

CORPORATE ELECTIONS UNDER SUBCHAPTER S[†]

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INTRODUCTORY

Over the years, there have been many suggestions that the Internal Revenue Code be amended to permit (or require) the shareholders of closely-held corporations to be taxed as though they were carrying on their activities as partners, *i.e.*, relieving the corporation from taxation on condition that each stockholder report his share of the corporation's income, whether distributed to him or not, on his individual income tax return. Such a proposal was passed by the Senate in 1954 to permit "small corporations which are essentially partnerships to enjoy the advantages of the corporate form of organization without being made subject to possible tax disadvantages of the corporation" and to "eliminate the influence of the federal income tax in the selection of the form of business organization which may be most desirable under the circumstances." The 1954 proposal was eliminated by the conference committee; but the idea was revived in 1958 and enacted into law as Subchapter S of the Internal Revenue Code (§§ 1371-77), for the announced purposes of allowing businesses to select their legal forms free of undue tax influence, aiding small business by taxing the corporation's income to shareholders who may be in lower brackets than their corporations, and permitting the shareholders of corporations that are suffering losses to offset the losses against individual income from other sources.¹

The principal features of Subchapter S, which will be discussed in detail hereafter, are these:

1. *Eligibility.* Subchapter S is applicable only to a "small business corporation," defined by § 1371(a) as a domestic corporation which does not have more than ten shareholders (all of whom must be either individuals or estates) or more than one class of stock. The corporation may not be a member of an affiliated group (as defined in § 1504, relating to the

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1. For the 1954 proposal, see S. Rep. No. 1622, 83d Cong., 2d Sess. 119 (1954); for the 1958 version, as enacted, see S. Rep. No. 1983, 85th Cong., 2d Sess. 87 (1958).

Although the 1954 proposal for permitting corporations to elect non-corporate treatment was not enacted, a companion provision allowing certain unincorporated businesses to elect to be taxed as corporations found favor in legislative eyes; but after a period of trial, it was found wanting, or unnecessary, and it was repealed in 1966.

privilege of filing consolidated returns) and it may not have a nonresident alien as a shareholder.

2. *Election.* A "small business corporation" becomes an "electing small business corporation," so as to bring Subchapter S into play, by filing an election, which is valid only if all shareholders consent. Once made, the election is effective for the taxable year for which it is made and for all succeeding taxable years, unless it is terminated (a) by the failure of a new shareholder to consent to the election, (b) by revocation, with the consent of all shareholders, (c) by disqualification (*e.g.*, acquisition of stock by a trust, corporation, or other ineligible shareholder, issuance of a second class of stock, etc.), (d) by the corporation's deriving more than eighty percent of its gross receipts from sources outside the United States, or (e) by the corporation's deriving more than twenty percent of its gross receipts from "passive investment income."

Once an election has been terminated or revoked, the corporation (and any successor corporation) is ineligible to make another election under Subchapter S for five years, unless the Treasury consents.

3. *Undistributed corporate income.* While the election is in effect, the corporation is not subject to the corporate income tax, the accumulated earnings tax, or the personal holding company tax; and the corporate income, whether distributed or not, is taxed to the shareholders. Not having been subjected to a tax at the corporate level, however, the income is not eligible for the dividend received exclusion in the hands of the shareholder. In the interest of simplicity, the income must be treated as ordinary income by the shareholder, without regard to any special characteristics it may have had at the corporate level, except that the excess of long-term capital gain over short-term capital loss is passed through to the shareholder. Since he is taxed on the corporation's undistributed income, provision is made for a later non-dividend distribution to him of this previously taxed income.

4. *Corporate losses.* If a corporation suffers a net operating loss for a year during which the Subchapter S election is in effect, it is passed through to the shareholders, each of whom may use his share of the loss (up to the aggregate basis of his investment in the corporation, in the form of stock or indebtedness) to offset his income from other sources. The excess of net operating loss over income from other sources, if any, may be carried back to prior years and forward to later years as though the loss had been incurred in his individual business. If the shareholder's pro rata share of the corporation's net operating loss exceeds his basis in the corporation's stock and indebtedness owed him, the excess is not allowable as a deduction for any taxable year.

5. *Adjustments to basis.* The shareholder's basis for his stock is increased to reflect the fact that he was taxed on his share of the corporation's undistributed income, and is decreased if this previously taxed in-

come is distributed to him. If the corporation suffers a net operating loss, the shareholder must reduce the basis of his stock (and, if necessary, of any corporate obligations he may hold) to reflect the fact that such loss has passed through to him for use on his individual tax return.

This rough summary of Subchapter S will be amplified in later pages, but it should be noted at the outset that the term "small business corporation" is misleading. The size of the corporation's income, assets, net worth, or other financial characteristics plays no part in determining its eligibility under Subchapter S; the only restriction of this type is that it may not have more than ten shareholders.² More important than labels, however, is the fact that an electing corporation remains a corporation—not only as a matter of state law, but also for many federal income tax purposes.³ This point cannot be over-emphasized, because it is often erroneously said that Subchapter S permits corporations to be treated as partnerships. In point of fact, there are many differences between a partnership and an "electing small business corporation." Even while the election is in effect, corporate redemptions, liquidations, reorganizations, and many other transactions are governed by the tax law applicable to corporations, rather than by the law of partnerships,⁴ and if the election is terminated, the corporate income tax will once again become fully applicable. Recognizing these facts, some commentators have sought to sum them up in a label—"pseudo-corporation," "conduit-corporation," and "hybrid corporation," to say nothing of more barbarous coinages like "corpnership" and "pseudo-type corporation." The authors prefer the more neutral terms "electing corporation" or "Subchapter S corporation," however, because they serve as a constant reminder that the corporation does not cease to be a corporation by electing to come under Subchapter S.⁵

2. Cf. Int. Rev. Code of 1954, § 1244 which defines a "small business corporation" in terms of its equity capital and the amounts received by it for stock, as contributions to capital, and as paid in surplus. This definition does not apply to Subchapter S.

3. Treas. Reg. § 1.1372-1(c) (1959) and see *infra* at 24.

In certain respects, the Subchapter S corporation is treated as a "conduit" and, therefore, it bears comparison with a number of other business and investment arrangements which are treated, to a greater or lesser degree, as conduits by other provisions of the Code, e.g., Subchapter K (partnerships); Subchapter J (trusts); §§ 551-58 (foreign personal holding companies); §§ 851-55 (mutual funds); §§ 856-58 (real estate investment trusts); and §§ 951-64 (controlled foreign corporations).

4. See *infra* at 24-26.

5. For discussions of Subchapter S, see Anthoine, *Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment*, 58 Colum. L. Rev. 1146, 1149-75 (1958); Caplin, *Subchapter S v. Partnership: A Proposed Legislation Program*, 46 Va. L. Rev. 61 (1960); Goodson, *Election to Tax Corporate Income to Shareholders*, 1959 So. Calif. Tax Inst. 75 (1959); Hoffman, *Let's Go Slow With Tax Option Corporations*, 37 Taxes 21 (1959); Horwich, *The Small Business Corporation*, 37 Taxes 20 (1959); Hrusoff, *Election, Operation and Termination of a Subchapter S Corporation*, 11 Vill. L. Rev. 1 (1965); Lourie, *Subchapter S after six years of operation: an analysis of its advantages and defects*, 22 J. Taxation 166 (1965); Lourie, *Subchapter S After Three Years of Operation*, 18 Tax L. Rev. 99 (1962); Meyer, *Subchapter S Corporations*, 36 Taxes 919

ELIGIBILITY TO ELECT UNDER SUBCHAPTER S

To make an election under Subchapter S, a corporation must be a "small business corporation," defined by § 1371(a) as a domestic corporation⁶ meeting the following conditions:

1. *Not more than ten shareholders.* The corporation may not have more than ten shareholders. The regulations provide that "ordinarily" the persons who would have to include the corporation's dividends in gross income are to be considered as shareholders, so that each joint tenant, etc. is "generally" to be considered as one shareholder.⁷ In 1959, § 1371(c) was added to provide that stock held by a husband and wife as joint tenants, tenants by the entirety, tenants in common, or community property is to be treated as owned by only one shareholder.⁸ This statutory change, dealing with a specific class of cotenants, seems to buttress the regulation's position (which, in proposed form, was promulgated before the statutory change) that each joint tenant and tenant in common is ordinarily a separate shareholder where they are not related as husband and wife. The regulations also provide that if stock is held by a nominee, agent, guardian, or custodian, the beneficial owner is "generally" to be treated as the shareholder; and that if stock is held by a partnership, the partnership and not its partners will be considered the shareholder.

2. *Individual shareholders (or estates) only.* All of the stock must be owned by individuals or estates; a corporation is ineligible to file an election under Subchapter S if any of its stock is owned by a trust, a partnership, or another corporation.⁹

(1958); Moore & Sorlien, *Adventures in Subchapter S and Section 1244*, 14 Tax L. Rev. 453 (1959); Nagel, *The Tax-Option Corporation*, 44 Taxes 364 (1966); Roberts & Alpert, *Subchapter S: Semantic and Procedural Traps in its Use; Analysis of Dangers*, 10 J. Taxation 2 (1959); Stein, *Optional Taxation of Closely Held Corporations Under the Technical Amendments Act of 1958*, 72 Harv. L. Rev. 710 (1959), which is continued in 3 Tax Counselor's Q., No. 2, 63 (1959).

6. Treas. Reg. § 1.1371-1(b) (1959) refers to Int. Rev. Code of 1954, § 7701(a)(3), thus including an "association" within the meaning of "corporation."

See J. Frentz, 44 T.C. 485 (1965) (no election until de facto corporate "existence" began).

7. Treas. Reg. § 1.137-1(d)(1) (1959).

8. This provision was made retroactive to 1958 and 1959, if the shareholders and corporation so elect, by § 23 of the Revenue Act of 1962.

9. If the grantor of a trust is "treated as the owner" of the corpus under Int. Rev. Code of 1954, §§ 671-77 because he has a power to revoke, etc., it is arguable that he rather than the trust is the shareholder for purposes of eligibility under Subchapter S; but Treas. Regs. § 1.1371-1(e) (1959) and § 1.1371-1(d)(1) (1959) explicitly reject this theory. These regulations also treat voting trusts on a par with other trusts, in spite of the fact that holders of voting trust certificates are considered the equitable owners of stock, and are thus deemed shareholders for tax purposes. See, e.g., *Commissioner v. National Bellas Hess, Inc.*, 220 F.2d 415, rehearing denied, 225 F.2d 340 (8th Cir. 1955); *Federal Grain Corp.*, 18 B.T.A. 242 (1929); see also, *Catalina Homes, Inc.*, 33 P-H Tax Ct. Mem. 1493 (1964).

As to stock held by a custodian under the Uniform Gifts to Minors Act, the Internal Revenue Service has ruled that the stock is owned by the minor, not by a trust. TIR-113 (Nov. 26, 1958).

Although estates are eligible shareholders, see generally *Old Virginia Brick Co.*, 44 T.C. 724 (1965), where an election was invalidated when the existence of

3. *One class of stock.* The corporation may not have more than one class of stock. The regulations state that a class of stock is to be counted for this purpose only if it is issued and outstanding, so that treasury stock or authorized but unissued stock of a second class will not disqualify the corporation. The term "class of stock" is not defined by the statute; the regulations state that if the outstanding shares "are not identical with respect to the rights and interest which they convey in the control, profits, and assets of the corporation," the corporation is considered to have more than one class. Despite, this, two or more "groups" of stock will be considered one "class" if they are identical in all respects except that each "group" has the right to elect members of the board of directors in a number proportionate to the number of shares in the group.¹⁰ The Service has ruled that a contractual agreement among the shareholders, requiring inactive shareholders to grant irrevocable voting proxies to the active shareholders, creates rights in the latter that are not identical with the rights of the inactive shareholders; and hence results in two classes of stock within the meaning of the above-quoted portion of the regulations.¹¹ This position has been criticized on the ground that the one-class-of-stock rule was enacted to avoid difficulties in allocating corporate income and loss among the shareholders, a problem that does not arise if the only differences among them relate to their relative voting power; and was intended to apply to differences created by corporate action only, not to differences created by shareholder agreements.

The regulations state that the term "stock" includes "stock which is improperly designated as a debt obligation." "Disguised" stock of this type would seem to disqualify the corporation, since it confers rights on the holders different from those created by their common stock, unless it can be totally disregarded under state law or viewed as evidence of a con-

an estate was terminated (because of unreasonably prolonged administration) and its stock passed to a trust.

For the disqualification of partnership-owned stock, see Rev. Rul. 235, 1959-2 Cum. Bull. 192.

10. Treas. Reg. § 1.1371-1(g) (1959). Cf. TIR-113 (Nov. 26, 1958), which states that one class exists where both Class A and Class B are outstanding and identical in all respects except that each class can elect one half of the board of directors. The regulation seem to take a narrower view in such a case, inasmuch as they require that the right to elect members of the board be limited to a number of board members proportionate to the number of shares in each group.

11. Rev. Rul. 226, 1963-2 Cum. Bull. 341. In addition to its holding on the facts the ruling provided:

In the event that the outstanding stock of a corporation is subject to any other type of voting control device or arrangement, such as a pooling or voting agreement or a charter provision granting certain shares a veto power or the like, which has the effect of modifying the voting rights of part of the stock so that particular shares possess disproportionate voting power as compared to the dividend rights or liquidation rights of those shares as compared to the voting, dividend and liquidation rights of the other shares of stock of the corporation outstanding, the corporation will be deemed to have more than one class of stock.

For criticism, see Note, *Shareholder Agreements and Subchapter S Corporations*, 19 Tax L. Rev. 391 (1964); see also Catalina Homes, Inc., 33 P-H Tax Ct. Mem. 1493 (1964).

tribution to capital, rather than as a separate class of stock. In *W. C. Gamman*, 46 T.C. 1 (1966), the Tax Court held that the regulation would be beyond the Treasury's authority if construed to require *all* "instruments which purport to be debt obligations but which in fact represent equity capital" to be treated as a second class of stock. It is necessary, the court held, to determine in each case whether the rights conferred on the "creditors" justify treating the obligations as a second class of stock; looking to "the realities of the situation," including the fact that the notes in question were held pro rata by the shareholders and that their formal terms were waived or ignored, the court held that the advances for which the notes were given "were simply contributions of additional capital which were in reality reflected in the value of the common stock already held by [the shareholders]." Although the decision curbs the scope of the regulation to some extent (sufficiently to cause five judges, who thought it was not "plainly inconsistent" with § 1371(a)(4), to dissent), the ultimately factual nature of the court's analysis means that shareholder-held debt will continue to cloud the status of electing corporations.¹²

4. *No nonresident alien shareholders.* The corporation may not have any nonresident alien shareholders. This restriction reflects the fact that the corporate income is exempt from tax under Subchapter S on the assumption that it will be subject to the graduated individual income tax rates, whereas only nonresident aliens are taxed under § 871(a)(1) at the flat rate of thirty percent.

5. *Not a member of an "affiliated group" under § 1504.* The corporation may not elect under Subchapter S if it is a member of an "affiliated group" defined by § 1504, relating to consolidated returns.¹³ The highly restrictive exception of § 1371(d) (enacted in 1964) for a sub-

12. In *Catalina Homes, Inc.*, *supra* note 9, it was held that shareholder open account advances to the corporation were preferred over no-par common stock and thus constituted a second class of stock, which disqualified the corporation from Subchapter S status. Treas. Reg. § 1.1371-1(g) (1959) speaks of an "instrument purporting to be a debt obligation," but the court seemed to attach no significance to the fact that the obligation was an open account debt. This possibility of transmuting debt into a second class of stock should be kept in mind when contemplating modes of avoiding the restrictions on distribution of previously taxed income, discussed *infra* at 21-24. See also *Henderson v. United States*, 245 F. Supp. 782 (M.D. Ala. 1965).

Catalina Homes was distinguished in *Gamman* on the ground that it assumed, rather than examined, the validity of the regulation.

See also *Burr Oaks Corp.*, 43 T.C. 635, 649 (1965), where the court treated promissory notes held by shareholders of the obligor corporation as preferred stock in applying § 351 because the holders occupied a preferred position vis-à-vis the holders of the common stock. The notes were held pro rata with the common by families, but not if shareholders were viewed individually.

13. When Subchapter S was enacted, the consolidated return provisions were amended to provide that an electing corporation was not an "includible corporation," with the result that a corporation that properly elected did not become disqualified by acquiring a subsidiary, even though such a subsidiary would have barred an election in the first place. This provision, § 1504(b)(8), was repealed by Pub. L. No. 376, 86th Cong., 1st Sess. § 1 (Sept. 23, 1959). Hereafter an election under Subchapter S will terminate if the corporation becomes a member of an affiliated group under Int. Rev. Code of 1954, § 1504.

sidiary that has not engaged in business and has no taxable income for a specified period, is designed to permit a Subchapter S election by a corporation that has subsidiaries in other states solely to protect its corporate name against appropriation.

6. *The election.* Rules governing the time and method of making the election and its effective date are prescribed by § 1372, which is amplified by Treas. Regs. §§ 1.1372-2 and -3. The election is made by the corporation, but all of the shareholders must consent. The regulations state that the consent of a minor shall be made by the minor himself, his legal guardian, or his natural guardian if no legal guardian has been appointed, and the Internal Revenue Service has ruled that this requirement is applicable even if the stock is held by a custodian.¹⁴ Failure to follow these mechanics with precision may vitiate an otherwise valid attempt to use Subchapter S; this hazard adds to the already large number of minor blunders that can generate substantial adverse tax consequences. See, for example, *William Pestcoe*, 40 T.C. 195 (1963), where late filing of the requisite forms, although perhaps excusable, prevented a valid election.

The regulations also state that a shareholder's consent may not be withdrawn once a valid election is made by the corporation, Treas. Reg. § 1.1372-3(a), a reasonable provision in view of the fact that § 1372(e) (2) permits a revocation of the election only if all of the shareholders consent.

Concern about the "one-shot" use of Subchapter S, especially in connection with corporate sales of assets, led to a statement in the proposed regulations, for which explicit statutory support is lacking, that a corporation may not make a Subchapter S election if it is in the process of complete or partial liquidation, has adopted a plan for such liquidation, or "contemplates" such action "in the near future." Proposed Treas. Reg. § 1.1372-1(a)(2). The final regulations, however, abandoned this position; and in *Hauptman v. Director of Internal Revenue*, 309 F.2d 62 (2d Cir. 1962), *cert. denied*, 372 U.S. 909 (1963) the Second Circuit treated this omission as a concession by the government that an election is not barred where bankruptcy is imminent. The court also found an implication to this effect in the fact that the statute allows a pass through of net operating losses and that such losses often lead to corporate liquidation. It held that "the likelihood that an otherwise qualifying corporation may be liquidated is not a factor that should be considered in order to justify a judicial restriction" on the right to elect Subchapter S.

TERMINATION OF THE ELECTION

Once made, an election under Subchapter S is effective for the taxable year of the corporation for which it is made and for all succeeding taxable years, unless it is terminated under § 1372(e) in one of the following ways:

14. Treas. Reg. § 1.1372-3(a) (1959); TIR-113 (Nov. 26, 1958).

1. *Non-consenting new shareholders.* New shareholders must consent to the election within the time prescribed by the Treasury under § 1372(e) (1). Under the regulations, the consent must be filed within the thirty-day period beginning on the day the person becomes a shareholder, with a limited extension of time for estates to permit the appointment of an executor or administrator.¹⁵ It is too early to say whether a sale or other transfer of an insignificant amount of stock for the sole purpose of introducing a non-consenting new shareholder will be effective.¹⁶ If it is every shareholder carries in his knapsack a formidable baton for use if he should wish to terminate the election. This in turn suggests an expansion of the typical shareholder buy-sell agreement to impose restraints on transfers of stock to non-consenting shareholders or to such unqualified shareholders as trusts and corporations.

2. *Revocation.* After the election has been effective for one taxable year, it can be terminated by a revocation under § 1372(e)(2). The revocation must be filed by the corporation, but all shareholders must consent.

The power to terminate the election by a revocation under § 1372(e)(2) is fundamental to tax planning in this area. It permits the shareholders to use Subchapter S to deduct a net operating loss incurred in the early years of a new venture or in a poor year for an older company, without permanently committing themselves to these provisions.¹⁷ Revoca-

15. Treas. Reg. § 1.1372-3(b) (1959). The statute provides that a termination shall be effective for the taxable year of the corporation in which such a person becomes a shareholder. The Service has ruled that the executor or administrator of a deceased shareholder, rather than his legatee or heir at law, is a "new shareholder" within the meaning of § 1372(e)(1) (relating to elections by "new shareholders"), if the stock is subject to his possession for purposes of administration, notwithstanding the fact that title to the stock passes directly to the legatees or heirs at law under applicable state law. Rev. Rul. 116, 1962-2 Cum. Bull. 207. See *Old Virginia Brick Co.*, 44 C. (1965), on the possibility that an election will terminate if the administration of an estate is unduly prolonged.

16. For an analogy, see *Commissioner v. Day & Zimmerman, Inc.*, 151 F.2d 517 (3d Cir. 1945). The regulations state with respect to the determination of shareholders in applying § 1373 (relating to "constructive dividends"), that a donee or purchaser, "is not considered a shareholder unless such stock is acquired in a bona fide transaction and the donee or purchaser is the real owner of such stock." Treas. Reg. § 1.1373-1(a)(2) (1959). But the regulations do foresee transfers late in the year, because just prior to the above-quoted portion they provide, "If stock is transferred on the last day of the taxable year of the corporation, the transferee (and not the transferor) will be considered the shareholder of such stock for the purposes of section 1373." The courts may look upon a transfer of this type with a jaundiced eye, in view of the fact that termination by revocation is available only if made during the first month of a taxable year and the consent of all shareholders is needed for a revocation of the election. Thus, they might hold that the non-consenting new shareholder is an agent of the old shareholder, imported to effect the termination; and treat the ploy as an invalid revocation. See *infra* note 25.

17. Since § 1372(e)(2) provides that a revocation is valid for the taxable year in which made only if made before the close of the first month of such taxable year, only an omniscient taxpayer can be sure that he is doing the right thing. The same is true of the election itself, since § 1372(c) requires it to be made in (or before) the first month of the taxable year for which it is to be effective.

tions also play a role in the use of Subchapter S by corporations realizing substantial capital gains (*e.g.*, on the sale of an industrial plant or other real estate) that are to be passed on to shareholders; although such arrangements were inhibited in some circumstances by the enactment of § 1378 in 1966.

3. *Disqualification.* The election is terminated under § 1372(e)(3) if the corporation ceases to be a "small business corporation" as defined by § 1371(a)—*i.e.*, by the acquisition of more than ten shareholders, a non-resident alien shareholder, or a shareholder who is not an individual or estate, or by the issuance of a second class of stock.¹⁸ On its face at least, § 1372(e)(3) terminates the election if a single shareholder transfers a single share of stock to an unqualified shareholder, even though the transferee be a corporation that is wholly owned by the transferor or, if Treas. Reg. § 1.1371-1(e) is valid, a paper-thin revocable trust. A decent respect for the legislative pattern, however, requires some restraint on such attempts to terminate the election by a meaningless gesture; otherwise, the requirement of unanimous consent for a voluntary revocation under § 1372(e)(2) is nullified.

4. *Foreign income.* The election is terminated under § 1372(e)(4) if in any taxable year the corporation derives more than eighty percent of its gross receipts from sources outside the United States. The term "gross receipts" is not defined by the Internal Revenue Code itself; but Treas. Regs. § 1.1372-4(b)(4) and (5)(ii) attempt a definition, with illustrations, and refer to §§ 861-864 of the Code for the meaning of the term "sources outside the United States."

5. *Passive investment income.* The election terminates under § 1372(e)(5) if in any taxable year more than twenty percent of the corporation's gross receipts constitute "passive investment income," defined to include gross receipts from royalties, rents, dividends, interest and annuities, and gains from the sale or exchange of stock or securities—*i.e.*, sources that are similar to, though not identical with, those that constitute personal holding company income under § 543(a). The purpose of this limitation is to restrict the use of Subchapter S to corporations having substantial amounts of "operating," as opposed to investment, income. Under an amendment enacted in 1966, however, the restriction is not applied to an electing corporation for the first or second taxable year of

18. In Rev. Rul. 94, 1964-1 Cum. Bull. 317, the Service ruled that a statutory merger of a Subchapter S corporation into a non-electing corporation does not terminate the former's election under § 1372(e)(3) with respect to its final taxable year ending on the date of the merger. The ruling is based on the theory that § 1372(e)(3) applies to a corporation which ceases to be a Subchapter S corporation by virtue of an event which does not terminate its taxable year; if the disqualifying event also terminates the Subchapter S corporation's taxable year, it remains a Subchapter S corporation throughout the taxable year so terminated. In Rev. Rul. 250, 1964-2 Cum. Bull. 333, the Service ruled that a reorganization under § 368(a)(1)(F) did not cause a termination of a Subchapter S corporation's election.

active conduct of a trade or business if its passive investment income is less than \$3,000; this relaxation of § 1372(e)(5) protects the election for a corporation in its initial years if, for example, its principal source of gross receipts is interest on bank accounts because normal operations have not gotten under way. This new rule can be applied retroactively to years beginning after 1962 if the shareholders so elect.

It should be noted that § 1372(e)(5) looks to the corporation's "gross receipts," rather than its "gross income," apparently to facilitate use of Subchapter S by corporations operating at a loss, which might be disqualified by the twenty percent requirement if gross income were the relevant standard (*e.g.*, where sales of inventory produce no gross income because the proceeds are less than the cost). "Gross receipts" is defined by Treas. Reg. § 1.1372-4 (b)(5)(ii) as the total amount received or accrued, depending on the corporation's method of tax accounting, from sales, services or investments. These amounts are not reduced by items of cost, returns and allowances, or other allowable deductions. However, the term does not include amounts received from non-taxable sales or exchanges (other than those to which § 337 applies), nor borrowed funds, repayments of a loan, or contributions to capital. In addition, the corporation's method of accounting controls the time when gross receipts are includible (*e.g.*, if the installment method of reporting gain is elected under § 453, payments actually received in a given year will constitute gross receipts for that year).

Although the term "passive investment income" as used in § 1372(e)(5) is similar to "personal holding company income" (indeed, before 1966, the latter term rather than the former was used), there are important differences in coverage. Thus, rents and royalties are includible in full in "passive investment income"¹⁹ even if they are excluded from "personal holding company income" as defined by § 543; conversely, income from personal services is excluded from § 1372(e)(5) even if included under § 543; and the use of the "gross receipts" standard by § 1372(e)(5) creates additional distinctions (*e.g.* tax-exempt interest is "passive investment income" though it is not "personal holding company income").²⁰ The inclusion of gross receipts from "rents" in § 1372(e)(5) bears special mention: Treas. Reg. § 1.1372-4(b)(5)(iv) distinguishes between passive rental income, and receipts from an active business where "significant services" are rendered to the lessee, which latter category is

19. See *United States v. 525 Co.*, 342 F.2d 759 (5th Cir. 1965), holding that receipts from a reserved oil payment were not included in § 1372(e)(5), although includible in "personal holding company income" under Treas. Reg. § 1.543-1(b)(11) (1958).

20. The treatment of life insurance proceeds, excludible by virtue of § 101, is less clear. The only example in Treas. Reg. § 1.1372-4(m)(5)(vii) (1959) relates to inclusion of amounts "received as an annuity," a statement which suggests that life insurance proceeds received at death would not constitute forbidden gross receipts under § 1372(e)(5). This issue will be important for electing corporations with shareholder-retirement agreements funded by life insurance.

not considered "rent." Thus amounts received from operating a hotel or motel, a warehouse storage business, or a parking lot do not constitute "rent" if significant services are rendered; on the other hand, where rental of space is the principal activity (*e.g.*, leasing of apartments, or offices in an office building), rental income would result.²¹ This "business versus investment" distinction in the case of rental income has numerous analogues in other provisions of the Code.²² Finally, it should be noted that statutory provisions creating "constructive" interest or dividend income in certain circumstances (*e.g.*, § 483, relating to imputed interest on the sale of capital assets, and § 78, providing for a gross up of dividends from some foreign corporations) may cause the unexpected loss of Subchapter S status for the unwary.

ELECTION AFTER TERMINATION

If an election is terminated or revoked under § 1372(e), the corporation may not make a new election for any year before the fifth taxable year beginning after the first year for which the termination or revocation was effective. This period of disqualification, which is equally applicable to any "successor corporation" of the electing corporation, may be shortened by the Internal Revenue Service under § 1372(f). The Code lays down no standards for the exercise of judgment under § 1372(f), but the regulations state (a) that the corporation has the burden of persuasion, (b) that a transfer of more than fifty percent of the stock to outsiders will "tend to establish that consent should be granted," and (c) that otherwise consent will ordinarily be denied unless the termination was involuntary so far as the corporation and its major shareholders were concerned. *Treas. Reg.* § 1.1372-5(a). A termination that might evoke favorable action by the government under § 1372(f) would be a transfer to a nonconsenting or ineligible shareholder by a minority shareholder in an effort to compel the others to buy him out.

The Internal Revenue Service is given no authority to mitigate the impact of § 1372(c)(1), which provides that an election must be made during the first month of the taxable year for which it is to be effective, or during the preceding month. This means that a termination, unless it occurs during the first month of a taxable year, will make Subchapter S

21. For recent rulings holding that various receipts did not constitute "rents" in this context, see: *Rev. Rul.* 112, 1961-1 *Cum. Bull.* 399 (crop-share agreement where "material participation" in crop production was present); *Rev. Rul.* 232, 1964-2 *Cum. Bull.* 334 (equipment rental business where significant services were performed); *Rev. Rul.* 91, 1965-1 *Cum. Bull.* 431 (warehousing, storage, and parking lot businesses involving performance of significant services); *Rev. Rul.* 83, 1965-1 *Cum. Bull.* 430 (payments for the use of various types of personal property did not constitute "rents" because significant services were rendered by the corporation).

22. *E.g.*, *Int. Rev. Code of 1954* § 1402(a)(1) (net earnings from self employment); § 911(b) (earned income); § 37 (retirement income); and § 954 (c) (foreign personal holding company income of a controlled foreign corporation).

inapplicable for at least one year,²³ no matter how generously the Internal Revenue Service may wish to exercise its discretion to shorten the five-year waiting period of § 1372(f).

The five-year waiting period of § 1372(f) is applicable not only to the corporation whose election was terminated, but also to any "successor corporation," defined by the regulations as a corporation that acquires a substantial part of the electing corporation's assets or whose assets were in substantial part owned by the electing corporation, provided fifty percent or more of its stock is owned directly or indirectly by persons who owned fifty percent or more of the stock of the electing corporation when the termination became effective. Treas. Reg. § 1.1372-5(b). Since § 1372(f) forbids only a *new* election by the successor corporation, the assets of a corporation whose election has terminated may evidently be transferred to another corporation that has *previously* made a valid election, even though it is controlled by the same or substantially the same shareholders, without necessarily terminating the second corporation's election. This suggests that the shareholders of an electing corporation who foresee a termination of its election because of some transitory condition (*e.g.*, excessive foreign gross receipts, temporary non-consent by a new shareholder, etc.) may organize a new corporation before the disqualifying event occurs, cause it to elect under Subchapter S, and then transfer the assets of the disqualified corporation to the awaiting vehicle immediately after the first corporation's election terminates, hoping thereby to avoid the five-year waiting period of § 1372(f). If the attempt to circumvent § 1372(f) is too blatant, the election by the second corporation might be regarded as a new election by a "successor corporation" under the statute even though it was made before the first corporation's election was terminated and its assets transferred.

TAXATION OF CORPORATE INCOME TO SHAREHOLDER

While an election under Subchapter S is in effect, the corporation is not subject to the corporate income tax,²⁴ and its income is taxed directly to its shareholders. Since amounts *actually* distributed to the shareholder are taxed to them in any event, the major concern of Subchapter S

23. This will not only revive the corporate income tax for the year of disqualification, but also irrevocably break the period during which previously taxed income may be distributed under § 1375. Treas. Reg. § 1.1375-4(d) (1959) (last sentence); *infra* at 21-24.

24. § 1372(b)(1) provides for exemption from "the taxes imposed by this chapter," which include not only the corporate income tax of § 11, but also the accumulated earnings tax of § 531 and the personal holding company tax of § 541. In theory, an electing corporation is also relieved of the more exotic taxes imposed by § 802 (insurance companies), § 852 (regulated investment companies), § 594 (certain mutual savings banks), and § 881(a) (certain foreign corporations), but the first two classes could rarely, and the second two never, qualify as electing corporations under Subchapter S.

Although tax-exempt, the electing corporation is required by § 6037 to file an annual information return.

is with the corporation's *undistributed* taxable income. Section 1373(b) provides that each person who is a shareholder of an electing corporation on the last day of the corporation's taxable year shall include in gross income "the amount he would have received as a dividend, if on such last day there had been distributed pro rata to its shareholders by such corporation an amount equal to the corporation's undistributed taxable income for the corporation's taxable year." Since the shareholder's status is determined as of the last day of the taxable year, it will be possible to transfer stock to a member of the family for income splitting purposes at the last minute, subject to general assignment of income and similar principles.²⁵

There are three steps in the computation of the "constructive dividend"²⁶ that is taxed to the shareholder under § 1373(b):

1. The corporation's "taxable income" is determined in the usual fashion, except that certain deductions are not allowed. These are (a) the deduction for net operating losses incurred in other years²⁷ and (b) the special deductions allowed only to corporations by § 242 (partially tax-exempt interest) and §§ 243-46 (dividends received from other corporations).
2. From the corporation's taxable income, as thus adjusted, there is deducted any money distributed as dividends during the taxable year, to the extent that the distribution was out of cur-

25. In *Henry D. Duarte*, 44 T.C. 193 (1965), it was held that purported transfers of a Subchapter S corporation's stock by the taxpayer to his two minor children lacked economic reality and were not bona fide; accordingly, the taxable income allocable to the children's shares was taxable to the taxpayer. See *Treas. Reg. § 1.1373-1(a)(2)* (1959); the discussion in note 16 *supra*; and *cf.* the family allocation rules of § 1375(c) of the Code.

In *Rev. Rul. 308, 1964-2 Cum. Bull. 176* the Service held that where a shareholder of a Subchapter S corporation died fifteen days before the end of the corporation's taxable year and the executor of his estate filed a timely election, no part of the corporation's undistributed taxable income is income in respect of a decedent under § 691 and no deduction for estate tax purposes is allowable under § 691(c). Since only shareholders on the last day of the corporation's taxable year are required to include "constructive dividends in their gross income, no part of the corporation's undistributed taxable income for the taxable year in which the shareholder died was includible in his gross income.

26. This phrase is used herein as a brief label for the amount includible in gross income under § 1373(b). The Code uses the phrases "amount treated as a dividend under section 1373(b)" and "amount required to be included in the gross income of such shareholder under section 1373(b)." *Int. Rev. Code of 1954, §§ 1375(b) and 1376(a)*. The phrase "dividend resulting from constructive distribution of undistributed taxable income" is used in *Treas. Reg. § 1.1373-1(e)* (1959).

The Internal Revenue Service has ruled that a minority shareholder of a Subchapter S corporation is subject to the penalty imposed by § 6654(d) (substantial underpayment of estimated tax) resulting from his lack of information about the corporation's undistributed taxable income, despite the fact that he endeavored but was unable to get the information from the officers of the corporation. *Rev. Rul. 62-202, 1962-2 Cum. Bull. 344*.

27. If such losses were incurred by the corporation in a year for which the Subchapter S election was in effect, they would have been passed through to the shareholders (*infra* at 19-21), and a duplication of deductions, would occur if they were allowed again in another year. If the losses occurred in a non-election year, they may be used by the corporation itself in other non-election years (*infra* note 40).

rent earnings and profits.²⁸ The remainder is the corporation's "undistributed taxable income."

3. The amount that would have been a dividend to the shareholders based on a hypothetical distribution of the corporation's undistributed taxable income on the last day of its taxable year, is computed. Since a distribution of the corporation's undistributed taxable income would be a dividend only to the extent of the corporation's earnings and profits,^{28a} the "constructive dividend" may be less than the shareholder's pro rata share of the undistributed taxable income.

As an illustration of these steps:

1. Assume that the taxable income of a Subchapter S corporation is \$60,000 and its current earnings and profits \$90,000, the difference between taxable income and current earnings and profits being attributable to the receipt of tax-exempt interest. It has no accumulated earnings and profits. The corporation distributes \$70,000 in cash to its shareholders during the taxable year. The \$70,000 would be treated as a regular dividend to the shareholders since distributed "out of earnings and profits." But there is no amount to be included as "a constructive dividend" under § 1373(b) since the corporation has no undistributed taxable income for the taxable year; the actual cash distribution is in excess of taxable income.

2. Assume that the corporation's taxable income and current earnings and profits for the year are both \$90,000. It has no accumulated earnings and profits. It distributes \$30,000 as a cash dividend to its shareholders, which amount is includible as such in their gross income. The undistributed taxable income of the corporation is \$60,000—\$90,000 of taxable income, minus the \$30,000 cash dividend. This amount, since fully covered by earnings and profits, constitutes a "constructive dividend" to the shareholders on the last day of the corporation's taxable year.

3. Assume the same facts as example 2, except that the corporation also distributes property with a basis of \$15,000 and a fair market value of \$30,000. The undistributed taxable income of the corporation for the year is \$60,000—\$90,000, minus the cash dividend of \$30,000—since the property distribution does not reduce taxable income for the purpose of computing undistributed taxable income. Although a property distribution does not reduce undistributed taxable income, some of the current earnings and profits must be allocated to it. The regulations provide that the excess of earnings and profits over distributions of money should be allocated ratably between the constructive distribution of undistributed taxable income and

28. Distributions of property, stock, or corporate obligations are not deducted, nor are distributions of any type that are attributable to earnings and profits accumulated in earlier years.

28a. See § 1377(b) for a special rule in computing current earnings and profits, insuring that shareholders will be taxed on a "floor" of corporate taxable income as if the business had been conducted as a proprietorship or partnership.

the actual distribution of non-cash property (taken into account at fair market value).²⁹ In this case, \$40,000 of earnings and profits would be allocated to the undistributed taxable income, and \$20,000 to the property distribution. Therefore, although the undistributed taxable income is \$60,000, only \$40,000 of it would be treated as a dividend if distributed as such, and that is the amount the shareholders must include in gross income pursuant to § 1373(b). The distribution of property is a dividend only to the extent of its allocable share of the earnings and profits, \$20,000. If the corporation has accumulated earnings and profits, the regulations state that they too would be allocated between the constructive dividend and the actual distribution of property. For further illustrations, see Treas. Reg. § 1.1373-1(g).

Because the "constructive dividend" of § 1373(b) is includible in gross income, the shareholder is allowed by § 1376(a) to increase the basis of his stock *pro tanto*. In effect, the "constructive dividend" is treated as though it had been distributed to him and then reinvested in the form of a contribution to capital.³⁰ As will be seen, the shareholder will not be taxed on a later distribution of the amount previously taxed as a "constructive dividend," provided certain conditions are satisfied; and the basis of his stock will be appropriately reduced to reflect such later tax-free receipts.

Because the current income of an electing corporation is taxed directly to the shareholders, rather than to the corporation, special rules for the treatment of dividends (both actual and constructive) at the shareholder's level are prescribed by § 1375(b) and (c). They are as follows:

1. *Dividends received exclusion disallowed.* In recognition of the fact that there is no "double taxation" of the income of an electing corporation, § 1375(b) denies the dividends received exclusion of § 116 as to certain dividends paid by an electing corporation.³¹ The retirement income

29. Treas. Reg. § 1.1373-1(e) (1959) sets up three levels for the allocation of current earnings and profits: (1) they are first allocated to current distributions of money; (2) any excess is allocated ratably between the constructive distribution of undistributed taxable income and actual distributions of property (other than money) which are not in exchange for stock; and (3) the remainder (if any) is available to be allocated to distributions in exchange for the stock of the corporation, such as distributions under § 302 or § 331 of the Code.

30. For analogies, see the "consent dividend" procedure applicable to the accumulated earnings tax and personal holding company tax, and the treatment of undistributed income taxed to the United States shareholders of a foreign personal holding company.

31. Prior to its amendment by the Revenue Act of 1964, § 1375(b) also disallowed the § 34 dividends received credit. With the repeal of this credit by the Revenue Act of 1964, the language of § 1375(b) was amended to omit reference to the credit.

In any given year, the shareholders, dividends from an electing corporation may be attributable to current earnings and profits, to accumulated earnings and profits, or both. The special rule of § 1375(b) is applicable only to distributions out of current earnings and profits. For the method of allocating current and accumulated earnings and profits to particular distributions, see Treas. Reg. § 1.1373-1(d)-(g) (1959); see also *infra* at 21-24.

credit of § 37 is also made inapplicable to such dividends, presumably because individual proprietors and partners may not treat their business income as "retirement income."

2. *Reallocation of dividends within family.* To curb the use of Subchapter S as a detour around the family partnership rules of § 704(e),³² § 1375(c) provides that dividends (both actual and constructive) received by a shareholder may be apportioned or allocated among members of his family if they are shareholders and the Internal Revenue Service finds this action necessary to reflect the value of services rendered to the corporation by them. The definition of "family" that is applicable to family partnerships, § 704(e)(3), is adopted for this purpose. Unlike § 704(e), however, § 1375(c) permits an allocation or apportionment to reflect the value of a shareholder's services not only if the other members of his family acquired their stock from him, but also where stock was acquired from outsiders in an arm's-length transaction. In another respect, however, § 1375(c) is narrower than § 704(e); the latter permits a reallocation as between donor and donee regardless of their relationship, but § 1375(c) permits allocation or apportionment only within a family.

Except for the pass-through of net long-term capital gains under § 1375(a), Subchapter S contemplates that the shareholder will report his dividends (both actual and constructive) from an electing corporation as ordinary income, regardless of the character of the income at the corporate level.

PASS-THROUGH OF LONG-TERM CAPITAL GAIN

Subchapter S adopts a true "conduct" approach for only one class of corporate income, viz., long-term capital gain. Under § 1375(a), if an electing corporation has an excess of net long-term capital gain over net short-term capital loss for its taxable year, each shareholder is entitled to treat a pro-rata portion of his "dividend income" (both actual and constructive) as long term capital gain. This capital gain pass-through is applicable only to distributions out of *current* earnings and profits, however; and it cannot exceed the corporation's taxable income for the year, computed under § 1373(d).

For example, if a corporation with three equal shareholders has taxable income and current earnings of \$90,000 (including a long-term capital gain of \$15,000), but makes no actual distributions during the year, each shareholder will include \$30,000 in gross income as a constructive dividend under

32. Under § 704(e) of the Code, a detailed consideration of which is beyond the scope of this work, a partner reports his distributive share of the partnership income, but if he acquired his partnership interest by gift, appropriate allowance must be made for reasonable compensation for services rendered to the partnership by donor. See Beck, *Use of the Family Partnership as an Operating Device—The New Regulations*, N.Y.U. 12th Inst. on Fed. Tax. 603 (1954); Comment, *Family Partnerships and the Revenue Act of 1951*, 61 Yale L.J. 541 (1962). See also note 25 *supra*.

§ 1373(b), of which \$5,000 will constitute long-term capital gain by virtue of § 1375(a). If instead, the corporation had made actual distributions of \$90,000 during the year, the results would be the same. But if either the corporation's taxable income or its current earnings and profits had been less than the amount of its capital gain, the capital gain pass-through could not exceed the lower of these two figures, regardless of the shareholder's "dividend" income.³³

The character of gain from the sale of property by an electing corporation is according to Treas. Reg. § 1.1375-1(d), ordinarily to be determined at the corporate level. If the gain is attributable to the sale of "trade or business property" (which is treated as long-term capital gain by virtue of § 1231), however, its character as "section 1231 gain" does not pass-through to the shareholders; they merely report their allocable share of this item is long-term capital gain in accordance with the rules of § 1375 (a). Lest the pass-through of long-term capital gain be employed by "dealers" in property as a means of converting ordinary income into capital gain by the device of transferring property to an electing corporation (or a series of such corporations), the regulations provide that the character which the property would have had in the hands of a "substantial" shareholder may influence the determination of whether the corporation realized capital gain or ordinary income on the sale.³⁴

Until 1966, the pass-through of long term capital gains under § 1375 (a) encouraged "one-shot" elections under Subchapter S by corporations that were about to realize a substantial capital gain on the sale of real estate or other assets and that wished to pass some or all of the gain on to shareholders. Absent a Subchapter S election, the corporation would realize capital gain on the sale, and the distribution to shareholders would be a taxable dividend to the extent of earnings and profits, unless it could qualify for "sale" treatment under § 302 or § 346. Subchapter S, on the other hand, offered the advantage of a single capital gain tax to the share-

33. If the taxable year of the corporation includes portions of two taxable years of a particular shareholder (because one is on a fiscal year and the other on a calendar year), the regulations require further allocation of his capital gain pass-through in proportion to the amount of his dividend income for each of those years. Treas. Reg. § 1.1375-1(c) and (e) (1959), Example (3). Thus, if one shareholder in the example in the text was on a June 30 fiscal year, and received \$12,000 of his total \$30,000 dividend distribution in March and \$18,000 in September, \$2,000 of the March distribution would constitute long-term capital gain (40 percent of \$5,000) as would \$3,000 of the September distribution (60 percent of \$5,000).

34. Treas. Reg. § 1.1375-1(d) (1959). For an analogy which may have inspired this effort to cure a defect in the statutory drafting scheme, see § 341(e), which at several points requires the corporation to treat property as it would be treated in the hands of shareholders.

The validity of the regulation, except in instances of egregious abuse, is debatable: the contemporaneous enactment of § 341(e) and Subchapter S may imply that the inclusion of elaborate shareholder-level characterization rules in the former excludes similar principles from the latter, on the other hand, there is no reason to think that the enactment of Subchapter S was intended to undermine the effectiveness of § 341.

holder, with no additional tax on the distribution of the sales proceeds up to the amount of the passed-through gain.³⁵ (An abortive effort to prevent Subchapter S elections by corporations contemplating a partial liquidation is described *supra* at 4-7.). After the pass-through and distribution, the corporation's Subchapter S election would be revoked and it would assume its prior status. This possibility of exploiting Subchapter S for a brief interlude was limited by the enactment of § 1378 in 1966, providing for a tax at the corporate level (coupled with a pass-through under § 1375(a)(3) of the capital gain, less the corporate tax thereon, for taxation at the shareholder level), if three conditions are met: (1) the excess of net long-term capital gain over short-term capital loss exceeds \$25,000 and also exceeds fifty percent of the corporation's taxable income; (2) the corporate taxable income exceeds \$25,000; and (3) the corporation was not subject to Subchapter S in the three immediately preceding taxable years (subject to an exception for new corporations that have been subject to Subchapter S since inception). (A special rule, to prevent manipulative transfers of appreciated property to an "aged" Subchapter S corporation, applies if it holds property, acquired during the three year period preceding the sale, with a substituted basis determined by reference to the basis of a non-electing corporation.) Although the enactment of § 1378 reduces the incentive to elect Subchapter S for a single year, it does not wholly eliminate the advantage of doing so; the maximum burden under the new provision will be somewhat less than two taxes at the capital gain rate,³⁶ whereas the sale-redemption route described earlier may generate ordinary income at the shareholder level in addition to capital gain at the corporate level.

Another way of exploiting the capital gain pass-through of § 1375 (a)—changing the taxable year of an electing corporation in order to segregate a long-term capital gain in a "short" taxable year, so that the election can be used to pass the capital gain through to shareholders,

35. This possibility was facilitated by the enactment in 1964 of a provision permitting an electing corporation and its shareholders to treat distributions of proceeds from the sale of capital or § 1231(b) assets, made in the first seventy-five days of the corporation's year following the year of sale, as if made in the year of sale. The purpose of this amendment was to prevent such capital gains from becoming "locked-in" at the corporate level, a problem considered in greater detail, *infra* at 21-24. The provision was repealed in 1966, and replaced by a seventy-five day grace period of much broader scope.

In Rev. Rul. 65-292, 1965 Int. Rev. Bull. No. 49, at 9, the Service ruled that if the corporation elected to report capital gain on the installment method under § 453, the deferred capital gain can be passed through ratably to the shareholders under § 1375(a).

36. Under § 1378(b) of the Code, the tax at the corporate level is the lesser of (a) twenty-five percent of the corporation's net capital gain in excess of \$25,000, and (b) the tax that would have been imposed if the corporation had not elected under Subchapter S. This means that the first \$25,000 of capital gain per year is passed through as it was before 1966, unscathed by the new tax; and since the computation is made year-by-year, rather than transaction-by-transaction, the \$25,000 exemption can be multiplied by a corporate election to report a larger capital gain on the installment basis method under § 453 (see Rev. Rul. 65-292, *supra* note 35).

isolated from ordinary income—is prohibited by Treas. Reg. § 1.442-1(b)(1). See also, *infra* at 24-25, for use of Subchapter S as a means for undercutting the elaborate rules governing collapsible corporations.

PASS-THROUGH OF CORPORATE NET OPERATION LOSS

One of the announced functions of Subchapter S is to permit “small corporations realizing losses for a period of years where there is no way of offsetting these losses against taxable income at the corporate level”—presumably for lack of corporate income during the eight-year carryover period by § 172 (deduction of net operating losses)—to pass these losses through to the shareholders for use as an offset against personal income from other sources. S. Rep. No. 1983, 85th Cong., 2d Sess. 87. Except for Subchapter S, corporate losses are reflected on the shareholder’s individual income tax return only when, as, and if his investment in the corporation becomes worthless, at which time the loss is almost always a capital loss rather than a deduction from ordinary income.³⁷ For this reason, taxpayers who anticipate a series of losses in the formative years of a new business enterprise sometimes conduct their affairs as a partnership at the outset, and incorporate only if and when the enterprise commences to be profitable. The pass-through of current net operating losses of a Subchapter S corporation, provided by § 1374, offers an alternative method of achieving this result. Moreover, the shareholders of an old, well-established corporation that anticipates a heavy non-recurring loss may file an election under Subchapter S in order to offset the loss against their individual income for that year, and then revoke the election for later years.

Under § 1374, each shareholder of an electing corporation carries his share of the corporation’s net operating loss over to his individual return (where it is treated, by virtue of § 1374(d)(1), as a deduction attributable to a trade or business), to be applied against his other income. Any unused excess is carried back three years and forward five years by the shareholder in the usual manner provided by § 172.³⁸ There is, however, an important limitation on this pass-through of the corporation’s net operating loss: under § 1374(c)(2), it may not exceed the adjusted basis of the shareholder’s investment in the corporation (including indebtedness

37. The shareholder’s loss on worthless stock or securities is usually a capital loss under § 165(g), except for the limited ordinary loss deduction of § 1244 stock (\$25,000 in any one year for individuals, \$50,000 for husband and wife filing a joint return), and an individual shareholder’s loss on loans not evidenced by “securities” is ordinarily a capital loss under § 166(d).

38. The corporation’s net operating loss is computed in the usual fashion under § 172, except that the special corporate deductions of §§ 242-46 are disallowed, as in computing the electing corporation’s undistributed taxable income under § 1373(d) (*supra* at 13).

Section 1374(d)(2) of the Code provides an interim rule for taxable years beginning prior to the effective date of Subchapter S, under which the shareholder cannot carry an electing corporation’s loss back to such years but instead employs it in later years.

as well as stock).³⁹ This restriction is similar to the partnership rule of § 704(d), under which a partner may deduct his distributive share of partnership losses only to the extent of the adjusted basis of his interest in the partnership. The shareholder may be able to circumvent the limitation of § 1374(c)(2) by increasing his investment in the corporation, but if the corporation is on its last legs, this may be throwing good money after bad. If this stratagem is not adopted, however, any unused portion of the corporation's net operating loss will be lost forever, since the enactment of Subchapter S was accompanied by an amendment to the net operating deduction provision, § 172(h), under which a net operating loss for any year in which the corporation is an electing corporation under Subchapter S may not be carried over by it to a non-electing year. For election years, in other words, the net operating loss belongs exclusively to the shareholders, but they may use it only to the extent of the basis of their investment in the corporation.⁴⁰

We have already seen (*supra* at 1-3) that the shareholder's basis for his stock in an electing corporation is increased to reflect any "constructive dividends" taxed to him by § 1373(b). Conversely, if a net operating loss is passed-through to him, it must be applied in reduction of the basis of his stock under § 1376(b); once the basis of the stock is reduced to zero, any excess is applied to reduce (but not below zero) the basis of any corporation indebtedness held by him. These adjustments to basis survive the election, see § 1016(a)(18), and will therefore affect his computation of gain or loss on a sale or other disposition of the stock or indebtedness in later years.

Unlike § 1373(b), which allocates the corporation's undistributed taxable income to those persons who are shareholders on the last day of the corporation's taxable year, § 1374(b) and (c)(1) provide that the corporation's net operating loss shall be allocated among all persons who owned stock at any time during the taxable year. This method of allocating the operating loss, presumably adopted to curb the market in "loss" corporations, requires a computation of the corporation's "daily net operating loss" (the net operating loss divided by the number of days in the

39. The adjusted basis of the shareholder's investment is determined as of the close of the corporation's taxable year, unless he disposed of some or all of his stock during the year. See Int. Rev. Code of 1954, § 1374(c)(2)(A) and (B).

In the case of stock or debt received by gift, the shareholder's basis for determining gain may be different from his basis for determining loss, see § 1015(a), but § 1374(c)(2) does not state which basis is to be employed. The shareholder's basis for computing loss should probably be controlling.

See generally *Byrne v. Comm'r*, 361 F.2d 939, (7th Cir. 1966).

40. Conversely, a net operating loss incurred by the corporation in a non-election year may not be employed by the shareholders in an election year, by virtue of § 1373(d)(1), but it may be carried forward or backward by the corporation to other non-election years. Intervening election years are counted in determining the three-year carryback and five-year carryover periods, but the corporate income of such years is not applied in reduction of the carryback or carryover, according to Treas. Reg. § 1.1374-1(a) (1959), third and fourth sentences.

taxable year), which is then assigned pro rata to the persons owning shares on that day. Unless there have been many transfers of stock, however, the allocation is simpler than the language of § 1374(c)(1) suggests.⁴¹

The pass-through of corporate losses under Subchapter S is restricted to the net *operating* loss. A *capital* loss incurred by an electing corporation will be applicable against its capital gains, and any excess can be carried forward under § 1212 to be applied against the corporation's capital gains for the succeeding five taxable years. The unused balance, if any, is lost.

It seems clear that a Subchapter S corporation may not be used as a device for obtaining loss deductions from activities which would not create allowable deductions if carried on directly by a shareholder. The general tenor of Subchapter S itself requires conduct of a "business" by the electing corporation; and the language of § 1374(c)(1) specifically states that the net operating loss subject to pass-through treatment is computed in accordance with the terms of § 172(c), which in turn provides that a net operating loss is the excess of *allowable* deductions over gross income. Thus, if an electing corporation is engaged primarily in the conduct of a "hobby," sport, or recreation for the benefit of its shareholders, rather than a profit-motivated activity, losses resulting from such operations should not be available to the shareholders despite their use of a Subchapter S corporation.⁴²

DISTRIBUTIONS OF PREVIOUSLY TAXED INCOME

Since the shareholders of an electing corporation must include the corporation's undistributed taxable income in their gross income (to the extent provided by § 1373, *supra* at 12-16), a mechanism is provided so that the actual distribution of these constructive dividends in a later year will not produce a second round of dividend income. Under § 1375(d), the shareholder's "net share of the corporation's undistributed taxable income" is computed, consisting of:

1. The sum of the amounts included in his gross income as "constructive dividends" under § 1373(b) for prior taxable years, less:
2. The sum of (1) the amounts allowable as deductions under § 1374(b) (pass-through of net operating losses) for prior years, and (2) the amounts previously distributed under § 1375(d) itself.

41. For illustrations, see Treas. Reg. § 1.1374-4 (1959). For the effect of corporate capital gains on the computation of the net operating loss pass-through, see *Byrne v. Comm'r*, 361 F.2d 939 (7th Cir. 1966).

42. In *DuPont v. United States*, 234 F. Supp. 681 (D. Del. 1964), the court stated that "hobby loss" corporations could not effectively pass-through losses by the election of Subchapter S, but found on the facts that the taxpayer's corporation was engaged in a trade or business so as to qualify for the loss pass-through treatment of § 1374. See also Treas. Reg. § 1.1374-2 (1959), stating that the shareholders' deduction may be of the type which is subject to the "hobby loss" limitations of § 270.

Under Treas. Reg. § 1.1375-4, any distribution of money by an electing corporation—if it would otherwise be a dividend out of accumulated earnings and profits⁴³—is to be considered a distribution of such previously taxed income. This means that the distribution will not be treated as a dividend; it will instead be applied against the shareholder's basis for his stock under § 301(c)(2), with any excess over basis being taxed as capital gain under § 301(c)(3).

The right to receive a non-dividend distribution of previously taxed income is subject to these qualifications:

1. Under Treas. Reg. § 1.1375-4(b), the distribution must be of money; a distribution of property will not qualify.
2. The right is not transferable, so that a transferee of stock in an electing corporation does not acquire any part of his transferor's share of the previously taxed income. (Thus an estate, being a new shareholder, does not inherit the decedent's previously taxed income amount.) This rule should serve to restrain transfers of stock to members of the family as a means of splitting income under the year-end rule of § 1373(b) (*supra* note 16). On the other hand, a shareholder who disposes of part of his stock does not suffer any reduction in his share of the previously taxed income, so that the dividends received by him thereafter on his remaining stock are evidently eligible for the non-dividend treatment of § 1375(d) to the full extent of his original share of the previously taxed income. Treas. Reg. § 1.1375-4(e). For the possibility of a shareholder's reacquiring a "lost" account, see *ibid*.
3. The corporation, with the consent of its shareholders, may forego the right to make a non-dividend distribution under Treas. Reg. § 1.1375-4(c).

Although the purpose of § 1375(d) is to permit a non-dividend distribution of amounts previously taxed to the shareholders as "constructive dividends" under § 1373, it does not follow that there is no difference between current distributions by a Subchapter S corporation and later distributions under § 1374(d). For one thing, if the corporation accumulates its taxable income and then suffers a net operating loss, the shareholder's net share of previously taxed income must be reduced under § 1375(d)(2)(B)(i) because the loss was passed through to him under § 1374(b). A distribution after the loss may, therefore, be taxed as a dividend even though the same amount would have enjoyed the protection of § 1375(d) had it been distributed earlier. Moreover, a tax-free distribution under § 1375(d) can be made only after the corporation's current earnings and profits have been distributed (*supra* note 43). Finally, the right to make a non-dividend distribution of previously taxed income

43. To the extent of *current* earnings and profits, any money distributed must be treated as a dividend under Treas. Reg. § 1.1373-1(d)-(e) (1959). Hence, the corporation must make an actual distribution of money in excess of its current earnings and profits before § 1375(d) comes into force.

under § 1375(d) lasts only as long as the Subchapter S election remains in force, and evaporates if the election is terminated.⁴⁴ A post-termination distribution will be governed by the usual rules of § 301, under which all current and accumulated earnings and profits must be distributed as dividends before the corporation can make a non-dividend distribution. Thus, a distribution that would have been shielded by § 1375(d) if the Subchapter S election had remained in effect, may constitute a dividend if made after the election is terminated. Of course, this will be true only if the corporation has current or accumulated earnings and profits when the distribution is made. In this connection, it should be noted that the corporation might have earnings and profits because (1) it had an accumulation of earnings and profits when it made the Subchapter S election, which were not distributed while the election was in force; (2) it accumulated some earnings and profits during the Subchapter S period;⁴⁵ or (3) its operations after the election was terminated produced earnings and profits.

Because a delay in making distributions may alter their character, some commentators have suggested that a Subchapter S corporation should make an *actual* distribution each year of the amount that would otherwise constitute a "constructive dividend" under § 1373(b). Such a program of distributions would be feasible only if the corporation can finance its operations without retaining its earnings, since to accomplish their purpose the distributions must be in money rather than in property or obligations.⁴⁶ If the corporation distributes money and the shareholders, by prearrangement, turn the funds back to the corporation as a loan, the transaction might well be treated as the distribution of a corporate obligation rather than money. Moreover, it is not inconceivable that, in some circumstances, the "obligation" would be regarded as a second class of stock (*supra* at 4-7), resulting in a termination of the election under § 1372(e)(3) and § 1371(a)(4).

Until 1966, however, a corporation that wished to distribute its earnings currently in order to avoid a "lock-in" in later years faced an annoying problem of timing: the precise amount to be distributed to the

44. Treas. Reg. § 1.1375-4(a) (1959) (last sentence), which is based upon the parenthetical qualification in § 1375(d)(2)(A). The same statutory provision supports Treas. Reg. § 1.1375-4(d) (1959) (last sentence), providing that a new election does not revive the right to make a non-dividend distribution of income accumulated in years before the new election.

For an analysis of this area, See Note, "Locked-In Earnings"—How Serious A Problem Under Subchapter S?, 49 Va. L. Rev. 1516 (1963).

45. The possibility of accumulating earnings and profits while the Subchapter S election is in force is somewhat limited, since the corporation's undistributed taxable income is taxed to the shareholder under § 1373(b), with a consequent reduction in earnings and profits under § 1377(a). But differences in computing earnings and profits and taxable income may result in an accumulation during the Subchapter S period despite taxability of the "constructive dividends" under § 1373(b).

46. Distributions of property do not serve to reduce the corporation's undistributed taxable income, § 1373(c), and the regulations state that distributions of property do not qualify as distributions of "previously taxed income" under § 1375(d). Treas. Reg. § 1.1375-4(b) (1959).

shareholders can rarely be determined by midnight of the last day of the corporation's taxable year, so that some gap between the amount distributed and the amount that should have been distributed is almost inevitable. A limited corrective was enacted in 1964 (*supra* note 35), permitting an election under which a distribution of money in the first seventy-five days of the taxable year following a sale of capital assets would be treated as a distribution during the year of sale. This provision was repealed in 1966, and it was replaced by § 1375(f), a non-elective rule under which all distributions of money during such a seventy-five day period to persons who were shareholders on the last day of the preceding year are to be treated (subject to certain conditions) as distributions of the corporation's undistributed taxable income for the preceding year.⁴⁷ This gives the corporation that wants to keep its cash distributions to shareholders in perfect balance with the "undistributed taxable income" previously taxed to them a grace period, during which its accounts for the prior taxable year can be closed and reviewed. Moreover, a cash distribution in the seventy-five day period will be attributed to the prior year even if the corporation's Subchapter S status for the current year is lost by revocation or otherwise during the grace period.

RELATION OF OTHER CORPORATE PROVISIONS TO SUBCHAPTER S

As noted earlier, a Subchapter S corporation remains a "corporation" for numerous purposes under the tax law; *i.e.*, the provisions of Subchapter C dealing with stock redemptions, liquidations and reorganizations remain applicable to an electing corporation and its shareholders, to the extent "not inconsistent" with the rules of Subchapter S, Treas. Reg. § 1.137-1 (c). Thus, a stock redemption or distribution in partial liquidation by a Subchapter S corporation must satisfy the requirements of §§ 302, 303, 304, or 346 in order to generate capital gain or loss at the shareholder level. Similarly, the computation of an electing corporation's earnings and profits is made in the same manner as if there had been no election (except for the special adjustments provided by §§ 1375(d)(1) and 1377). Likewise, the tax consequences of a distribution in kind to the distributing corporation and to its shareholders are controlled by the provisions of §§ 311 and 301 even though made by an electing corporation. Despite this overlap between Subchapter C and Subchapter S, however, several situations exist where use of Subchapter S offers an alternative course of action which is superior to the more general corporate provisions.

1. Subchapter S and § 341. There is a curious lack of correlation between the provisions of § 341 and Subchapter S. This stems from the fact that the capital gain pass-through of an electing corporation does not constitute a "collapsible transaction" within the meaning of § 341(a) (*i.e.*,

47. Section 1375(f) applies to all distributions after its enactment (Apr. 14, 1966); and it can be applied retroactively if the corporation and its shareholders so elect, subject to adjustment rules of great complexity.

sale of stock, capital distribution, or liquidation distribution). As a result, a collapsible corporation that contemplates the sale of an appreciated capital or § 1231 asset may consider employing a Subchapter S election to pass the gain thereon through to its shareholders; if it had distributed the property to permit the sale to be made by the shareholders, they would have realized ordinary income on the distribution under § 341(a), unless § 341(e) applied. In many situations, of course, § 341(e) would provide a safe refuge, so that a Subchapter S election would offer no special advantage. If the property (though a capital or § 1231 asset in the hands of the corporation) would not qualify under § 341(e) because it would have been "dealer property" if held directly by the shareholders, however, the capital gain pass-through of § 1375(a) seems to afford a safer route to the realization of capital gain at the shareholder level. The regulations seek to restrict this possibility by providing that the shareholders' other business activities may "infect" otherwise pure capital gains in applying § 1375; but, as already pointed out (*supra* note 34), the validity of this provision is open to argument.

The importance of this issue was reduced somewhat by the 1966 restrictions on "one-shot" elections (*supra* at 19-21), under which both the corporation and the shareholders will be taxed if there is a last minute effort to make use of Subchapter S to pass through a substantial capital gain.

2. *Use of Subchapter S by liquidating corporations.* In view of the Service's apparent concession that Subchapter S may be used by corporations in the process of, or contemplating, complete liquidation (*supra* at 4-7), it must be added to the list of statutory techniques for effecting liquidation sales of corporate assets with only a single capital gain tax at the shareholder level.⁴⁸ The relationship of Subchapter S to the special liquidation rules of Subchapter C can, however, become quite complex. For example, Subchapter S may yield results superior to the non-recognition rule of § 337, where the parties desire the benefits of installment sale treatment under § 453 with respect to asset liquidation sales, since such gains of an electing corporation can be passed-through to the shareholders when collected under Subchapter S (*supra* note 35), a technique not available where the § 337 route is used. In addition, § 337 cannot be used by a collapsible corporation, § 337(c)(1)(A); but § 341, as noted above, may not be applicable to asset sales by Subchapter S corporations. Similarly, liquidations under § 337 must follow a rigid statutory timetable (*viz.*, adoption of complete liquidation plan, sale of assets, then distribution within twelve months of the "plan" date), a restriction not present when the sales are made by an electing Subchapter S corporation.

In some cases, however, a Subchapter S election may be worse than

48. The discussion assumes that the Subchapter S election has been in effect for the three-year period required by Int. Rev. Code of 1954, § 1378; otherwise, the two-tax principle enacted in 1966 (*supra* at 19-21) will apply.

reliance on § 337: thus, if the corporate assets would produce ordinary gain when sold (*e.g.*, “dealer” property, short term capital or “business” assets, and “artistic” property), § 337 is superior to Subchapter S in that corporate non-recognition can be obtained with respect to sales thereof under § 337, while use of Subchapter S would result in a pass-through of ordinary income to shareholders. Also, if the shareholders’ stock basis is greater than the corporation’s basis for its assets, use of Subchapter S to effect the sale of assets can result in distortions of the liquidation transaction considered as a whole, especially if the sale and liquidation occur in different years. For example, assume that A, the sole shareholder of X corporation, has a basis of \$200 for his stock, while the corporate assets have a basis of \$100 and a value of \$400 in the hands of X. Sale of the assets under Subchapter S would result in a pass-through of \$300 of gain to A, whose stock basis would be stepped up to \$500 by virtue of § 1376. Upon the subsequent liquidation of X, which would distribute \$400 to A, he would realize a capital loss of \$100. If the transaction had come within § 337, however, A would have realized \$200 of gain on the liquidation of X, the difference between his basis for the X stock and the fair market value of the liquidation distribution.

Where the corporation incurs a net operating loss during the year it proposes to sell all or part of its assets at a gain, the decision to use Subchapter S or § 337 depends upon the following considerations: (1) whether the parties wish to preserve the net operating loss as a carryback deduction at the corporate level, in which case a sale of assets tax-free under § 337 would be preferable; or (2) whether it is more desirable to pass-through the corporation’s net operating loss to the shareholders, in which case Subchapter S should be elected. If Subchapter S is elected, however, recognized gain from the sale of corporate assets must be set off against the corporation’s operating losses in determining the amount of income (or loss) which will be passed-through to shareholders. But this dilution of the Subchapter S net operating loss pass-through could be avoided, it would seem, by causing the electing corporation to sell its assets under the provisions of § 337; in this case, the gain would not be recognized, and thus would not enter into the net operating loss computation. This simultaneous use of § 337 and the Subchapter S election is not expressly prohibited by the statute, although it does appear somewhat too good to be true. The Commissioner therefore, may seek to deny either (a) the Subchapter S loss pass-through, or (b) non-recognition of gain on the corporate sale of its assets, by arguing that Congress did not intend to confer such a double tax benefit in this situation. Whether a court would, or should, accept such an argument is still an open question.

ADVANTAGES OF SUBCHAPTER S ELECTION

Probably the principal tax advantage flowing from an election under Subchapter S is elimination of the corporate tax, thereby avoiding the

“double taxation” of corporate earnings, while at the same time preserving the traditional legal advantages of operating in corporate form. Certainly the underlying purpose of Subchapter S was to promote “tax neutrality” in the choice of the form of doing business: to the extent that the corporate tax influenced this choice, it often served to distort normal business practices. Election of Subchapter S treatment will, of course, be most favorable where the shareholders are in lower tax brackets than their corporation, a situation that became more common after the 1964 reduction in individual tax rates than it was when Subchapter S was enacted in 1958. Also, it should be noted that Subchapter S is only one of several devices for avoiding the effects of corporate “double taxation”; others include (a) “thin capitalization”; (b) payment of “salaries” to shareholder-employees; and (c) having shareholders lease property to the corporation. As such, Subchapter S may have merely added another “tax factor” to be considered in selecting the form of business entity.

While elimination of the corporate tax is the main concern of Subchapter S, several other important uses of the election have been noted: (a) the pass-through of current corporate net operating losses, especially in the early years of a new business (*supra* at 19-21); (b) “one-shot” elections for the purpose of passing through non-recurring capital gains from the sale of corporate property (*supra* at 16-19); (c) avoiding the collapsible corporation provisions (*supra* at 24-26); and (d) obtaining the benefits of § 453 deferral where corporate assets are sold on the installment method (*supra* at 24-26). In addition, the following collateral tax advantages of a Subchapter S election should also be noted:

1. Different taxable years for corporation and shareholders.

Since the undistributed taxable income of an electing corporation is includible in shareholder gross income in their taxable years in which or with which the corporation’s taxable year ends, § 1372(b)(2), adoption of a corporate fiscal year (typically in the case of a newly organized electing corporation) will serve to defer reporting of the first year’s income from the business for one year. For an illustration of this technique, see *R. E. Hughes, Jr.*, 42 T.C. 1005 (1964); but note that the Commissioner’s approval is required for change of an existing corporation’s tax period, § 442.

2. Partial liquidation sales. Where a corporation wishes to sell part, but not all, of its assets (at the price of a single capital gain tax to its shareholders), § 337 non-recognition of gain treatment is available only if the corporation is willing to completely liquidate. Although a partial liquidation distribution in kind of these assets under § 346, followed by a sale thereof at the shareholder-level, might be effective to avoid corporate tax on the gain, possible application of the *Court Holding Company* doctrine⁴⁹ may render this method unattractive. An electing corporation can sell the assets without liquidating, and the gain

49. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

will be taxed to the shareholders; but, as pointed out *supra* at 16-19, there may also be a gain at the corporate level if the election is a "one-shot" affair, as a result of the enactment of § 1378 in 1966.

3. *Neutralizing problems of "thin capitalization" and "unreasonable compensation."* Subchapter S, as noted above, affords a "cleaner" and less litigious method of avoiding double taxation of corporate earnings than resort to shareholder "loans" and payment of "excessive" compensation to shareholder-employees. As such, it offers a relatively safe harbor for those who are weary of wrangling with the Service over questions of shareholder-held debt and salary.

4. *Availability of corporate "fringe benefits" for shareholder-employees.* One of the attractions of a Subchapter S corporation, as opposed to the partnership form of doing business, is that shareholders, as "employees," may participate in the deferred compensation benefits of pension and profit-sharing plans, which are closed to individual proprietors and partners, as well as in other tax benefits that require "employee status": *e.g.*, § 101(b) (employee death benefits); §§ 104-106 (accident and health compensation); § 119 (meals and lodging for the convenience of the employer); § 79 (group-term life insurance premiums); §§ 421-424 (stock options); and § 217 (employee moving expenses).