Kean v. Commissioner, 52 T. C. 550 (1969)

All shareholders, including beneficial owners, must consent to a subchapter S election for it to be valid.

Summary

In Kean v. Commissioner, the Tax Court held that a subchapter S election by Ocean Shores Bowl, Inc. , was invalid because not all beneficial shareholders had consented. The case centered on whether Murdock MacPherson, who co-funded the purchase of shares with his brother William, was a shareholder of record or beneficial owner. The court found that Murdock was a beneficial owner and his failure to consent invalidated the election, thus disallowing deductions for net operating losses claimed by petitioners on their tax returns. This decision underscores the necessity for all shareholders, including those with beneficial interests, to consent to a subchapter S election.

Facts

Ocean Shores Bowl, Inc. , elected to be taxed as a subchapter S corporation in 1962. The election required the consent of all shareholders. William MacPherson purchased shares with funds from a company account, which were charged equally to his and his brother Murdock's drawing accounts. Despite the stock being issued solely in William's name, both brothers claimed deductions for the corporation's net operating losses on their tax returns, suggesting a shared interest. Murdock did not sign the election consent, leading the IRS to challenge the validity of the subchapter S election.

Procedural History

The case originated from tax deficiencies assessed by the IRS against the petitioners for the tax years 1962, 1963, and 1964. The petitioners contested the disallowance of their deductions for net operating losses from Ocean Shores Bowl, Inc. The cases were consolidated for trial before the U. S. Tax Court, where the primary issue was the validity of the subchapter S election due to the absence of Murdock's consent.

Issue(s)

1. Whether the subchapter S election by Ocean Shores Bowl, Inc. , was valid without the consent of Murdock MacPherson, a beneficial owner of the corporation's stock?

Holding

1. No, because the court determined that Murdock was a beneficial owner of the stock, and his failure to consent invalidated the election under section 1372(a) of the Internal Revenue Code.

Court's Reasoning

The court applied the legal rule that all shareholders, including beneficial owners, must consent to a subchapter S election for it to be valid. The court found that the evidence supported the conclusion that Murdock was a beneficial owner of half of the shares issued to William, despite the shares being registered solely in William's name. The court rejected the petitioners' arguments that only shareholders of record need consent, emphasizing that the purpose of subchapter S was to tax income to real owners. The court also dismissed claims that William could consent on behalf of Murdock without an agency relationship or that Murdock could file a late consent, citing lack of evidence of attempts to do so. The decision was influenced by policy considerations to ensure that all parties with a tax liability interest in the corporation's income are included in the election process.

Practical Implications

This decision clarifies that for a subchapter S election to be valid, consent must be obtained from all shareholders, including those with beneficial interests. Practitioners must advise clients to thoroughly document ownership and ensure all parties with a financial interest in the corporation consent to the election. The ruling impacts how businesses structure ownership and manage tax elections, emphasizing the importance of clear records and formal agreements. Subsequent cases, such as Alfred N. Hoffman, have followed this precedent, reinforcing the necessity of consent from beneficial owners in subchapter S elections.