Taproot Administrative Services, Inc. v. Commissioner, 133 T. C. 202; 2009 U. S. Tax Ct. LEXIS 29; 133 T. C. No. 9 (United States Tax Court, 2009)

In *Taproot Administrative Services, Inc. v. Commissioner*, the United States Tax Court ruled that a Roth Individual Retirement Account (IRA) cannot be an eligible shareholder of an S corporation. The court's decision, stemming from a dispute over Taproot's tax status for 2003, affirmed the IRS's position that such accounts do not qualify as shareholders, thus classifying Taproot as a C corporation. This ruling clarifies the boundaries of S corporation eligibility and impacts how investors structure their holdings to maintain tax benefits.

Parties

Taproot Administrative Services, Inc. , the petitioner, sought a redetermination of a tax deficiency for the 2003 tax year, with the Commissioner of Internal Revenue as the respondent. The case was heard on the respondent's motion for partial summary judgment.

Facts

Taproot, a Nevada corporation, elected S corporation status and filed its 2003 tax return as such. During 2003, Taproot's sole shareholder was a Roth IRA custodial account benefiting Paul DiMundo. The IRS issued a notice of deficiency on April 10, 2007, determining that Taproot was taxable as a C corporation for 2003 because its shareholder was ineligible under S corporation rules. Taproot filed a petition with the Tax Court on July 6, 2007, contesting the IRS's determination.

Procedural History

The IRS moved for partial summary judgment on October 23, 2008, arguing that Taproot's S election was invalid due to the ineligible shareholder status of the Roth IRA. The Tax Court granted the motion on September 29, 2009, holding that Taproot was ineligible for S corporation status in 2003 and was thus taxable as a C corporation. The decision was reviewed by the full court and was unanimous in the majority opinion, with concurring and dissenting opinions addressing different aspects of the ruling.

Issue(s)

Whether a Roth IRA can be considered an eligible shareholder of an S corporation under section 1361 of the Internal Revenue Code?

Rule(s) of Law

The Internal Revenue Code, section 1361, defines an S corporation as a domestic corporation that does not have a shareholder who is not an individual, estate, certain types of trusts, or certain exempt organizations. Section 1361(c)(2)(A) lists eligible trusts, but does not include IRAs. Revenue Ruling 92-73 states that a trust qualifying as an IRA is not a permitted S corporation shareholder. The court also considered the treatment of custodial accounts under section 1. 1361-1(e)(1) of the Income Tax Regulations.

Holding

The Tax Court held that a Roth IRA is not an eligible S corporation shareholder. Consequently, Taproot's S corporation election was invalid for the 2003 tax year, and it was taxable as a C corporation.

Reasoning

The court's reasoning focused on the statutory and regulatory framework governing S corporations and IRAs. It emphasized that IRAs are not explicitly listed as eligible shareholders under section 1361. The court rejected Taproot's arguments that the Roth IRA should be treated as a grantor trust or that its beneficiary should be considered the shareholder under the custodial account regulations. The court found Revenue Ruling 92-73 persuasive in distinguishing IRAs from grantor trusts due to the different tax treatment of income. The court also noted that subsequent congressional actions, such as the limited exception allowing IRAs to hold S corporation bank stock, indicated that Congress did not intend to allow IRAs to be general S corporation shareholders. The concurring opinion reinforced the incompatibility of IRA tax treatment with the flow-through taxation of S corporations, while the dissenting opinion argued that the 1995 regulations should allow the IRA beneficiary to be considered the shareholder.

Disposition

The court granted the respondent's motion for partial summary judgment, affirming that Taproot was a C corporation for the 2003 tax year.

Significance/Impact

This case is significant for clarifying that IRAs, including Roth IRAs, are not eligible shareholders of S corporations, affecting the tax planning strategies of investors and businesses. The ruling reinforces the IRS's position and the boundaries of S corporation eligibility. Subsequent legislative attempts to expand eligibility to include IRAs have failed, underscoring the decision's doctrinal importance. The case also highlights the tension between the tax benefits of IRAs and the flow-through taxation of S corporations, influencing how these entities are structured and operated.

