Parker Oil Co. v. Commissioner, 58 T. C. 985 (1972)

An irrevocable proxy and shareholder agreement that shifts voting rights but not economic rights does not create a second class of stock under Subchapter S.

Summary

In Parker Oil Co. v. Commissioner, the U. S. Tax Court ruled that an irrevocable proxy and shareholder agreement that altered voting rights did not terminate the company's Subchapter S election by creating a second class of stock. Parker Oil shareholders had settled a dispute over 5 shares by transferring them back to the original owner, Don W. Parker, but with an irrevocable proxy to a third party, M. N. Brown, to vote those shares. The IRS argued this arrangement created a second class of stock, violating the one-class requirement for Subchapter S status. The court disagreed, holding that the proxy did not affect the economic rights of the shares, thus maintaining the single-class structure. This decision emphasizes that voting rights alone, without affecting economic rights, do not create a second class of stock for Subchapter S purposes.

Facts

Parker Oil Co. , Inc. , a small business corporation under Subchapter S, faced a dispute among its shareholders over the ownership of 5 shares of stock. The dispute was settled by transferring the shares back to Don W. Parker, who then executed an irrevocable proxy to M. N. Brown, allowing Brown to vote those shares until the corporation's dissolution. The settlement agreement also set voting arrangements for the election of directors. The IRS argued that this arrangement created a second class of stock, potentially terminating the company's Subchapter S election. The articles of incorporation specified only one class of stock, and no amendments were made to reflect the settlement agreement.

Procedural History

Parker Oil Co. filed a petition with the U. S. Tax Court challenging the IRS's determination of a tax deficiency for the fiscal year ending June 30, 1967. The IRS had determined that the company's Subchapter S election was terminated due to the creation of a second class of stock. The Tax Court heard the case and ruled in favor of Parker Oil, holding that no second class of stock was created.

Issue(s)

1. Whether an irrevocable proxy and shareholder agreement that shifts voting rights but not economic rights creates a second class of stock under Section 1371(a)(4) of the Internal Revenue Code, thereby terminating a corporation's Subchapter S election.

Holding

1. No, because the proxy and agreement did not alter the economic rights of the shares, which are the critical factor in determining the existence of a second class of stock under Subchapter S. The court found that the arrangement was a practical solution to shareholder discord and did not affect the distribution of profits, thus maintaining the single-class structure necessary for Subchapter S status.

Court's Reasoning

The court reasoned that the purpose of the one-class-of-stock requirement under Subchapter S is to simplify the taxation of income to shareholders with different preferences for profit distribution. The irrevocable proxy and shareholder agreement in this case did not affect the economic rights of the shares, only the voting rights. The court emphasized that voting rights alone, without affecting economic rights, do not create a second class of stock. The court also criticized the broad language of the applicable Treasury regulations and revenue rulings, stating they were inconsistent with congressional intent. Judge Featherston's concurring opinion supported this view, arguing that the proxy did not change the nature of the stock's voting rights but only designated who would exercise those rights. The dissenting opinions, however, argued that the irrevocable proxy effectively created a different class of stock by permanently altering the voting rights of the 5 shares.

Practical Implications

This decision has significant implications for closely held corporations seeking to maintain Subchapter S status. It allows shareholders to use proxies and agreements to manage voting rights without risking their tax benefits, as long as the economic rights of the shares remain unchanged. Legal practitioners should advise clients that such arrangements can be used to resolve shareholder disputes without triggering a termination of Subchapter S status. However, practitioners must be cautious, as the dissent suggests that some courts might view similar arrangements as creating a second class of stock. This case has been cited in subsequent rulings to support the position that voting arrangements do not necessarily create a second class of stock, but it also highlights the ongoing debate over the interpretation of the one-class requirement.

