and their estates are treated as one shareholder. Thus, if a husband and wife both own stock in a corporation, whether they each hold their stock individually or in some form of co-

ownership, they will be treated as one shareholder in determining whether the corporation complies with the 100-shareholder limit.

Over the years, Congress has repeatedly expanded the number of persons who are permitted to be shareholders of an S corporation by increasing the number of permitted shareholders and by treating some groups of shareholders as a single shareholder for purposes of the S qualification. Before 2004, section 1361(c)(1) (which was then the husband-wife provision) was the only provision that combined several shareholders to make a single shareholder. In section 231(a) of the American Jobs Creation Act of 2004, however, Congress broadened the combination principle to include as a single shareholder all “members of a family” for purposes of satisfying the shareholder limit for S corporations. It did that by amending section 1361(c)(1) to provide that members of a family, as defined in the provision, were to be combined and treated as one shareholder if any member of the family made an election for that provision to apply. The delineation of members of a family in the Jobs Act was broad. However, the 2004 provision did not apply to the estate of a deceased member of a family. As a result, if a family member died so that his stock was held by his estate, the estate was treated as a separate shareholder and not as a member of the family.

The provision was modified by section 403(b) of the Gulf Opportunity Zone Act of 2005. The 2005 amendment eliminated the requirement that an election be made. Instead, all members of a family, as defined in the statute, are treated as one shareholder, and no election is required. Also, the 2005 amendment includes the estate of a deceased member of a family as part of the group that is treated as a single shareholder.

As discussed below, the possible number of persons who can constitute a member of a family under the statute is astonishing. Perhaps because the code permits an S corporation to have as many as 100 shareholders, Congress has little concern about the scope of that provision. Nevertheless, the family consolidation rule is so broad and so amorphous that it may be difficult for the IRS to police and enforce the S corporation shareholder limit because it may be difficult to know whether the shareholder limitation has been breached. In any case, while the current provision is liberal, there are some interesting questions about just how extensive a family can be.

The code defines members of a family to refer to a common ancestor, all lineal descendants of that ancestor, and the spouses and former spouses of the common

1Sections 1363(a) and 1366(a).
2Section 1361(b)(1)(A). When subchapter S was originally adopted in 1958, it was limited to corporations that had no more than 10 shareholders. The number of permissible shareholders has been increased over the years, and currently 100 shareholders are permitted.
3Section 1361(c)(1)(A)(i).
4Section 1361(c)(1)(A)(ii).
ancestor of the lineal descendants. The generation spread between the common ancestor and the youngest generation of the ancestor's family who hold stock in the corporation cannot exceed six generations — at least when the common ancestor is determined. There are several open questions concerning the operation of this provision, and there are no regulations yet to help resolve those questions.

As one example of the breadth of the "members of a family" provision, consider how the family of K, who is a shareholder of the X corporation, can be determined under the statute. K is married to S2 and is divorced from S1. Neither S1 nor S2 owns any stock of X. There are several alternative methods for determining the identity of the other shareholders of X who can be combined with K to be treated as a single shareholder.

One available approach is to go back six generations from K and select one of K's ancestors in that generation. If that ancestor has a family member who is of a younger generation than K and is a shareholder, then one cannot use that ancestor, but must use an ancestor who is no more than six generations removed from the youngest generation family member who is also a shareholder. Once the ancestor is selected, that ancestor, his spouse and former spouse, and all of his lineal descendants and their spouses and former spouses are members of the same family and are treated as one shareholder. Also, the estate of a deceased member of that group is included in the group that is treated as one shareholder. It seems that one can select any ancestor of that generation whose descendants would provide the optimal result in minimizing the number of shareholders for the purpose of applying the 100-shareholder limit.

Moreover, it is possible that one could select an ancestor of either S2 or S1 (subject to the six-generation separation limitation), and then the lineal descendants of that ancestor and their spouses and former spouses would be treated as one shareholder. If so, K would be a member of that family, which, of course, would be a significantly different family than if the common ancestor were an ancestor of K. On one hand, it is possible to read the first sentence of section 1361(c)(1)(B)(i) as limiting the common ancestor to only an ancestor of a person who is actually a shareholder of the corporation. On the other hand, the two sentences of section 1361(c)(1)(B)(i) can reasonably be read together to permit the common ancestor to include an ancestor of a spouse or former spouse of a shareholder.

The first sentence refers to a common ancestor of a member of a family but speaks in terms of being six generations removed from "the youngest generation of shareholders." Does that language mean to suggest that a lineal descendant of the putative common ancestor must be an actual shareholder? While such an interpretation might be arguable if the first sentence stood alone, the authors believe that any such construction is dispelled by the second sentence, which states that a spouse or former spouse shall be treated as part of the same generation as the individual to whom that spouse or former spouse is (or was) married.

The authors believe that the second sentence of section 1361(c)(1)(B)(ii) would have little or no purpose if the first sentence were read to require the common ancestor to be an ancestor of an actual shareholder of the corporation. The authors submit that the purpose of the second sentence is to provide a way to connect a spouse or former spouse of an actual shareholder to the six-generation measurement that the first sentence applies in determining the common ancestor. Therefore, the provision must contemplate that a common ancestor of a spouse or former spouse can qualify for that purpose. It seems to the authors that the provision limits the choice of an ancestor to any person who is no more than six generations removed from the youngest generation of shareholders who are members of the ancestor's family within the statutory definition of that term. The limitation refers to a generation in which one or more members of the ancestor's family are shareholders, but there is nothing in the statute that requires that the member of the family who is a shareholder be a descendant of the chosen ancestor.

Of course, if S1 or S2 owns stock of X, it is even clearer that an ancestor of that person could be selected, and K would then qualify as a member of that family as a spouse or former spouse of a descendant of the ancestor.

Perhaps a more significant issue under this member of a family provision relates to what happens if an ancestor whose descendants comprise the members of a family ceases to qualify as a permissible ancestor because stock of the corporation is acquired by a descendant who is more than six generations removed from that ancestor. As of that change, must a new calculation be made to select a different person as the ancestor and to see if the 100-shareholder limit is still satisfied? The answer to that question should turn on the meaning of "applicable date" for purposes of the statute because the "six generations" test is expressly stated to be applied on the applicable date. Section 1361(c)(1)(B)(iii) defines applicable date as the latest of (1) the date of the S election, (2) the earliest date that an individual described in clause (i) [that is, a member of the family] holds stock in the S corporation, or (3) October 22, 2004. Obviously, the key language in this definition is the second option — "the earliest date that [a member of the family] held stock in the S corporation."

If the change were to cause the number of shareholders to exceed 100, the corporation would cease to be
an S corporation on that date.\textsuperscript{9} The termination of a subchapter S election can cause serious consequences,\textsuperscript{10} but the parties may be able to obtain relief under section 1362(f) if the parties are promptly able to bring the corporation back in compliance with the subchapter S requirements. However, it is far from clear under the statutory language that any changes would be required to the shareholders of the corporation or that any relief would be required from the IRS on those facts.

As noted above, section 1361(c)(1)(B) makes it clear that the determination of the common ancestor is made on the applicable date, which is defined as the latest of three dates that include the date the S election was made, the effective date of the amendment to section 1361(c) that added the member of the family provision, and "the earliest date that an individual described in clause (i) [a member of the family] holds stock in the S corporation." Standing alone, that statutory language would seem to indicate that the determination of the common ancestor is made on the basis of facts revealed in a "snapshot" that is taken once and only once on the applicable date. When a member of the relevant family acquires shares of the S corporation, the common ancestor is determined at that time for purposes of applying the members of the family provision to that corporation for all time regarding that family.

So what happens if in a few years stock of the S corporation is acquired by a descendant who is more than six generations removed from the common ancestor? Unless one can identify a basis for finding another applicable date, the answer one should derive from a reading of the statutory language is that the new shareholder's stock is aggregated with that of the rest of the family and treated as owned by a single shareholder. That is because there is nothing in the statute that prohibits the family from spanning more than seven generations (that is, that of the common ancestor plus six more), except on the applicable date, when the generational snapshot is taken and the common ancestor is identified.

Section 1361(c)(1)(B)(i) defines members of a family to mean "a common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of such common ancestor or any such lineal descendant." (Emphasis added.) Notably, the six-generation limit is not incorporated into the definition of members of a family; it is used only in identifying the "common ancestor," and there is no provision in the statute calling for a second look at the common ancestor determination. Thus, there is nothing that prevents the family membership from growing to extend beyond six generations removed from the common ancestor as long as it is limited to six generations at the applicable date.

The legislative history of this amendment to section 1361(c) provides further support for the conclusion that the applicable date occurs once with respect to any given family, that the common ancestor is determined on that applicable date by applying the six-generation limitation at that time, and that thereafter all lineal descendants of that common ancestor are considered members of the family. For example, when the provision was originally enacted in the Jobs Act, the House report (H.R. Rep. No. 108-548, pt. 1) stated as follows:

The common ancestor cannot be more than three generations removed from the youngest generation of shareholder at the time the S election is made (or the effective date of this provision, if later). (Emphasis added.)

The Senate included no such provision in its version of the bill. The conference agreement (H.R. Conf. Rep. No. 108-755) then explained that "the conference agreement includes the provision in the House bill except that the number of generations is increased from three to six."

Thus, as originally enacted, the statutory language and the relevant committee reports indicate that the determination of the common ancestor was intended to be a snapshot taken at the S corporation election or, if later, on the effective date of the law change, and no later redetermination of the common ancestor was contemplated. When in 2005 Congress amended the provision to eliminate the requirement of an election to trigger the member of a family provision and to make it automatically applicable whenever a family member acquired stock, it included the amendment among the technical corrections to the Jobs Act and gave no indication that any further change was intended. Moreover, in the Joint Committee on Taxation's explanation of the Gulf Opportunity Zone Act (which is the only committee report the authors have been able to find that summarizes the change made to section 1361(c)), the intention for a one-time determination of the common ancestor is once again made clear:

The determination of whether a common ancestor is more than six generations removed from the youngest generation of shareholders is made at the latest of (i) the date the subchapter S election is made; (ii) the date a family member first holds stock in the S corporation; or (iii) October 22, 2004. (Emphasis added.)

That language confirms the point expressed at the beginning of this article that the member of a family provision is exceptionally broad. Over time, it is at least theoretically possible for the family that is treated as one shareholder to expand and encompass many more than six generations. Some commentators have suggested that whenever stock is acquired by a lineal descendant who is more than six generations removed from the common ancestor, a new common ancestor or series of common ancestors would have to be determined.\textsuperscript{11} The policy justification for that interpretation seems to be to vindicate Congress's intention to limit the scope of the provision to six generations (actually seven generations if one

\textsuperscript{9}Section 1362(d).
\textsuperscript{10}See, e.g., section 1362(g).
counts the common ancestor). However, as has been noted above, the most that one can reasonably discern from the language of either the statute or the legislative history is an intent to apply the six-generation test on the earliest date that a member of a family acquires stock in the S corporation. The failure to include a limitation within the definition of member of a family makes it difficult to infer a broader congressional intent. The more reasonable interpretations of the statutory language and legislative history seem to be either that Congress did not consider that families tend to expand to additional generations with time or that Congress did not care about that.

Nevertheless, Treasury may try to limit the scope of this provision to six generations by providing in regulations an event that would give rise to a new applicable date. One possibility would be to say that a new applicable date is created when a seventh-generation lineal descendant of the common ancestor acquires stock in the S corporation. However, it is difficult to see how that interpretation of the statute would be sustainable in light of the “earliest date” language in the statute and the confirmatory language in the legislative history. Another possibility would be to declare that, when the seventh-generation descendant acquires stock of the S corporation, she is not included in the original family and represents a member of a new family that triggers a new applicable date for that family. However, that interpretation would be difficult to square with the statutory definition of member of a family, which is not limited to any number of generations once the common ancestor is identified.

In the face of the statutory language and legislative history, there is reason to doubt that a regulation creating a new applicable date whenever a seventh-generation lineal descendant acquired stock would be regarded as a reasonable interpretation of the statute and thus would be found valid. Rather, if a limit is believed to be necessary, it would make more sense for such a change to be effected by legislation rather than by regulation.

In any event, given how rare it is for family businesses to stay together for multiple generations, it is unlikely that the question of whether the family can extend beyond six generations will arise except in exceptional circumstances. Even then, it is unlikely to be viewed as some sort of tax abuse to allow the S corporation status to survive such an expansion of the family, particularly in light of Congress’s obvious willingness to accept S corporations that have many shareholders. In that light, it is doubtful that Congress or Treasury would view this potentially even broader scope of the members of a family provision as requiring a limiting amendment to section 1361(c). The better course would be for Treasury to confirm this “plain meaning” interpretation of the statutory language in a regulation.