After the Facelift, is Subchapter S Any More Attractive?

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COMMENT

AFTER THE FACELIFT, IS SUBCHAPTER S ANY MORE ATTRACTIVE?

INTRODUCTION

In his 1954 budget message to Congress, President Eisenhower, commenting on the proposed revision of the federal tax system, recommended that corporations with a small number of active stockholders be given the option to be taxed as partnerships. The Senate adopted the President's recommendation, but the House of Representatives failed to concur and the proposal was defeated in conference committee.

Four years later, again at the urging of President Eisenhower, Congress added subchapter S, originally sections 1371-1377, to the Internal Revenue Code as part of the Technical Amendments Act of 1958. By enacting subchapter S, Congress intended to permit small businesses to select the form of business organization desired without the necessity of taking into account major differences in tax consequences.

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Small businesses should be able to operate under whatever form of organization is desirable for their particular circumstances without incurring unnecessary tax penalties. To secure this result, I recommend that corporations with a small number of active stockholders be given the option to be taxed as partnerships and that certain partnerships be given the option to be taxed as corporations.


There are certain technical tax revisions which will give substantial benefits to small business, with a minimum loss of revenue and with no changes in tax rates. These revisions will be set forth in the Economic Report. They are based on the work of the cabinet Committee on Small Business.

5. The substance of subchapter S of the Internal Revenue Code was amended by the Subchapter S Revision Act of 1982, P.L. No. 97-354, and currently consists of sections 1361-1379.

between operating as a corporation or as a partnership. Although this was the express intent of Congress, the 1958 Act, as distinguished from the 1954 legislative proposal, implemented a hybrid taxing system with a set of independent and complex rules for avoiding the double taxation on distributed corporate earnings and for permitting the pro-rate shareholder recognition of corporate net operating losses.

THE FRAMEWORK OF SUBCHAPTER S AS AMENDED PRIOR TO 1982

By consenting to be taxed directly on corporate earnings, whether distributed or not, the shareholders of a subchapter S corporation were able to realize the non-tax advantages of operating in the corporate form (limited liability, centralization of management, ease of transferring ownership) while being exempt from federal corporate income taxes. However, with the exception of net long-term capital gain which retained its character at the shareholder level, the income of the subchapter S corporation which was taxed directly to the shareholders was treated as ordinary dividend income regardless of its tax character at the corporate level.

Any net operating loss sustained by the corporation was not retained by the corporation, but rather passed through to the shareholders pro-rata to the extent of their adjusted bases in the corporate stock plus any outstanding indebtedness owed them by the corporation. Any "allocated" loss in excess of a shareholder's stock and indebtedness bases was forever lost. This was contrary to the partnership rules which enabled partners to recognize such losses in subsequent years to the extent the partner's basis in his partnership interest was reestablished.

The subchapter S provisions also provided for multifarious eligibility requirements, the noncompliance with any of these requirements resulted in the rejection or termination of the election. The eligibility constraints included:

(1) The corporation could not be a member of an affiliated group;
(2) The corporation could only have one class of stock;

8. Louisiana has yet to adopt a concept similar to subchapter S with respect to state corporate taxes. See discussion infra notes 292-95 and accompanying text.
(3) The corporation could only have a limited number of shareholders (originally ten);\(^{16}\)

(4) Each shareholder of the corporation had to be either an individual or an estate;\(^{17}\)

(5) No shareholder of the corporation could be a nonresident alien;\(^{18}\)

(6) All post-election shareholders were required to give express, timely consent to the corporation’s small business election;\(^{19}\)

(7) The corporation could not derive more than 80% of its gross receipts from sources outside of the United States during any taxable year for which the election was in effect;\(^{20}\)

(8) The corporation could not derive more than 20 percent of its gross receipts from passive investment income sources;\(^{21}\) and

(9) The termination or revocation of a subchapter S election precluded a re-election of subchapter S status by the corporation during the subsequent five year period, except with the express consent of the Internal Revenue Service.\(^ {22}\)

Amendments to Subchapter S Between 1958 and 1982

Although the requirements for subchapter S status have undergone repeated technical changes since 1958, Congress had not changed the basic structure or concepts of the election until 1982.\(^ {23}\) Many of the amendments which had been made prior to 1982 were in response to court decisions revealing problems with the original law\(^ {24}\) and were generally of a liberalizing nature.

From 1958 to 1982 the restrictions on the number and qualifications of shareholders were eased to make the subchapter S election available to more corporations and to remove some of the technical traps which had caused many corporations to inadvertently lose their subchapter S status. In 1959 Congress effectively raised the number of shareholders a subchapter S corporation could have by providing that a husband and wife owning stock in a small business corporation as joint or community

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property would be counted as only one shareholder.\textsuperscript{25} Then in 1976 the shareholder limitation was increased from ten to fifteen if the corporation had been an electing small business corporation for at least five years and the additional shareholders (those over ten) had acquired their stock in the corporation solely by reason of inheritance.\textsuperscript{26} Finally, in 1978 the limitation was unqualifiedly raised from ten to fifteen\textsuperscript{27} and then further increased from fifteen to twenty-five in 1981.\textsuperscript{28} The types of shareholders allowed to own stock in a subchapter S corporation were also expanded. Beginning in 1976, amendments to subchapter S permitted a number of specified trusts\textsuperscript{29} and estates of bankrupt stockholders\textsuperscript{30} to have an equity interest in a subchapter S corporation.

Other technical traps which had caused noxious tax consequences to unsuspecting subchapter S corporation shareholders were also eliminated or minimized prior to the 1982 Revision. With the addition of I.R.C. § 1371(d) in 1964, Congress permitted subchapter S corporations to own inactive subsidiaries.\textsuperscript{31} In 1964\textsuperscript{32} and 1966,\textsuperscript{33} Congress eased the problem of "locked-in," previously taxed income by allowing certain distributions in the first two and one-half months of the corporate taxable year to be treated as non-dividend disbursements of undistributed taxable income of the prior year. In 1971 the definition of passive income found in former I.R.C. § 1373(e)(5) was amended to exclude amounts realized on the liquidation of corporations in which a subchapter S corporation had an ownership interest in excess of 50% in each class of stock.\textsuperscript{34} The Tax Reform Act of 1976 eliminated the risk that a new shareholder would terminate a subchapter S election inadvertently by

\begin{itemize}
\item \textsuperscript{25} Pub. L. No. 86-376, § 2(a) 73 Stat. 699, reprinted in 1962-3 CB 111. See also, Revenue Act of 1978. Pub. L. No. 95-600, § 342(a), 92 Stat. 2763, 2843, reprinted in 1978-3 CB (Vol. 1) 1, 77, which further amended § 1371(c) with respect to stock ownership by a married couple.
\item \textsuperscript{26} The Tax Reform Act of 1976, Pub. L. No. 94-455 § 902(a), 90 Stat. 1520, 1608, reprinted in 1976-3 CB (Vol. 1) 1, 84.
\item \textsuperscript{33} Pub. L. No. 89-389, § 1, 80 Stat. 111, reprinted in 1966-1 CB 419.
\item \textsuperscript{34} Pub. L. No. 91-683, 84 Stat. 2067, reprinted in 1971-1 CB 549.
\end{itemize}
requiring the shareholder to “affirmatively” refuse to consent to the election.\footnote{35} Finally, in 1978 Congress expanded the period in which to make a timely subchapter S election from two months (the first month of the taxable year and the preceding month) to one year and 75 days (the first 75 days of the election year and the preceding taxable year).\footnote{36}

Between 1958 and 1982, Congress also eliminated some of the unintended benefits of a subchapter S election. Prior to 1966, a subchapter S corporation was not taxed on any part of its income. But in 1966, Congress added I.R.C. \textsection 1378,\footnote{37} which imposed a tax on certain capital gains of subchapter S corporations. The impetus for the amendment was Congressional reaction to corporations which temporarily elected subchapter S status merely to avoid being taxed on large nonrecurring capital gains by passing the capital gains through to their shareholders who could then avail themselves of the favorable individual capital gains tax deduction.\footnote{38}

In 1969, section 1379 was added to the Internal Revenue Code\footnote{39} to conform the tax treatment of deferred compensation plans of subchapter S corporations to that applicable to partnerships.\footnote{40} Prior to the amendment, a shareholder employee could participate in corporate qualified plans without any special restrictions. After the amendment, the retirement benefits available to shareholder-employees became subject to limitations similar to those imposed by Keogh (H.R. 10) plans.

\section*{The Original Concept}

\textit{The Advantages of Subchapter S Status Prior to the Subchapter S Revision Act of 1982}

As a hybrid taxation scheme, subchapter S had many of the advantages and disadvantages of both the corporate and partnership forms of operation. A subchapter S election did not deprive the corporation's shareholders of any of the non-tax advantages of operating in the corporate form (e.g., limited liability, centralization of management, continuity of life, and free transferability of ownership interests), since subchapter S was nothing more than a federal taxation alternative. Although some of these non-tax advantages could have been realized...
through the use of a limited partnership, there was always the risk that
the Internal Revenue Service would reclassify such an entity as an
"association," pursuant to Treas. Reg. § 301.7701-2, and tax it as a
corporation.

Before the enactment of the Subchapter S Revision Act of 1982, a
second advantage available to a subchapter S corporation, but not to
a partnership, was the ability to provide its shareholder-employees non-
taxable fringe benefits. These benefits, which were generally not available
to self-employed persons (e.g., partners), included: death benefit pay-
ments of $5,000 or less,\(^4\) corporate contributions to employee accident
and health plans,\(^4\) employee group life insurance\(^4\) and group legal
services,\(^4\) and meals and lodging furnished for the benefit of the em-
ployer.\(^5\)

Third, where partnerships were generally limited to a calendar taxable
year or a fiscal year corresponding to the taxable year of its principal
partners,\(^6\) a subchapter S corporation had a great deal more flexibility
in selecting a taxable year. A subchapter S corporation, as other cor-
porations (hereinafter referred to as "C" corporations), could choose
a fiscal year ending on the last day of any month as its annual accounting
period.\(^7\) This flexibility afforded tax planning opportunities generally
not available to partnerships. Since a subchapter S corporation's earnings
were not taxable to its shareholders until distributed or until the cor-
poration's fiscal year ended, the shareholders could defer the recognition
of income simply by adopting a taxable year for the corporation different
from their own and then not make any distributions to themselves until
after their taxable year-end. For example, by adopting a corporate fiscal
year-end of January 31, calendar year shareholders could determine their
tax situation in December and ascertain whether it would be more
advantageous to recognize the corporation's income in the current year
through corporate distributions or defer such recognition until the fol-
lowing year by postponing the distribution of corporate earnings.

A fourth major advantage of operating as a corporation was the
ability to participate in a tax-free corporate reorganization.\(^8\) The re-
quirements for the favorable nonrecognition of gain or loss from ex-
changes of property and stock between a subchapter S corporation and
its shareholders pursuant to a tax-free corporate reorganization or di-

\(^{41}\) I.R.C. § 101(b) (1982).
\(^{42}\) I.R.C. §§ 105 and 106 (1982).
\(^{43}\) I.R.C. § 79 (1982).
\(^{44}\) I.R.C. § 120 (1982).
\(^{46}\) I.R.C. § 706(b) (1982).
\(^{47}\) I.R.C. § 441 (1982).
supra note 24, ch. 14; B. Bittker & J. Eustice, Federal Income Taxation of Corporations
vision were generally the same for electing corporations as for non-electing corporations.\footnote{49}

There were also several advantages generally shared by subchapter S corporations and partnerships which were not available to non-electing corporations. Perhaps the most significant was the avoidance of a double income tax on corporate earnings (i.e., a corporate income tax when earned and an individual income tax when distributed as dividends). Generally, no tax was imposed at the corporate level for subchapter S corporations;\footnote{50} rather, under the "conduit" concept, taxable income flowed from the corporate level to the shareholders and was reported by them on their personal income tax returns.\footnote{51} The avoidance of the double tax was an important consideration when a corporation wished to make large distributions to its shareholders for which no deduction at the corporate level was available.

A second advantage that a subchapter S corporation had over a "C" corporation was the ability to pass corporate net operating losses,\footnote{52} but not net capital losses,\footnote{53} to its shareholders. The shareholders would then deduct such losses on their individual income tax returns to the extent of their adjusted bases in the corporation's stock and debt.\footnote{54} The ability of an individual to take advantage of corporate losses was a particularly relevant consideration for a new business in which losses in the early years were anticipated.

A third advantage which was shared by a subchapter S corporation and a partnership was the avoidance of the accumulated earnings tax due to the pass-through nature of the entity. The accumulated earnings tax was enacted as a penalty on corporate earnings which were accumulated beyond the reasonable needs of the business simply to enable the shareholders to avoid the payment of tax on dividends.

The Disadvantages of the Subchapter S Election Prior to the Subchapter S Revision Act of 1982

The subchapter S provisions passed in 1958 and amended over the years contained many difficulties and disadvantages not present in other forms of operating a business enterprise. Perhaps the greatest disadvantage prior to the Subchapter S Revision Act of 1982 was the tendency

\footnote{49. Tax-free corporate reorganizations or divisions generally require a plan of reorganization with a legitimate business purpose and the continuity of both the business enterprise and the proprietary interests within that enterprise. See generally, J. Eustice & K. Kuntz, supra note 24, at p.14.1.}
\footnote{50. Former I.R.C. § 1372(b) (1976).}
\footnote{51. Former I.R.C. §§ 1373, 1375 (1976).}
\footnote{52. Former I.R.C. § 1374 (1976).}
\footnote{53. Former I.R.C. § 1373(d)(1) (1976).}
\footnote{54. Former I.R.C. § 1374(c)(2) (1976).}
of the numerous technical provisions to create “traps for the unwary.” The inadvertent deviation from these technical provisions often resulted in the unexpected loss of tax benefits sought by the election. The uncertainty of the subchapter S election was exacerbated by the Internal Revenue Service and the courts applying these technical rules strictly and literally against nonconforming corporations. Therefore, before a subchapter S election was made, one needed to weigh the risk of both initial and continued eligibility.

A second “trap” created by the technical provisions of subchapter S was the unnecessary complexity of determining the tax consequences to shareholders receiving corporate distributions. The earnings and profits of a corporation were taxed to the shareholders either as dividends (without the benefit of the section 116 dividends received exclusion) when distributed \(^5\) or as constructive dividends \(^6\) if not fully distributed by corporate year-end. The latter retained amount, unless distributed pursuant to former section 1375(f) within two and one-half months of the close of the corporate taxable year, was referred to as “previously taxed income” (PTI). The ability to withdraw such amounts in later years with no additional tax consequences was the subject of much confusion. To make distributions of PTI a corporation had to be fairly liquid because these distributions could only be made from corporate cash. In addition, many people believed that they could freely withdraw previously taxed income at anytime, tax-free, but former section 1375 and the regulations thereunder provided that previously taxed income could only be withdrawn if the corporation’s current year earnings and profits had been fully distributed. For example, assume a subchapter S corporation had a June 30 fiscal taxable year-end while its sole shareholder reported his income on a calendar taxable year. The corporation had $10,000 and $5,000 of earnings and profits in 1980 and 1981, respectively. During the 1980 fiscal year no distributions were made. During the 1981 fiscal year the corporation made the following cash distributions: $4,000 on August 1, 1980 and $6,000 on October 1, 1980. The $10,000 undistributed taxable income (UTI) of the 1980 fiscal year would have been required to have been included as a constructive dividend on the shareholder’s 1980 tax return. Since the $4,000 distribution was made during the 2½ month grace period, it would not have been considered a dividend but rather a tax-free distribution of the corporation’s fiscal 1980 UTI ($10,000) which had been previously included in the shareholder’s taxable income. In contrast since the $6,000 distribution was made after September 15 it would have been considered

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\(^6\) Treas. Reg. § 1.1372-1(c)(2) (1960).

\(^7\) Former I.R.C. § 1373 (1976).
a dividend to the extent of fiscal 1981 corporate earnings ($5,000) and only the excess ($1,000) would have been considered a tax-free distribution of previously taxed income. Accordingly, the shareholder would have had to include $15,000 of the corporate earnings on his 1980 individual income tax return (i.e., $10,000 pass-through of UTI plus $5,000 of fiscal 1981 earnings distributed in calendar year 1980) even though only $10,000 was actually distributed to him during that period.

Another problem associated with PTI was that its nontaxable character did not survive the termination of the subchapter S election. If a subchapter S election was terminated, either intentionally or inadvertently, any PTI attributed to years prior to the termination was treated as accumulated corporate earnings and profits, and any distributions made from this account were considered dividends despite the fact that this amount had been previously taxed to the shareholder as UTI pursuant to former I.R.C. § 1373. For example, assume that during the fiscal year ended June 30, 1980, a subchapter S corporation had earnings and profits and taxable income of $10,000. On November 11, 1980, the corporation made a $10,000 distribution to its sole shareholder. If the corporation generated no earnings and profits during the year ended June 30, 1981, the $10,000 distribution would normally have been deemed a non-dividend distribution of previously taxed income. But if on November 14, 1980, the shareholder sold 3% of his stock to a third party who then affirmatively refused to consent to the election, the subchapter S election would have been terminated, retroactive to the beginning of the corporation’s taxable year (i.e., July 1, 1980). The $10,000 November 11 distribution would therefore have been treated as a dividend out of accumulated earnings and profits and not as a tax-free distribution of PTI. Consequently, the calendar year taxpayer would have been taxed as if he had received $20,000 of income in 1980 ($10,000 UTI on 6-30-80 and $10,000 dividend on 11-11-80) when in fact the corporation had only generated $10,000 of income during its existence. To put it in another way, if the shareholder was in a 50% tax bracket, the entire $10,000 generated by the corporation as of June 30, 1980 would have been paid to the government. This double taxation of the shareholder of corporate income demonstrates one of the harsh results which inadvertent terminations could have caused under the prior subchapter S provisions.

In addition to the problem of “frozen-in” previously taxed income, difficulty often arose because the right to receive PTI was personal to the shareholder who had originally paid the tax and was not transfer-
able. Therefore, upon the death of a shareholder or upon a transfer of the stock for any other reason the PTI would have been taxed a second time.

A third shortcoming of a subchapter S election was the permanent disallowance of corporate losses in excess of a shareholder’s basis in his stock plus any indebtedness owed him by the corporation. Because of this limitation, corporate losses could not be carried forward by either the corporation or the shareholder, but rather were forever lost. This loss limitation, plus the fact that a shareholder’s basis in a subchapter S corporation was not increased by third-party corporate indebtedness even in the situation where the shareholder personally guaranteed a corporate loan, made the subchapter S election very unfavorable in highly leveraged business ventures.

Unlike the partnership provisions which provided for a complete pass-through of tax characteristics of the items of income and deduction incurred by the partnership, the subchapter S provisions did not provide for such treatment. Except for net capital gains, earnings and profits and taxable income were calculated at the corporate level and passed through to the shareholders either as dividends or as constructive dividends, and the shareholders would then report their share of the corporate earnings as ordinary income (loss) on their individual income tax returns. This limited conduit effect had adverse tax consequences with respect to the availability of such items as foreign tax credits, percentage depletion, net capital losses, and farm income treatment.

66. Perry v. Commissioner, 47 TC 159 (1966), aff’d, 392 F.2d 458 (8th Cir. 1968).
69. Former I.R.C. § 1373(d) (1976); Treas. Reg. § 1.1372-1(c)(1), (b) (6) (1960).
71. Former I.R.C. § 1373(b) (1976).
75. Capital losses recognized by a subchapter S corporation under the prior law were not passed through to the shareholders. Therefore the disallowance rules I.R.C. §§ 1211(a) and 1212(a) (1976 & Supp. V 1981) relating to corporate capital losses in excess of capital gains was applicable to subchapter S corporations as well as regular “C” corporations. In other words, as was the case for nonelecting corporations, subchapter S corporations with recognized capital losses could only deduct such losses to the extent of capital gains. Unlike a nonelecting corporation, a subchapter S corporation could not carry a capital
On October 19, 1982, President Reagan signed into law the Subchapter S Revision Act of 1982, which extensively revised the provisions governing subchapter S of Chapter 1 of Subtitle A to the Internal Revenue Code (sections 1361-1379, as amended). The reformulation was enacted primarily to make the provisions of subchapter S conform more fully with the general congressional intent of their original passage, i.e., "to minimize the effect of federal income taxes on choices of the form of business organization and to permit the incorporation and operation of certain small businesses without the incidence of income taxation at both the corporate and shareholder levels."

As discussed supra, the application of the subchapter S rules prior to 1982 demonstrated that, in the attempt to achieve the goal of minimizing the importance of tax consequences when deciding whether or not to incorporate small, closely-held businesses, the original legislation was imperfect at best, and, at worst, it was fraught with technical traps with highly adverse tax ramifications for the unsuspecting taxpayer. The Subchapter S Revision Act of 1982 was therefore passed to "simplify and modify the tax rules relating to eligibility for subchapter S status and the operation of subchapter S corporation" and, thereby, to

loss back to a prior year [(I.R.C. § 1212(a)(3) (1976)], but was only allowed to carry such losses forward to each of the five succeeding tax years. I.R.C. § 1212(a)(1) (B) (1976). This result should be contrasted with the tax treatment available to partners who recognized such losses on their individual returns whereby I.R.C. §§ 1211(b) (relating to the capital loss deduction of $3,000) and 1212(b) (1976 & Supp. V 1981) (permitting an indefinite carryover of unused capital losses) were applicable.

The pro-rata allocation to the shareholder of a subchapter S corporation engaged in farming activities was not considered farm income as to the shareholders. Rev. Rul. 76-141, 1976-1 CB 381.

The inadequacy of the 1958 legislation was brought to the attention of the Senate Finance Committee by Sen. Paul H. Douglas' statement accompanying the committee's report. Id. The major problem with which section 68 [(the section of the bill relating to subchapter S)] is concerned is the fact that the present law does not integrate the individual and corporation income taxes and therefore gives rise to the alleged problem of double taxation. The taxability of dividends, as indicated elsewhere, is surely a matter of major concern in the present tax law. The approach in section 68, however, makes no major progress toward an equitable solution to this problem, but introduces an additional element of complexity in an already overcomplicated tax law. 1958 Code Cong. & Ad. News 5041, 5052.

remove common traps for the unwary and to eliminate a few of the benefits realized by the unforeseen manipulation of the former provisions. This was accomplished by more closely aligning the tax treatment of "S" corporations (as denoted by the 1982 Act) with the partnership rules of subchapter K of the Internal Revenue Code. Most of the provisions of the Act became effective for the taxable years beginning after 1982.

**Eligibility To Make an S Corporation Election**

**A. Requirements**

The Subchapter S Revision Act of 1982 removed what were deemed to be unnecessary eligibility restrictions to make the small business corporation election available to more corporations. Under the 1982 Act, to be eligible to make a valid election, a corporation must qualify as a "small business corporation," i.e.:

1. be a domestic corporation,
2. have no more than 35 shareholders (a husband and wife and their estates are treated as one shareholder),

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83. The election is made by the corporation, but all persons who are shareholders of the corporation on the day the election is made must consent. I.R.C. § 1362(a)(1) and (2) (1982).

84. I.R.C. § 1361 (1982). The requisites to make the election prior to 1983 in accordance with former I.R.C. § 1371 (1976 & Supp. V 1981), were:
   1) The corporation needed to be a domestic corporation;
   2) It could not be a member of an affiliated group;
   3) It could have no more than 25 shareholders (husband and wife (including their estates) were treated as a single shareholder);
   4) It could have as shareholders, only individuals (other than nonresident aliens), estates, and certain type of trusts (grantor trusts, testamentary trusts for a 60-day period, voting trusts, and certain "qualified subchapter S trusts");
   5) It could have only one class of stock.

85. As defined by Treas. Reg. § 1.1371-1(b) (1960) domestic corporation, "means a corporation as defined in section 7701(a)(3) created or organized in the United States or under the law of the United States or of any State or Territory. The term does not include an unincorporated business enterprise electing to be taxed as a domestic corporation under 1361." Although this regulation was adopted pursuant to the prior law, it is the position of the Service that "[t]he regulations and revenue rulings published under subchapter S of the Code prior to its amendment by the Subchapter S Revision Act of 1982, 1982-2 C.B. 702, where not inconsistent with the new law, are still in effect." PLR 8422052.

86. The number of shareholders was increased from 25 to 35, to correspond with the private placement exemption of Rule 505 and 506 of Regulation D under the Federal Securities Law. H.R. Rep. No. 826, 97th Cong., 2d Sess. 7 (1982); S. Rep. No. 640, 97th Cong., 2d Sess. 7 (1982).

87. I.R.C. § 1361(c) (1982).
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(3) have as shareholders only individuals (other than nonresident aliens), estates, estates, and certain trusts (i.e., neither partnerships nor other corporations may be shareholders),

(4) have no more than one class of stock.

In addition, even if the above criteria are met, the following corporations are ineligible to make the election:

88. According to section 1361(c)(3) the term estate "includes the estate of an individual in a case under title 11 of the United States Code" (the Bankruptcy Code). Otherwise, the term "estate" for subchapter S eligibility has been narrowly interpreted by the Internal Revenue Service as meaning only decedents' estates and not estates of a minor or incompetent. Rev. Rul. 66-266, 1966-2 CB 356.

When administering an estate, an executor or administrator should exercise reasonable diligence to avoid the transformation of the estate into a trust for federal income tax purposes, resulting in the possible loss of the small business election. See Treas. Reg. 1.641(b)-3(a) (1960); Old Virginia Brick Co, 44 T.C. 724 (1965) aff'd, 267 F.2d 276 (4th Cir. 1966).

90. What constitutes a second class of stock? According to the Committee Reports, "the outstanding shares of the corporation must . . . be identical as to the rights of the holders in the profits and in the assets of the corporation." H. R. Rep. No. 826, 97th Cong., 2d Sess. 8 (1982); S. Rep. No. 640, 97th Cong., 2d Sess. 8; (emphasis added). Therefore, anything short of the actual issuance of a second class of stock will not disqualify a corporation from being a small business corporation eligible for S corporation status. In other words, a second class of treasury stock or authorized but unissued stock or even options, warrants or convertible debentures will have no effect on a subchapter S election. See Treas. Regs. § 1.1371-1(g), T.D. 6904, 31 F.R. 16527 (1966); Rev. Rul. 67-269, 1967-2 CB 298.

To help resolve two highly litigated and uncertain issues under the old law relating to what constituted a second class of stock, the Subchapter S Revision Act of 1982 added I.R.C. §§ 1361(c)(4) and (5) (1982). Unlike prior law, section 1361(c)(4) provides that a corporation will not be treated as having more than one class of stock solely because of differences in voting rights; it is now possible for an S corporation to have voting and nonvoting common stock outstanding. Furthermore, section 1361(c)(5) was added to provide a safe harbor pursuant to which debt instruments will not be considered a second class of stock. This section provides that an instrument which is "straight debt" will not be regarded as a second class of stock and therefore will not disqualify a subchapter S election. A straight debt instrument is defined by this section as a written unconditional promise to pay on demand or on a specified date a sum certain in money at a noncontingent interest rate. In addition, the debt instrument must not be convertible into stock and the creditor must be a person eligible to hold subchapter S stock. See H. R. Rep. No. 826, 97th Cong., 2d Sess. 8 (1982) and S.R. No. 640, 97th Cong., 2d Sess. 8 (1982).

91. These corporations are referred to as "ineligible corporations" and do not qualify as "small business corporations." I.R.C. § 1361(b) (1982).
(1) a member of an affiliated group,\(^92\)

(2) a financial institution for which a bad debt deduction is allowed under I.R.C. §§ 585 or 593,\(^93\)

(3) an insurance company subject to tax under subchapter L of the Internal Revenue Code,\(^94\)

(4) a corporation electing the Puerto Rico and possessions tax credit (I.R.C. § 936), and

(5) a domestic international sales corporation\(^95\) (DISC) or a former DISC.\(^96\)

B. Making the Election

If a corporation satisfies the statutory definition of a small business corporation,\(^97\) then it may make a valid subchapter S election. In this regard, the crucial considerations become who must make the election and when must it be made.

C. Who Must Elect

It is the corporation which must make the subchapter S election by filing Form 2553.\(^98\) But to be valid the election must be consented to

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92. A member of an affiliated group is determined under section 1504 without regard to the exceptions of foreign corporations and domestic international sales corporations (DISCs) for pre-1985 transactions by U.S. exporters or Foreign Sales Corporations (FSCs) for post-1984 transactions by U.S. Exporters. Thus, an S corporation cannot own 80% or more of the stock of another "active" corporation. An active corporation is one that has either begun business or has taxable income.

93. Congress excluded these corporations because they have the advantage of being able to claim bad debt deductions generally not allowed to individuals. H.R. Rep. No. 826, 97th Cong., 2d Sess. 9 (1982); S. Rep. No. 640, 97th Cong., 2d Sess. 9 (1982).

94. Virtually all insurance companies are taxable under the provisions of subchapter L. Insurance companies were excluded because, being subject to the special insurance company rules of the Code, they are entitled to certain deductions generally unavailable to individuals. H. R. Rep. No. 826, 97th Cong., 2d Sess. 9 (1982) and S. Rep. No. 640, 97th Cong., 2d Sess. 9 (1982).

95. A DISC is a United States corporation whose income is predominantly (95% or more) derived from export activities. I.R.C. § 992(a) (1) (1982). The relevance of the DISC exception has been virtually eliminated by the Tax Reform Act of 1984 (P.L. 98-369, §§ 801-805, adding §§ 921-27 to the Internal Revenue Code) replacing the DISC export tax incentive with the less favorable concept of Foreign Sales Corporations (FSCs) for transactions after 1984 by U.S. exporters.

96. A "former DISC" is defined by section 992(a)(3) as a corporation which is not a DISC for the current taxable year but was DISC in a preceding taxable year and at the beginning of the current taxable year has undistributed previously taxed income or accumulated DISC income. Therefore, a corporation can be a "former DISC" for no more than one year following the end of its DISC election.


by all persons who are shareholders of the corporation on the day the election is made.\textsuperscript{99} If corporate stock is owned as community property or is owned by joint tenants, tenants in common, or tenants by the entirety, each person having a community or joint interest in the stock must consent to the election.\textsuperscript{100}

\textbf{D. When to Elect}

To be effective for a particular tax year, the election must be made by the corporation during the preceding taxable year or on or before the fifteenth day of the third month of the taxable year for which the election is to take effect.\textsuperscript{101} Therefore, for a calendar taxable year, an election made on March 15, 1985 will be retroactive to January 1, 1985. There are two limitations, however, to the two and one-half month extension period for making the election: (1) the corporation must have been a "small business corporation," and thus eligible to make the election, for the entirety of the extension period;\textsuperscript{102} and (2) every person who held stock in the corporation during the extension period, even if he or she subsequently disposed of the stock prior to the election date, must consent to the election.\textsuperscript{103} Therefore, if Ms. Jones owned stock in ABC corporation on January 1, 1985 and sold it to Mr. Smith on that date, the ABC corporation may not make a valid subchapter S election for the 1985 calendar year without Ms. Jones' consent. If Ms. Jones refuses to consent, then the election will not become effective until January 1, 1986.\textsuperscript{104}

\textit{Taxable Year of S Corporations}

The selection of a taxable year by an S corporation was limited under the Subchapter S Revision Act of 1982 to restrict the use of an S corporation for tax deferral purposes by its shareholders.\textsuperscript{105} New I.R.C. § 1378(a)(2) generally conforms with the partnership rule of section 706\textsuperscript{106} and requires the taxable year of an S corporation to be either a

\begin{itemize}
  \item[Section 706(b)(2) provides: "A partnership may not change to, or adopt, a taxable year other than that of all its principal partners unless it establishes, to the satisfaction of the Secretary, a business purpose thereof." Since, for the most part, the shareholders of an S corporation are limited to individuals who almost universally have calendar taxable years (I.R.C. § 441(g) (1982)) limiting an S corporation's taxable year to a calendar year, in the absence of IRS' permission to the contrary, corresponds with the requirement under section 706(b)(2) that a partnership taxable year conform with that of its principal partners.]
\end{itemize}
calendar year or other taxable year for which the corporation establishes
a business purpose (within the meaning of Treas. Reg. § 1.442-1(b)(1))
to the satisfaction of the Internal Revenue Service.¹⁰⁷

Under certain situations, the Internal Revenue Service has provided
for the automatic approval of the selection of fiscal taxable years. An
S corporation may select an accounting period which corresponds to
the taxable year used by the shareholders holding more than one-half
of the corporation's stock as of the first day of the taxable year to
which the request relates.¹⁰⁸ The Service will also grant automatic ap-
proval of an S corporation selecting a fiscal year which results in the
derferment of income of three months or less for the majority share-
holders.¹⁰⁹ In addition, I.R.C. § 1378(a) will be deemed satisfied, if a
fiscal year is adopted, retained, or changed to correspond with the
corporation's "natural business year."¹¹⁰ The request for a taxable year
other than one ending on December 31, is made on Internal Revenue
Form 2553.¹¹¹

Treatment of Income, Deductions and Credits

For the most part, the S corporation is a tax reporting, not a tax
paying entity.¹¹² The only federal taxes which the corporation is subject
to at the corporate level are: (1) a tax imposed on relatively large net
capital gains realized by an established corporation during the first three
years after making a subchapter S election,¹¹³ (2) a penalty tax imposed
on the realization of excessive passive investment income,¹¹⁴ and (3) the

(1983).
¹⁰⁹. Id. If an S corporation has a majority shareholder(s) with a calendar taxable
year (as will usually be the case for individuals), the selection of a fiscal year end of
September 30, October 31 or November 30 should not be questioned by the Service.
¹¹⁰. Id. at 92. A corporation's "natural business year" is determined by a mathematical
test of gross receipts. A natural business year occurs when the gross receipts from sales
or services for the last two months of each of the three preceding twelve month periods
ending with the last month of the requested natural business year, equal or exceed 25
percent of the total gross receipts for sales or services for each twelve month period (i.e.,

last 2 months gross receipts > total gross receipts).

¹² month gross receipts

For example, if a corporation had gross receipts from sales and services of $100,000,
$150,000 and $200,000 respectively for each of the preceding twelve month periods ending
on June 30, then the small business corporation electing subchapter S status may select
a June 30 fiscal year end if its gross receipts from sales or service for May and June
of the preceding twelve month periods were at least $25,000, $37,500 and $50,000 re-
spectively.

recapture of investment tax credits taken prior to the effective date of
the subchapter S election.115 Otherwise, an S corporation is treated as
a conduit, much like a partnership, with the shareholders taxed on their
proportionate share of the corporate income whether or not it is dis-
tributed to them in the form of actual dividends.116 Similarly, losses of
an S corporation are allocated among the shareholders on a pro-rata
basis and deducted by them, to the extent of their debt and stock bases
in the corporation, on their personal income tax returns. As with part-
nerships, the tax characteristics of the various items of income, deduc-
tions, and credits of an S corporation flow through to the shareholders
who report their pro-rata share117 of such transactions on their individual
tax returns (as if they were realized directly from the same source or
incurred in the same manner as by the corporation.118

Taxes Imposed on the Corporation

A. Capital Gains Tax

To discourage the election of subchapter S status on a temporary
"one-shot" basis119 simply to funnel capital gains through to share-
holders, Congress retained intact the substance of former section 1378
by imposing a corporate level tax on certain net capital gains.120 Under
amended section 1374, an S corporation is subject to a special tax if the
following conditions are met for the taxable year:

117. A shareholder’s pro-rata share is determined according to the number of days a
taxpayer holds stock in the corporation during the taxable year. I.R.C. § 1377(a) (1982).
118. I.R.C. § 1366(b) (1982).
120. When enacted in 1966 it was the intent
of Congress that the capital gains penalty
tax would apply "only in those situations where the ‘pass through’ treatment was elected
to avoid taxes on capital gains." The situation that particularly disturbed Congress was where:
A corporation . . . arranges to have a large amount of capital gains realized
in 1 year, elects the “pass through” treatment for that year, distributes these
realized capital gains, and then deliberately causes its “pass through” status to
be terminated. This avoids a capital gains tax at the corporate level and substi-
tutes capital gains tax for an ordinary (dividend) income tax at the shareholder
level. Normally, this could be done where a corporation sold its assets and
completely liquidated within a 12-month period (under the provisions of sec.
337). However, by using the “pass through” treatment the shareholders can
obtain the same results without liquidating the business.

It was intended for an organization desiring this tax treatment [sic] at least
for a number of years and certainly not for a single year as a device to avoid
(1) It had been a nonelecting "C" corporation during any of the three years immediately preceding the current taxable year;

(2) It had taxable income in excess of $25,000 for the current year;\(^{121}\)

(3) Its net capital gain exceeded $25,000 for the year; and,

(4) Its net capital gain exceeded 50% of its taxable income for such year.

When the above circumstances exist, an S corporation will be subject to a tax, the amount of which will be the lower of: (1) the corporate capital gains tax (alternative tax rate which is presently 28%) on the corporate net capital gains in excess of $25,000; or (2) the corporate income tax which would have been imposed\(^{122}\) had the corporation not

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121. Since the policy behind the enactment of section 1378 (new section 1374) was to prevent the manipulative use of the subchapter S provisions to make "one-shot" elections simply to avoid the corporate tax on capital gains, Congress provided two mechanical exemptions from the capital gains tax for those situations in which it was deemed that the improper motivation for the election was not present. S. Rep. No. 1007, 89th Cong., 2d Sess. 6-7 (1966), reprinted in 1966-1 CB 527, 531; H. Rep. 826, 97th Cong., 2d Sess. 13 (1982); and S. Rep. No. 640, 97th Cong., 2d Sess. 14 (1982). In general, I.R.C. § 1374(c)(1) (1982) provides that if a corporation has been an S corporation for the three taxable years immediately preceding the taxable year in which excessive capital gain was recognized, it will not be subject to tax on the gain. Secondly § 1374(c)(2) (1982) provides that a new corporation which has been in existence for less than four taxable years and which has been an S corporation during its entire existence, is not subject to the tax imposed under 1374(a).

The above two exemptions from the section 1374 tax liability do not apply to long term capital gains realized on the sale of substituted basis property (i.e. property acquired tax-free from another corporation through a corporate reorganization) under the following conditions:

(1) the property was acquired in the current year or within one of the three preceding years;

(2) the property was acquired from another corporation which was either an S corporation, which would have been subject to the tax, or a C corporation; and

(3) the basis of the property in the hands of the S corporation is determined in whole or in part by reference to the basis of any property of the other corporation (i.e. a substituted basis). See I.R.C. § 1374(c)(3) (1982); Treas. Reg. § 1.1378-2 (b)(2) (1968); S. Rep. No. 1007, 89th Cong., 2d Sess. 8 (1966), reprinted in 1966-1 CB 527, 532.

Without the statutory safeguard of § 1374(c)(3), corporations could avoid the tax under § 1374(a) and thus usurp the congressional policy of discouraging manipulative tax practices designed to avoid corporate taxes on capital gains, by simply merging the corporation with an S corporation (likely newly formed to take advantage of § 1374(c)(2) and controlled by the same shareholder(s)) and having the S corporation make the sale of the capital assets.

122. Except that the credits allowable under I.R.C. §§ 31-45 (other than section 39) and the deductions allowable under I.R.C. §§ 172 (net operating loss) and 241-250 (other than section 248) shall be disregarded. I.R.C. § 1374(d) (1982).
been an S corporation. The amount of the section 1374 tax imposed on the corporation will reduce the amount of long-term capital gain to be passed through to the shareholders. To illustrate: assume that a corporation which was incorporated in 1980 did not make a subchapter S election until 1982. For the taxable year ended December 31, 1985, the corporation has gross retail sales of $10,000, net long term capital gains of $125,000, net short term capital losses of $25,000 and allowable deductions of $50,000. Net capital gain equals $100,000 calculated pursuant to I.R.C. § 1222(11) ($125,000 N.L.T.C.G. - $25,000 N.S.T.C.L.). Taxable income calculated pursuant to I.R.C. § 1374(d) amounts to $60,000 ($10,000 gross sales + $100,000 net capital gain - $50,000 allowable deductions). Since the S corporation has taxable income in excess of $25,000 (i.e., $60,000) and net capital gain in excess of $25,000 (i.e., $100,000), it has a section 1374 tax liability of $11,250 calculated pursuant to 1374(b)(2) ($60,000 taxable income multiplied by the various corporate income tax rates of I.R.C. § 11), which is lower than the $21,000 calculated according to section 1374(b)(1) (28% x $75,000). If there are five equal shareholders, each would recognize $17,750 of long-term capital gains (1/5 of $88,750) on his individual income tax return.

If, as a practical matter, a corporation has net taxable income, without considering the net capital gain, rather than a loss as under the above hypothetical, then the application of the 28% alternate tax rate with regard to the net capital gain in excess of $25,000 will result in the lower tax liability for the corporation. In those cases in which the 28% alternative tax rate is used to calculate the excessive net capital gains tax and the net capital gain is in excess of $35,000, the corporation will also be subject to the 15 percent minimum tax. For an S corporation, the corporate minimum tax is imposed only on the corporation's capital gain preference income and is calculated according to the requirements of I.R.C. § 56.

B. Investment Tax Credit Recapture

One of the administrative burdens of a subchapter S election under the prior law was the necessity of executing and filing a special share-
holder agreement\textsuperscript{130} to prevent the recapture of any investment tax credit (I.T.C.) claimed on pre-election investments in section 38 property.\textsuperscript{131} Under the current law, no such agreement is required to avoid the recapture of investment credits when an S election is made. Rather, the election is now treated as a mere change in the form of conducting a trade or business and the status as section 38 property is maintained.\textsuperscript{132} As a result, the corporation and not the shareholder(s) continues to be liable for the investment tax credit recapture resulting from the premature disposition of pre-election section 38 property.\textsuperscript{133}

Once an S election is made, any credits resulting from the qualified investment in section 38 property are passed through to the shareholders on a pro-rata basis\textsuperscript{134} subject to the at-risk limitations.\textsuperscript{135} Likewise, shareholders of the S corporation will realize any I.T.C. recapture on the premature disposition of property placed in service while the S election was in effect.\textsuperscript{136} Not only will a shareholder who has been allocated the benefits of an investment in section 38 property be accountable for the recapture of all or part of the credit upon the disposition by the corporation of the property prior to the end of its estimated life or ACRS recovery period, but he will also be considered as having made a "disposition" of section 38 property if his interest in the S corporation is reduced (e.g., by sale, gift, or redemption or by the issuance of additional shares) by more than one-third during the recapture period.\textsuperscript{137} For example, if an S corporation with two 50% shareholders, Ms. Jones and Mr. Smith, who each own 100 shares of stock, purchases and places into service a $100,000 piece of equipment (5 year ACRS property) in December, 1984, Ms. Jones and Mr. Smith would each include $50,000 on their individual tax returns as a qualified investment in section 38 property giving each an investment tax credit of $5,000 (10% of $50,000). If Ms. Jones sells 33 shares of her stock in May 1985, she would not have to recapture any of her prior $5,000 credit. But if instead she sold 34 shares of stock, thereby reducing her ownership in the corporation below 66 2/3% of what it was when the investment was apportioned, she would need to repay $1,700 ($5,000 x 34%) of the investment credit.\textsuperscript{138}

The treasury regulations provide further that "once property has been treated . . . as having ceased to be section 38 property to any

\textsuperscript{130} Treas. Reg. § 1.47-4(b)(2) (1967).
\textsuperscript{132} I.R.C. § 1371(d)(1) (1982).
\textsuperscript{133} I.R.C. § 1371(d)(2) (1982).
\textsuperscript{134} I.R.C. § 1366(a)(1)(A) (1982).
\textsuperscript{135} I.R.C. § 46(c)(8) (1982).
\textsuperscript{136} Treas. Reg. § 1.47-4(a)(1) (1967).
\textsuperscript{137} Treas. Reg. § 1.47-4 (1967).
\textsuperscript{138} Treas. Reg. § 1.47-4(a)(2)(b) (1967).
there will be no additional recapture unless the shareholder's stock ownership is further reduced to less than 1/3 (33 1/3%) of what it was on the apportionment date. Therefore, the application of Treas. Reg. § 1.47-4(a)(2)(b)(ii) to the above hypothetical suggests that if Ms. Jones would dispose of 32 more shares of her interest in the S corporation in 1986, she would suffer no additional recapture of I.T.C. with regard to the equipment placed in service during December 1984. But if she would further reduce her interest in the S corporation to only 33 shares by selling one share in November of 1987, additional recapture of the 1984 investment tax credit would be triggered to the extent of $990.140

C. Passive Investment Income

The law prior to 1983 contained a harshly technical and often criticized termination provision which was triggered by the realization of excessive "passive investment income" by a subchapter S corporation. Pursuant to former section 1372(e)(5), a corporation could inadvertently lose its subchapter S status simply by having passive investment income in excess of 20% of its gross receipts for the taxable year. The principal rationale adduced for this severe penalty was to prevent individuals from incorporating their investment activities primarily for the purpose of implementing qualified pension and profit-sharing plans. But as pointed out by the staff of the Joint Committee on Taxation, whose recommendations for the most part were enacted by the Subchapter S Revision Act of 1982, this rationale became much less valid.

140. The additional recapture amount is calculated as follows. $5,000 (original ITC reported in 1984) x 60% (the recapture percentage for ACRS recovery property disposed of after two years of being placed in service, I.R.C. § 47(a)(5)(B)) x 33% (percentage of Ms. Jones stock ownership disposed of since the equipment was placed in service and which had not previously been subject to ITC recapture).
141. This restriction . . . led to much grief for taxpayers. Because corporations . . . had difficulty controlling their gross receipts and because of ambiguities in the definition of "passive investment income" 1372(e)(5) had been a leading cause of inadvertent terminations and litigation. Many corporations shun[ned] the use of subchapter S at least in part because of the restrictions on passive income.
J. Eustice & K. Kuntz, supra note 24, para. 4.6[1].
142. Although the definition of passive investment income under I.R.C. § 1362(d)(3)(i) ("gross receipts derived from royalties, rents, dividends, interest and sales or exchanges of stock or securities") is similar to the definition of "personal holding company income" under I.R.C. § 543(a), there are several differences in the applicable tests under the two provisions. For a detailed discussion of the six types of gross receipts which are considered passive investment income items under I.R.C. § 1362(d)(3)(D) (1982), see id., para. 4.6.
after the passage of the Tax Reform Act of 1969 when Congress restricted the use of qualified plans by imposing, on contributions to such plans by shareholder-employees, limitations which were similar to those levied on contributions to the self-employment retirement plans (Keogh Plans) of partners and sole proprietors.\footnote{145}

In light of the 1969 alignment of the qualified retirement plans available to shareholder-employees holding more than 5\% of the outstanding stock of an S corporation with those available to partners in a partnership, the two revisionary proposals preceding the Subchapter S Revision Act of 1982 both recommended that the passive investment income limitation be abandoned.\footnote{146} Unfortunately, the Treasury Department disregarded its 1969 agreement to support the “complete elimination of the passive investment income test [after] the American Bar Association agree[d] to support the limitation on retirement plan benefits . . . for subchapter S [corporations]”\footnote{147} and pressed to have the 20\% limitation on passive investment income retained under the 1982 Revision if the election was made by a corporation which had accumulated earnings and profits.\footnote{148} The issue was hotly debated;\footnote{149} and ultimately,

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\footnote{145} The Joint Committee on Taxation stated:

[T]his reason appears to have been substantially reduced with the imposition by the Tax Reform Act of 1969 of the H.R. 10-type of limitation on contributions made for an employee holding more than 5 percent of the subchapter S corporation’s stock. Because subchapter S income is taxed currently to the shareholders, the allowance of passive investment income does not subvert the purposes of the personal holding company provisions.

Furthermore, the passive investment income limitation has caused a number of inadvertent terminations of elections, as well as a substantial amount of litigation as to what constitutes passive investment income. Controversy exists as to whether the term passive investment income includes interest and rents which are earned in the active conduct of a trade or business (e.g., interest of a small loan company or produced from rents of an active production company). Elimination of this restriction would remove much uncertainty, reduce litigation, and prevent terminations of subchapter S elections. Staff of Joint Comm. on Taxation, 96th Cong., 2d Sess., Recommendations for Simplification of Tax Rules Relating to Subchapter S Corporations 11 (1982).


\footnote{148} Id. at 72-75, 85-87 (testimony of David Glickman, Dept. Asst. Sec. of the Treas. for Tax Legislation).

\footnote{149} One will look in vain through the legislative history of subchapter S, as amended, to find a satisfactory explanation of why restrictions and penalties are still imposed on S corporations with subchapter C accumulated earnings and profits that realize proportionately high passive income. The abusive scenario advanced by the Treasury Department is that without restraints, individuals would be encouraged to incorporate a business
COMMENT

Congress adopted a milder and more narrow disincentive than that imposed by former I.R.C. § 1372(e)(5).

enterprise under subchapter C to benefit from the relatively favorable corporate income tax rate. The shareholders through their control of the corporation would not declare dividends but rather reinvest the earnings and profits into corporate assets and thereby shelter the corporate income from additional and usually higher individual income tax rates. The corporation would realize steady growth and prosperity and after some degree of success, the shareholders holding low basis stock would convert the corporation's accumulated earnings and high basis operating assets into investment assets and then elect subchapter S status. Although the corporation would recognize gain or loss on the sale of its assets, the shareholders would not, and by consenting to the S election, the shareholders could enjoy the fruits of the corporation's earlier earnings and profits without ever having been taxed on those amounts. During their lifetime the shareholders of the S corporation would receive the current income from the passive investments without the burden of a tax at the corporate level. They would also be able to defer the shareholder level tax on pre-election undistributed corporate earnings; then upon death, there would be a step-up in basis of the corporate stock, and consequently, the second tax on the earlier earnings and profits could be completely avoided.

Other than the fact that upon the election, an S corporation operates as a conduit resulting in a single tax being imposed on the investment income, would there be any difference in tax treatment under the above scenario between a non-electing C corporation and an S corporation? Mr. James Bridges and other witnesses testifying before the House of Representatives Ways and Means Committee properly pointed out that there would be no significant differences of the tax treatment under the two models. Id. at 296-98, 307-13. Should the fact that the S corporation's passive income is subjected to a single tax be determinative for implementing a passive income limitation? Arguably not, especially in light of the express objective of the 1982 Revision to simplify and expand the availability of the election. Why the emphasis in the above set of facts on the S corporation's assets generating investment income? If after the election, the corporation continues the active conduct of a trade or business, there is no “toll” charged on the conversion to the subchapter S corporation conduit concept. Why the distinction between a holding company and an operating business? With respect to this question, Mr. David Glickman, Deputy Assistant Secretary for Tax Legislation, Department of the Treasury, addressing the House of Representatives Ways and Means Committee could only respond:

"It is difficult to see a conceptual difference between the case where you sell all of your active assets and invest the proceeds in passive investments and the case where you continue to operate a going trade or business. Why should the going business be permitted to achieve pass through taxation without payment of tax while the corporation with passive assets cannot." (sic)

"Intellectually, I can't see why there ought to be a distinction, but at the same time, on balance, there does seem to be a problem in permitting corporations with accumulated E & P to elect subchapter C [S?] without payment of a tax. To some degree we are using the passive investment income test to avoid that problem, or at least to keep that problem from getting worse than it is under current law. Id. at 74 (emphasis added).

So, there is no rational basis for compelling a corporation that anticipates receiving substantial passive investment income to distribute all of its accumulated profits before making an S election to avoid the risk of penalty in the form of a tax and eventual termination of the election (I.R.C. §§ 1075, 1062) and not subjecting the S corporation generating primarily operating income to the same precondition. The distinction made in this regard is likely merely the result of the government's historic antagonistic attitude toward passive income.
Under the current law, a corporation’s subchapter S election will be jeopardized because of relatively high passive investment income only if it has subchapter C earnings and profits.\textsuperscript{150} Even then, the election will not be terminated unless the corporation fails to eliminate the subchapter C accumulated earnings account for three consecutive years, and during each of those three years, has passive investment income in excess of 25\% of its gross receipts.\textsuperscript{151} Therefore, even if an S corporation does have subchapter C earnings and profits, it need not be haunted with the fear that a miscalculation or a business downturn in a single year will cause the retroactive termination of its subchapter S status. The three consecutive year requirement has virtually eliminated any possibility of an inadvertent termination, but in the event of such a termination, the effect is prospective only.\textsuperscript{152}

As is readily apparent, the risk of termination under section 1362 is a fairly weak deterrent to a corporation with accumulated earnings from electing subchapter S status with the expectation of realizing significant passive income. Consequently, a second, more compelling disincentive was added to the Internal Revenue Code by the 1982 Revision. Section 1375 provides that a penalty tax shall be imposed on those S corporations which would have had their election terminated under 1362(d)(3) if not for the three consecutive year dispensation. If at the close of any taxable year, an S corporation has subchapter C earnings and profits and passive income in excess of 25\% of gross receipts, then a corporate tax will be levied at the highest corporate rate (currently 46\%) on the excess “net passive investment income.”\textsuperscript{153} “Excess net passive income” is defined by I.R.C. § 1375(b)(1) as the amount which bears the same ratio to “net passive income” (passive income reduced by the amount of allowable deductions directly connected with the production of that income) for the taxable year as the “excessive passive income” (that amount in excess of 25\% of gross receipts) bears to the “gross passive income” for the year. Expressed in mathematical terms, this formula may be more easily understood by the following equation:

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\]

Using simple algebra the unknown variable of excess net passive income may be ascertained as follows:

\textsuperscript{150} I.R.C. § 1362(d)(3)(B) (1982). The subchapter C earnings and profits may be acquired either prior to making the small business election or from another corporation after the election is made. See I.R.C. §§ 312 (h), 381(c)(2) (1982).
\textsuperscript{151} I.R.C. § 1362(d)(3)(A) (1982). To prevent the churning of assets, only the net capital gain from the disposition of capital assets (other than stock and securities) shall be considered in computing gross receipts. I.R.C. § 1362(d)(3)(c).
\textsuperscript{153} I.R.C. § 1375(a) (1982).
As with the tax on capital gains, the section 1375 tax on excess net passive income shall not exceed the tax that would have been imposed had no S election been in effect for the year. Section 1375 is further coordinated with section 1374 (the capital gains tax provision) by the fact that any net capital gains subject to the passive investment income tax will not also be considered in determining the capital gains tax under section 1374. In addition, as under section 1374(b), no nonrefundable tax credits may be used to reduce the penalty tax incurred under section 1375. Finally, section 1366(f) provides that as with net capital gains, each item of passive income allocated to the shareholders shall be reduced by their pro-rata share of the tax.

To avoid the headaches of having to monitor closely the amount of passive investment income as compared to gross receipts, it may be advisable to comply with the Service's avidity of eliminating the corporation's accumulated earnings and profits account prior to the making of the subchapter S election so that the passive investment income rules will not apply. In this regard it should be pointed out that there

\[
\text{E.N.P.I.} = \frac{\text{E.P.I.}}{\text{G.P.I.}} \times \text{N.P.I.}^{154}
\]

154. Consider the following set of facts: An S corporation with subchapter C earnings and profits had gross receipts for 1985 of $300,000 of which $110,000 was derived from rental income for which directly related expenses (allowable deductions) amounted to $10,000. Since the S corporation had subchapter C earnings and profits and investment income in excess of 25% of the gross receipts for the taxable year, it is subject to the "toll" tax of § 1375. The gross passive income equals $110,000, the net passive income equals $110,000 less the allowable deductions directly connected with the rental activities ($10,000) or $100,000; and the excess passive income equals the amount by which gross passive income ($110,000) exceeds 25% of the corporation's gross receipts ($300,000) for 1985 ($75,000) or $35,000. To determine the tax under section 1375, excess net passive investment income must be ascertained by using the equation in the text and multiplying that amount by 46%:

\[
\text{ENPI} = \frac{\$35,000 \times \$100,000}{\$110,000} = \$31,818
\]

Section 1375 tax = \$31,818 \times 46\% = \$14,636


156. I.R.C. § 1375(b)(1)(B) (1982). Therefore the tax under § 1375 may be reduced or eliminated if the corporation realizes a net operating loss for the taxable year, but the excess passive income will still be considered under § 1362(d) (1982) as one of the three consecutive years required for the termination of the election.


159. After the S election is made, the shareholders by unanimous consent may elect to have the subchapter C earnings and profits distributed to them without the distribution being deemed a distribution from the post-election accumulated adjustments account. I.R.C. § 1368(e)(3) (1982).
is no *de minimis* rule under the current law comparable to former I.R.C. § 1372(e)(5(B),\textsuperscript{160} so that even a slight miscalculation of the ratio of passive income to operating income will result in the application of the passive investment income penalty tax provision.

**Taxes Imposed on the Shareholders of an S Corporation**

**A. Prior Law**

With the exception of the limited applicability of the special capital gains tax designed to penalize "one-shot" subchapter S elections made for the purpose of capital gains tax avoidance, the subchapter S corporation was exempt from all federal income taxes under the law prior to 1983.\textsuperscript{161} The income earned by the electing small business corporation was taxed to the shareholders as dividends in the year earned either at the time of the distribution\textsuperscript{162} or, to the extent not distributed during the taxable year, at the corporation's year end.\textsuperscript{163} Except for net capital gains, various tax preference items, and certain tax credits, the taxing of the corporate income to the shareholders as dividends resulted in a filtering conduit tax structure by which the net corporate income or loss was passed through to the shareholders but without the coalescence of the tax character of the specific items (e.g., charitable contributions and tax exempt income) which comprised such taxable income or loss.

**B. Current Law**

As under the prior law, an S corporation is primarily a tax reporting rather than a tax paying entity. No federal income taxes are imposed at the corporate level of an S corporation other than the four special and relatively easily avoided corporate taxes discussed *supra*.\textsuperscript{164} The shareholders of an S corporation must report their proportionate share of income or loss on their individual income tax returns.\textsuperscript{165} But in keeping with the objective of aligning the income tax provisions of subchapter S with those of subchapter K, individual items of income and loss pass through to the shareholders in the same general manner as partnerships.\textsuperscript{166} Consequently, a subchapter S corporation's taxable income is computed

\textsuperscript{160} The passive income limitation under the prior law did not apply during the first or second year in which a corporation engaged in the active conduct of any trade or business, provided its passive income for the year was less than $3,000.

\textsuperscript{161} Former I.R.C. § 1372(b)(1) (1976).

\textsuperscript{162} Treas. Reg. § 1.1372-1(a)(2), (7) (1960).

\textsuperscript{163} Former I.R.C. § 1373 (1976).

\textsuperscript{164} I.R.C. § 1363(a) (1982). The fourth tax is the section 58 corporate minimum tax discussed *supra* in conjunction with the capital gains tax at notes 126-29 and accompanying text.

\textsuperscript{165} I.R.C. § 1366 (1982).

\textsuperscript{166} I.R.C. § 1366(b) (1982).
under rules similar to those applicable to partnerships under I.R.C. § 703, except that S corporations may amortize organization expenditures under section 248.\textsuperscript{167}

\textbf{C. The Conduit Concept More Fully Realized}

Since the purpose of the subchapter S rules is to permit small business corporations to elect to be treated as “pass-through” entities,\textsuperscript{168} section 1366 was added to effect that purpose. It provides that the income and expenses of an S corporation are to be divided into two categories, items that are separately stated, and items comprising a nonseparately computed income or loss account. Items of income, loss, deduction, or credit that could affect the tax liability of the shareholders\textsuperscript{169} are stated separately on schedule K-1 (Form 1120S) and thereby are passed through to the shareholders pro-rata on a per-share, per-day basis as if the items were realized or incurred directly by the individual shareholders.\textsuperscript{170} The items which must be separately stated by the S corporation are generally the same items which must be separately reported by the individual taxpayer (i.e., for an individual, a separate line item on Form 1040). Separate pass through items include, but are not limited to:\textsuperscript{171} (1) capital gains and losses, (2) section 1231 gains or losses, (3) dividends received that qualify for the section 116 dividend exclusion,\textsuperscript{172} (4) charitable contributions (no longer subject to the 10% subchapter C limitation of section 170(a)(2)), (5) tax exempt income and nondeductible expenses, (6) foreign taxes, (7) all credits (except the section 39 credit for certain uses of various petroleum products), (8) intangible drilling and development costs, (9) investment interest expenses, (10) foreign income or loss, (11) the section 179 deduction, (12) recoveries of bad debts, prior taxes, or delinquency amounts, and (13) the amount of an S corporation’s discharged debts.

The remaining items of income and deductions (such as gross receipts from the sale of goods and the cost of goods sold) which are not affected by the other tax considerations or circumstances of the individual taxpayer, are then netted together according to the rules applicable to

\textsuperscript{167} I.R.C. § 1366(b)(3) (1982).
\textsuperscript{170} I.R.C. §§ 1366, 1363 (1982).
\textsuperscript{172} If an S corporation is a shareholder of another corporation, it shall be treated for such purposes as an individual (I.R.C. § 1371(a)(2) (1982)); thus, the Code provisions which pertain to corporate shareholders (such as the section 243 dividends received deduction), will not be applicable.
individuals\textsuperscript{173} as "nonseparately computed income or loss."\textsuperscript{174} This amount, and the separately stated items, are allocated to the shareholders on a pro-rata basis as defined by section 1377(a).

**Distributions**

**A. Prior Law**

Under the pre-1983 subchapter S provisions, tax ramifications for both the corporation and the shareholder with respect to corporate distributions were determined by the application of a complicated and ponderous modification of the subchapter C distribution rules. Although the general concept of section 301 with respect to taxing corporate distributions first as dividends to the extent of earnings and profits, then as a reduction of the shareholder's basis in his stock ownership and thirdly as capital gains, was sought to be retained, the hybrid nature of the subchapter S corporation necessitated the adoption of numerous "special rules\textsuperscript{175} relating to distributions. The difficulty and incongruity of this overlay of special subchapter S rules on top of general subchapter C distribution concepts manifested itself by making the character of subchapter S corporate distributions contingent upon a number of factors, including: whether there was a cash or noncash distribution, the extent of current earnings and profits, the extent of pre-election accumulated earnings and profits, at what time during the corporation's taxable year the distribution was made, whether there had been changes in ownership of the corporate stock, and whether there had been a termination of the subchapter S election.

These considerations required a seven-tier analysis to determine the nature of cash distributions\textsuperscript{176} in a subchapter S corporation. Pursuant to this analysis, distributions of money had the following tax consequences (assuming a sufficient stock basis) in the following order of priority:

1. Distributions made during the first two and one-half months of the corporation's taxable year were considered as distributions of the prior year's earnings (assuming the corporation had a

\textsuperscript{173} As with partnerships under I.R.C. § 703 (1982), no deduction is allowable for personal exemptions, net operating losses (such losses are passed through to the shareholders to the extent of their adjusted basis), the zero bracket amount, medical and dental expenses, expenses for the care of certain dependants, alimony, and personal moving expenses. In addition, the special rules relating to corporate preference items under section 291 do not apply to S corporations.


\textsuperscript{176} The tax implications of distributing non-cash items differed greatly from those resulting from the distribution of money. Although the analysis was different the rules were equally complex and extensive. See J. Eustice & K. Kuntz, supra note 24, ch. 10.
subchapter S status during the prior year as well), and therefore were not taxed to the extent that the prior year's taxable income had not been distributed.

(2) Additional cash distributions made during the taxable year were considered dividends to the extent of the corporation's current earnings and profits (without considering any accelerated depreciation or cost recovery deductions under section 312(k)).

(3) Distribution in excess of current earnings were considered to be made from the previously taxable income (PTI) account, and no additional tax was imposed on such amounts.

(4) The fourth priority distribution was from current earnings and profits attributable to accelerated depreciation or cost recovery deductions under section 312(k), which was taxed as ordinary dividend income.

(5) If the corporation had accumulated earnings and profits (usually left over from those years in which the corporation did not operate under subchapter S), and if the election under Regulation § 1.1375-4(c) was not made, then cash distributions in excess of the undistributed subchapter S earnings would have been considered as made from this account as an additional taxable dividend.

(6) If prior distributions had depleted all of the corporation's earnings and profits then, to the extent of a shareholder's stock basis, additional distributions to him were tax free.

(7) Any distributions in excess of a shareholder's stock basis were treated as a gain from the disposition of corporate stock (i.e., usually capital gain).

177. The prior year's taxable income was referred to as "undistributed taxable income" (UTI) by former I.R.C. § 1373 (1976); this amount would have already been allocated to the shareholders as an imputed dividend at the corporation's year end.


180. Due to the fact a subchapter S corporation was not a true conduit under the prior law, current earnings were not always consistent with the corporation's taxable income; e.g., tax exempt income would reduce the current taxable year's income but not current earnings and profits. Nevertheless the shareholders would be taxed as receiving dividends to the full extent of current earnings and profits despite the lower taxable income amount.

181. Previously taxable income consisted of the accumulation of undistributed taxable income amounts which had been taxed to the shareholders in prior years without having been actually distributed.


183. Former I.R.C. § 1377(d) (1976) and the Treasury Regulations thereunder.


185. I.R.C. § 301(c)(2) (1982).

Due to the complex nature of the pre-1983 subchapter S distribution scheme, which created many acknowledged "traps for the unwary," Congress passed the Subchapter S Revision Act of 1982, extensively revising and simplifying the distribution rules to generally conform with the provisions of subchapter K. Consistent with the concept that an S corporation is for the most part a tax reporting entity, it will no longer be considered as generating earnings or profits that are taxable as dividends to the shareholders upon distribution. Rather, since income and expense items are passed through and taxed to the shareholders at the corporation's year end, a distribution to the shareholders is considered merely as a tax-free return of capital to the extent of the shareholders' bases in their stock without regard to the time of year the distribution was made, whether it was a cash or non-cash distribution, or any of the other factors considered under the prior law. Any distributions in excess of a shareholder's basis in the stock will be treated as a gain on the sale or exchange of property (i.e., capital gain unless the corporation is collapsible under section 341).

Although an S corporation will no longer generate earnings and profits, it may nevertheless have accumulated earnings and profits, carried over from (1) taxable years for which the election was not in effect, (2) taxable years prior to 1983 for which the election was in effect, or (3) a corporate acquisition that results in a carryover of earnings and profits pursuant to section 381. Distributions of these subchapter C and pre-1983 subchapter S earnings and profits will be taxed to the shareholders as dividends within the meaning of section 316.

An S corporation for which the small business election has been in effect since before 1983 will likely have to maintain three separate earnings accounts: (1) an accumulated earnings and profits account,
(2) a previously taxed income (PTI) account carried over from pre-1983 taxable years, and (3) an accumulated adjustments account (AAA) which is essentially the aggregate of the S corporation's undistributed post-1982 taxable income as defined by section 1368(e)(1). The distributions of the above earnings accounts will be deemed to occur in the following order:¹⁹⁴

1. A nontaxable return of capital to the extent of a shareholder’s interest in the accumulated adjustments account. The AAA is adjusted in a fashion similar to the manner in which adjustments of the shareholder’s basis in his corporate stock are made, except that no adjustments are made for tax-exempt income or for nondeductible expenses not properly chargeable to a capital account (e.g., illegal payments under section 162, or investment tax credit recapture of pre-election acquisitions of section 38 property).¹⁹⁵

Furthermore, redemptions which are

¹⁹⁴. Section 1368(e)(3) was added to the revised subchapter S provisions by the Technical Corrections Act of 1982 (Pub. L. No. 97-448, § 305(d)(2), 96 Stat. 2365, 2399-2400). It provides that by unanimous consent of all “affected shareholders” (i.e., those to whom distributions were made during the taxable year), an S corporation may elect to treat part or all of a distribution as dividends from accumulated earnings and profits without having to first deplete the accumulated adjustments account. Therefore, the amendment permits an S corporation to distribute its accumulated earnings and profits and thereby eliminate the risk of the passive investment income tax (I.R.C. § 1375 (1982), discussed supra), without compelling the corporation to first distribute all of its post-election earnings needed to meet the business demands of the corporation. See H. Conf. Rep. No. 986, 97th Cong. 2d Sess. 22 (1982), reprinted in 1982 U.S. Code Cong. & Ad. News 4203, 4210, which states:

The House amendment also allows subchapter S corporations to elect to treat distributions as dividends. This will allow a corporation to distribute its earnings and profit: to avoid the passive income restrictions, or to obtain a dividend paid deduction for the accumulated earnings tax or personal holding company tax for the year prior to becoming a subchapter S corporation. It will thus not be necessary to distribute the entire amount in the accumulated adjustment account at the end of the taxable year in order to pay a dividend. The procedure for checking dividend treatment will generally be similar to the procedure of prior law (Treas. Reg. sec. 1.1375-4(a) (1960) allowing distributions out of earnings and profits to be made prior to distributions of previously taxed income).

¹⁹⁵. As explained by IRS Publication 587, Tax Information on S Corporations 11 (1984), an S corporation must maintain an AAA regardless of whether or not the corporation was in existence prior to the enactment of the Subchapter S Revision Act of 1982. The AAA begins with a zero balance on the first day of the corporation’s taxable year that begins after 1982 (i.e. January 1, 1983 for pre-1983 calendar year subchapter S corporations) for which the subchapter S election was in effect (referred to as the “S period” by section 1368(e)). The AAA is then adjusted each year by the corporation’s taxable income as defined by § 1363(b) and then reduced by any distributions attributed to the account.

Even though a reduction of a shareholder’s basis below zero is prohibited under section 1367(a)(2), section 1368(e)(1)(A) requires the AAA to be adjusted “in a manner similar to the adjustment [made] under 1367.” IRS Publication 589 provides that an AAA can have negative balance if the post 1982 deductible expenses have been in excess of the undistributed accumulated gross income for that period. The publication further provides that income in later years will result in a positive balance “only after the negative balance has been restored.”
treated as an exchange under sections 302(a) or 303(a) require a proportional reduction in the AAA.\textsuperscript{196}

(2) If a shareholder has any previously taxed income (PTI) retained in the S corporation from pre-1983 taxable years, it is deemed to be distributed tax free after his interest in the accumulated adjustment account has been exhausted.\textsuperscript{197}

(3) Any subchapter C or pre-1983 subchapter S accumulated earnings and profits are then taxed to the shareholder as a dividend to the extent of his interest in such earnings, subject to the limited benefit of the section 116 dividend exclusion since such earnings and profits had been previously taxed to the corporation.\textsuperscript{198}

Once the shareholder’s interest in all three of the corporation’s earnings accounts has been exhausted, then any additional distribution will be considered a nontaxable reduction of the basis in his corporate stock. Finally, if the corporate distribution exceeds the shareholder’s tax basis in his corporate stock, the excess amount is taxable to him as a gain from the sale or exchange of property (i.e., capital gains treatment unless the corporation is collapsible).\textsuperscript{199}

C. Property Distributions

Under the pre-1983 subchapter S provisions, distributions of corporate property were taxed differently to the shareholders than distributions of cash. Generally, such distributions required the application of relevant subchapter C provisions.\textsuperscript{200} A hybrid tax structure thereby resulted, with many pitfalls for subchapter S corporate shareholders. One adverse tax consequence of non-cash distributions was that such distributions did not reduce the taxable income of the corporation for purposes of calculating undistributed taxable income; thus, if only non-cash distributions were made during the taxable year, the shareholders would be required to report as dividend income not only the property received to the extent of its fair market value, but also their proportionate share of the corporation’s taxable income for the year, undiminished by the non-cash disbursements.\textsuperscript{201} A second shortcoming of property

\textsuperscript{196} I.R.C. § 1368(a)(1)(B) (1982). For example, if the AAA is $100,000, a redemption of 250 of 1000 outstanding shares will decrease the AAA by 25% ($25,000). This rule follows the analysis of section 312(e) for determining what portion of a section 302(a) or 303 redemption is considered a return of capital.


\textsuperscript{198} Id.

\textsuperscript{199} Id.

\textsuperscript{200} Treas. Reg. § 1.1372-1(c) (1960).

\textsuperscript{201} Former I.R.C. §§ 1373 (b) and (c) (1976).
distributions, which was related to the first, was that former section 1375(f) provided that only disbursements of money could qualify for the two and one-half month throwback rule which considered distributions made during the first two and one-half months of a corporation's current taxable year as being disbursements of the prior year's undistributed taxable income. A third major drawback was that non-cash distributions were not considered as tax-free distributions of previously taxed income.

The 1982 Revision substantially eliminated the dichotomy between distributions of money and distributions of other corporate property. As with cash distributions, non-cash distributions are considered a mere reduction of the shareholder's investment in the corporation. The distributions are tax-free to the extent of the shareholder's stock basis and taxable as a sale or exchange of property to the extent of any excess. But there is some doubt as to the continued validity of Treasury Regulation § 1.1375-4(b) with regard to pre-1983 previously taxable income (PTI) and whether such amounts still can only be distributed in the form of cash payments. Given the obvious policy objective of treating cash and non-cash distributions similarly under the 1982 Revision, it would be consistent to allow PTI to be distributed in the form of money or other corporate property. The Internal Revenue Service, however, has maintained in its private letter rulings that "the regulations and revenue rulings published under subchapter S of the Code prior to its amendment by the Subchapter S Revision Act of 1982 . . . , where not inconsistent with the new law, are still in effect," and will likely conclude that since Congress did not take an express position directly adverse to Treasury Regulation § 1.1375-4(b) in either the 1982 Act or in its legislative history, it is still valid.

Although under the 1982 Revision the tax consequences to the shareholders will generally be the same whether a cash or non-cash distribution is made, the tax ramifications will differ at the corporate level depending upon the type of disbursement made. Section 1363(d) provides that with respect to the distribution of appreciated property, gain shall be recognized by the subchapter S corporation in the same manner as if the property had been sold at its fair market value and therefore requires the recognition of capital gain and any recapture of previously recognized tax benefits. The amendment of section 1363(d)

205. See e.g., P.L.R. 8422052.
206. Since section 1363(d) is applicable only to distributions of appreciated property, it is likely that the analysis of § 311(a)(2) will continue to apply to disallow the recognition of any loss regarding distributions of property for which the fair market value has declined below its adjusted basis in the hands of the S corporation.
has proven to be the harbinger of what became a general repudiation by Congress in 1984\textsuperscript{207} of the General Utilities\textsuperscript{208} doctrine which held that the distribution of appreciated property to its shareholders was a nontaxable event for the corporation. Section 1363(e), which was added by the Tax Reform Act of 1984, however, makes it clear that the gain recognition provision of 1363(d) was not intended to apply to distributions of appreciated property made in complete liquidation of the corporation or distributions of property made pursuant to section 354, 355, or 356 reorganizations.\textsuperscript{209}

**Shareholder’s Tax Basis and the Recognition of Corporate Losses**

As with an investment in a C corporation, a shareholder’s initial tax basis in an S corporation’s stock is dependent upon the manner in which the stock is acquired (e.g., purchase, gift, inheritance). However, subsequent adjustments of an S corporation shareholder’s stock basis essentially conform with the rules provided for partnerships under section 705. Pursuant to section 1367, a shareholder’s basis in an S corporation’s stock is adjusted by all items of corporate income and expense, regardless of their tax character. In other words, a shareholder’s basis in the stock of the corporation is increased by taxable \textit{and} nontaxable items of income and decreased by deductible \textit{and} nondeductible expenses. A shareholder’s


\begin{quote}
The committee believes that under a double-tax system, the distributing corporation generally should be taxed on any appreciation in value of any property distributed in a nonliquidating distribution. For example, had the corporation sold the property and distributed the proceeds, it would have been taxed. The result should not be different if the corporation distributes the property to its shareholders and the shareholders then sell it. Furthermore, if the shareholder is a corporation, present law generally permits gain on distribution property to be deferred, until the shareholder sells it. The committee generally believes that deferral to be inappropriate.
\end{quote}

\begin{quote}
Under the bill, gain (but not loss) is generally recognized to the distributing corporation on any ordinary, non-liquidating distribution, whether or not it qualifies as a dividend, of property to which subpart A (secs. 301 through 307) applies as if such property had been sold by the distributing corporation for its fair market value rather than distributed. The general rule applies whether or not there is a redemption of stock.
\end{quote}


\textsuperscript{208} General Utilities & Operating Co. v. Commissioner, 296 U.S. 200 (1935).

stock basis is then further reduced by any distributions\textsuperscript{210} treated as nontaxable returns of capital as contemplated by section 1368.

The adjustment of basis due to corporate expenses reflects one of the major advantages of a subchapter S election; that is, the ability to pass through corporate net operating losses to its shareholders who are then able to deduct their pro-rata share of such business losses on their individual tax returns. The ability of a shareholder to recognize his proportionate share of corporate losses is, however, limited to the amount of his investment in the corporation.\textsuperscript{211} A shareholder's investment in an S corporation for purposes of recognizing corporate net operating losses is considered by section 1366(d) to consist not only of the shareholder's equity interest in the corporation, but also the extent of his adjusted basis in any indebtedness of the S corporation owed to the shareholder himself.\textsuperscript{212} But it is only after a net operating loss has reduced a shareholder's stock basis to zero (but not below zero) that his indebtedness basis is diminished (but not below zero).\textsuperscript{213}

Under the prior law once the shareholder's basis in stock and debt was reduced to zero, he could no longer share in any additional corporate losses, and since there was no carryover provision, such unrecognized losses were forever lost.\textsuperscript{214} The Subchapter S Revision Act of 1982 eliminated this harsh result by adopting the partnership rule\textsuperscript{215} that allows an indefinite loss carryover for any loss or deduction not recognized by a shareholder due to an insufficient investment basis.\textsuperscript{216} Section 1367(b)(2)(B) further provides that when the corporation becomes profitable, the net income will first be applied to restore the shareholder's basis in the corporate indebtedness to him. This is a significant improvement over the prior law which permitted only the restoration of the shareholder's stock basis and not his indebtedness basis, thereby resulting in the recognition of income rather than the mere repayment of principal upon the discharge of the indebtedness by the corporation.\textsuperscript{217}

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\textsuperscript{210} Unlike what is provided for partnerships under §§ 705 and 733, non-cash property distributions by an S corporation to its shareholders are treated as a nontaxable return of capital and reduces the shareholders' stock bases to the extent of the fair market value of the property received, rather than to the extent of its adjusted basis to the tax reporting entity. This result is consistent with section 1363(d) which requires the recognition by the corporation of any gain on the distribution of appreciated property and the corresponding step-up in basis of the property to the fair market value in the hands of the receiving stockholder.


\textsuperscript{212} I.R.C. § 1367(b)(2)(A) (1982).

\textsuperscript{213} Id.

\textsuperscript{214} Treas. Reg. § 1.1374-1(b)(3) (1960).


\textsuperscript{216} I.R.C. § 1366(d)(3) (1982).

\textsuperscript{217} Former I.R.C. § 1376(a) (1976) provided for increases in basis of "stock" only. In addition if section 1232(a) was not applicable (e.g., the repayment if an open account), then the resulting gain was ordinary income and not capital gains. See Cornelius v. Commissioner, 587 T.C. 417 (1972), aff'd, 494 F.2d 465 (5th Cir. 1974); and Smith v. Commissioner, 487 T.C. 872 (1967), aff'd, 424 F.2d 219 (9th Cir. 1970).
One of the distinct advantages of an S corporation is that, as a corporation, its shareholders are only liable to the extent of their investment in the enterprise. Consistent with the notion of limited personal liability, the shareholders of an S corporation, unlike partners of a partnership, may not increase the basis of their ownership interest for the purpose of recognizing corporate losses by the amount of general corporate indebtedness because they are not "at risk" for corporate liabilities incurred in excess of their investment. However, this reasoning does not support the diverging treatment of basis adjustments between partners and S corporation shareholders when the individual investors are secondarily liable with respect to the entity's indebtedness. A partner is able to increase his basis in the partnership by his allocable share of recourse loans and, although generally subject to the "at risk" limitations of section 465, by his allocable share of non-recourse loans as well. Yet the jurisprudence is well-settled that an S corporation shareholder may not increase his basis as a result of third-party indebtedness incurred by the corporation, even if he personally guarantees such loans. The explanation typically advanced to support this dis-

219. I.R.C. § 1367(b)(2) (1982). The Tax Court in Klein v. Commissioner, 75 T.C. 298, 303 (1980) articulated this rationale: [The limitation of section 1367(b)(2)] is one of the at risk limitations appearing throughout the Code . . . designed to ensure that a taxpayer should not be able to deduct a loss in excess of that which he actually bears. In subchapter S, the "at risk" limitation denies a shareholder the net operating loss flow-through in excess of his investment in the corporation . . . in recognition that the corporate shield protects him from sustaining a financial loss beyond this amount.
222. Perry v. Commissioner, 47 T.C. 159 (1966), aff'd, 392 F.2d 458 (8th Cir. 1968) held that a shareholder guarantee of a third party loan to the corporation does not constitute "indebtedness of the corporation to the shareholder" as contemplated by section 1367(b)(2) (former section 1374(c)(2)(B)). The legislative history of former section 1374(c)(2) indicates that the deductible net operating loss of a shareholder was limited "to the adjusted basis of the shareholder's investment in the corporation; that is, to the adjusted basis of the stock in the corporation owned by the shareholder and the adjusted basis of any indebtedness of the corporation to the shareholder." S. Rep. No. 1983, 85th Cong. 2d Sess. 220, reprinted in 1958-3 CB 922, 1141.

In the second Perry v. Commissioner decision, 54 T.C. 1293 (1970), aff'd, 27 AFTR 2d 1464, 71-2 U.S.T.C. ¶ 9502 (8th Cir. 1971), the tax court construed the foregoing committee report language as indicating an intent on the part of the committee, to limit adjustments in a shareholder's debt basis to the "actual economic outlay" of the shareholder. Citing Horne v. Commissioner, 5 T.C. 250 (1945), the court went on to state: "The rule which we reach by this interpretation is no more than a restatement of the well-settled maxim which requires that 'Before any deduction is allowable there must have occurred some transaction which when fully consumated left the taxpayer poorer in a material sense.'" Id., at 1296. See also, Rev. Rul. 81-187, 1981-2 C.B. 167. See generally, the cases cited at note 139; J. Eustice & K. Kuntz, supra note 24, § 12.3[1] [b][vii].
tinction is that a partner will usually be taxed on the income used to repay partnership debts, where a profitable S corporation can terminate its election and then extinguish the shareholder-guaranteed debt from income that had not been taxed to the shareholder. But perhaps a more plausible explanation of why Congress did not expressly overrule the restrictive judicial interpretations of section 1367(b)(2) (former section 1374(c)(2)(B)) was a disinclination to extend the liberal basis adjustment rules available for partnerships when such provisions have induced the creation of many perceived abusive tax shelters.

Effectively, the only way for a shareholder to increase his debt basis in an S corporation is for him to be the actual lender of the corporate indebtedness in which case there can be no doubt that he is “at risk” for the amounts advanced. Consequently, if a shareholder desires to increase his debt basis to permit the recognition of corporate net operating loss in excess of his stock basis, it will likely require a two-step lending transaction by which he personally borrows the money from a financial institution and then contributes the proceeds to the corporation under a separate loan agreement. But what policy objectives are advanced by requiring such a burdensome and obviously artificial transaction?

223. J. Eustice & K. Kuntz, supra note 24, at 12.1 n. 5, 12.3(1)[a] n. 113.
224. The jurisprudence suggests only “direct loans” made by the shareholder to the corporation are contemplated by I.R.C. § 1367(b)(2) (1982) (from section 1374(c)(2)(B)) in calculating the basis for the net operating loss pass through. Frankel v. Commissioner 61, T.C. 343, 349 (1973), aff’d, 506 F.2d 1051 (3d Cir. 1974) citing Raynor v. Commissioner, 50 T.C. 762 (1968).
225. Assume the following set of facts: Mr. Smith and Ms. Jones are 50% shareholders of S corporation. Ms. Jones borrows $50,000 from Bank at a 10% rate of interest. She then turns around and lends the money to the corporation to help finance its operations. The following year S corporation has net income of $85,000, including interest payments on the Jones loan. What are the tax consequences to Ms. Jones assuming all corporate income and deductions are of an ordinary nature, (i.e. items not separately reported as contemplated by I.R.C. § 1366 (a)(2) (1982))? Income:
Pro rata share of S corporation’s income $42,500
Interest payments on $50,000 loan to S corporation $5,000
Gross Income received from S corporation $47,500
Deductions:
Interest payments on $50,000 loan from Bank $5,000
Net Increase of Ms. Jones’ reportable income due to her investment in S corporation $42,500

Contrast the above with the situation where S corporation borrows the money from the Bank and Ms. Jones personally guarantees it. What are the tax consequences to her now?
Income:
Pro rata share of S corporation’s income $42,500
Deductions None
Net Increase of Ms. Jones’ reportable income due to her investment in S corporation $42,500
By insisting on compliance with such seemingly irrational, technical preconditions, does the statutory provision and the interpretive jurisprudence accomplish anything more than the fostering of a general disrespect and frustration with regard to federal tax law?

The disparity between the treatment of entity indebtedness with respect to the investor's basis in the enterprise will generally mean that an S corporation will continue to be less attractive as a tax shelter medium than a general or limited partnership. The Subchapter S Revision Act of 1982, however, did mitigate the harshness of the former law by providing in section 1366(d)(2) that a shareholder's allocable share of corporate net operating losses in excess of his basis will no longer be permanently lost, but rather may be carried over to succeeding taxable years during which he regains an investment basis. Of course, if he sells his stock or the S corporation terminates while he still has a zero basis, he will be deprived of the benefit of the previously unrecognized losses.226

Why insist on a different result when the corporation has incurred a net loss and Ms. Jones stock basis has been depleted? Consider the same situation as above, but assume the corporation suffered a net loss of $85,000 and Ms. Jones' stock basis in the corporation is $37,500. What will be the tax effect to her if she had loaned the money to the corporation?

Income:
Interest payments on $50,000 loan to S corporation $ 5,000

Deductions:
Pro rata share of S corporation net operation loss $42,500
Interest payments on $50,000 loan from Bank 5,000

$47,500

Effective loss with respect to Ms. Jones' investment in S corporation $42,500

Reportable loss:
Stock basis $37,500
Debt basis 5,000

Ms. Jones will therefore be able to fully recognize her allocable share of S corporation's net operating loss. But what is the result if she had only guaranteed a $50,000 loan made to S corporation?

Income:

Deductions:
Pro rata share of S corporation net operating loss $42,500

Effective loss with respect to her investment in S corporation $42,500

Reportable loss:
Stock basis $37,500
Debt basis (Perry v. Commissioner) None

The $5,000 unrecognized loss, however, may be carried forward pursuant to section 1366(d)(3) and deducted in a future period in which she re-establishes an adequate basis either by the corporation generating sufficient net income or by investing additional funds into the corporation (debt or equity) or if she is required to honor her guarantee on the $50,000 corporate loan. But why the variation from the partnership rule?

Nevertheless, section 1366(d)(2) has been described as "one of the most important single features of the Subchapter S Revision Act," and if a shareholder has personally guaranteed a corporate debt and is then called upon to honor the guarantee, the payment of the debt to the third party transfers the debt from the original creditor to the shareholder and thereby increases his debt basis in the corporation under section 1367(b)(2)(B), and thus, to the extent of this increased basis, he may recognize previously disallowed losses pursuant to section 1366(d)(3).

Revocation and Termination of the Election

Revocation

Under the law prior to 1983 a curious contrariety existed whereby a voluntary revocation of a subchapter S election required the unanimous consent of the persons who were shareholders on the day of the revocation, but a new shareholder of a corporation (one who obtained his interest after the initial election), no matter how negligible his acquired interest, could terminate the small business election simply by affirmatively refusing to consent to the election on or before the sixtieth day after he acquired the stock. A more sensible design regarding the revocation of a small business election was therefore adopted by Congress in 1982. No longer may minority interest shareholders determine the fate of a small business election; rather, under section 1362(a) the revocation of a subchapter S election now merely requires the consent of the shareholders who hold a majority of the shares of the outstanding stock (including nonvoting stock) of the corporation at the time the


By no means is the position taken by the Treasury unassailable with respect to having to include nonvoting stock as well as voting stock in calculating the majority interest that must consent to an S election revocation. Section 1362(d)(1)(B) merely provides: "An election may be revoked only if shareholders holding more than one-half of the shares of stock of the corporation on the day on which the revocation is made consent to the revocation." The committee reports suggest that the "shares" contemplated by Congress in enacting section 1362(d)(1)(B) include only voting shares and not nonvoting shares: (1) "The bill provides that an election can be revoked by those shareholders holding a majority of the corporation's voting stock (as contrasted with the current rule which requires all shareholders to consent to a revocation)." H.R. Rep. No. 826, 97th Cong. 2d Sess. 2 (1982), S. Rep. No. 640, 97th Cong. 2d Sess. 2 (1982)(emphasis added); (2) "An election can be revoked only by shareholders holding more than one-half of the corporation's voting stock." Id., at p. 11 of both committee reports (emphasis added); (3) "A person becoming a shareholder of a subchapter S corporation after the initial election will not have the power to terminate the election by affirmatively refusing to consent to the election (unless that person owns more than one-half the voting stock)." Id., at p. 12 of both committee reports (emphasis added).
revocation is made. In addition, the substance of former 1372(e)(1) (regarding new shareholders) has been repealed by the new legislation. A shareholder who acquires his interest after the initial small business election will now be bound by the election unless, of course, he acquires more than fifty percent of the corporation's outstanding stock.233

The 1982 Revision also liberalized the rules with respect to the effective date of an election revocation. Under section 1362(d)(1)(C) (consistent with the retroactive election period) a revocation made during the first two and one-half months of a taxable year will be effective as of the first day of that taxable year. A revocation made thereafter will be effective on the first day of the following year. Section 1362(d)(1)(D) provides for a flexible exception to the above two general rules; that is, a revocation may specify a prospective date upon which the revocation is to be considered effective. If the prospective date results in a split taxable year, then section 1362(e), discussed infra, will apply.234

Termination

One of the principal objectives of the Subchapter S Revision Act of 1982 was to eliminate the risk of "unintentional violation of the continuing eligibility rules, resulting in a retroactive termination of elections."235 Accordingly, Congress re-evaluated the election termination events of the prior law and found the rationale for many to be lacking. As a result, Congress eliminated the ability of a single new minority shareholder to terminate an S election, the foreign income restriction, and for all practical purposes, the possibility of an inadvertent termination due to the realization of excessive passive investment income. Effectively, the only remaining events which will terminate a corporation's S election are those which disqualify its continued status as an eligible small business corporation within the meaning of section 1361(b). But even in this regard the eligibility criteria of a small business corporation, and thus the continued effectiveness of an S election, have been eased.

233. The rationale for the abandonment of the substance of former I.R.C. § 1372(c)(1) (Supp. V 1981) was pointedly explained by the Staff of the Joint Committee on Taxation:

It is believed that there is little or no justification for a new shareholder, who knows or should know he is acquiring stock of a subchapter S corporation, to have the power (described by some as blackmail power) to terminate that corporation's election. More appropriately, his acquisition of that stock should be viewed as consent to subchapter S treatment.

Staff of the Joint Comm. on Taxation, 96th Cong. 2nd Sess. Staff Recommendations for Simplification of Tax Rules Relating to Subchapter S Corporations 11 (1980).


235. Id., at p. 6 of both committee reports.
Although after considerable legislative debate\textsuperscript{236} the possibility of an election termination due to excessive passive investment income remains, the substance of the prior law has been significantly amended such that the likelihood of an unintentional loss of an S election because of the realization of passive income is extremely remote. Section 1362(b) provides that an S election will be terminated as a result of the realization of income from passive sources only if the corporation retains subchapter C earnings and profits and has passive income in excess of 25 percent of gross receipts for three consecutive taxable years. To eliminate any likelihood of the penalty tax (which is the true disincentive under the current law from realizing excessive passive income, see discussion supra) and the risk of the termination of the S election (however remote), it may be advisable for the corporation to distribute all of its subchapter C earnings and profits prior to making the election. If this is impracticable and it is likely the corporation will incur significant amounts of passive investment income in the future, then it is doubtful that an S election will provide the most advantageous taxing scheme for the corporation's shareholders.

With Congress deciding to deter a corporation with accumulated earnings and profits from making an S election and then realizing excessive amounts of passive investment income primarily through the imposition of a special tax, the only real risk of a statutorily imposed election termination that a corporation need now be concerned with is the occurrence of specific events which will cause the corporation to fail to satisfy the definitional requirements of a small business corporation. Accordingly, a corporation will lose its election on the date: (1) the thirty-sixth shareholder invests in the corporation;\textsuperscript{237} (2) stock of the corporation is transferred to a partnership, ineligible trust, nonresident alien, or another corporation;\textsuperscript{238} (3) a second class of stock is created;\textsuperscript{239} or (4) an operating subsidiary is acquired.\textsuperscript{240}

Unlike the prior law which required a retroactive application of subchapter C rules to the first day of the taxable year in which the S election terminating event occurred,\textsuperscript{241} section 1362(d)(2) provides that the termination will be effective on and after the date the corporation ceases to be a small business corporation. With the abandonment of the retroactive termination provisions which had resulted in the unintended benefit of shareholders being able to prevent the attribution of substantial amounts of corporate income of a particularly successful

\textsuperscript{236} See supra note 149.
\textsuperscript{237} I.R.C. § 1361(b)(1)(A) (1982).
\textsuperscript{238} I.R.C. § 1361(b)(1)(B) (1982).
\textsuperscript{239} I.R.C. § 1361(b)(1)(D) (1982).
\textsuperscript{240} I.R.C. § 1361(b)(2)(A) (1982).
year, section 1362(e) provides that there shall be a split tax year referred to as the S termination year. The day before the day on which the terminating event occurs is considered the last day of a short taxable year for which the tax treatment under subchapter S is available (the "S Short Year"), and the day of the termination is considered the first day of a short taxable year for which the tax provisions under subchapter C will apply (the "C Short Year"). The same rules will also apply with respect to the prospective voluntary revocation of an S election.

The corporation need not incur the administrative burden of closing the corporate books as of the termination date. Rather, unless otherwise elected, the corporation will wait until the year end and simply allocate the amount of income, loss, deduction, and credit items for the entire year between the S Short Year and the C Short Year on a pro rata basis. The corporation, however, with the consent of all persons who were shareholders of the corporation at any time from the first day of the taxable year through the date on which the termination event occurred, may elect to have all items of income, loss, deduction, or credit reported and assigned to each short taxable year under "normal tax accounting rules." Under this approach, items will be allocated between the two short taxable years according to the time they were realized or incurred as reflected on the books and records (including work papers) of the corporation.

As under the prior law, if a corporation's small business election is revoked or statutorily terminated, a new election may not be made, without the consent of the Internal Revenue Service, for five taxable years.

Inadvertent Terminations

To further minimize what was perceived under the former subchapter S provisions as "traps for those not knowledgeable about its technical
provisions,247 particularly with respect to an “unintentional violation of the continuing eligibility rules,”248 Congress enacted section 1362(f), which instructs the Commissioner of the Internal Revenue Service to waive the effect of an inadvertent termination, provided he determines that certain preconditions have been satisfied. To take advantage of section 1362(f), the corporation must satisfactorily demonstrate to the Internal Revenue Service: (1) the termination resulted from the corporation’s ceasing to qualify as a small business corporation or by reason of the realization of excess passive investment income;249 (2) the termination was inadvertent;250 (3) the corporation took steps to correct the terminating condition within a reasonable time after its discovery;251 and (4) the corporation and the persons who were shareholders during the period of termination agree to be treated as if the event had never occurred.252

Congress clearly indicated that the Service should be tolerant regarding the application of section 1362(f) in disregarding inadvertent election terminations by good faith taxpayers. As expressed within the Finance Committee Report, it is intended that the “Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment.”253

248. Id.
252. I.R.C. § 1362(f)(4) (1982). This may require adjustments to be made with respect to the termination period which the Internal Revenue Service determines to be necessary for the consistent treatment of the corporation as an S corporation.

The committee report goes on to state:
In granting a waiver, it is hoped that taxpayers and the government will work out agreements that protect the revenues without undue hardship to taxpayers. For example, if a corporation, in good faith, determined that it had no earnings and profits, but it is later determined on audit that its election terminated by reason of violating the passive income test for three consecutive years because the corporation in fact did have accumulated earnings, if the shareholders were to agree to treat the earnings as distributed and include the dividends in income, it may be appropriate to waive the terminating events, so that the election is treated as never terminated. Likewise, it may be appropriate to waive the terminating event when the one class of stock requirement was inadvertently breached, but no tax avoidance had resulted. It is expected that the waiver may be made retroactive for all years, or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.
Subchapter S as Compared With Subchapter K: Has Equality Under the Internal Revenue Code Been Achieved?

The Economic Recovery Tax Act of 1981\(^\text{254}\) provided significant across the board tax relief for the American taxpayer. In addition to reducing the marginal income tax rates for individuals, it also lowered the maximum individual income tax rate from 70% to 50%, only slightly in excess of the 46% maximum tax rate imposed upon C corporations. Then in 1982, the advantages of corporate qualified retirement plans over the benefit plans available to self-employed individuals and subchapter S shareholder-employees were virtually eliminated by the Tax Equity and Fiscal Responsibility Act of 1982.\(^\text{255}\) It was in light of this legislative activity that many commentators after the enactment of the Subchapter S Revision Act of 1982 were prompted to proclaim that subchapter S status had become a far more attractive taxation alternative than under the prior law.\(^\text{256}\) A practitioner, however, in contemplating which of the various taxation schemes would be the most advantageous for his client, may find the perceived attractiveness of the subchapter S election to be illusory and may even terminate pre-1983 subchapter S elections after the expiration of the various transitional rules of the Subchapter S Revision Act of 1982 (e.g., the five-year grandfather exception pertaining to established fringe benefit plans of S corporations for which the small business election was in effect as of September 28, 1982).\(^\text{257}\)

In simplifying the rules and eradicating some of the pitfalls of the prior law, the Subchapter S Revision Act of 1982 also eliminated some of the former tax planning opportunities. No longer may shareholders defer the recognition of income for more than three months by selecting a corporate taxable year different from their own without establishing a business purpose to the satisfaction of the Internal Revenue Service. Secondly, an S corporation may no longer take advantage of the former retroactive election termination provisions to prevent the pass through to its shareholders of a substantial amount of corporate income realized during a particularly successful year. Thirdly, S corporation shareholders may no longer shift the recognition of their allocable portion of corporate income to another taxpayer by selling or otherwise disposing of their stock prior to the corporation’s year end. Lastly, the several statutory exemptions for fringe benefits available to shareholder-employees of C corporations will no longer be available to S corporation shareholder-

\(^{254}\) P.L. 97-34, 97 Stat. 172.
employees who own more than two percent of all outstanding corporate stock or more than two percent of the voting stock of the corporation.\footnote{258}{I.R.C. § 1372 (1982). A "2-percent shareholder" of an S corporation is now treated the same as a partner of a partnership.}

Partly as a consequence of the elimination of the above tax planning opportunities, a more logical and less perilous tax structure has been established under subchapter S. The question remains, however, how viable of an alternative is it to operating as a partnership? Although the intent of enacting and later revising subchapter S of the Internal Revenue Code was to permit small businesses to incorporate and yet be taxed as partnerships, Congress has still failed to fully realize this policy objective. There remain numerous tax advantages in operating a business as a partnership rather than as an S corporation even after the Subchapter S Revision Act of 1982. The non-tax privileges of operating in the corporate form, as bridled by the restrictions of subchapter S, will in many instances be an insufficient counterpoise to warrant the small business corporation election.

To qualify for subchapter S status the eligibility requirements of I.R.C. § 1361(b) must be satisfied. No such restrictions are imposed on partnerships which may have unlimited owners of whatever type (e.g., corporations, foreign individuals and legal entities, trusts and other partnerships), and they are not limited in their ability to control or be controlled by other legal entities.\footnote{259}{I.R.C. §§ 761 and 7701(a)(2) (1982).} A limited partnership even offers the advantage of limited personal liability for those investors who are unwilling to accept the financial exposure of being a general partner.\footnote{260}{La. Civ. Code art. 2840 (Supp. 1985); Treas. Reg. §§ 301.7701-2(d), 301.7701-3(b) (1967), T.D. 7515, 42 F.R. 55612 (1977).} In fact, the unattractiveness of unlimited personal liability may be overcome entirely through the use of a limited partnership in which the sole general partner is a viable corporation.\footnote{261}{Treas. Reg. § 7701-2(d)(2), T.D. 7515, 42 F.R. 55612 (1977) prohibits the general partner of a limited partnership being a mere "dummy" acting as the agent of the limited partners."} Of course, a limited partnership has its disadvantages: the limited partners are prohibited from participating in the management of the enterprise,\footnote{262}{La. Civ. Code arts. 2843, 2844 (Supp. 1985).} and its status as a partnership is always subject to being challenged by the IRS as being an association taxable as a corporation.\footnote{263}{Treas. Reg. § 301.7701-2, T.D. 7515, 42 F.R. 55612 (1977); T.D. 7889, 48 F.R. 18804 (1983).} These disadvantages, however, may be more theoretical than practical. An individual investor may have neither the time nor inclination to participate in the management of the enterprise, especially if he merely desires "mail-box" income or a tax shelter. If he is concerned with the day-to-day operations of the small business, then although his liability will be limited with respect to any
delictual claims brought against the S corporation, it is likely that any lender (especially in light of the significant lending losses and bank failures in recent years due to questionable lending practices) will insist upon the availability of his personal wealth as security for any advances made to the enterprise regardless of its legal form. Furthermore, of the four general non-tax characteristics associated with a corporation, as many as two may usually be present in a partnership before it will be reclassified as an association. Consequently, to realize the tax advantages available to partnerships but not to S corporations, the investors in a limited partnership need only sacrifice the corporate characteristics of the perpetuation of the entity's existence and the free transferability of ownership interests, which they may very well be willing or even desirous of doing, particularly with respect to limiting the transferability of ownership interests in a closely held business venture.

In general, an S corporation and a partnership can be capitalized tax-free; however, the rules applicable to S corporations are more onerous. To incorporate assets tax-free under section 351, the transferors of property to a C corporation (including an S corporation) must meet the 80% control requirement of section 368(a) immediately after the exchange of the assets for the corporation's stock. As the corporation attracts new investors, this limitation will usually preclude subsequent contributions of appreciated property to the corporation from qualifying as a tax-free exchange. Furthermore, transfers of debt encumbered property to a corporation in exchange for stock or other securities in the corporation are subject to the limitations of section 357. Under section 351, the shareholder will be taxed to the extent that the encumbrance exceeds his basis in the contributed property, but he may even be compelled to recognize the full extent of the transferred indebtedness as a taxable gain if the principal purpose of having the corporation assume the liability was tax avoidance or if the assumption was not motivated by a bona fide business purpose. In contrast there is no control requirement for the nonrecognition of gain by a partner contributing appreciated property to a partnership. Furthermore, a contribution of encumbered property to a partnership which assumes the liability is considered a cash distribution by the partnership to the contributing partner causing no gain recognition unless the indebtedness exceeds the basis of his partnership interest.

266. I.R.C. § 357(c) (1982).
269. I.R.C. § 752(b) (1982).
Once a partnership has been capitalized, the federal tax provisions relating to the recognition or nonrecognition of income, loss, and various credits by its partners are generally more favorable than under the approach adopted for S corporations. An S corporation on an accrual method of accounting cannot deduct items of income and interest owed to cash-method shareholders owing two percent or more of the stock of the corporation until such items are actually paid.\textsuperscript{271} There is no comparable restriction on a partnership which reports its taxable income on an accrual basis. Secondly, although both partners and S corporation shareholders may deduct their allocable share of the losses sustained at the entity level to the extent of their ownership interest (basis) in the enterprise, an S corporation shareholder's basis is not increased by any corporate indebtedness incurred unless he was the actual lender of the corporate debt (i.e., a personal guarantee of corporate indebtedness is irrelevant).\textsuperscript{272} In contrast, a partner, even a limited partner, will increase his basis in the enterprise by his allocable share (based upon the partnership's profit-sharing ratio) of any nonrecourse liabilities incurred by the partnership, and general partners will further increase their basis in the partnership by their loss-sharing, proportionate interest in any recourse partnership indebtedness.\textsuperscript{273} Furthermore, subchapter S does not permit the flexibility in allocating certain taxable income items among the owners that is available to partnerships under subchapter K.\textsuperscript{274} All allocations of the taxable income items of an S corporation to its shareholders must be made on a per-share, per-day basis,\textsuperscript{275} while a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) is determined in accordance with the terms of the partnership agreement as confected on the due date of the partnership.

\textsuperscript{271} I.R.C. § 267(f) (1982).


\textsuperscript{273} I.R.C. §§ 722, 752(a) (1982); Treas. Reg. § 1.752-1(e) (1960) provides that a limited partner's share of partnership liabilities may not exceed the difference between his actual capital contribution to the partnership and the total contribution which he is obligated to make under the partnership agreement, however if none of the partners have any personal liability for a particular partnership debt, then they will be considered as sharing such liability with the general partners according to their profit sharing ratios.

Although a partner's basis may be increased under section 752 by his proportional interest in partnership liabilities, the amount of loss he may deduct in a current taxable year is subject to the "at-risk" limitations of section 465. A partner is only considered "at-risk" for those partnership liabilities incurred for which he is personally liable or for which he has pledged personal property (but only to the extent of the fair market value of such property) as security (i.e., recourse indebtedness). I.R.C. § 465(b) (1982). However, the "at-risk" rules do not apply to real estate ventures nor to section 1245 equipment leasing by closely-held businesses. It is for this reason, that in the vast majority of cases, the limited partnership will remain the preferred entity for real estate syndications.

\textsuperscript{274} This is particularly true because of the one class of stock limitation of section 1361(b)(1)(D).

\textsuperscript{275} I.R.C. §§ 1366(a), 1377(a)(1) (1982).
return, limited only by the requirement that the allocations have "substantial economic effect."\(^\text{276}\)

One of the planning advantages afforded to partnerships due to this ability to make special allocations of taxable income and deduction items and thereby shift potential tax benefits to those partners who are better able to fully utilize them (subject of course to the scrutiny of the IRS) is the ability to eliminate the inequity which would otherwise result as a consequence of the owners contributing property with differing tax attributes. This is accomplished by the application of section 704(c) which requires the partners of a partnership, pursuant to regulations to be prescribed by the Treasury Department, to make special allocations of depletion, depreciation, and gain or loss with respect to contributed property for which there is a disparity between its carryover basis to the partnership and its fair market value at the time of contribution.\(^\text{277}\) This can be a particularly significant feature where one partner desires to contribute appreciated property to the enterprise, but his co-owners refuse to share the potential tax liability of the pre-contribution appreciation which will be realized upon a subsequent disposition of the asset by the partnership. No similar mechanism is available under subchapter S to adjust for pre-contribution appreciation value of property contributed by the various shareholders in a tax-free capitalization of the corporation.

The greater flexibility provided by the partnership model is also evident in the various elections which are available under subchapter K but not under subchapter S. Section 754 authorizes a partnership to elect to adjust the basis of partnership assets as a result of either a sale or exchange,\(^\text{278}\) or transfer at death,\(^\text{279}\) of an ownership interest in the enterprise or as a result of a distribution of property by the partnership to one or more of its partners.\(^\text{280}\) This election enables an owner of a newly acquired partnership interest to have the basis of partnership assets adjusted to correspond with his basis in the partnership; and thereby, for purposes of gain or loss, depreciation, depletion and earnings distribution, reflect his true investment in the partnership rather than that of his transferor.\(^\text{281}\) In addition, where the partnership makes a

\(^{276}\) I.R.C. §§ 704(a), 704(b), 761(c) (1982).

\(^{277}\) Prior to the Tax Reform Act of 1984, section 704(c) was an elective provision; it is now mandatory.

\(^{278}\) One of the advantages of an S corporation as compared to a partnership is that upon the sale or exchange of shares of stock in a non-collapsible S corporation, the transferor will recognize a capital gain (loss). A partner, on the other hand, desiring to sell or exchange his interest in a partnership must recognize ordinary income to the extent of his interest in the partnership's section 751 property (i.e. unrealized receivables and substantially appreciated inventory) prior to the transfer.

\(^{279}\) I.R.C. §§ 754, 743 (1982).


\(^{281}\) The adjustment of partnership assets applies to the transferee partner only.
distribution to a partner who recognizes a gain or which causes the partner's basis in the distributed property to be less than the partnership's adjusted basis therein immediately prior to the distribution, then the section 754 election will cause the partnership's adjusted basis in its remaining assets to be increased. This affords potentially greater depreciation deductions and smaller taxable gains (or greater deductible losses) upon disposition by the partnership of its remaining assets. A comparable basis adjustment election is not available under the rigid framework of subchapter S which, unlike subchapter K, does not even permit the deferral of gain recognition upon a nonliquidating distribution of appreciated property to its shareholders.282

Distributions made in complete redemption of an ownership interest further demonstrate the rigidity of subchapter S as compared with subchapter K. When an S corporation redeems stock of one of its shareholders at a price in excess of his basis in the stock, the shareholder will generally recognize a capital gain unless the corporation is collapsible. Redemption of a collapsible corporation's stock results in the recognition of the entire gain as ordinary income, with no corresponding deduction to the corporation.283 The provisions under subchapter K, however, provide the partners of a partnership with greater flexibility in structuring the retirement of an ownership interest. Under the rather complex rules of section 736, a retiring partner, upon the liquidation of his ownership interest, could either recognize no gain or loss, a capital gain or loss, an ordinary gain or loss with a corresponding deduction to the partnership, or any combination of the above, depending upon such factors as the particular assets of the partnership at the time of redemption, the retiring partners' allocated share of those assets (in particular stated or unstated goodwill), what partnership assets were distributed to the liquidating partner, the terms of the partnership agreement, and the payment terms (e.g., guaranteed or not) of the redemption.

Counterbalancing the above redemption disadvantage are the reorganization and liquidation rules under subchapter C, made applicable to S corporations and their shareholders by section 1371. These rules generally provide a more malleable set of alternatives for electing or terminating subchapter S status than exist under subchapter K for converting an enterprise to or from a partnership framework. The transition from an eligible small business C corporation to an S corporation is made simply by filing the election under section 1362(a) which may be rescinded at a later date by a mere majority vote of the affected shareholders. Other than the disallowance of carryforwards and carrybacks between electing and non-electing taxable years,284 no significant tax consequence at the corporate level occurs as a result of the election

284. I.R.C. § 1371(b) (1982).
or its rescission. On the other hand, because the conversion from an S corporation to a partnership is accomplished only by the liquidation of the corporation rather than by a nonrecognition election, such conversions precipitate various tax ramifications and considerations not present when the corporate structure is maintained. Secondly, an S corporation may avail itself of the tax-free reorganization provisions of sections 354, 355, and 356 without any recognition of gain on the transfer of appreciated assets or the termination of the S election, provided that after the reorganization is completed the S corporation is not a member of an affiliated group and none of its stock is held by another corporation. Thirdly, the various liquidation options under subchapter C, part II, are applicable to S corporations contemplating dissolution. Under these provisions no gain or loss will be recognized by the S corporation upon its complete liquidation. The tax consequences to its shareholders will depend upon which liquidation alternative is selected.

In comparison to their corporate counterparts, the partnership merger and division rules have been described as a "pallid and primitive edifice." No longer will the section 1031 like-kind exchange rules apply to exchanges of interests in different partnerships, rather an exchange

285. As explained by Professor Eustice:

[T]his transaction (1) triggers installment sale gain, depreciation and investment credit recapture, and income recognition under the assignment of income and tax benefit doctrines; (2) eliminates its accumulated earnings or deficit; (3) purges its other tax history items (for example, suspended loss carryovers from pre-election C years); and (4) results in a new basis for the corporation’s distributed properties. Eustice, Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Proposals), 39 Tax L. Rev. 345, 390 (1984) (footnotes omitted).

286. I.R.C. § 1363(e) (1982). The Internal Revenue Service has indicated that where as part of a plan of reorganization an S corporation acquires a subsidiary (and thereby becomes a member of a prohibited affiliated group) or distributes its stock to the target corporation, its subchapter S status will not necessarily be terminated for having a corporate shareholder if, pursuant to the plan of reorganization, the transferor corporation liquidates and distributes the assets of stock acquired from the S corporation to its shareholders. Rev. Rul. 73-496, 1973-2 CB 312; Rev. Rul. 72-320, 1972-1 CB 270; and Rev. Rul. 69-566, 1969-2 C.B. 165. The service appears to have arbitrarily set a 30-day time limit within which the acquired corporation must be terminated. Rev. Rul. 73-496, 1973-2 CB 312; P.L.R. 8228099 (April 16, 1982).

287. Typically, the shareholders will recognize a capital gain or loss on the liquidating distribution in an amount equal to the difference between the fair market value of the property received and their adjusted stock basis. I.R.C. § 331 (1982). The shareholders may, however, prefer the tax deferral treatment of the one-month liquidation method under section 333, in which case they need only immediately recognize as ordinary income their distributive share of the corporation’s pre-election accumulated earnings and profits and, as capital gains, any remaining realized gain to the extent they receive cash, stock and securities in excess of their ratable share of the corporation’s accumulated earnings and profits.


COMMENT

of partnership interests will be treated as an "exchange of interests in the assets of the respective organizations and the applicability of section 1031 [will] be determined on the basis of those exchanges." 290 Consequently, the only remaining statutory guidance under subchapter K with respect to mergers and divisions of partnerships is the limited provision found in section 708(b)(2)(A) which provides that where two or more partnerships merge or consolidate into one partnership, the resulting partnership is considered as a continuation of only that partnership whose members own an interest of more than 50% in the capital and profits of the consolidated partnership while the other merging partnerships are considered as having been terminated. 291 Secondly, although subchapter K does not offer the flexibility of the various liquidation alternatives available to corporations, the general nonrecognition of capital gain or loss by the partners upon the receipt of liquidation distributions (unless such distributions are disproportionate or are made in cash in excess of a partner's basis in his partnership interest) 292 will often be more favorable than any of the liquidation approaches available under subchapter C, which will usually require gain recognition to some extent. Thirdly, it is generally easier and less deleterious to incorporate a partnership on a section 351, tax-free basis, and then elect subchapter S status, than it is to convert an S corporation into a partnership.

Finally, under the revenue and taxation statutes of Louisiana, the taxation of partnerships is far more favorable than that of S corporations. Louisiana has yet to adopt the policy objective of permitting small, closely-held corporations to be taxed in a manner similar to partnerships, but rather compels corporations which have elected subchapter S treatment under the federal scheme to report their income and to pay taxes thereon as any other corporation. The nondistinction between S corporations and regular corporations by Louisiana makes S corporations the worst possible organizational form for purposes of paying state taxes. Not only must the corporation pay Louisiana corporate taxes at a maximum rate of 8% on income in excess of $200,000, 293 but its shareholders must also include their pro-rata share of such income on their individual income tax returns (whether distributed or not) because, under the federal "piggy back" tax scheme adopted by Louisiana, an individual's taxable income is directly tied to the amount of adjusted

gross income reported on his federal income tax return. Accordingly, an individual must in effect pay between four and eight percent more income tax for electing subchapter S status than if he operated under a partnership agreement. As the fiscal demands of the state for additional revenues increase, this perversion may become even more pronounced, since the Louisiana Legislature is constitutionally barred from raising the individual, but not the corporate, income tax rate schedules. Furthermore, the state of Louisiana imposes additional taxes and fees on corporations (again with no distinction made for S corporations) which are not levied on partnerships (e.g., incorporation taxes, fees and charges under LA R.S. 12:171, and the corporate franchise tax which was doubled in the past year from $1.50 to $3.00 on each $1,000 of owner's equity retained in the corporation). These charges further diminish the appeal of an S corporation election.

CONCLUSION

Despite the fanfare following the passage of the Subchapter S Revision Act of 1982 for its simplification of the use of S corporations and for its narrowing of the major differences in tax consequences between partnerships and S corporations, significant distinctions between the two concepts remain in the Internal Revenue Code as well as in the Louisiana Revised Statutes. The Subchapter S Revision Act of 1982, however, should alter a practitioner's perspective as to the most advantageous use of the subchapter S election. With the loss of various planning opportunities available under the prior law, a practitioner's more aggressive and sophisticated clients will likely choose the flexibility of a partnership over the rigidity of an S corporation in organizing a business enterprise, while other clients may prefer the certainty, ease of administration, and limited liability of incorporating and then filing a subchapter S election to derive the benefits of a conduit tax entity.

In any event, the determination of the most appropriate business form will of course depend upon the facts and circumstances of the particular case, and it will often require an amalgamation of various entities to satisfy the needs and demands of the various investors (e.g., using S corporations as individual partners in a general or limited partnership to realize the flexibility of the partnership form while protecting the individual investors from unlimited liability). Finally, the preferred form of organization will likely change with the evolution of a closely-held business. During the initial years of operation when losses

294. La. R.S. 47:290-99 (Supp. 1985). An individual's Louisiana tax table income (the amount upon which his income tax is determined) is the adjusted gross income reported on his federal tax return with minor adjustments (e.g., less federal excess itemized deductions and federal income taxes). La. R.S. 47:293(5) (Supp. 1985).
are expected, the owners of the enterprise will typically desire to have such losses allocated to them and the selection of a partnership form of conducting business will usually be desirable to permit the adaptable allocation of such losses among its owners. As the business becomes profitable, the partners will likely incorporate under a section 351, tax-free capitalization, as a C corporation to take advantage of the lower corporate income tax rates if retention of earnings within the corporation is desired for the continued growth of the business and if the business is able to make deductible distributions of income (e.g., salaries) to its owners. Then when the desired plateau of success is achieved and accumulations of earnings (and the potential penalty tax thereon) becomes a concern, a transition back to a tax conduit, either a partnership or an S corporation, depending upon the circumstances, may be advisable.

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