1994

Planning with S Corporations

Richard A. Shaw

FORTIETH WILLIAM AND MARY TAX CONFERENCE

Williamsburg Lodge
Williamsburg, Virginia

December 2-3, 1994

PLANNING WITH S CORPORATIONS

by

Richard A. Shaw
Shenas, Shaw & Spievak,
A Professional Corporation
701 "B" Street, Suite 2200
San Diego, California 92101
Telephone: (619) 236-1777

PLANNING WITH S CORPORATIONS

¶ 100. INTRODUCTION

Subchapter S has matured into one of the most important Chapters of the Internal Revenue Code for major business planning for closely-held businesses. There are now more than 1.5 million S Corporation Federal Income Tax Returns being filed each year, representing more than 42 percent of all corporate returns.

As federal tax policies change and taxpayers create new vehicles for conducting business, it is evident that the advantages and disadvantages of S corporations as a preferred choice of entity for closely-held corporations, must constantly be reevaluated in order that the S election can be utilized to the best advantage of interested taxpayers.

We are now entering a time for refinement and reflection in evaluating the utility of subchapter S as a form of business entity.

¶ 100.1. Time For Refinement

It has now been more than a decade since passage of the Subchapter S Simplification Act of 1982 converted subchapter S from a dividend pass-through vehicle to a partnership pass-through system. Tax practitioners have waited patiently for the Treasury Department to issue adequate guidelines for interpreting the 1982 changes. Finally, in the last two years, we have seen a parade of new regulations. After a vociferous debate over two sets of Proposed Regulations on the second class of stock issue, the Treasury Department issued Final Regulations defining the one class of stock rules under section 1361(b)(1)(D).[1] Final Regulations were issued relating to the election, revocation and termination of S corporations under section 1362[2] and concerning the tax effect of subchapter S status under section 1363.[3] Final Regulations have been issued on adjustments to basis under

---

1 All section references are to the Internal Revenue Code of 1986, as amended, unless stated otherwise. *See* Treas. Reg. § 1.1361-1 (May 28, 1992).

2 Treas. Reg. § 1.1362-1 through § 1.1362-7 (Nov. 24, 1992).

3 Treas. Reg. § 1.1363-1 (Nov. 24, 1992).

section 1367[4] and the treatment of distributions under section 1368.[5] Proposed Regulations have been issued on the determination of built-in gains under section 1374,[6] and applying the LIFO inventory recapture rules of section 1363(d) to acquisitions of C corporations by S corporations.[7] These Final and Proposed Regulations have resolved substantial uncertainties in the application of subchapter S which have remained for over a decade.

¶ 100.2. Time For Reflection and Change

Subchapter S became popular in 1986[8] when, for the first time, federal income tax rates on corporations were higher than for individuals (34 percent versus 28 percent), capital gain rates were repealed, and corporations were forced to recognize gain on distributions of appreciated property in liquidation.

A. Tax Rate Changes

The Revenue Reconciliation Act of 1993[9] has increased the maximum individual tax rate to 39.6 percent, making individual rates now substantially higher than the current corporate rate of 34 percent on taxable income from $335,000 to $10,000,000, and 35 percent thereafter. These changes, along with the increase in the tax rate to 39.6 percent for the personal holding company tax penalty and accumulated earnings tax penalty, will take on greater importance for corporations with significant retained profits. Likewise, there has been a return to capital gain rates with an individual capital gain rate of 28 percent versus a maximum individual ordinary income rate of 39.6 percent. Corporate capital gain transactions are taxed at the maximum ordinary corporate rate of 35 percent.

---

4 Treas. Reg. § 1.1367-0 through 1.1367-3 (Jan. 3, 1994).

5 Treas. Reg. § 1.1368-1 through 1.136888-4 (Jan. 3, 1994).

6 Treas. Reg. § 1.1374-0 through 1.13774-10 (Dec. 8, 1992).

7 Treas. Reg. § 1.1363-2(a) (Aug. 18, 1992).

8 Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

9 Revenue Reconciliation Act of 1993, Publ. L. No. 103-66,107 Stat. 312 (1993).

These changes are requiring a reevaluation of the utility of subchapter S in instances where the corporation needs to retain earnings for operations or capital expansion. This reevaluation will also require consideration of the traditional C corporation tax provisions aimed at forcing distributions, such as the accumulated earning tax and the personal holding company tax.

B. The Emergence of the Limited Liability Company

A second development which is having a traumatic impact on subchapter S planning is the emergence of the limited liability company as a new entity for conducting business.

In 1976, the State of Wyoming created a new entity with the corporate characteristics of limited liability, while at the same time preserving the ownership, management and operational features of a partnership for the investors. Since the Service in Revenue Ruling 88-76[10] acknowledged that limited liability companies should be taxed as partnerships, the flood gates have opened, and more than 35 states have adopted limited liability company statutes. California has had several bills introduced in its Legislature and is likely to pass a limited liability company statute in 1994.

Tax practitioners need to give serious attention to the limited liability company as an alternative form of business. The limited liability company offers many attractions which are not available to S corporations and eventually will likely surpass the S corporation in business popularity.

The limited liability company preserves limited liability for investors and the benefits of a single tax pass-through of taxable income which were the initial reasons for the enactment of subchapter S in 1958. More importantly, the application of partnership taxation attributes avoids most of the eligibility, operational, and termination controls which Congress found it necessary to force upon S corporations, such as the limitation on eligibility of shareholders to individuals, estates, and certain trusts, the limit to 35 shareholders, the prohibition against the use of more than one class of stock or the use of affiliated corporations, the imposition of a corporate level tax on net excess passive investment income and on net recognized built-in gains, and ultimately the

[10] Rev. Rul. 88-76, 1988-2 C.B. 360. *See also*, August and Shaw, The Limited Liability Company - a New Tax Refuge, 7 J. of Taxation of Investments 179 (1990).

harsh tax consequences of subchapter S disqualification for technical violations of the rules.

On the limited liability company side, appreciated property can be easily transferred tax-free to and from limited liability companies under the partnership rules of sections 721 and 731 without the corporate tax burdens of section 351 going in, or the taxes imposed under sections 311, 336, and 331 coming out of the entity. Likewise, limited liability companies are permitted to have special allocations of profits and capital among owners under section 704, as contrasted to the one class of stock limitation in subchapter S, which severely restricts financial investment planning with shareholders or creditors. The limited liability company tax rules give investors basis for company loans which are not available under subchapter S and permit the entity to make a section 754 election to make special optional basis adjustments to the basis of company assets under sections 743 and 734 to protect members in the event of changed in interests through distributions, sales or death.

These and other distinguishing features between limited liability companies and S corporations are requiring a serious reappraisal of the utility of subchapter S for the future.

Even with the advent of the limited liability company, it is too early to see the demise of subchapter S. Many small businesses may find that the corporate structure and the certainties of regulation provided under state corporate and security laws are more appropriate for their businesses. In addition, existing S corporations will find it somewhat difficult to convert from subchapter S status to limited liability companies because of the heavy corporate taxes imposed under sections 331 and 336 on the distribution of appreciated property from the S corporation to its investors.

C. Revisions to Subchapter S

The role of the S corporation in business practice may also be influenced by new efforts to simplify and reform its archaic restrictions.

1. The Tax Simplification and Technical Corrections Act of 1993

For two years, a tax simplification bill has been floating through Congress which would provide limited simplification revisions to subchapter S. The primary changes would permit new electing small business trusts with multiple income beneficiaries as shareholders (section 1361(c)), permit reinstatement of S corporations with defective elections or late elections (section 1362(b)(5) and (f)), permit S corporations to have a C corporation affiliated subsidiary (section 1361(b)(2)), apply the income in respect of decedent rules to subchapter S (section 1367(b)(4)), change the ordering rules for distributions to reduce basis for losses after adjustments for income and before distributions (section 1368(d) and (e)), and repeal section 1371(a)(2), which treats an S corporation as an individual with respect to stock owned by the corporation.

The tax simplification proposals have been incorporated in the Tax Simplification and Technical Corrections Bill of 1993,[11] introduced in the House of Representatives Ways and Means Committee on November 16, 1993 (H.R. 3419). Ultimate passage of these provisions is anticipated because they are considered noncontroversial and are revenue neutral.

2. *The S Corporation Reform Bill of 1993*

On November 19, 1993, Senate Finance Committee members David Pryor (D-Arkansas) and John Danforth (R-Missouri) introduced the proposed S Corporation Reform Act of 1993, which would provide for a comprehensive reform of subchapter S. It would substantially overhaul subchapter S and eliminate many of the unnecessary restrictions which presently apply.

The S Corporation Reform Bill of 1993 would contain 26 revisions to subchapter S. In addition to those already covered in the Proposed Tax Simplification and Technical Corrections Act, some of the other changes would include an increase in the number of permitted shareholders from 35 to 50 shareholders, permit tax-exempt organizations, financial institutions and nonresident aliens as shareholders, permit the S corporation to issue "plain vanilla" preferred stock which would be treated as corporate debt for federal tax purposes, permit an S corporation to own 80 percent of another corporation's stock (including S corporation subsidiaries), expand the safe harbor debt provisions to permit convertible stock, permit venture capitalists and lending institutions to hold safe harbor stock, exclude trade and business income from the passive investment income restriction, and treat S corporation shareholders in the same manner as owners of C corporations with respect to fringe benefits, thereby repealing the rule treating 2 percent shareholders/employees as partners.

---

11 Proposed Tax Simplification and Technical Corrections Act of 1993, § 501-504 (H.R. 3419) (introduced November 1, 1993).

The primary concern with the S Corporation Reform Act proposal is that it would have a substantial impact on revenue by increasing the availability and attractiveness of subchapter S to more businesses. It will be difficult to pass at a time when deficit reduction is a major policy issue.

3. *The Health Security Act of 1993*

Tax practitioners may also find that the treatment of S corporation is significantly impacted by new health care administration. Section 7141 of President Clinton's Health Security Act[12] Legislation would have provided an amendment to section 1402 of the Code requiring that any 2 percent shareholder of an S corporation who materially participates in the activities of the corporation during a taxable year will be required to treat all of the shareholder's pro rata share of taxable income of the corporation from service-related businesses as self-employment income for employment tax purposes. Therefore, the pass-through of an S corporation's income to shareholders would be subject to employment tax, whether or not distributed, whether or not they are employees of the corporation, and whether or not capital investment was a significant income producing factor.

¶ 101. GENERAL TAX STRUCTURE OF SUBCHAPTER S

¶ 101.1. Congressional Purpose

The purpose of subchapter S is to permit taxpayers to select the corporate form of business without having the income of the business being taxed twice, once at the corporate level when earned and then again upon distribution to the shareholders. To carry out this intent, subchapter S treats the S corporation as a conduit for the shareholders.

¶ 101.2. Taxation of the S Corporation

The taxable income of the S corporations is generally computed in the same manner as in the case of an individual and passed through to the shareholders.[13] The S corporation is not subject to the corporate income tax provisions of Chapter 1.[14] There are important

---

12 Proposed Health Security Act of 1993 (H.R. 3600).

13 § 1363(b).

14 Id.

exceptions, such as for net recognized built-in gains,[15] investment credit recapture,[16] net excess passive investment income,[17] and section 291 corporation tax preference treatment.

¶ 101.3. Shareholder Taxation

A. Pass-Through of Income

Each shareholder will take into account separately his or her pro rata share of each item of corporate income, loss, deduction or credit, for the taxable year of the corporation whether or it is to not be distributed to the shareholder.[18]

B. Character of Pass-Through

The character and source of each item is determined at the corporate level and then passed through to the shareholders.[19]

C. Restrictions on Losses

There are special rules which limit the pass through of losses to the shareholders' investment in the corporate stock and loans.[20]

D. Distributions

Income which has previously been taxed to the shareholders when earned by the S corporations may be distributed to the shareholders tax free.[21] If the corporation has pre-election accumulated earnings and profits, excess distributions may be subject to dividend tax treatment.[22]

---

15 § 1374.

16 § 1371(d).

17 § 1375.

18 § 1366(a).

19 § 1366(b).

20 § 1366(d).

21 § 1368(a).

22 § 1368(c).

E. Basis Adjustments

Taxable and nontaxable income will increase a shareholder's basis in the stock of the corporation, and deductible and nondeductible expenses and nontaxable distributions will decrease the shareholder's basis.[23] If the shareholder's basis in stock has been previously reduced to zero, excess expenses or distributions may affect the shareholder's basis in shareholder loans to the corporation.[24]

¶ 101.4. Coordination with Subchapter C

The general tax rules of subchapter C will apply to the S corporation and its shareholders except to the extent inconsistent with subchapter S.[25]

¶ 102. ELIGIBILITY

¶ 102.1. Small Business Corporation

Only a "small business corporation," as defined in section 1361(b), is eligible to be an S corporation. A corporation qualifies as a small business corporation if it:

1. is a domestic corporation;
2. which is not an ineligible corporation;
3. does not have more than 35 shareholders;
4. has only individuals, estates or certain trusts as shareholders;
5. does not have a nonresident alien as a shareholder; and
6. has only one class of stock.

¶ 102.2. Domestic Corporation

An S corporation must be a domestic corporation created or organized in the United States or under the laws of the United States or any state or territory.[26]

---

23 § 1367.

24 Id.

25 § 1371(a).

26 §§ 1361(b)(1) and 7701(a)(3); Prop. Treas. Reg.

¶ 102.3. Ineligible Corporations

Certain types of corporations are prohibited from qualifying under subchapter S.

A. Affiliated Corporations

A corporation will be an ineligible corporation if it is a member of an affiliated group of corporations as defined in section 1504.[27]

1. Control

An S corporation is a member of an affiliated group if it owns at least 80 percent of the total voting power of another corporation, and at least 80 percent of the value of the stock of the other corporation.[28] "Stock" does not include certain preferred shares defined in section 1504(b)(4).[29]

2. Consolidated Returns

The fact that a consolidated return has not been filed does not affect the ineligibility of the affiliated group.[30]

3. Ownership by Related Persons

Since the affiliated corporation provisions of section 1504 have no related party rules (such as section 318), affiliation may be avoided by shifting stock to shareholders, directors, officers or other related persons.

---

§ 1.1361-1A (1986).

27 § 1361(a)(2); Prop Treas. Reg. § 1.1361-1A(d) (1986). *See also* Haley Brothers Construction Corp. v. Commissioner, 87 T.C. 498 (1986); O.E. Qualley v. Commissioner, 35 T.C.M. 887 (1976); Barnes Motors & Parts Co. v. United States, 309 F.Supp. 298 (E.D. N.C. 1970).

28 § 1504(a)(2).

29 Id.

30 O. E. Qualley v. Commissioner, 35 T.C.M. at 887 (1976).

(a) Examples of Permitted Relationships:

(1) S corporation was eligible when it transferred 21 percent of the stock of its DISC subsidiary to shareholders.[31]

(2) S corporation was eligible when a beneficiary of a trust shareholder bought 21 percent of the stock of a DISC subsidiary.[32]

(b) In some instances the Internal Revenue Service (the "Service" or the "IRS") has required that the minority be able to elect over 20 percent of the board of directors. A corporate officer who bought over 20 percent of the stock was required to have the power to elect over 20 percent of the subsidiary's board of directors.[33] In another instance, a favorable ruling was conditioned upon holders of 21 percent of the preferred stock having the right to elect two of nine directors.[34]

(c) An S corporation may also utilize a partnership as the holder of the stock of the subsidiary. For example, prior to conversion from subchapter C to subchapter S, the parent might transfer part or all of the stock of the subsidiary to a partnership in which the parent owns substantially all the partnership interests (e.g., 79-99 percent) and related persons own the balance.[35]

4. *Transitory Subsidiaries*

Transitory control of a subsidiary is permissible when acquisition of control is merely an interim step in an integrated transaction.

(a) Corporation Separations. The momentary control of a subsidiary has been permitted in a section 368(a)(1)(D) transfer of assets to a newly-created subsidiary immediately followed by a

---

31 Priv. Ltr. Rul. 84-51-049 (Sep. 18, 1984).

32 Priv. Ltr. Rul. 84-21-025 (Feb. 16, 1984).

33 Priv. Ltr. Rul. 84-26-007 (Mar. 12, 1984), *citing* Rev. Rul. 69-126, 1969-1 C.B. 218.

34 Priv. Ltr. Rul. 84-41-009 (Jun. 29, 1984).

35 See discussion of partnerships of S corporations, *supra*, at ¶ 102.7.

section 355 split-up. In Revenue Ruling 72-320,[36] the Service disregarded the formation of the transitory subsidiary, since the temporary ownership was treated as a mere interim step in an integrated plan to split the corporation among shareholders. In disregarding the prohibited interim affiliation, the Service recognized that the ultimate goal was to transfer part of the assets to some of the shareholders and applied the step transaction principles of American Bantam Car Company v. Commissioner,[37] to ignore the short-term subsidiary.

(1) Period of Transitory Ownership. The current policy of the Service is to issue favorable rulings in this area only if there is a commitment to dispose the acquired stock within one day.

Earlier in Revenue Ruling 73-496,[38] the Service permitted the acquiring S corporation to control the target subsidiary for up to 30 days prior to liquidation.

The Service's practice of permitting a 30-day period was modified shortly after 1986, when the Tax Court in Haley Bros. Construction Co. Corp. v. Commissioner,[39] terminated an S corporation for holding a newly acquired active subsidiary for approximately 23 months before liquidating it. In dictum, the Tax Court rejected the 30-day period approved in Revenue Ruling 73-496 and suggested that the statute would not permit the court to ignore any transitory ownership of the active subsidiary.

---

36 Rev. Rul. 72-320, 1972-1 C.B. 270.

37 American Bantam Car Company v. Commissioner, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3rd Cir. 1949). *See also* T.A.M. 92-45-004 (July 28, 1992).

38 Rev. Rul. 73-496, 1973-2 C.B. 320 (30 days); Rev. Rul. 72-320, 1972-1 C.B. 270; Priv. Ltr. Rul. 82-28-099 (Apr. 16, 1982) (set 30-day limit); Priv. Ltr. Rul. 78-12-051 (Dec. 22, 1977) (election terminated for ownership in excess of 100 days caused by delay in obtaining federal agency approval for liquidation). In Private Letter Ruling 89-21-021 (Feb. 17, 1989), a merger within 26 days was ineffective where the plan to merge occurred after the acquisition.

39 Haley Bros. Construction Co. Corp. v. Commissioner, 87 T.C. 498 (1986).

Notwithstanding the Haley Bros. dictum, the Service has continued to issue favorable rulings for divisive organizations when the acquired stock is transferred immediately to the shareholders.*(40)* Since the Service has consistently issued favorable rulings in this area, careful practitioners should obtain protective rulings in order to avoid the risks presented by the Haley Bros. case. All of the steps in the divisive reorganization should be orchestrated well ahead of time in order that the shares of the acquired corporation can be distributed to shareholders within one day of creation or acquisition.

(b) Stock Acquisitions to Obtain Assets. A frequent problem arises when an operating S corporation desires to buy the assets of another corporation and the target corporation shareholders insist on selling stock rather than the target's assets. The acquisition of controlling stock of another corporation creates problems for an S corporation because it is prohibited from being part of an affiliated group and because the S corporation, as a shareholder, is treated as an individual owner, rather than a corporate owner of the acquired stock under section 1371(a)(2).

(1) Prior Law. Under the old Kimbell-Diamond doctrine, the courts adopted the position that the purchase by one corporation of the stock of another corporation in order to obtain its assets followed by an immediate liquidation should be treated as a single transaction involving the purchase of assets.*(41)* The controlled subsidiary liquidation rules of sections 332 and 334(b)(1) were ignored and upon liquidation, the assets acquired a cost basis in the hands of the acquiring corporation. The Kimbell-Diamond doctrine was subsequently superseded by Congress in 1954 with the enactment of section 334(b)(2), expressly recognizing that upon the purchase of stock for the purpose of liquidation, the transaction would be treated essentially as a purchase of assets rather than stock.

---

40 In G.C.M. 39768 (Dec. 1, 1988), the Service formally reaffirmed its liberal transitory ownership guidelines first enunciated in Revenue Ruling 72-320. *See also* Priv. Ltr. Rul. 88-01-026 (Oct. 9, 1987); Priv. Ltr. Rul. 89-22-04 (Feb. 16, 1989).

41 Kimbell Diamond Milling Co. v. Commissioner, 14 T.C. 74, *aff'd per curiam* 187 F.2d 718 (5th Cir. 1950). *See also* H.B. Snively v. Commissioner, 19 T.C. 850 (1953).

(2) Section 332-334(b)(2) Liquidation as an Asset Purchase. In Revenue Ruling 73-496,[42] the Service treated the acquisition of the controlling stock of another corporation as a mere transitory step to acquire the assets for the purpose of a prompt liquidation which occurred within 30 days. The Service treated the integrated transaction as an asset purchase.

(3) Stock Purchases Under Section 338. In 1982, section 334(b)(2) was replaced by section 338 in order to permit the qualifying purchasing corporation to elect a cost basis in the assets without liquidating the subsidiary. After the passage of section 338, there was uncertainty as to whether the purchase by an S corporation of stock might be disregarded and treated as an acquisition of assets. When section 338 was enacted, the Conference Report explained that section 338 was "intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine."[43]

Under the current code, the parent may liquidate the newly acquired subsidiary under section 332, obtain a carryover basis in assets under section 334(a)(1), and avoid tax at the subsidiary level under section 337, or in the alternative under section 338, the parent in a qualified stock purchase by a "purchasing corporation" may elect to obtain a fair market value in the acquired assets at the cost of gain recognition on the excess of fair market value over basis in those assets, with or without liquidation.

(c) Service Rejects Asset Acquisition Treatment. In Revenue Ruling 90-95,[44] the Service has ruled that an acquiring corporation which purchases the stock of a target and immediately liquidates the target under a plan to obtain the target's assets, must be treated as having made a qualified stock purchase under section 338, followed by a liquidation, and cannot treat the transaction as an asset acquisition.

---

42 Rev. Rul. 73-496, 1973-2 C.B. 312.

43 H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 536 (1982), 1982-2 C.B. 600, 632.

44 Rev. Rul. 90-95, 1990-2 C.B. 67.

(d) Liquidation Issues for S Corporations. If S corporations cannot disregard the stock purchase, it is faced with two problems. The S corporation cannot own 80 percent or more of the stock of another corporation because of the anti-affiliation rule under section 1361(b)(2)(A). In addition, section 1371 (a)(2) provides that when an S corporation owns the stock of another corporation, it is treated as an individual. Section 332 applies only to a "controlling corporation" and section 338 applies only to a "purchasing corporation."

(1) Early Position of the Service. In 1988, the Service set a negative atmosphere in Private Letter Ruling 88-18-049,[45] by ruling that an acquiring S corporation could not make a section 338 election because it could not qualify as a "purchasing corporation" under section 338(d) and because of section 1371(a)(2).[46] The transaction involved an S corporation which acquired all the stock of a target S corporation followed within two days with a liquidation.

(2) Present Service Position. Recently in Technical Advise Memorandum 92-45-004,[47] the Service has reversed its position and ruled that section 1371(a)(2) does not preclude an S corporation from making a qualified stock purchase under section 338, and then engaging in a tax-free section 332 liquidation. In doing so, the Service observed that the legislative and ruling history concerning S corporations and tax-free reorganizations demonstrate that Congress intended for S corporations to have the same business and tax flexibility in effectuating corporation acquisitions as C corporations have.

After citing Revenue Ruling 90-95, and the congressional history indicating that the stock purchase must be recognized and the Kimbell-Diamond asset purchase doctrine thereby discarded, the Service proceeded to expressly reaffirm the Revenue Ruling 72-320 holding that momentary control of a subsidiary in a divisive reorganization would not terminate the S election and further applied the rationale to a

---

45 Priv. Ltr. Rul. 88-18-049 (Feb. 10, 1988).

46 The Service also relied upon consistent language in Treasury Regulation section 1.338-4(t)(D), Ans. 4).

47 T.A.M. 92-45-004 (July 28, 1992).

section 338 stock purchase followed by an immediate section 332 liquidation.(48)

(e) Reorganizations. In General Counsel Memorandum 13768,(49) the Service determined that section 1371(a)(2) does not prevent the corporation from being a party to a reorganization during the momentary ownership of the stock of another corporation in an "A," "C" or "D" reorganization under section 355 or 368.

(f) Tax Simplification and Technical Corrections Act of 1993. Section 504(a) of the Proposed Tax Simplification and Technical Correction Act of 1993,(50) would repeal the section 1371(a)(2) characterization of the S corporation as an individual, and would permit S corporation affiliation with a C corporation subsidiary under section 1361 (b)(2). The S corporation would be prohibited from being included in a group filing a consolidated return. However, if the S corporation owned 100 percent of the stock of a C corporation which owned 100 percent of its own subsidiary C corporation, the two C corporation subsidiaries could elect to file a consolidated return. This provision would not permit an S corporation to own controlling stock in another S corporation, since an S corporation would still be prohibited from having a corporate shareholder.

5. Inactive Subsidiary

Under a special rule, an S corporation may still own a subsidiary if the subsidiary has not begun business and does not have gross income.(51)

---

48 In 1993, in Private Letter Ruling 93-23-024, the Service revoked old Private Letter Ruling 88-18-049 (Feb. 10, 1988).

49 G.C.M. 13768 (Dec. 1, 1988). The General Counsel Memorandum relied, in part, upon the concurrent enactment of section 1363(e) in 1982, which explicitly recognized the application of sections 354, 355 and 356 and noted that the 1988 repeal of section 1363(e) was to remove "deadwood" which was a redundant overlap of subchapter C.

50 Proposed Tax Simplification and Technical Corrections Act of 1993, section 504(a) (H.R. 3419) (Nov. 1, 1993), introduced November 1, 1993.

51 § 1361(c)(6).

(a) Beginning Business. The proposed regulations state that a facts and circumstances test is to be applied in determining when the subsidiary begins business. Proposed Regulation section 1.1361-1A(d)(2):[52]

B. Other Ineligible Corporations

The following corporations are not eligible to qualify as S corporations:

1. Financial institutions which are allowed deductions for bad debts under sections 585 or 593.

2. Insurance companies which are subject to tax under the special insurance company rules of subchapter L. Revenue Ruling 74-344[53] previously held life insurance companies were not eligible. However, Revenue Ruling 74-437,[54] held stock casualty insurance companies taxable under section 831(a) were eligible.

3. A corporation to which a section 936 possession tax credit election applies.

4. A DISC or former DISC.

¶ 102.4. Authorized Number of Shareholders

The maximum number of shareholders permitted is 35.[55]

A. Spouses

Since husband and wife shareholders (and their estates) are treated as a single shareholder, the S corporation may have a maximum of 70 investors.[56]

---

52 Coca-Cola Bottling Company of Gallup v. United States, 443 F.2d 1253 (10th Cir. 1971) (ownership of franchise, real property and plant was destructive); May v. United States, 644 F.2d 578 (6th Cir. 1981), Rev'g 78-2 U.S.T.C. (CCH) ¶ 9564 (E.D. Ky. 1978) (election invalid where merely holding title to land).

53 Rev. Rul. 74-344, 1974-2 C.B. 273.

54 Rev. Rul. 74-437, 1974-2 C.B. 274.

55 § 1362(b)(1)(A).

56 § 1361(c)(1).

B. Tax Avoidance

The Service ruled in Revenue Ruling 77-220 that subchapter S was not available when three S corporations (each with the maximum number of shareholders) were formed to operate a single business through a partnership because the principal purpose was to use subchapter S.(57) In its ruling, the Service relied heavily upon the corporate common law doctrine espoused in Gregory v. Helvering, that there must be a business purpose other than a tax purpose for the transaction to be given economic significance.(58)

In Revenue Ruling 94-43,(59) the Service revoked Revenue Ruling 77-220 on the premise that the number of shareholders requirement was to obtain administrative simplicity and that administrative simplicity is not affected by the corporation's participation in a partnership with other S corporation partners. The Service also concluded that shareholders of one S corporation should not be considered a shareholder of another S corporation just because both S corporations are partners in a partnership.

¶ 102.5. One Class of Stock Limitation

A. General

The S corporation may have no more than one class of stock.(60)

B. Voting Rights

1. Non-Voting Common Stock

In 1982, the one class of stock rule was modified to provide that a an S corporation will not be treated as having more than one class of stock "solely because there are differences in voting rights among the shares of common stock."(61)

2. Planning Opportunities

Multiple voting rights will permit greater latitude in structuring management control and in shifting ownership

57 Rev. Rul. 77-220, 1977-1 C.B. 263.

58 Gregory v. Helvering, 293 U.S. 465 (1935).

59 Rev. Rul. 94-43 I.R.B. 1994-27 (July 5, 1994).

60 § 1361(b)(1)(D).

61 § 1361(c)(4).

for estate planning purposes. Voting trusts may be used under section 1361(c)(2)(A)(iv) for creative tax planning.

3. *Examples for Use of Nonvoting Common Stock*

Corporation X may now authorize class A voting common stock and class B nonvoting common stock in the Articles of Incorporation.

Upon issuance to shareholder F of 100 shares of voting class A and 100 shares of nonvoting class B, shareholder F may transfer the nonvoting stock to a qualified subchapter S trust for the benefit of a son. Henceforth, one-half of all future income will be taxed to the son while F will control management of the corporation. Also, one-half of the future growth will pass on to future generations.[62]

The corporation may issue voting stock to management and nonvoting stock to outside venture capital investors.

The corporation may issue stock with limited voting rights to key employees which entitles them to vote only upon a merger, sale of substantially all assets other reorganizations or liquidation.

4. *Regulations*

Under the regulations, differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock.[63] The corporation may have voting and nonvoting common stock, a "class" of stock that may vote only on certain issues, irrevocable proxy agreements or a group of shares that differ with respect to rights to elect members of the board of directors, so long as all shares of stock of a S corporation have identical rights to distribution and liquidation proceeds.

C. *Economic Interests Which Are Not Stock*

1. *Section 83 Restricted Stock*

(a) Restricted Stock is not Recognized as Stock. The regulations provide that restricted stock which is substantially nonvested is not treated as

---

62 *See* Priv. Ltr. Rul. 85-40-062 (Jul. 9, 1985); Priv. Ltr. Rul. 84-35-042 (May 25, 1984); Priv. Ltr. Rul. 84-15-025 (Jan. 5, 1984); Priv. Ltr. Rul. 84-07-018 (Nov. 19, 1983).

63 Treas. Reg. § 1.1361-(1)(1) (May 28, 1992).

outstanding stock for purposes of subchapter S.[64] Thus stock issued to a person in connection with the performance of services may not be recognized as stock, if it is subject to section 83 and if the stock is subject to a substantial risk of forfeiture and is nontransferable.[65]

(b) Holder of Stock is not a Shareholder. The holder of restricted stock is not treated as a shareholder for purposes of subchapter S.[66]

(1) Until such property becomes substantially vested the transferor will be regarded as the owner of such property (i.e., stock will be treated as non-issued) and any distribution constitutes wages to the recipient.[67]

(2) Subchapter S items of income, loss deductions and credit will be allocated to unrestricted shareholders and distributions on restricted stock will be treated as compensation deductible by the corporation.

(c) Example. Assume Corporation S has three equal shareholders A, B and C, but A's shares are subject to a substantial risk of forfeiture. The corporation earns $90,000 for the year.

If the $90,000 is distributed in the year earned, Corporation S will have a compensation deduction for the $30,000 distributed to A, and an obligation to withhold and pay related employment taxes. A will have compensation income. B and C will allocate the net $60,000 of income between them in accordance with their ownership of stock under subchapter S (50 percent - 50 percent).

If the $90,000 is retained for later distribution, B and C will each report $45,000 of current income. Later they would benefit from the $30,000 corporate deduction for compensation deemed paid to A when distributions are made equally to the three shareholders in a future year.

---

64 Treas. Reg. § 1.1361-1(b)(3) (May 28, 1992).

65 § 83(a); Treas. Reg. § 1.83-3(b) (as amended in 1985).

66 Treas. Reg. § 1.1361-1(b)(3) (May 28, 1992).

67 Rev. Proc. 80-11, 1980-1, C.B. 616.

(d) Section 83(b) Election. If the shareholder elects to include the excess of FMV over the cost of the stock in gross income when received pursuant to section 83(b), the stock will be treated as outstanding stock and the holder will be treated as a shareholder.[68]

(e) Ineligible section 83 S corporation Shareholders. Since the owner of restricted shares is not recognized as a shareholder, the status of the subchapter S election is not adversely affected when an ineligible person is the owner of substantially unvested stock (e.g., a nonresident alien shareholder).

2. *Deferred Compensation Plans*

(a) General. A deferred compensation instrument, obligation or arrangement is not treated as stock if it:

(1) does not convey voting rights;

(2) is an unfunded and unsecured promise to pay money or property in the future;

(3) is issued only to an employee or an independent contractor in connection with the performance of services for the corporation; and

(4) is under a plan where the employee or independent contractor is not taxed currently on income.[69]

(b) Stock Appreciation Rights. Stock appreciation rights and phantom stock agreements, historically have been found not to constitute second class of stock when there has been no participation as shareholders, no rights to shareholder notices, and no voting rights.[70] The final regulations provide that a deferred compensation plan is not a second class merely because it provides for current payments such

---

68 Treas. Reg. § 1.1361-1(b)(3) (May 28, 1992). *See also* Priv. Ltr. Rul. 88-19-041 (Feb. 11, 1988).

69 Treas. Reg. § 1.1361-1(b)(4) (May 28, 1992).

70 G.C.M. 39750 (Aug. 11, 1988); Priv. Ltr. Rul. 88-34-085 (Jun. 2, 1988).

as the annual payment of dividend equivalent amounts which are taxed currently as compensation.[71]

D. Multiple "Classes" of Stock

1. General-Identical Rights Required

An S Corporation will be treated as having more than one class of stock if all of the outstanding shares do not confer identical rights to distribution and liquidation proceeds.[72] The corporation cannot have preferred stock with dividend or liquidation preferences.

2. Source of Stock Rights

The regulations provide that the determination of whether all shares confer identical rights to distribution and liquidation process is "based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreement relating to distribution and liquidation proceeds (collectively the "governing provisions."[73]

(a) <u>"Commercial Contractional Arrangement" Exceptions</u>. A commercial contractual arrangement such as a lease, employment agreement or loan agreement is not treated as a "binding agreement relating to distribution or liquidation proceeds," unless a principal purpose of the agreement is to "circumvent" the one class of stock requirement.[74]

(b) <u>Impact of State Laws and Regulations</u>.

(1) <u>State Law Regulating Ownership Preferences</u>. State laws or regulations which may cause differences in rights to dividends or liquidation proceeds, will have the effect of causing a second class of stock.

(i) Some states may impose restrictions on promotional shares requiring a temporary waiver of the right to receive dividends and

---

71 Treas. Reg. § 1.1361-1(b)(4) (May 28, 1992).

72 Treas. Reg. § 1.1361-1(l) (May 28, 1992).

73 Treas. Reg. § 1.1361-1(l)(2)(i) (May 28, 1992).

74 Treas. Reg. § 1.1361-1(l)(2)(i) (May 28, 1992).

the right to participate in distributions in liquidation.(75)

(ii) California authorizes shareholders in a statutory close corporation to use shareholder agreements to modify a corporation's management structure, the division of profits or the distribution of assets in liquidation.(76)

(2) State Laws Requiring Payment of Taxes. In order to control collection of taxes from nonresident shareholders many states require the corporation to pay or withhold state income taxes from nonresident shareholders. The Treasury Regulations disregard such laws in determining whether there is a second class of stock, if all the shares confer identical rights to distribution and liquidation after all actual distributions and the construction distributions resulting from the payment or withholding of taxes by the corporation are taken into account.(77) Thus a difference in timing between constructive distributions for taxes and actual distributions to other shareholders will not cause a second class of stock.

(i) Example 1. Assume state X requires corporations to pay state income taxes on behalf of nonresident shareholders, but not for resident shareholders. The state obligation for the corporation to make the constructive payments on behalf of nonresident shareholders will be disregarded, if the resident shareholders have the right (under state law, or corporate bylaws or a binding agreement requiring equal distributions) to receive larger actual distributions to take into account and equalize the constructive distributions to the nonresident shareholders.(78)

---

75 California Corporation Rule 260.141. *See* Paige v. United States, 580 F.2d 960 (9th Cir. 1978); Revenue Ruling 71-522, 1971-2 C.B. 316; Treas. Reg. § 1.1361-1(l)(2)(V) Example 1 (May 28, 1992).

76 California Corporations Code §§ 158, 204(a), and 300 (January 1977).

77 Treas. Reg. § 1.1361-1(l)(2)(ii) (May 28, 1992).

78 Treas. Reg. § 1.1361-1(l)(2)(v) Example 7 (May 28, 1992).

The same result applies if the state income taxes paid for nonresident shareholders are treated as advances which are required to be repaid or offset by reductions in distributions to the nonresident shareholder under state governing provisions.

3. *Stock Purchase Agreements*

The regulations have carved out some specific exceptions to the single class of stock rule which will insulate most stock purchase agreements from the risk of inadvertently terminating the election.

(a) Redemptions and Cross-Purchases Based Upon Death, Divorce, Disability or Termination of Employment. Generally, bona fide agreements to redeem or purchase shares at the time of death, divorce, disability or termination of employment are disregarded in testing whether the corporation has than one class of stock.[79]

(b) Shareholder Redemption Agreements, Shareholder Buy-Sell Agreements, and Transfer Restriction Agreements. Other buy-sell agreements among shareholders, agreements restricting the transferability of stock and redemption agreements are generally disregarded in testing for differences in distribution or liquidation rights, unless:

(1) The principal purpose of the agreements is to "circumvent" the one class of stock requirement; and

(2) The agreement establishes a purchase price which is significantly in excess or below the FMV at the time the agreement is entered into.[80]

The regulation also provides that if section 83 restricted stock that is substantially nonvested (under section 1.83-3(b)) is treated as outstanding for the purpose of a buy-sell or redemption agreement, the forfeiture provisions will be disregarded.

Although not expressly covered in the regulations, the concept of buy-sell agreements should include right of first refusal agreements.

---

79 Treas. Reg. § 1.1361-1(l)(2)(iii)(B) (May 28, 1992).

80 Treas. Reg. § 1.1361-1(l)(2)(iii)(B) (May 28, 1992).

(c) Qualification of Price of Stock Purchase Agreement. An agreement that provides for a price at book value or between book value and FMV is not considered significantly in excess or below FMV for the purpose of testing the qualification of the stock purchase agreement price.[81]

A good faith determination of FMV will be respected, unless the value is "substantially in error and the determination of the value was not performed with reasonable diligence".[82]

A safe harbor is also created for the determination of book value in the regulations. A determination of book value will be respected if:

(1) The book value is determined in accordance with Generally Accepted Accounting Principles (GAAP) (including optional adjustments), or

(2) The book value is used for any substantial non-tax purpose.

This safe harbor may be of little use to many closely-held service-oriented businesses which use the cash receipts and disbursements method of accounting and do not conform to GAAP accounting principles.

(d) Example of Redemption. Assume that J, K and L are shareholders of corporation S. L is also an employee but the shares were not issued to L in connection with the performance of services. By agreement, S will redeem L's shares for an amount significantly below fair market value either on the termination of L's employment or if S's sales fall below a certain level.

The portion of the agreement causing a redemption on termination of employment will be disregarded for testing for a second class of stock under Treasury Regulation section 1.1361-1(1)(2)(iii)(B), and the portion of the agreement providing for a redemption if sales fall below a certain level will be disregarded under Treasury Regulation section 1.1361-1(1)(2)(iii)(A), even though the redemption price is significantly below fair market value, so long as there is not a

81 Treas. Reg. § 1.1361-1(1)(2)(iii)(A) (May 28, 1992).

82 Id.

principal purpose to circumvent the one class of stock requirement.[83]

(e) Prior Rulings on Shareholder Agreements. The Service issued several rulings prior to the new 1992 regulations which acknowledged that redemption rights and buy-sell restrictions would not cause a second class of stock when the rights did not otherwise affect the rights of the person to profits or assets while a shareholder.

(1) Revenue Ruling 85-161[84] concerned a closely held S corporation where three related persons owned all of the voting stock. An employee owned only nonvoting stock. The buy-sell agreement provided that: (i) the employee could transfer stock only with the consents of the other shareholders; (ii) without consent the employee could only sell to the corporation or other shareholders at book value; and (iii) on death, disability or termination the corporation or other shareholders had a right to buy the employee's stock. The agreement limited only the rights of the employee. The Service ruled that the agreement did not destroy the subchapter S election since it did not affect the shareholders' rights in the corporation's projects or assets.

(2) In another instance, stock acquired by employees under an employee stock option plan were subject to forfeiture upon voluntary termination of employment during the option period or were redeemable at only 70 percent of the adjusted book value in the event of death or permanent disability. There was no second class of stock since the plan restrictions did "not affect a shareholder's interest in the company's profits or assets."

4. Non-Conforming Distributions - Differences in Timing or Amounts

Even though actual distributions may differ in time or amount among the shareholders, such differences will not cause a destructive second class of stock, so long as the governing provisions provide for identical distribution and liquidation rights.[85]

---

83 Treas. Reg. § 1.1361-1(1)(2) Example 9 (May 28, 1992).

84 Rev. Rul. 85-161, 1985-2 C.B. 191.

85 Treas. Reg. § 1.1361-1(1)(2)(i) (May 28, 1992). Earlier 1990 proposed regulations had created a very

(a) Non-Conforming Distribution Given Separate Tax Effect. Although the subchapter S election will not be terminated by such non-pro rata distributions, any such nonconforming distributions (whether an actual, constructive or deemed distribution) will be given independent tax effect under the application facts and circumstances. The standards and their impact may be illustrated by a number of examples:

(1) Example 1. Actual distributions Differing in Timing. Assume Corporation S has two equal shareholders, A and B. S distributes $50,000 to A in year 1, but does not distribute $50,000 to B until year 2. The bylaws require equal distributions. The regulations provide that the timing difference does not cause a second class of stock, so long as the circumstances indicate that the difference in timing is not by reason of any binding agreement relating to distribution or liquidation proceeds.[86]

(2) Example 2. Excess Compensation. Assume Corporation S has two equal shareholders, C and D. C's binding employment agreement is reasonable. However, compensation paid to D under his binding employment agreement is found to be excessive. D's employment agreement was not designed to circumvent the one class of stock requirement. Under the regulations, the employment agreements are not governing provisions and there is only one class of stock. S is not allowed a business deduction for the excess compensation paid to D.[87]

(3) Example 3. Fringe Benefits. Corporation S has a binding agreement to pay accident

---

serious problem on the second class of stock issue by expressly prohibiting any nonconforming distributions. Proposed Regulation section 1361-1(l)(2)(ii) (1990) held there would be more than one class if there were actual distributions which differed in timing or amount among the shareholders, even if the shares were identical in distribution and liquidation rights. This could have caused serious consequences for even a minor deviation from strict pro rata distribution requirements.

86 Treas. Reg. § 1.1361-1(l)(2)(v) Example 2 (May 28, 1992).

87 Treas. Reg. § 1.1361-1(l)(2)(v) Example 3 (May 28, 1992).

and health insurance premiums on behalf of employees which results in different premiums to each shareholder employee. The different fringe benefits do not cause a second class of stock.(88)

(4) Example 4. Below-Market Corporation-Shareholder Loan. Assume Corporation S makes a below-market loan to shareholder E that is a corporation-shareholder loan subject to section 7872. The loan agreement is not considered a governing provision and S is not deemed to have more than one class of stock.(89)

(b) Distributions Which Take Into Account Changing Interests in Stock. An S Corporation does not have a second class of stock merely because of an agreement which provides that if there is a change in stock ownership, distributions in a taxable year will be made based upon the shareholders' varying interests in the current or immediately preceding taxable year.(90) This permits the S Corporation to wait until after the close of the prior taxable year to make distributions to shareholders based on their ownership during the year. If the distributions under the agreement are not made within a reasonable time after the close of the taxable year, the distributions may be recharacterized, but will not cause a second class of stock.

E. Other Financing Arrangements as Second Class of Stock

1. *General Rule for Debt Instruments*

Debt instruments, obligations or other financing arrangements will not be treated as a second class of stock for subchapter S purposes unless two conditions are present:

(a) Debt as Equity. The obligation constitutes equity or otherwise results in the holder being treated as the owner under general principles of Federal tax law; and

---

88 Treas. Reg. § 1.1361-1(l)(2)(v) Example 4 (May 28, 1992).

89 Treas. Reg. § 1.1361-1(l)(2)(v) Example 5 (May 28, 1992).

90 Treas. Reg. § 1.1361-1(l)(2)(iv) (May 28, 1992).

(b) Principal Purpose. The principal purpose of issuing or entering into the obligation is:

(1) To circumvent the rights to distribution or liquidation proceeds conferred on outstanding shares; or

(2) To circumvent the limitation on eligible shareholders.[91]

2. *Regulating Shareholders for Obligations Designated as Debt*

The regulations establish some safeguards for small financing advances to the corporation and when the debt is held proportionately by the shareholders.[92]

(a) Unwritten Advances. Unwritten advances from a shareholder which do not exceed $10,000 in the aggregate at any time during the taxable year of the corporation, which are treated as debt by the parties and which are expected to be repaid within a reasonable time, are not to be treated as a second class of stock, even if the advances would be equity under general principles of Federal tax law. An advance which fails this test (e.g., long-term repayment) is still not a second class of stock unless the advance is treated as equity held for a principal purpose of circumventing the rights of outstanding shares or the limitation on eligible shareholders.

(b) Proportionately-Held Obligations. Obligations which are owned solely by shareholders in the same proportion as they own stock in the Corporation will be disregarded, even if they would be equity under general principles of Federal Tax law.[93]

3. *General Principles of Federal Tax Law (The Debt-Equity Issue)*

(a) Case History. The courts have consistently rejected efforts by the Service to treat

91 Treas. Reg. § 1.1361-1(l)(4) (May 28, 1992).

92 Treas. Reg. § 1.1361-1(l)(4)(i)(B) (May 28, 1992).

93 Treas. Reg. § 1.1361-1(l)(4)(ii)(B)(2) (May 28, 1992). This is consistent with former Treas. Reg. § 1.1371-1(g) (1959), but not withdrawn Prop. Reg. § 1.1361-1(l)(5) Example 3. (Oct 4, 1990).

shareholder loans as a second class of stock even when having characteristics of equity capital.[94]

(b) History of Regulations.

(1) Initial Second Class of Stock Regulations. The initial 1959 regulations on the second class of stock issue provided:

> "*If an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock.*"[95]

In 1966, the Tax Court invalidated part of former Treasury Regulation section 1.1371-1(g) in Gamman v. Commissioner, finding that there was:

> "nothing in the law itself, the committee reports, or the assumed purpose of the legislation that would justify holding, arbitrarily and per se, that all instruments which purport to be debt obligations but which in fact represent equity capital, must be treated as a second class of stock for purposes of section 1371."[96]

(2) Second Amended Regulation. In response to the Gamman decision, the Treasury Department immediately modified the last sentence of the regulation to provide:

> "Obligations which purport to represent debt but actually represent equity capital will generally constitute a second class of stock. *However, if such purported debt obligations are owned solely by the owners of the nominal stock of the corporation in substantially the same proportion as they own such nominal stock, such purported debt obligations will be treated as contributions*

---

94 W. C. Gamman, 46 T.C. 1 (1966); James L. Stinnett, Jr., 54 T.C. 221 (1970); Amory Cotton Oil Co. v. United States, 468 F.2d 1046 (5th Cir. 1972); Shores Realty Co., Inc. v. United States, 468 F.2d 572 (5th Cir. 1972); Portage Plastics Company, Inc. v. United States, 486 F.2d 632 (7th Cir. 1973); Michael G. Jolin v. Commissioner, 50 T.C.M. 140 (1985).

95 Former Treas. Reg. § 1.1371-1(g) (1959) (emphasis added).

96 Gamman v. Commissioner, 46 T.C. 1, 8 (1966).

to capital rather than a second class of stock."(97)

Next, in Stinnett v. Commissioner,(98) the Tax Court expressly rejected the effort of the modified regulation to prohibit all non-stock equity, unless it was held proportionally by the common stock shareholders, and held the revised regulation invalid.

(3) The Courts of Appeals consistently invalidated the modified second class of stock regulation:

(i) In Amory Cotton Oil, Company v. United States,(99) the court recharacterized advances by shareholders as equity, but not as a second class of stock. The court in Amory found Treasury Regulation section 1371-1(g) invalid on its face.

(ii) In Shores Realty Company v. United States,(100) the court found that funds advanced by shareholders to purchase undeveloped land were equity, but not second class of stock. The court reasoned that Congress did not intend a "debt-equity" analysis or "proportionability" analysis as enunciated in the regulation.

(iii) In Portage Plastics Company v. United States,(101) the court characterized loans by relatives of shareholders as equity contributions to capital, but not second class. The Court of Appeals found that:

> "the traditional thin capitalization doctrine tests for determining whether a purported loan should be treated as an equity contribution in order to prevent improper tax avoidance in other contexts are not suitable for determining whether

---

97 T.D. 6904, 1967-1 C.B. 219 (emphasis added).

98 Stinnett v. Commissioner, 54 T.C. 221 (1970).

99 Amory Cotton Oil, Company v. United States, 468 F.2d 1046 (5th Cir. 1972).

100 Shores Realty Company v. United States, 468 F.2d 572 (5th Cir. 1972).

101 Portage Plastics Company v. United States, 480 F.2d 632 (7th Cir. 1973).

a purported loan constitutes a second class of stock. . . ."[102]

(iv) The Service finally abandoned its litigation position on the debt-equity issue in 1973.[103]

4. *Straight Debt Safe Harbor*

(a) The 1982 Act created a straight debt safe harbor by providing that "straight debt" will not be treated as a second class of stock.[104]

(b) "Straight debt" is defined as any written unconditional promise to pay a sum certain in money on demand or on a specified date if:

(1) The interest rate and interest payment date are not contingent on profits, the borrower's discretion or similar factors;

(2) There is no convertibility, directly or indirectly, into stock; and

(3) The creditor is an individual (other than a nonresident alien) an estate or certain trusts.

(c) The Secretary was authorized to prescribe regulations to provide for proper treatment of straight debt.[105]

(d) Regulatory Factors.

(1) Reasonable Interest Rate - Proposed Regulations. Although section 1361(c)(5) does not require that interest rates be reasonable,

---

102 Id. at 636.

103 Tech. Info. Rel. No. 1248 (July 27, 1973).

104 § 1361(c)(5).

105 § 1361(c)(5)(C). The Senate Finance Committee Report explained: "It is intended that these rules will treat the instrument in such a way as to prevent tax avoidances, on the one hand, and also to prevent unfair, harsh results to the taxpayer. . . . The classification of an instrument outside the safe harbor rules as stock or debt will be made under the usual tax law classification principles." S. Rep. No. 97-640, 97th Cong. 2nd Sess. (1982) reprinted in 1982 U.S. Code Cong. & Admin. News.

withdrawn proposed regulations would have added a straight debt requirement that the obligation bear a reasonable interest rate.[106]

(2) Unreasonable Interest - Final Regulations. The final regulations also provide that if a straight debt obligation bears an unreasonably high interest rate, a portion may be recharacterized and treated as a payment that is not interest. The recharacterization will not cause a second class of stock.[107]

In the 1990 Proposed Regulations, the Treasury attempted, without statutory authority, to impose a reasonable interest requirement for qualification under the safe harbor rules. This standard was eliminated from the final regulations.

(3) Dividend Condition. The regulations prohibit a restriction that interest payments be contingent upon the payment of dividends with respect to common shares.[108] This is not a limitation set forth by section 1361(c)(5).

(4) Subordination. The fact that the obligation is subordinated to other debt of the corporation does not per se prevent qualification as straight debt.[109] The Service has permitted subordination to corporate financing, but opposed subordination to general creditors.[110]

(5) Convertibility. Although a convertible debenture cannot qualify as straight debt, the Service has treated convertible debentures as debt obligations when other characteristics are consistent with debt.[111] However, in one ruling, the Service held that adjustable rate convertible notes (ARCN's) issued at $1,000, but callable at $600 after two years

---

106 Withdrawn Prop. Reg. § 1.1361-1(l)(4)(i)(B) (Oct. 4, 1990).

107 Treas. Reg. § 1.1361-1(l)(5)(iv) (May 28, 1992).

108 Treas. Reg. § 1.1361-1(l)(5)(A) (May 28, 1992).

109 Treas. Reg. § 1.1361-1(l)(5)(ii) (May 28, 1992).

110 *See for example* Priv. Ltr. Rul. 87-35-008 (May 22, 1987).

111 Priv. Ltr. Rul. 87-35-008 (May 22, 1987).

unless converted for $1,000 of stock, were treated as equity.[112]

(e) Analysis of the New Equity/Prohibited Principal Purpose Second Class of Stock Test. The new standard in the final regulations that treats debt as a second class of stock when the obligation is equity under general principles of federal law, and if the principal purpose is to circumvent rights to distribution or liquidation proceeds on common stock, or to circumvent the limitation on eligible shareholders, raises a number of questions.

The new standard in Regulation section 1.1361-1(l)(4) is a much more liberal standard than that asserted by the Service through the years, but is also clearly more conservative than the latitude permitted by the courts. For example, the courts have traditionally required a two-step test, the first is to determine whether the obligation should be treated as equity and the second step is whether the obligation (treated as equity) rises to the level of being a second class of stock under general principles of federal tax law.

General principles of federal tax law should encompass the line of cases applicable to S corporations, such as Amory Cotton Oil Company,[113] Shores Realty Company,[114] and Portage Plastics Company,[115] which would create a tough standard for the Service to satisfy, as well as those basic principles which apply just to C corporations, such as the thin capitalization doctrine.

The principal purpose test is an unclear test since promissory notes and debentures, by their nature, will always have preferences to income stream (although called interest instead of dividends) and will always have basic creditor law priorities preferring payment to creditors over shareholders. Therefore, the principal purpose of the debt instrument will invariably be to circumvent (i.e.,

112 Rev. Rul. 83-98, 1983-2 C.B. 40.

113 Amory Cotton Oil Company v. United States, 468 F.2d 1046 (5th Cir. 1972).

114 Shores Realty Company v. United States, 68 F.2d 572 (5th Cir. 1972).

115 Portage Plastics Company v. United States, 480 F.2d 632 (7th Cir. 1973).

have priority over) the dividend and liquidation rights of the shareholder. It is merely incidental that the second class of stock problem raised by issuing *preferred stock* is avoided. Creditors will also generally be aware that subchapter S permits only one class of stock and that they want economic preferences not permitted to common shares.

The equity/principal purpose test is also deficient in that classification as equity is sufficient to cause a second class of stock, so long as the prohibited "principal purpose" exists, whether or not the characteristics of the "equity" debt instrument are such as to create primary differences in rights to distribution and liquidation proceeds which would rise to the level of being a second class of stock under the accepted case law for S corporations.

Finally, the prohibition against a purpose to avoid the shareholder eligibility rules is new. There has been no precedent for this issue in either the prior regulations or cases. This author has never heard of debt instruments being characterized as "equity" or as a "second class of stock," simply because it is owned by a financial institution, or other corporation, financial institution, trust or partnership.

5. *Debt-Equity Examples*

Example 1: Assume A needs $100,000 to start a business. A will contribute $10,000 and can obtain $90,000 from B. A wants at least one-half of expected early losses. B wants at least a 10 percent return on his investment and priority of return on investment in liquidation over A. B also wants at least one-half of all profits, The corporation might issue $10,000 shares of common stock each to A and to B and separately give $80,000 in straight debt to B. If A is to have voting control, then the voting rights of shares held by B might be reduced or eliminated. However, the liquidation preference would not be permissible.

Example 2: Assume in Example 1 that B is A's mother, that the note is for 5 years, renewable at B's option for 5 years, interest payable annually equal to 6 percent of profits and the debt subordinated to outside creditors. After losing money in year one, the S corporation pays substantial interest every year. B renews the note after 5 years and later exchanges his note for common stock. These were essentially the facts in <u>Portage Plastics Company, Inc. v. United States</u>, where the Seventh Circuit Court of Appeals concluded that even with contingent interest, subordination and convertibility, there was no second class of stock.[116]

6. Debt-Equity Degrees of Risk

Tax practitioners evaluating the degree of risk which S corporations may be prepared to take with debt instruments should carefully weigh the alternative characteristics and the degree of acceptance offered by the choices made.

(a) The safety of the straight debt safe harbor.[117]

(b) Revised Regulation section 1.1361-1 (l)(4), which applies general principles of federal tax law to treat the obligation as equity, and then treats it as a second class if there is a principal purpose to circumvent distribution or liquidation rights or circumvent shareholders' eligibility standards.

(c) Decisions applying general principles of Federal tax law. See for example, Portage Plaster Co., Inc. v. United States[118]; Amory Cotton Oil Company v. United States[119]; Shores Realty Company, Inc. v. United States[120].

(d) Debt which would fit within the guidelines of the withdrawn proposed section 385 regulations, such as a non-convertible non-participating loan obtained from a third party creditor (e.g., a bank) applying a low debt-to-equity ratio.

(e) Applying general principles of subchapter C debt-equity classification.

---

116 Portage Plastics Company, Inc. v. United States, 486 F.2d 632 (7th Cir. 1973).

117 § 1361(c)(5).

118 Portage Plaster Co., Inc. v. United States, 486 F.2d 632 (7th Cir. 1973).

119 Amory Cotton Oil Company v. United States, 486 F.2d 1046 (5th Cir. 1972).

120 Shores Realty Company, Inc. v. United States, 68 F.2d 572 (5th Cir. 1972).

(1) The Ninth Circuit Court of Appeals in Hartman v. United States,[121] applied 11 factors to find that a transfer of land to a corporation was an installment sale, not a contribution to capital. W owned 25 percent of the corporation's stock (H and W owned 89 percent. When she was unable to make payments to a third person on land purchased three years earlier, she conveyed the land to the corporation for one-third of the profits on resale.

(2) The 11 factors identified in Hartman include:

(1) The name given to the certificate (Bond versus Stock);

(2) presence or absence of maturity date (maturity indicates indebtedness);

(3) source of payments (e.g., contingency upon profits);

(4) right to enforce payment of principal and interest;

(5) participation and management (e.g., voting rights)

(6) a status equal to or inferior to regular corporate creditors (subordination);

(7) the intent of the parties;

(8) "thin" or adequate capitalization (economic stability -- risk of ability to repay);

(9) identity of interest between creditor and stockholder (e.g., proportionality);

(10) payment of interest only out of "dividend" money; and

(11) ability of the corporation to obtain loans from outside lending institution (debt if able to borrow from outside creditors).

121 Hartman v. United States, 827 F.2d 1409 (1987).

7. Options and Warrants

Historically, options and warrants to acquire stock have not been treated as a second class of stock.[122]

(a) "In The Money" Call Options or Warrants. The final regulations provide that a call option, warrant or similar instrument (collectively "call options") will be treated as a second class of stock if the call option (a) is substantially certain to be exercised by the holder and (b) has a strike price substantially below the fair market value of the stock.[123] A call option will not have a strike price substantially below FMV if the price at the time of exercise cannot, under the terms of the instrument, be substantially below the FMV of the underlying stock at the time of exercise.[124]

(b) Time of Determination. The determination is made (a) at the time of issuance, (b) in the event of a material modification, or (c) at the time of subsequent transfer to a person who is not an eligible shareholder.

If an option is issued in connection with a loan, and the exercise time period is extended in connection with a modification of the terms of the loan, the extension of the time period within which the option may be exercised is not a material modification.[125]

Example. Assume Corporation S has 10 shareholders and issues call options to A, B and C (who are not shareholders, employees or independent contractors of S). The strike price and FMV at issue are \$40. A year later, A sells his option to Partnership P when the FMV is \$80. When the option was transferred to P, it was not an eligible shareholder. Since there has been a transfer from an eligible Shareholder A to an ineligible Partnership P, the option must be retested. Since the strike price is only 50 percent of the FMV

---

122 Rev. Rul. 67-269, 1967-2 C.B. 298; Priv. Ltr. Rul. 88-19-041 (Feb. 11, 1988) (employee stock option plan); Priv. Ltr. Rul. 88-11-061 (Dec. 23, 1987) (issuance of warrants provided); issuance of incentive stock options, unqualified options and convertible notes not destructive in Priv. Ltr. Rul. 88-42-005 (Jul. 19, 1988).

123 Treas. Reg. § 1.1361-1(l)(4)(iii) (May 28, 1992).

124 Id.

125 Treas. Reg. § 1.1361-1(l)(4)(iii)(A) (May 28, 1992).

of the stock at the time of the option transfer, the strike price is substantially below the FMV and the option will be a second class of stock if the option is substantially certain to be exercised based on all of the facts and circumstances.[126]

(c) Safe Harbor Exceptions. The regulations provide some safe harbors for financial lenders, employees and independent contractors.

(1) Options with Financial Lender. A call option will not be treated as a second class of stock if it is issued by a corporation to a person that is actively and regularly engaged in the business of lending and is issued in connection with a loan to the corporation that is commercially reasonable.[127] This exception will continue to apply even if the lender transfers the option and corresponding loan to another lender.

(2) Options to Employees or Independent Contractors. A call option that is issued to an individual who is an employee or an independent contractor in connection with the performance of services to the corporation or a related corporation (that is not excessive for the services rendered) is not a second class of stock if:

(i) The option is nontransferable within the meaning of Treasury Regulation section 1.83-3(d); and

(ii) The option does not have a readily ascertainable FMV as defined in Treasury Regulation section 1.83-7(b) at the time the option is issued.[128]

(iii) For the purpose of this employment exemption, a corporation is related to the issuing corporation if more than 50 percent of the voting power and value of its stock is owned by the issuing corporation.

---

126 Treas. Reg. § 1.1361-1(l)(4)(v) Example 1 (May 28, 1992).

127 Treas. Reg. § 1.1361-1(l)(4)(iii)(B)(1) (May 28, 1992).

128 Treas. Reg. § 1.1361-1(l)(4)(iii)(B)(2) (May 28, 1992).

(d) 90 Percent FMV Safe Harbor. A call option is not treated as substantially certain of being exercised if the stock price at the time of issuance, modification or transfer is at least 90 percent of the FMV of the stock subject to the call option.[129]

A good faith determination of FMV by the corporation will be respected unless the value is substantially in error and the determination of value was not made with due diligence.

8. Convertible Debt

The regulations also take the position that if a convertible debt instrument embodies rights equivalent to those of a call option, it is evaluated both as debt and as a call option.[130]

¶ 102.6. Eligible Shareholders

A corporation may qualify as a "small business corporation" only if its stockholders are individuals, estates, or certain trusts.[131]

A. Individuals

Individuals are eligible shareholders.

B. Nonresident Aliens

Nonresident aliens are prohibited from eligibility.[132] In Revenue Ruling 73-478,[133] the Service limited eligibility to residents of the 50 states and the District of Columbia and held that an alien resident of Puerto Rico was ineligible. This restriction may create real problems for United States citizens or resident aliens who have spouses subject to the community property laws of other countries. For example, in Ward v. United States, the

---

129 Treas. Reg. § 1361-1(l)(4)(iii)(C) (May 28, 1992).

130 Treas. Reg. § 1.1361-1(l)(4)(iv) (May 28, 1992).

131 § 1361(b)(1)(B).

132 § 1361(b)(1)(c), Rev. Rul. 78-274, 1978-2 C.B. 220. The term "nonresident alien" probably applies only to individuals and not alien estate, but the issue is uncertain. *See* Eustice & Kuntz, Fed. Income Taxation of S Corporations, ¶ 3.03(2).

133 Rev. Rul. 73-478, 1973-2 C.B. 310.

United States Claims Court found a New Mexico corporation was not eligible since the shareholder's wife (a citizen and resident of Mexico) was deemed to have a community property interest under the laws of Mexico.[134] Foreign trusts are also ineligible shareholders.[135]

1. Split Ownership Interests

(a) An individual may own stock as a tenant in common, joint tenant, tenant by the entirety, or as community property.

(b) An interest for a term of years does not qualify.[136]

(c) A life estate or usufruct will qualify only if: (1) the interest is owned by one individual who is a citizen or resident of the United States; (2) the individual has not transferred the interest; and (3) the interest will terminate upon the owner's death.[137]

C. Estates

1. Decedents Estates

Decedents Estates are eligible shareholders under section 1361(b)(1)(B).

(a) Unduly Prolonged Administration. If the administration is unduly prolonged in order to preserve a subchapter S election, it would be deemed converted to a testamentary trust.[138]

(b) Payment Deferral for Closely-Held Business. The estate may be kept open for the 15-year

---

134 Ward v. United States, 661 F.2d 226 (Ct. Cl. 1981). *See also* §§ 7701(b)(1) (A)(i) and (6) (lawful permanent alien).

135 § 1361(c)(2)(A).

136 Prop Reg. § 1.1361-1A(f) (1986).

137 Prop. Reg. § 1.1361-1A(f)(3). *See* S. Rep. 97-640, 97th Cong., 2d Sess. 9 (1982) (applying Qualified Trust rules), Rev. Rul. 64-249, 1964-2 C.B. 332.

138 Old Virginia Brick Co., 367 F.2d 276 (4th Cir. 1966), *aff'g* 44 T.C. 724 (1965) (estate commenced in 1941 and consented as shareholder to S election in 1959). *See also* Treas. Reg. § 1.641(b)-3(a).

period permitted for the deferrals of estate tax for interests in closely held businesses.(139)

(c) Completion of Estate Tax Audit. In Private Letter Ruling 79-51-131, the Service has held that it is a factual determination whether an estate needs to be kept open pending completion of a federal estate tax audit.(140)

2. Bankruptcy Estate

Since 1980, the bankruptcy estate of an individual under Title 11 of the United States Code qualifies as an eligible shareholder.(141)

D. Trusts as Shareholders

1. General

Subchapter S permits only those trusts specifically authorized in section 1361(c) as eligible shareholders of an S corporation.

2. "Grantor Trust"

"A "Grantor Trust," all of which is treated as owned by an individual citizen or United States resident under the grantor trust rules of sections 671 through 678 is an eligible shareholder. Section 1361(c)(2)(A)(i) permits any "trust all of which is treated under subpart E part I of subchapter J of this chapter, as owned by an individual who is a citizen or resident of the United States."(142)

(a) The deemed owner of the trust is treated as the shareholder for the purpose of determining eligibility under section 1361(b)(1). The deemed owner may be the grantor in the case of a trust under sections 673 through 677. A trust may deemed owned by another individual under section 678.

---

139 Rev. Rul. 76-23 1976-1 C.B. 264; Priv. Ltr. Rul. 82-16-115 (Jan. 25, 1982).

140 Priv. Ltr. Rul. 79-51-131 (Sep. 24, 1979).

141 § 1361(c)(4).

142 *See also* Prop. Reg. § 1.1361-1A(h)(3)(i).

(b) <u>The Trust, All of Which is Owned by "an Individual."</u>

(1) Proposed Regulation section 1.1361-1A(h)(3)(i) states "for the purpose of determining whether the entire trust is owned by one individual, a husband and wife who file a joint return, and each of whom is a citizen or resident of the United States shall be treated as one individual."(143) The Service has ruled that a husband and wife who contributed stock owned jointly and separately to a revocable trust would be treated as a single owner.(144)

3. A Trust "All of Which" is Owned

All of the trust must be owned by an individual. The proposed regulations require that all "income and corpus" be treated as owned by the individual.(145) Is the trust treated as owning all income and corpus if all items of income, including both ordinary income and capital gains are allocated to the individual for tax purposes, even though some powers may exist in the hands of others?

<u>Example</u>. Consider section 678 which treats a person other than the grantor as the taxpayer if he has a power exercisable solely by himself "to vest the corpus <u>or</u> the income" in himself.

4. Grantor Powers Under Subpart E

In planning eligibility for treatment as a grantor trust, careful attention must be directed to the various retained powers which will cause a grantor to be treated for tax purposes as the continuing owner of the trust after transfer.

5. Section 678 Trust

The Economic Recovery Tax Act of 1981 extended the grantor trust eligibility rules under subchapter S to section 678 trusts treated as owned by an individual other than the grantor.

(a) A trust which treats a person other than the grantor as the owner under section 678 is an

---

143 Pre-1982 Proposed Regulation section 1.1361-1(d)(3)(i) referred to a trust owned by a "grantor" (or "grantors").

144 Priv. Ltr. Rul. 87-04-092 (Oct. 31, 1986).

145 Prop. Reg. 1.1361-1A(h)(3)(i).

eligible shareholder, when the individual has the power to vest corpus or income in himself or after releasing such powers retains such control as would subject him as a grantor under sections 671-677. The deemed owner is treated as the shareholder of the S corporation. The individual must be a citizen or resident of the United States. Section 678 will not apply to any power over income when the grantor is otherwise treated as the owner of the trust under subpart E.[146]

(b) "All of which" Test. Although section 678 treats a person as the owner if he has the power to vest the corpus or the income in himself, Proposed Regulation section 1.1361-1A(h)(3)(i) requires a subpart E trust "all of which (income and corpus) is treated" as owned by one individual. Thus, the Regulation is more restrictive than section 678, upon which it is supposed to be based.

(c) Section 678 Rulings.

(1) A section 678 trust was permitted when the grantor set up five separate grandchildren's trusts providing for a power to withdraw principal for thirty days after any gift. After thirty days the non-adverse trustee could pay income to the grandchild.[147] Five separate trusts were used to comply with the restriction requiring the entire trust to be owned by one individual. The Service found that each beneficiary had released a power to vest corpus under section 678(a)(2) and retained the right to receive income in the discretion of a non-adverse party.[148]

(2) The Service had also held that a section 678 trust qualified under subchapter S when the child income beneficiary had a Crummey Power to withdraw the lesser of the amount of any principal contribution or the gift tax annual exclusion for 30 days after receipt by the trust.[149] The Service previously ruled that a section 678 trust providing

---

146 § 678(b).

147 Priv. Ltr. Rul. 86-13-054 (Dec. 31, 1985).

148 *See also* Priv. Ltr. Rul. 88-09-043 (Dec. 4, 1987); Priv. Ltr. Rul. 88-27-023 (Apr. 6, 1988).

149 Priv. Ltr. Rul. 89-36-031 (Jun. 12, 1989).

for a Crummy Power did not qualify since the power to withdraw principal is not absolute.(150)

(3) A section 678 marital deduction trust was eligible where the beneficiary had the power to withdraw all of the corpus.(151)

6. Termination of Subpart E Status

Once a revocable trust becomes irrevocable, or a subpart E trust otherwise loses its status as a grantor trust or section 678 trust, the trust will lose its eligibility as a shareholder of an S corporation.

7. Death of Grantor Trust Deemed Owner

If a grantor trust or section 678 trust ceases to qualify upon the death of the deemed owner, a continuing trust will continue to be treated as an eligible shareholder for sixty days after death.(152)

(a) If the entire corpus of the trust is includible in the gross estate of the deemed owner the qualification period is extended to two years from the date of death.(153)

(b) The estate of the deemed owner will be treated as the shareholder.(154)

This raises some interesting problems not covered by either the statute or regulations. Presumably the estate is treated as the owner as the successor to the grantor who was the deemed owner prior to death. While this is logical, it may cause numerous problems. There may be a successor irrevocable trust which requires that income and corpus are payable to a person other than the estate. Income will not be distributable to the estate's representative to cover the income tax obligation of the estate on the

---

150 Priv. Ltr. Rul. 83-36-018 (Jun. 3, 1983). *See also* Rev. Rul. 81-6, 1981-1 C.B. 385, upholding Crummey Power where minor had power but not capacity to exercise the power.

151 Priv. Ltr. Rul. 86-07-044 (Nov. 19, 1985).

152 § 1361(c)(2)(A)(ii); Prop. Reg. § 1.1361-1A(h)(1)(i).

153 § 1361(c)(2)(A)(ii).

154 § 1361(c)(2)(B)(ii).

estate's fiduciary income tax return. Advanced estate planning may be required to avoid this consequence.

(c) Since a QSST is treated as a subpart E trust under section 1361(c)(2)(i), a sound argument can be made for applying the 60-day/2-year grace period to the irrevocable QSST upon the death of the income beneficiary, but the proposed regulations have not discussed this issue.

E. Testamentary Trust

A testamentary trust is a qualified stockholder, but only for 60 days beginning on the date on which the stock is transferred to it.[155] The estate of the testator is treated as the shareholder.[156]

F. Qualified Subchapter S Trust

Since 1981, subchapter S has permitted a Qualified Subchapter S Trust (QSST) to be treated as a grantor trust for purposes of subchapter S. If the current income beneficiary elects to subject the QSST to subchapter S the beneficiary will be treated under section 678 as the owner of that portion of the trust which consists of the S corporation stock.[157] Other income of the trust would be taxed under the regular trust tax rules of section 671.

1. Definition of QSST

The "Qualified subchapter S Trust" is defined as a trust which satisfies specific conditions.

(a) The trust must satisfy four express requirements which must be set forth in the terms of the agreement:

(1) Current Income Beneficiary. During the life of the current income beneficiary there can be only one income beneficiary of the trust.[158]

(i) The Subchapter S Simplification Act of 1982 clarified that the terms of the trust instrument need only require that there be a

155 § 1361(c)(2)(iii).

156 § 1361(c)(2)(B)(iii).

157 § 1361(d)(1); Prop. Reg. § 1.1361-1A(i)(4).

158 § 1361(d)(3)(A)(i).

single income beneficiary during the life of the current income beneficiary. The mere possibility of multiple successor beneficiaries after the death of the current income beneficiary will not disqualify the trust.

(ii) The fact that a remainderman beneficiary would be an ineligible shareholder will not affect the current election.

(iii) A QSST will qualify in the year of the death of the income beneficiary, even if under applicable law or the Trust, any accrued and unpaid earnings at the time of death are payable to the successor beneficiary.[159]

(iv) A substantially separate and independent share of a trust within the meaning of section 663(c) will be treated as a separate trust under sections 1361(c) and (d).[160]

(2) <u>Corpus Distributions</u>. Any corpus distributed during the life of the current income beneficiary may be distributed only to the income beneficiary.[161] This rule applies to all trust property and not just the S corporation stock.

(i) The Service has ruled that a trust which may expand for after-born grandchildren cannot qualify since a corpus distribution may go to a person other than the current income beneficiary. There must be a separate trust for each grandchild.[162]

(ii) A QSST has also qualified when a beneficiary relinquished a power of appointment under local law to appoint trust principal to others.[163]

---

159 Rev. Rul. 92-64, 1992-33 I.R.B. 9.

160 § 1361(d)(3). *See also* Priv. Ltr. Rul. 86-43-047 (Jul. 29, 1986); Priv. Ltr. Rul. 85-27-081 (Apr. 11, 1985); Priv. Ltr. Rul. 84-11-031 (Dec. 9, 1983).

161 § 1361(d)(3)(A)(ii).

162 Rev. Rul. 89-45, 1989-14 I.R.B. 15; Priv. Ltr. Rul. 85-46-108 (Aug. 21, 1985).

163 Priv. Ltr. Rul. 85-14-018 (Jan. 2, 1985).

(iii) In Revenue Ruling 93-31, the Service held that a separate share trust qualified under section 663(c), could not qualify for a QSST when there was a power to pay out corpus to a non-income beneficiary "even though the possibility of exercise of the power is remote."[164]

(3) Termination of Income Interest. The income interest of the current income beneficiary will terminate on the earlier of the beneficiary's death or the termination of the trust.[165]

(i) As a consequence, the income interest of the beneficiary cannot end before her death or termination of the trust.

(ii) An income interest for a term of years could not qualify unless the trust will terminated at the end of the term.

(4) Corpus at Termination. All assets of the trust must be distributed to the current income beneficiary if the trust terminates during the trust beneficiary's life.[166]

(i) If the trust provides for termination only upon the death of the current income beneficiary, this condition is met since the trust agreement precludes the possibility of the trust terminating during the income beneficiary's life.[167]

(ii) A trust for a term of years can qualify only if all principal will go to the income beneficiary at the expiration of the term.

Example If C creates a trust for his son D (age 13) to receive all income until D attains 21 years, with a remainder reversion to C, this test fails because, upon termination during D's life, corpus may go to a person other than the income beneficiary. If C gifts the remainder interest to D the test may be met.[168]

---

164 Rev. Rul. 93-31, 1993-17 I.R.B. 51; *See also* Treas. Reg. § 1.663(c)-3(b).

165 § 1361(d)(3)(A)(iii).

166 § 1361(d)(3)(A)(iv).

167 Prop. Reg. § 1361-1A(j) Example G.

168 Prop. Reg. § 1.1361-1A(j) Example 7.

2. *Current Income*

All of the income of the trust must be distributed (or required to be distributed) currently to one individual who is a United States citizen or resident.[169]

Income is determined within the meaning of section 643(b) which provides that income is determined under local law or the terms of the agreement.[170]

(a) The earnings of an S corporation are not "income" to the trust unless it is distributed to the trust.

(b) The distribution requirement applies to all income of the trust, not just the income of the S corporation.

(c) If the trust is a complex trust which does not require current distribution, the QSST will qualify only if income is actually distributed currently.[171]

(d) If retained income is taxed to the beneficiary, who has elected to have the trustee retain income, the QSST qualifies.[172]

(e) Retained trust income from pre-S election years need not be distributed, so long as current QSST income is distributed.[173]

3. *Trust Must Qualify as QSST, Even Without S Stock*

The Service ruled in Revenue Ruling 88-55 that a QSST cannot qualify if restrictions will apply to the trust only when it holds S corporation stock.[174] Under the facts of the ruling, when trust held S corporation stock, the children were treated as successive income beneficiaries.

---

169 § 1361(d)(3)(B).

170 *See* Treas. Reg. § 1.643(b)-1.

171 Prop. Reg. § 1.1361-1A(j) Example 4; Priv. Ltr. Rul. 86-43-047 (Jul. 29, 1986).

172 Priv. Ltr. Rul. 85-08-048 (Nov. 27, 1984).

173 Priv. Ltr. Rul. 84-11-031 (Dec. 9, 1983).

174 Rev. Rul. 88-55, 1989-15, I.R.B. 14.

Trust corpus was distributable upon termination of the trust, after the children's death. If the trust held no S corporation stock, it could terminate and distribute shares equally to the beneficiaries. The Service found that the trust violated section 1361(d)(3)(A)(iv), which provides that upon termination during the life of the current income beneficiary, the trust must distribute all of its income to the current income beneficiary.

4. *Effect of Subsequent Disqualification*

(a) If the terms of the QSST cease to meet the restrictions of section 1361(d)(3), then the trust can no longer qualify as a QSST as of the date it ceases to meet the requirements.[175] For example, this would be the situation when a single child income beneficiary dies and is succeeded by two grandchildren income beneficiaries.[176]

(b) If the QSST fails to distribute income during the taxable year (which is not required to be distributed), the trust will become disqualified as of the beginning of the next taxable year.[177]

5. *Election by a Qualified Subchapter S Trust*

The subchapter S election will be effective only if a qualified subchapter S trust has made an election to be treated as an eligible trust. There must be an affirmative election by the current income beneficiary or his legal representative.[178]

(a) Election for Each S corporation. A separate election is made for each subchapter S corporation in which the trust owns stock.

(b) Election by Parent. The regulations permit the natural or adoptive parent to elect on behalf of the income beneficiary where no legal

---

175 § 1361(d)(4)(A).

176 Prop. Reg. § 1.1361-1A(j) Example 4; § 1361(d)(3).

177 § 1361(d)(4)(B); Prop. Reg. § 1.1361-1A(j) Example 4(ii).

178 § 1361(d)(2). The election to qualify as a QSST must be distinguished from the separate election of the corporation to be subject to subchapter S under section 1362(a)(1).

representative has been appointed, if the income beneficiary is a minor.(179)

(c) Procedure. The time, manner and form of election are prescribed by regulations.(180)

(d) Substantial Compliance.

(1) The Service has determined that there has been substantial compliance with the QSST election requirement when all beneficiaries have clearly indicated their intent to be taxed as shareholders of an election on Form 2553, either individually or through their legal guardians, even though an express QSST election was not made.(181) Literal compliance with procedural directions in Treasury regulations on making elections is not always required.(182)

(e) Effective Date of QSST Election. A QSST election may be effective up to 15 days and 2 months before the date of the election.(183)

The election must be filed within the later of the 16-day and 2-month period beginning on the date the stock was transferred to trust or the first day of the first taxable year the S election is to be effective.(184)

Example 1. Assume that on January 1, 1994, stock is transferred to a trust. On January 31, the corporation files an election effective January 1, 1994. The QSST election must be filed within the period beginning on January 1 and ending on March 16,

---

179 Prop. Reg. § 1361A(i)(3).

180 § 1361(d)(2)(B)(iii).

181 Priv. Ltr. Rul. 88-16-025 (Jan. 15, 1988), trust election not timely filed.

182 *See* Hewlett-Packard Company v. Commissioner, 67 T.C. 736 (1977) *acq. in result* 1979-1 C.B. 1. *See also* Columbia Iron & Metal Company v. Commissioner, 61 T.C. 5 (1973), *acq*. 1979-2 C.B. 1.

183 § 1361(d)(2)(D).

184 Prop. Reg. § 1.1361-1A(i)(3).

1994, in order for the S election to be effective on January 1.(185)

Could the QSST election be made before the date of the S election (January 31)? Example 8 of the proposed regulation seems to permit this, although Temporary Regulation section 18.1361-1A(a) required the S election before the QSST election.

Example 2. Assume instead that the S election is made on April 1, 1994. Since it was filed after 2 months and 15 days into the taxable year it cannot be effective until January 1, 1995. Since an S election (even prospective) must be effective when made the QSST election must be filed within the 16-day and 2-month period beginning on April 1, 1994, and ending on June 16, 1994 (and the election must state it is effective on April 1, 1994).(186)

(f) Continuing Election. An election made by a prior income beneficiary will be binding on a qualified successor income beneficiary unless the successor affirmatively refuses to consent.(187) The affirmative refusal of a successor income beneficiary will terminate the election even though all of the remaining shareholders desire to continue the election. An affirmative refusal must be filed within 15 days and 2 months after the successive income beneficiary becomes the income beneficiary. If an affirmative refusal is filed, it is effective as of the date the successor becomes the income beneficiary.

(g) Revocation of Election. An election by a QSST once made may be revoked only with consent of the Service by filing an application for consent to revoke with the Commission explaining the reasons for seeking revocation of the QSST election.(188)

(h) Examples of Eligible QSSTs.

(1) A "QTIP" marital deduction trust under section 2056(b)(7).

(2) A marital deduction trust under section 2056(b)(5), providing for all income for life

185 Prop. Reg. § 1.1361-1A(j) Example 8(i).

186 Prop. Reg. § 1.1361-1A(j) Example 8(ii).

187 § 1361(d)(2)(B)(ii); Prop. Reg. § 1.1361-1A(i)(6).

188 § 1361(d)(2)(cf); Prop. Reg. § 1.1361-1A(i)(6).

with a power of appointment in the entire interest.[189]

(3) A minor's trust that qualifies for the annual gift tax exclusion under sections 2503(b) and (c). There were 4 trusts which each paid income to four grandchildren until age 25, and then gave each income beneficiary all the principal. They all were qualified in Private Letter Ruling 85-14-017.[190]

(4) A trust that will terminate when the beneficiary attains a certain age.

(5) A trust which gives the beneficiary income for life.[191]

(6) A revocable inter vivos trust after the death of the trustor.[192]

(i) Taxation of the Qualified Subchapter S Trust. For purposes of subchapter S, the beneficiary of a QSST will be treated as the owner of the subchapter S stock which is held by the trust. Thus, all items of corporate income, loss, deduction and credit will be treated as having been directly received by the beneficiary and not by the trust.

(1) Tax on Sale of S Corporation Stock by a QSST. The Service in Revenue Ruling 92-84, held that when the QSST sells stock in the S corporation, the current income beneficiary, rather than the Trust, must recognize the gain or loss on the sale, even if, under applicable local law, the gain or loss will be allocated to corpus rather than from income.[193]

(i) If the gain is allocated to corpus, there is no requirement that it be distributed currently under section 1361(d)(3)(B), since it is not income under applicable local law as required under section 643(b).

---

189 Priv. Ltr. Rul. 84-15-025 (Jan. 5, 1984).

190 Priv. Ltr. Rul. 85-14-017 (Jan. 2, 1985).

191 Priv. Ltr. Rul. 86-07-020 (Nov. 15, 1985) (income to surviving spouse); Priv. Ltr. Rul. 84-24-096 (May 16, 1984) (inter vivos gift of income to child).

192 Priv. Ltr. Rul. 84-04-086 (Oct. 26, 1983).

193 Rev. Rul. 92-84, 1992-40, I.R.B. 24.

(ii) The effect is that the income beneficiary will be taxed under subchapter S but the funds will be shifted to the remainder beneficiary on the death of the income beneficiary.

(2) Installment Disposition of S Corporation Stock by a QSST. There is an open question as to whether the QSST is entitled to defer income under section 453 in the event of an installment sale of S corporation stock held by it.

(i) Assume that there is a liquidation, redemption, or a sale by a QSST of its subchapter S stock to a third party for an installment obligation providing for a deferred payments in future years. Would the QSST qualify for installment sale treatment under section 453?

(ii) Under section 1361(d)(1), an electing QSST is treated as a Subpart E Trust under which the S corporation stock is treated as if it were owned by the income beneficiary pursuant to section 678.

(iii) Since Revenue Ruling 92-84 held that gain from the sale of S corporation shares by a QSST should be taxed to the income beneficiary, consider Revenue Ruling 77-402,[194] where the Service in an anti-tax shelter ruling ruled that the conversion of a grantor trust to a non-grantor trust would be a sufficient change in ownership to cause a deemed disposition, accelerating gain on any installment obligation under section 453B.

(iv) Would the Service apply the principles of Revenue Ruling 77-402 to tax the beneficiary immediately on the sale by the trust of the S corporation shares in exchange for an installment obligation? Note that the proceeds would be allocated to corpus under applicable law and subsequent income on the note would be taxed to trust, not the beneficiary.

(v) The American Bar Association Section of Taxation, Committee on Fiduciary Income Taxation and Committee on S Corporations Report of Joint Task Force on Revenue Ruling 92-84, dated July 15, 1993, has distinguished Revenue Ruling 77-402 on the basis that:

---

194 Rev. Rul. 77-402, 1977-2 C.B. 222.

(A) The trust does not cease to be a QSST under section 1361(d) on sale of the stock.

(B) The installment note is never treated as owned by the beneficiary. The income beneficiary is deemed to own only "that portion of the trust which consists of stock in an S corporation" under section 1361(d)(1)(B).

(C) QSST is not a normal section 678 trust since the income beneficiary generally has no controlling powers. It is a section 678 trust only to permit taxation on the beneficiary. There is no transfer of control on sale of the stock.

(3) Redemption of S Stock. In the event of the redemption of the S stock held by the trust, the current income beneficiary will be treated as the deemed owner for the purposes of determining whether there has been an exchange under section 302(a) or a dividend under section 301(c).[195]

G. Voting Trusts

A trust created primarily to exercise the voting powers of stock transferred to the trust may qualify as an S corporation shareholder.[196]

1. Proposed Regulation section 1.1361-1A(h)(3)(ii) requires the trust to be a written agreement that:

(a) Delegates to the trustee the right to vote.

(b) Requires all distributions to be paid to or on behalf of the beneficial owners.

(c) Requires title and possession of the stock to be delivered to those beneficial owners upon termination of the trust.

(d) Must terminate, under its terms or by state law on or before a specific date or event.

---

195 Priv. Ltr. Rul. 92-24-036.

196 § 1361(c)(4). Prior to inclusion in the Code, voting rights were permitted under A & N Furniture & Appliance Co. v. United States, 271 F.Supp. 40 (S.D. Ohio 1967) and Lafayette Distributors, Inc. v. U.S., 397 F.Supp. 719 (W.D. La. 1975).

H. Ineligible Trusts

1. Foreign Trusts

Foreign trusts are now expressly prohibited as shareholders under section 1361(c)(2)(A).

2. Other Trusts

All other trusts are prohibited. Examples include:

(a) Irrevocable revisionary "Clifford Trust," under sections 673 and 676.

(b) Employee stock ownership plans (ESOPs). Under sections 409(A)(a)(1) and 401(a), a trust must own the stock in the employer.[197]

(c) An Individual Retirement Account (IRA) under section 408(a).[198]

(d) Other defined benefit or defined contribution qualified retirement trusts under section 401(a) which own corporate stock.

(e) Charitable Remainder Trust. In Revenue Ruling 92-48, the Service ruled that the section 664 provisions taxing charitable trusts are not compatible with subchapter S, even if the literal conditions of a QSST are satisfied.[199]

I. Electing Small Business Trusts

The Tax Simplification and Technical Corrections Bill of 1993 (H.R. 3419) would permit a new "electing small business trust" as an eligible shareholder.

1. Electing Small Business Trust Defined

Under these proposals a trust would be an electing small business trust only if:

(a) each beneficiary is either an individual, estate, or a qualified charitable remainder interest (an organization described in section 170(c)(2), (3), (4) or (5) which holds a

---

197 TIR 1413 (Nov. 4, 1975).

198 Rev. Rul. 92-73, 1992-37 I.R.B. 7.

199 Rev. Rul. 92-48, 1992-1 C.B. 301.

contingent interest and is not a potential current beneficiary);

(b) no interest in the trust was acquired by purchase; and

(c) an election is made to be an electing small business trust.[200]

2. Deemed Shareholder

Each potential current beneficiary would be treated as a shareholder. If there is no potential current beneficiary, then the trust is treated as the beneficiary.[201]

3. Potential Current Beneficiary

The term "Potential Current Beneficiary" means any person who at any time during the year is entitled to or at the discretion of any person may receive, a distribution from the principal or income of the trust. If the trust disposes of all of its S corporation stock, then the term "potential current beneficiary" does not include a person who met the requirements during the 60-day period ending on the date of disposition.[202]

4. Taxation of S Corporation Income

The income pass-through from the S corporation would be taxed at the maximum individual tax rate.

5. Election

The election would be made by the Trustee and would continue for subsequent years until revoked with the consent of the Service.[203]

J. Corporations

An S corporation is not permitted to have a corporate shareholder. However, the Service has permitted a C corporation to purchase the stock of an S corporation and

---

200 Prop. I.R.C. § 1361(e)(1)(A).

201 Prop. I.R.C. § 1361(c)(2)(B).

202 Prop. I.R.C. § 1361(e)(2).

203 Prop. I.R.C. § 1361(e)(4).

immediately distribute the stock to its eligible shareholders. The transitory ownership was disregarded for tax purposes.[204]

K. Partnerships

Partnerships are prohibited from being stockholders of S corporation.[205]

¶ 102.7. Partnership of S Corporations

A. Tax Avoidance Restrictions

For many years, there was practitioner concern as to whether an S corporation would lose its subchapter S status if it participated in a partnership where the other partners were ineligible persons. This concern emanated from the Service's early holding in Revenue Ruling 77-220.[206]

In Revenue Ruling 77-220, the Service found that an S election was not available when 30 individuals organized three separate S corporations in order to become investors in a single business. Subchapter S then permitted a maximum of 10 shareholders. The Service found that the three corporations must be considered as a single corporation, since the principal purpose of organizing 3 separate corporations instead of one corporation was to make the election under subchapter S. As a result, the 30-shareholder "single corporation" was disqualified. The Service relied upon the holding in Gregory v. Helvering,[207] that an elaborate and devious form consummated solely for tax avoidance may be disregarded. Gregory v. Helvering would require a distinct business purpose separate from a purpose to avoid the shareholder eligibility restrictions of subchapter S. The ruling also relied upon Higgins v. Smith,[208] for the proposition that the Service may look to the actualities of the case and disregard a form employed to do business which is unreal or a sham.

---

204 Priv. Ltr. Rul. 87-39-010 (Jun. 26, 1987).

205 Rev. Rul. 59-235, 1959-2 C.B. 192; Prop. Treas. Reg. § 1.1361-1A(f)(1); Kates v. Commissioner, 27 T.C.M. 1423 (CCH) (1968).

206 Rev. Rul. 77-220, 1977-1 C.B. 263.

207 Gregory v. Helvering, 293 U.S. 465, 1935.

208 Higgins v. Smith, 308 U.S. 473 (1940).

In recent years, the use of partnership of S corporations have become common place as the Service has adopted a policy of issuing favorable rulings so long as there is a business purpose to the partnership of S corporations which has economic substance. In a number of the rulings, the other partner has been an ineligible person and was brought into the partnership as a means of obtaining investment capital.

In 1994 the Service reviewed its tax policies for limiting S corporation participation in partnerships and formally revoked Revenue Ruling 77-220 in Revenue Ruling 94-43.(209) In reversing its prior position, Revenue Ruling 94-43 explained that the purpose of limiting the number of shareholders under subchapter S was to obtain administrative simplification in the management of corporate affairs. The Service then acknowledged that administrative simplicity is not affected by the S corporation's participation in a partnership with other S corporations. The Service also determined in Revenue Ruling 94-43 that it was inappropriate to cause the shareholder of one S corporation to be considered as a shareholder in another corporation just because the S corporations are partners in a partnership. In withdrawing old Revenue Ruling 72-220, the Service focused entirely on administrative simplicity, and curiously avoided any reference to the common law business purpose and sham doctrines upon which its prior conclusion had been premised.

B. Private Letter Rulings Endorsing Use Partnerships of S Corporations

1. An investment banking corporation obtained a favorable ruling as an eligible corporation when it sold one-half of its assets to an unrelated investment banking corporation and they then formed a partnership to operate an investment banking business.(210) The Service found that there was a business purpose with economic substance since both corporations had been in business for many years, each had separate business activities, and the C corporation buyer of one-half of the assets did not elect subchapter S.

2. Under the facts of another ruling, a minority shareholder of an S corporation formed a new corporation in which the shareholder had a controlling

---

209 Rev. Rul. 94-43 I.R.B. 1994-27 (July 5, 1994).

210 Priv. Ltr. Rul. 87-11-020 (Jan 15, 1986).

interest.[211] The S corporation and new corporation then formed a partnership. The partnership agreement contained special allocations of income. The Service found that the parties had diverse economic objectives and that the S corporation had been in existence for several years and continued to retain investment assets outside of the partnership in which the new corporation was not interested. The Service concluded that joining the partnership did not cause a second class of stock, since the S corporation and new corporation were viewed as separate corporations.

3. A favorable ruling was obtained when individual partners in a law partnership formed professional S corporations in order to limit their malpractice exposure. The Service concluded that there was an independent business purpose for the transaction.[212]

4. In another interesting situation, 19 S corporations, which had a total of 136 shareholders, formed a partnership for business purposes. Each S corporation had existed previously and continued to retain its own business assets. The Service found that the 35-shareholder limit was not violated.[213]

¶ 103. ELECTION

¶ 103.1. General

A. Corporate Election

Subchapter S may be utilized only by a small business corporation which specifically elects to apply subchapter S.[214] Once made, an election is effective for the first taxable year for which it is made and continues until the election is revoked or otherwise terminated.[215]

---

211 Priv. Ltr. Rul. 88-04-015 (Oct 28, 1987).

212 Priv. Ltr. Rul. 88-23-027 (Mar 8, 1988). *See also* Priv. Ltr. Rul. 89-50-066 (Sep. 20, 1989).

213 Priv. Ltr. Rul. 90-17-057 (1990).

214 § 1362(a)(1).

215 Treas. Reg. § 1.1362-1(b) (Nov. 24, 1992).

B. Shareholder Consent

All persons who are shareholders on the date of the election must consent.[216] Once a valid election is made, new shareholders do not need to consent to the election.

1. *Consent for Current Year*

If the election is to be effective for the current year in which made, each person who was a shareholder at any time during the year prior to the date of the election must consent even though no longer a shareholder.[217]

2. *Special Rules*

Special rules are provided in Treasury Regulation section 1362-6(b)(2) governing the person who is obligated to consent with respect to the shares.

(a) Community Interest. When stock is owned as community property, or as tenants in common, joint tenants, or tenants by the entirety, each co-owner must consent to the election.[218]

(b) Minor. A consent for a minor may be made by the minor or the legal representative or his natural or adoptive parent if no legal representative has been appointed. In Private Letter Ruling 88-39-010,[219] consent of parents, as shareholders, was also treated as consent for minor children.

(c) Estate. The consent of an estate must be made by the executor or administrator, even if title is passed directly to the heirs under local law.[220] The Service described the rules for consents by estates in Revenue Ruling 92-82.[221]

---

216 § 1362(a)(2). When stock is held by a nominee or agent, the beneficial owner of the stock must consent. Kean v. Commissioner, 469 F.2d 1183 (9th Cir. 1972); Wilson v. Commissioner, 560 F.2d 687 (5th Cir. 1977); Rev. Rul. 75-261, 1975-2 C.B. 350; Rev. Rul. 70-615, 1970-2 C.B. 169.

217 Treas. Reg. § 1362-6(a)(2)(ii)(B) (Nov. 24, 1992).

218 *See* Seely v. Commissioner, 51 T.C.M. 1087 (1986) (husband not permitted to act for the community).

219 Priv. Ltr. Rul. 88-39-010 (Jun. 27, 1988).

220 Rev. Rul. 62-116, 1962-1 C.B. 207.

221 Rev. Rul. 92-82, 1992-89 I.R.B. 10.

Under the facts in Revenue Ruling 92-82, the shareholder died on March 1, 1991. The corporation elected subchapter S on March 15, 1991, for the current calendar year. The Service held that the shareholder's executor had authority to file the consent as fiduciary for both the deceased shareholder and for the successor estate. The consent of the estate was required as a shareholder on the date of the election under section 1362(a)(2) and the consent of the deceased shareholder was required since he had been a shareholder during part of the year preceding the election, pursuant to Temporary Regulation section 18.1362-2(b)(1).

(d) Trust. The deemed owner must file a consent on behalf of a subpart E trust (i.e., grantor trust or section 678 trust). The regulations do not require the consent of the Trustee. If husband and wife have community a interest in trust property, the consent of both is required.

(e) Administration After Death of Grantor of Trust. During either a 60-day or two-year period after the death of grantor of grantor trust, the estate administrator may consent to an election as shareholder.[222]

(f) QSST. The income beneficiary of a qualified subchapter S trust is the deemed owner and would file the consent. Section 1361(d)(1)(A) applies the section 1361(c)(2)(A)(i) grantor trust rules for determining the deemed owner. In Private Letter Ruling 90-15-039,[223] the Service waived the error when an individual consented in his role as trustee of a QSST, when the person was also the income beneficiary.

(g) Bankruptcy. The "Administrator" of a bankruptcy estate of an individual in a Title 11 bankruptcy must consent to the election.[224]

(h) Testamentary Trust. The executor must consent on behalf of a qualifying Testamentary trust.

(i) Voting Trust. All the beneficiaries of a voting trust must consent.

---

222 § 1361(c)(2)(B)(ii).

223 Priv. Ltr. Rul. 90-15-039 (Jan. 12, 1990).

224 *See* Prop. Reg. § 1.1362-2(b)(2).

(j) A person who owns stock both directly and also as a beneficiary of a trust must consent in both capacities.[225]

(k) The signature of attorney-in-fact under a power of attorney has been accepted as the consent of the income beneficiary of a QSST.

3. Consent Irrevocable After Election

A shareholder's consent is binding and cannot be withdrawn after a valid election by the corporation.[226]

4. Procedure for Elections

The eligible corporation must timely file a Form 2553 containing all of the information required on the form, including the consents of all of the shareholders.[227] The Form 2553 may be signed by any person authorized to sign the corporation's tax return Form 1120-S under section 6037 and is filed at the Service center designated on Form 2553.

(a) The Form 2553 must be signed by "the president, treasurer, assistant treasurer, chief accounting officer, or other corporate officer (such as tax officer) authorized to sign."[228] The secretary or a vice president would appear to require special authority.

(b) Defects in preparation have generally been liberally applied but caution is recommended.

(1) In Robert Hicks Thompson,[229] Form 2553 erroneously stated that the election was to be effective for the taxable year beginning January 1, 1969 instead of December 1, 1969. The corporation did not exist until January 16, 1969. The Tax Court overlooked the error.

(2) In Aaron J. Leve,[230] an election

---

225 Priv. Ltr. Rul. 85-06-029.

226 Treas. Reg. § 1.1362-6(b)(3) (Nov. 24, 1992).

227 Treas. Reg. § 1.1362-6(a)(2) (Nov. 24, 1992).

228 Instructions for Form 2553 (Rev. Apr. 1988).

229 Thompson v. Commissioner, 66 T.C. 737 (1976) (*acq.*).

230 Leve v. Commissioner, ¶ 85,255 P.H. Memo T.C. (1985).

was permitted when the corporation failed to complete boxes asking when corporation first had assets, shareholders and business.(231)

(3) The Service also has acknowledged that literal compliance with the procedural regulation is not always required.(232)

¶ 103.2. Time of Election

The election may be made at any time during the prior taxable year or any time on or before the fifteenth day of the third month of the current year.(233)

For example, if the corporation begins its first taxable year on January 7, the election may be made any time on or after January 7 and before March 22.(234)

Section 1362(b)(4) also expressly permits an election to be made by the fifteenth day of the third month after the beginning of the taxable year, even though the taxable year is less than 2-1/2 months long.(235) For example, if the first taxable year begins on November 8, the corporation must make an election for its first taxable year ended on December 31, before January 23, of the next year.(236)

---

231 An earlier case found an election invalid when the shareholder consents failed to state the number of shares owned. Brutsche v. Commissioner, 585 F.2d 436 (10th Cir. 1978).

232 Priv. Ltr. Rul. 87-23-043 (Mar. 10, 1987). *See also* Priv. Ltr. Rul. 88-17-014 (Jan. 30, 1988) (Form 2553 indicated effective date of December 1, 1986, but Service permitted September 1, 1987, which was the first day of the next fiscal year and the intended date); Priv. Ltr. Rul. 90-09-033 (Dec. 4, 1989) ("minor errors" permitted).

233 § 1362(b)(1); Treas. Reg. § 1.1362-6(a)(2)(ii) (Nov. 24, 1992).

234 Treas. Reg. § 1.1362-6(a)(2)(iii) Example 1 (Nov. 24, 1992).

235 § 1362(b)(4); 1984 T.R.A. § 721(1).

236 Treas. Reg. § 1.1366(a)(2)(iii) Example 2 (Nov. 24, 1992). *See also* § 1362(b)(4).

¶ 103.3. Effective Date of Election

A. *Current Year*

An election may be effective for the current year only if three conditions are met:

1. The election is made on or before the fifteenth day of the third month.

2. The corporation meets all eligibility requirements for all days of the year.

B. *Following Year*

An election is treated as made for the following year if:

1. Eligibility requirements are not met for the entire period prior to the election date;

2. If the consent of all shareholders who disposed of their stock prior to the election date is not obtained; or

3. If the election is made after the fifteenth day of the third month.[237]

C. *Effect of Interim Disqualification*

If the corporation qualifies on the date of election and on the first day of the next year, the election will be effective for the following year even though qualification was not met on other days prior to the first day of the following year.[238]

D. *Extension for Election Prohibited*

Since the permissible period for filing elections is statutory the Service has no authority to grant an extension for filing an election.[239] This is contrasted with authority which the Service has to grant extensions for shareholder consents under the regulations.[240]

---

237 *See* Treas. Reg. § 1.1362-6(a)(2)(ii)(B) (Nov. 24, 1992).

238 Treas. Reg. § 1.1362-2(b)(2) (Nov. 24, 1992).

239 § 1362(b).

240 Treas. Reg. § 1.1362-6(b)(3)(iii) (Nov. 24, 1992).

E. Election of New Corporation

Treasury Regulation section 1.1362-1(c)(3) provides that the first month of the first taxable year of a new corporation does not begin until the corporation "*has shareholders or acquires assets or begins doing business, whichever is first to occur.*" An election filed before the beginning of the first taxable year is not valid.[241]

1. Corporate Existence

The filing of the Articles of Incorporation is a prerequisite to corporate existence.[242] The Tax Court has also found that the filing of election by a shell corporation, which does not have shareholders, assets or a business may be defective.[243]

2. Shareholders

The corporation will come into existence when it first has shareholders. The corporation cannot have shareholders before the Articles of Incorporation are filed, even though individuals have earlier signed subscription agreements. However, the corporation would come into existence on the date the Articles are filed, since the subscription agreement confers special rights applicable to shareholders under state law.[244] The corporation may also be treated as having shareholders before the shares are issued based on board of directors' authorization. For example, in Thomas E. Bone,[245] the Tax Court found that corporate board of director approval of offer to purchase shares was sufficient, even though the approval was contingent upon future California Department of Corporations qualification.

The regulations explain that the existence of incorporators does not necessarily begin the taxable year of the new corporation.[246]

---

241 Treas. Reg. § 1.1362-6(a)(2).

242 Frentz v. United States, 375 F.2d 662 (6th Cir. 1967), *aff'd* 44 T.C. 485 (1965).

243 Artukovich v. Commissioner, 61 T.C. 100, 104, n.5 (1973).

244 Rev. Rul. 72-257, 1972-1 C.B. 270.

245 Bone v. Commissioner, 52 T.C. 913 (1969).

246 Treas. Reg. § 1.1362-6(a)(2)(ii)(A) (Nov. 24, 1992).

3. *Corporate Assets*

The corporation may be treated as coming into existence when it first has assets, even though it does not yet have any owner shareholder. The indicia for establishing the existence of corporate assets is very minimal. It may include the mere leasing of equipment,[247] or loans to the corporation,[248] even though neither gives the corporation any net worth per se.

4. *Commencement of Business*

The corporation may first come into existence when it commences business, although the shareholder or asset test is usually satisfied first.[249]

F. Extension of Time for Shareholder Consents

1. *General Standards*

The regulations provide that an extension of time for filing the consent may be granted by the Commissioner where it is shown that: (1) there is "reasonable cause for the failure to file such consent; (2) the request is made within a reasonable time under the circumstances; and (3) the interest of the government will not be "jeopardized" by treating the election as valid or as not having been terminated".[250]

Example. Corporation A does not have shareholders when it is first required to make an election and needs an extension until shareholders exist.[251]

> (a) Procedure. If an extension is authorized, then new consents must be filed by all persons who were shareholders at any time during the period beginning as of the date the election became invalid and ending on the date on which the extension of time is granted, and who have not previously

---

247 Artukovich v. Commissioner, 61 T.C. 100 (1973); Calhoun v. United States, 370 F.Supp 434 (W.D. Va. 1973).

248 Artukovich v. Commissioner, 61 T.C. 100 (1973).

249 *See* T.H. Campbell and Bros. v. Commissioner, T.C. Memo 1975-149, 34 T.C.M. 695.

250 Treas. Reg. § 1.1362-6(b)(3)(iii) (Nov. 24, 1992).

251 *See* Calhoun v. United States, 370 F.Supp. 434 (W.D. Va. 1973) (corporations required to file a timely election even though there were no shareholders to consent).

consented to the election.[252] A request for an extension of time to file a consent should be sent to the IRS center where the Form 2553 is filed.[253]

2. *"Reasonable Cause" Cases*

Several cases have examined the issue of "reasonable cause" and have generally applied the standard liberally for the benefit of the taxpayer. For example, in Kean v. Commissioner,[254] the Ninth Circuit found there was an abuse of discretion by the Service when it rejected a request for an extension of time filed immediately after the taxpayer lost a lawsuit which found the taxpayer was the beneficial owner of shares and therefore required to consent. Likewise, in Hicks Nurseries, Inc. v. Commissioner,[255] there was an abuse of discretion when the Service rejected a request for an extension of time to consent filed 5 years after a transfer of the stock to an estate on death.

¶ 103.4. Five-Year Restriction after Prior Termination

A. General Rule

After termination, a new election is prohibited for 5 years without the consent of the Commissioner.[256]

---

252 Treas. Reg. § 1.1362-6(b)(3)(iii) (Nov. 24, 1992).

253 See IRS Pub. No. 589, Tax Information on S corporations.

254 Kean v. Commissioner, 469 F.2d 1183 (9th Cir. 1972) *aff'd* in part 51 T.C. 337 (1968) (extension to consent requested after trial on eligibility issue).

255 Hicks Nurseries, Inc. v. Commissioner, 62 T.C. 138 (1974) *rev'd* on other issues 517 F.2d 437 (2nd Cir. 1975) (extension requested 5 years after estate created). *See also* Garrett & Garret, P.C. v. Commissioner, T.C. Memo 1993-453, rejecting election when a shareholder-lawyer excluded shareholder information and consents, on the ground that the information was none of the government's business.

256 § 1362(g); Treas. Reg. § 1.1362-5(a) (Nov. 24, 1992).

B. 50 percent Change in Ownership

Consent will generally be granted if there is more than a 50 percent change in ownership since the year of termination.(257)

C. Absence of Control Over Event

Consent will ordinarily be denied unless (a) the event causing termination was not reasonably within the control of the corporation or shareholders who have a substantial interest, and (b) the event was not part of a plan to terminate the election in which such shareholders participated.(258)

D. Successor Corporation

A corporation will be considered a successor corporation to the corporation whose election was terminated if 50 percent or more of the stock of the new corporation is owned by the same persons who owned 50 percent or more of the stock of the corporation whose election was terminated, and either the new corporation acquires a substantial portion of the assets of the old corporation, or a substantial portion of the assets of the new corporation were assets of the old corporation.(259)

E. Five-Year Rule when Prior Election not Effective

The 5-year restriction does not apply when a prior election was revoked before it became effective, or if the corporation failed to meet the definition of a small business corporation on the first day the election was to be effective. The corporation never benefited from, nor was subject to, the S corporation requirements and therefore no abuse or tax avoidance is involved. The corporation may make a new election without the Commission's consent.(260)

---

257 Treas. Reg. § 1.1362-5(a) (Nov. 24, 1992).

258 Id.

259 Treas. Reg. § 1.1362-5(b).

260 Treas. Reg. § 1.1362-5(c).

¶ 103.5. Equitable Estoppel and Substantial Compliance

Recent cases have rejected equitable estoppel and substantial compliance as grounds for preserving the subchapter S election.(261)

¶ 103.6. Tax Simplification Proposals Would Permit Correction of Defective Election

Changes in the proposed 1993 Tax Simplification and Technical Corrections Act would permit the Service to waive the effect of an inadvertent invalid election for failure to qualify as an eligible small business corporation or to obtain shareholder consents. The Service would also be given discretion to permit a late election if it determines that there was reasonable cause for the failure to timely make the election. This provision would be retroactive to taxable years beginning after 1982.(262)

¶ 104. TERMINATION

¶ 104.1. General

The election may be terminated for any of the following reasons:

A. Revocation of the election;

B. Failure to qualify as a small business corporation; or

C. The receipt of excessive passive investment income for three consecutive years while the corporation has subchapter C earnings and profits.

¶ 104.2. Effective Date of Termination

A. Effective on Date of Event

A corporation's election will be deemed terminated as of the date of the event causing disqualification.(263)

Example. Shareholder A sells stock to corporation X on November 30. The S election ends on the day before the

---

261 Smith S, Inc. v. Commissioner, (E.D.N.C. 1993), 93-2 U.S.T.C. ¶ 50,514; Rockwell Inn, Ltd. v. Commissioner, T.C. Memo 1993-158.

262 Tax Simplification and Technical Corrections Act of 1993, § 501 (H.R. 3419) (introduced November 1, 1993).

263 § 1362(d)(2).

day of the terminating event (sale of stock). The last day of the "S Short Year" is November 29. The remaining 32 days of the calendar year corporation, known as the "C Short Year", will be taxed under subchapter C.

¶ 104.3. Allocation of Income on Termination

A. General Rule - Pro Rata Allocation

Under the general rule, the corporation will allocate income or loss for the entire year ("S Termination Year") between the S Short Year and the C Short Year on a pro rata basis.[264]

Each item of income, loss, deduction and credit, and the amount of non-separately computed income and loss for the year is allocated pro rata to each day of the S Termination Year.[265]

Thus there is no closing of the corporate books on the termination date.

B. Election to Close the Books

The corporation may elect to waive the pro rata allocation formula and cause the items to be attributed to the S Short Year and the C Short Year according to when the items were incurred or realized as reflected on the books of the corporation.[266] This election requires the consent of all persons who are shareholders during the S Short Year and all persons who are shareholders on the first day of the C Short Year.[267]

<u>Example</u>. Assume calendar year corporation X operates at a loss for 10 months, becomes disqualified, and then has a profit of $100,000 in December. Should the corporation elect to allocate all the losses to the S Short Year, passing the losses through to high income shareholders, and report the income as a corporation under subchapter C?

---

264 § 1362(e)(2); Treas. Reg. § 1.1362-3(a) (Nov. 24, 1992).

265 § 1362(e)(2).

266 § 1362(e)(3).

267 § 1362(e)(3)(B) (T.R.A. 1984); Treas. Reg. § 1362-3(b) (Nov. 24, 1992).

C. Special Rules

1. Section 338 Election

If a qualified stock purchase is made by a corporation which elects to apply section 338, the pro rata allocation rule does not apply.[268] As a result, income resulting from the election which is subject to depreciation recapture will be reported on the C corporation return and the selling shareholders will not take the income on their individual returns.

The S Short Year ends the day before the qualified stock purchase. On the date of acquisition, the acquired corporation is no longer an eligible S corporation, since it has a corporate shareholder. The date of acquisition is a one-day C corporation year during which the C corporation is treated as selling all of its assets under section 338(a)(1). The corporation is then treated as a new corporation beginning on the day after the acquisition under section 338(a)(2).

2. Sale or Exchange of 50 percent of the Stock

Pro rata allocation is not permitted for an S Termination Year if as a result of a "sale or exchange," 50 percent or more of the stock is "newly owned stock."[269] Stock which has previously been sold during the S Termination Year will not be counted on any resale during the year.

¶ 104.4. Special Timing Rules

A. Carryforwards

The S Short Year and the C Short Year will be treated as one year for the purpose of counting the number of years an item (such as a net operating loss) may be carried back or forward.[270]

B. S Corporation Which is a Partner

The 1992 regulations apply a special rule for partnership taxation purposes upon the termination of an S corporation partner. If the election of an S corporation, which is a partner in a partnership, is

---

268 § 1362(e)(6)(C); (T.R.A. 1984).

269 § 1362(e)(6)(D); Treas. Reg. § 1.1362-3(b)(3) (Nov. 24, 1992).

270 § 1362(e)(6)(A).

terminated, and if (a) the pro rata allocation rules do not apply to the corporation, and (b) the taxable year of the partnership ends within the C Short Year, then the termination will be treated as a sale or exchange of the corporation's entire interest in the partnership on the last day of the S Short Year, solely for the purpose of determining that the tax year of the partnership has closed with respect to the corporate partner under section 706(c).(271)

C. Termination for Excessive Passive Investment Income

Termination because of excessive passive investment income will not cause a split S Termination Year since the termination is not effective until the beginning of the taxable year after disqualification.(272)

D. Tax Return Due Date

The tax return for the S Short Year is due when the tax return for the C Short Year is due, including extensions.(273)

¶ 104.5. Revocation

A. Democracy Rule

The election may be revoked by the corporation with the consent of more than one-half of the shares of stock (including nonvoting stock) held on the date of revocation.(274)

B. Effective Date of Revocation

1. Current Year

The revocation is effective for the current year if it is made on or before the 15th day of the third month.(275)

---

271 Treas. Reg. § 1.1362-3(c) (Nov. 24, 1992).

272 § 1362(d)(3)(A)(ii).

273 § 1362(e)(6)(B).

274 Treas. Reg. § 1.1362-2(a) (Nov. 24, 1992).

275 § 1362(d)(1)(C)(i).

2. Following Year

Any revocation made after the fifteenth day of the third month is effective as of the beginning of the next taxable year.

3. Designation of Prospective Date

The corporation may designate a prospective date in the future upon which revocation becomes effective.[276] If the prospective revocation splits a taxable year, the normal rules for an S Termination Year apply. A revocation intended to take effect in the future must be filed on or before the prospective date.[277] In Private Letter Ruling 89-38-008, the Service found that a revocation adopted and intended to be "effective" on October 27, 1988, but not mailed until November 3, 1988, was "made" on the date mailed pursuant to section 7502(a)(i). Accordingly, the revocation was not effective until the next calendar year.

C. Effect of Revocation on Taxable Year

If the corporation revokes the S election before it becomes effective, any statement made with the election regarding any change in the corporation's taxable year has no effect.

D. Rescission of Revocation

Shareholders have the right to revoke a prospective revocation before it becomes effective.[278]

The rescission requires the consent of each person who consented to the revocation plus each person who became a shareholder after the date of the revocation and ending on the date of the rescission.[279]

¶ 104.6. Passive Investment Income Restriction

A. General Rule

There is no passive investment income restriction for corporations which have no accumulated earnings and profits at the time of election. Thus, a newly incorporated

---

276 § 1362(d)(1)(D); Treas. Reg. § 1.1362-2(a)(2)(ii) (Nov. 24, 1992).

277 Treas. Reg. § 1.1362-2(a)(2) (ii).

278 Treas. Reg. § 1.1362-2(a)(4).

279 Treas. Reg. § 1.1362-2(a)(4).

S corporation, or an S corporation which has converted from subchapter C but has no retained subchapter C earnings and profits, may have unlimited income from passive investment sources such as interest, rents, dividends or royalties, without placing the S election at risk.

B. Corporation With Accumulated Earnings and Profits

If an S corporation has subchapter C earnings and profits and if the passive investment income exceeds 25 percent of gross receipts for three consecutive years the election is terminated.[280]

"Subchapter C earnings and profits" means earnings and profits for a taxable year in which the subchapter S election was not in effect, including those of an acquired or predecessor corporation.[281]

1. Accumulated earnings and profits earned by subchapter S corporations while an S corporation prior to 1982 (e.g., tax-exempt interest and straight line depreciation adjustments under section 312(k)) are not counted.

2. An S corporation must be careful that income is not thrown back into a pre-election year causing subchapter C earnings and profits.[282]

<u>Example</u>. Corporation X sells personal property on an installment sale in 1987 and elects subchapter S in 1998. Payment is received in 1999 and an audit determines the personal property was inventory which does not qualify for an installment sale under section 453(b)(2)(B).

3. There is no statute of limitations for determining the existence of accumulated earnings and profits.

---

280 § 1362(d)(3); Treas. Reg. § 1.1362-2(c) (Nov. 24, 1992).

281 § 1362(d)(3)(B).

282 *See also* <u>Meyer's Estate v. Commissioner</u>, 200 F.2d 592 (5th Cir. 1952), where shareholders in a section 333 liquidation erroneously thought earnings and profits were $80,000 instead of $900,000.

C. Existence of Passive Investment Income

1. Passive Investment Income Defined

Passive investment income means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stocks or securities (but only to the extent of gains).[283]

2. Gross Receipts Defined

Gross receipts means the total amount received or accrued, without reduction for returns and allowances, cost of goods sold, or deductions.[284]

(a) Sales of Capital Assets. Gross receipts from the sale or exchange of capital assets (other than stock and securities) are taken into account only to the extent of capital gain net income under section 1222(9). This is the excess of gains from sales of capital assets over losses from such sales.[285] This definition prevents the corporation from artificially increasing its gross receipts from the sale of non-passive investment income and thereby decreasing the percentage of passive investment income below 25 percent of gross receipts.

(b) Sales of Stock or Securities.

(1) General. Gross receipts from sales or exchanges of stock or securities are taken into account only to the extent of gains therefrom. Loss from such sales or exchanges do not offset gains.

(2) Treatment of Stock in Liquidations. Gross receipts does not include amounts received by the S corporation from the sale or exchange of stock in a section 331 corporation liquidation, when the S corporation owns more than 50 percent of each class of stock of the liquidating corporation.[286]

(3) Definition of Stock or Securities. The 1992 regulations provide an expanded definition of stock or securities which includes shares of stock,

---

283 § 1362(d)(3)(D)(i).

284 Treas. Reg. § 1.1362-2(c)(4).

285 § 1362(d)(3)(c).

286 § 1362(d)(3)(D)(iv).

stock rights, warrants, an interest in an association taxable as a corporation under section 7701, an interest as a limited partner, certificates of participation in a profit sharing agreement, or in any oil, gas or mineral lease, collateral trust certificates, voting trust certificates, bonds, debentures, certificates of indebtedness or notes.(287)

(4) General Partnership Interest. If an S corporation disposes of a general partner interest, the gain from the disposition is treated as gain from the sale of stock, to the extent the corporation would have received a distributive share of gain from the sale of stock or securities held by the partnership if the partnership had then sold all of its stock and securities at fair market value. The general partner may elect to treat the disposition as a disposition of an interest as a limited partner.(288)

(c) Other Exclusions. Gross receipts do not include:

(1) Amounts received in nontaxable sales or exchange, except to the extent gain is recognized;

(2) Amounts received as a loan, repayment of a loan, as a contribution to capital, or on the issuance of its own stock.

3. Specific Items of Passive Investment Income

(a) Rents.

(1) General Rule. Rents means amounts received for the use or, or right to use real or personal property of the corporation.(289)

(2) Rents from the Active Trade or Business of Renting Property. The final regulations under section 1362 adopted broad exclusions for rents derived from the active business of renting property. Rents are treated as derived from the active trade or business of renting property only if, under all the

287 Treas. Reg. § 1.1362-2(c)(4)(ii)(B)(3) (Nov. 24, 1992).

288 Treas. Reg. § 1.1362-2(c)(4)(ii)(B)(4) (Nov. 24, 1992).

289 Treas. Reg. § 1.1362-2(c)(5)(ii)(B) (Nov. 24, 1992).

facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, rent from net leases does not qualify.

(3) Prior Proposed Regulation Guidelines. The earlier proposed regulations had specifically excluded rent received from hotels, boarding houses or motels where significant services were rendered. The proposed regulations had also required that the significant services be principally for the occupants' convenience and be other than those usually or customarily rendered with rentals, such as maid service, cleaning public entrances and lobbies, and trash collection were not enough.(290)

Examples:

Shopping Centers. Income was not considered rents where extensive significant services were provided for tenants.(291) Non-customary services included advertising and promotional services, newsletters, store directories, informational memoranda, community room, assisting employee hiring process, library of reference materials, demographic information.

Office Buildings. Maids, porters, elevator operators, maintenance engineer and night watchman are not enough.(292)

Tennis Courts. The Service found that tennis court income was not rents in Revenue Ruling 76-48.(293)

Mobilehome Parks. Mobilehome park income generally has not been treated as rents,(294) unless

---

290 Prop. Reg. § 1.1362-3(d)(5)(iv).

291 Priv. Ltr. Rul. 88-10-013 Nov. 30, 1987); Priv. Ltr. Rul. 89-04-012 (Oct. 26, 1988); Priv. Ltr. Rul. 89-06-035 (Nov. 12, 1988).

292 Bramlette Building Corp. v. Commissioner, 52 T.C. 200 (1969) *aff'd* 424 F.2d 751 (5th Cir. 1970).

293 Rev. Rul. 76-48, 1976-1 C.B. 265.

294 Priv. Ltr. Rul. 78-36-051 (Jun. 9, 1978); Priv. Ltr. Rul. 85-27-037 (Apr. 8, 1985).

the Service rendered were found to be customary based on comparison with other mobile home parks.[295]

(4) Produced Film Rents. Rent from film production is expressly excluded from rents.[296]

(5) Leased Self-Produced Tangible Property. Income from leasing self-produced tangible property is excluded from rents if the taxpayer is engaged in substantial development, manufacturing, or production of real or tangible personal property of the same type.[297]

(b) Dividends. Dividends includes dividends as defined in section 316, consent dividends under section 565, and amounts includable in gross income under section 551 (foreign personal holding income taxes to the U.S. shareholders).

(c) Interest. Interest means any amount received for the use of money (including tax-exempt interest, and amounts treated as interest under sections 483, 1272, 1274 or 7872). Interest received on deferred obligations from the sale of section 1221(1) inventory or property held primarily for sale in the ordinary course of business is excluded.[298]

(d) Annuities. Annuities means the entire amount received as an annuity under an annuity, endowment or life insurance contract, if part is includable in gross income under section 72.

(e) Gross Receipts From the Sale of Stock or Securities. Passive investment income includes gross receipts from the sale of stocks or securities to the extent of gains therefrom. Losses do not offset gains.

(f) Royalties.

(1) General royalties means all royalties, including oil and gas royalties and amounts received from the privilege of using patents,

---

295 Stover v. United States, 781 F.2d 137 (8th Cir. 1986).

296 § 543(a)(5).

297 Treas. Reg. § 1.1362-2(c)(5)(ii)(B)(4) (Nov. 24, 1992).

298 § 1362(d)(3)(D)(ii).

copyrights, secret processes, formulas, goodwill, trademarks, trade brands, and franchises.(299)

However, royalties does not include royalties derived in the ordinary course of a trade or business of franchising or licensing if the corporation created the property or performed significant services or incurred substantial costs in the development or marketing of the property.

The term "royalties" does not include copyright royalties which are not treated as personal holding company income under sections 543(a)(3) and (4). Also excluded are active business computer software royalties defined under section 543(d) (without regard to section 543(d)(5)).

(g) Certain Trade or Business Activities. The final regulations issued in 1992 also provide for the first time that passive investment income does not include gross receipts that are directly derived in the ordinary course of a trade or business of:

(1) Lending or financing;

(2) Dealing in property;

(3) Purchasing or discounting accounts receivables, notes or installment obligations; or

(4) Servicing mortgages.(300)

Interest earned from the investment of idle funds in short-term accounts and dealer income or gain from property held any time for investment in such a business, does not qualify for exclusion.

(h) Dealers in Options or Commodities. In the case of an option or commodities dealer, any gain or loss (in the normal course of the taxpayer's activity of dealing in or trading section 1256 contracts) for any section 1256 contract or property related to such contract is also deferred as non-passive income.(301)

---

299 Treas. Reg. § 1.1362-2(c)(5)(ii)(A).

300 Treas. Reg. § 1.1362-2(c)(5)(iii)(b) (Nov. 24, 1992).

301 § 1362(d)(3)(E).

D. Recognized Built-In Gains

The amount of passive investment income is determined without taking into account any recognized built-in gains or losses for any taxable year in a recognition period under section 1374.(302)

E. Corporate Level Tax

The coexistence of subchapter C accumulated earnings and profits and excessive passive investment income at the end of any year will cause the S corporation to pay a corporate level tax even though the S election is not terminated because of the 3 consecutive-year rule.(303)

F. Investment Companies

Investment companies and holding companies may use subchapter S and thereby avoid the personal holding company tax and accumulated earnings tax on profits retained at the corporate level, so long as there is no subchapter C accumulated earnings and profits.

1. Beware of section 351(e) prohibiting the tax-free transfer of property to an 80 percent controlled "investment company".(304)

Section 351 does not define an investment company. However, Treasury Regulation section 1.351-1(c)(1) explains:

> "The general rule of section 351 does not apply, and consequently gain or loss will be recognized, where property is transferred to an investment company after June 30, 1967. A transfer of property after June 30, 1967, will be considered to be a transfer to an investment company if--
>
> (i) The transfer results, directly or indirectly, in diversification of the transferor's interests, and
>
> (ii) The transferee is (i) a regulated investment company, (ii) a real estate

---

302 § 1375(b)(A).

303 § 1375.

304 *See also* Treas. Reg. § 1.533-1(c) (concerning an "investment company" for accumulated earnings tax purposes).

investment trust, or (iii) a corporation more than 80 percent of the value of whose assets (excluding cash and nonconvertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts."

¶ 104.7. Active or Inactive Business

A corporation may qualify under subchapter S even though it is not engaged in an active business activity.(305)

¶ 104.8. Inadvertent Termination

A. General

A corporation will continue to be treated as a subchapter S corporation during a period of inadvertent termination, if:

1. The election has been terminated, either because the corporation is disqualified as an electing small business corporation, or as a result of the passive investment income rule.

2. The Service determines that the termination was inadvertent;

3. The corporation timely corrects the condition; and

4. If the corporation and shareholders agree to treat the election as having been continuously in effect.(306)

B. Service Rulings

The Service has a liberal policy for issuing rulings granting relief from inadvertent termination. For guidelines see Revenue Ruling 86-110.(307)

---

305 *See* Howell v. Commissioner, 57 T.C. 546 (1972) (passive holding and sale of undeveloped real estate); Rev. Rul. 75-188, 1975-1 C.B. 276 (sale of real estate by corporation with no active business).

306 § 1362(f).

307 Rev. Rul. 86-110, 1986-38 I.R.B. 4.

Examples:

1. Transfer of stock to ineligible trust was held to be inadvertent.[308] Upon discovery the trust distributed the stock to the income beneficiary. Trust treated as the shareholder for 10 months.

2. Transfer of stock to corporation was held to be inadvertent.[309] A corporation bought the S stock as agent for four individuals on March 19, 1985 and transferred the stock to the individual on April 30, 1985. The corporation was required to pick up its pro rata share of the income.

3. Transfer of stock to partnership was held to be inadvertent.[310] Stock was bought by an unrelated partnership. Upon discovery the stock was distributed pro rata to the partners. The ruling was premised upon the understanding that the partners shared equally in profits, gains and losses, and shared equally on termination.

4. The failure of a qualified subchapter S trust beneficiary to consent to S corporation treatment within the grace period constituted as inadvertent termination.[311]

5. Transfer of stock to an individual retirement account (IRA). Under Private Letter Ruling 89-15-067,[312] the Service would treat the IRA as shareholder if there was a loss, but would require the individual shareholder to report any net income.

¶ 105. TAXABLE YEAR OF CORPORATION

¶ 105.1. General Rule

The taxable year of an S corporation is required to be a permitted year, which is either a calendar year ending December 31 or any other accounting period for which the

---

308 Priv. Ltr. Rul. 85-23-097 (Mar. 15, 1985).

309 Priv. Ltr. Rul. 85-50-033 (Sep. 16, 1985).

310 Priv. Ltr. Rul. 85-41-059 (Jul. 16, 1985). *See also* Rev. Rul. 59-235, 1959-2 C.B. 1921; Kates v. Commissioner, 27 T.C.M. 1423 (CCH) (1968) (regarding partnerships as shareholders).

311 Priv. Ltr. Rul. 85-35-068 (Jun. 6, 1985).

312 Priv. Ltr. Rul. 89-15-067 (Jan. 23, 1989).

corporation establishes a business purpose to the satisfaction of the Service.[313]

¶ 105.2. Automatic Business Purpose Tests

The Service has two objective standards for establishing a business purpose. [314] If either the mechanical "natural business year" test or the "ownership tax year" test is satisfied the corporation will receive automatic approval of the accounting period.

A. Natural Business Year "25-Percent Test"

There is a natural business year if the corporation received 25 percent or more of its gross receipts from sales and services during the last two months of each of the preceding three years ending on the last day of the last month of the proposed fiscal year, prior to the request for adoption or change. This is a continuation of the automatic approval test adopted by the Service in Revenue Procedure 83-25.

1. If the corporation qualifies for more than one natural business year the fiscal year producing the highest average of those two month periods must be used.

2. The corporation must compute its gross receipts under the method of accounting used for its tax returns.

3. The corporation must use the gross receipts of any predecessor in satisfying the 25 percent test.

4. If the corporation does not have a 47-month period of gross receipts (36-month period for requested tax year plus 11 months for comparing the requested tax year with other potential tax years), then it cannot use the mechanical natural business year test of Revenue Procedure 87-32.

5. If the requested tax year is a 52-53 week year, the calendar month ending nearest to the last day of the 52-53 tax year is treated as the last month of the requested tax year for the 25 percent test. This prevents a 52-53 week taxable year ending on January 2 from shifting the S corporation's income to the subsequent shareholder tax year.

---

313 § 1378(a) and (b).

314 Rev. Proc. 87-32, 1987-2 C.B. 396.

B. "Ownership Tax Year"

An S corporation meets the ownership tax year test if the corporation adopting, retaining or changing to a tax year and shareholders holding more than 50 percent of its issued and outstanding stock (as of the first day of the proposed taxable year) have, or are currently charging to the same tax year.[315]

If on the first day of any tax year the S corporation no longer meets the ownership tax year test it must change its tax year to a permitted year.

C. Expeditious Approval

1. The corporation has a business purpose if either the natural business 25 percent test or the ownership test is satisfied.[316]

2. The Revenue Procedure states that automatic approval is granted if the corporation satisfies the mechanical business purpose test and files an income tax return for the short period required to effect the proposed tax year.[317]

¶ 105.3. Business Purpose Test

The S corporation may establish a business purpose for a fiscal year other than a calendar year for reasons not within the mechanical tests.

A. Natural Business Year Test

1. Historically the Service has relied upon Revenue Procedure 74-33,[318] which indicates that a substantial business purpose exists for a fiscal year if the desired taxable year coincides with the natural year of the business, The natural business year depends upon the type of business and locality. If all related income and expenses are encompassed within the annual accounting period, that would generally be a natural business year.

---

315 Rev. Proc. 87-32, § 4.01(2). *See also* Priv. Ltr. Rul. 89-26-060 (Apr. 4, 1989).

316 Rev. Proc. 87-32, § 4.02(1).

317 Id.

318 Rev. Proc. 87-32, 1974-2 C.B. 489.

2. The 1986 Act Conference Report states that the following reasons are not ordinarily sufficient to establish a business purpose requirement:

(a) Use of a particular year for regulating a financial accounting purpose.

(b) The hiring patterns of a particular business (seasonal hiring).

(c) The use of a particular year for administrative purposes such as the admission or retirement of owners, promotion of staff and compensation or retirement.

(d) The use of price lists, model year or other items that change on an annual basis.[319]

3. Revenue Ruling 87-57[320] sets forth a series of examples showing considerations used in determining the establishment of a business purpose.

B. "Deferral of Income" Is Not a Business Purpose

The mere deferral of income is not permitted as a business purpose.[321] This 1987 change was made to close a long-standing IRS practice of permitting an automatic 3-month deferral without requiring any business purpose.[322]

¶ 105.4. Taxable Year Selection Procedures

Temporary Regulation section 18.1378-1 establishes procedures for selecting a permitted taxable year.[323]

---

319 *See* Conf. Rept. on 86 Act p.II-319.

320 Rev. Rul. 87-57, 1987-2 C.B. 117.

321 § 1378(b).

322 *See* Rev. Proc. 83-25, 1982-1 C.B. 689 (S corporations); Rev. Proc. 72-51, 1972-1 C.B. 832 (partnerships).

323 Temp. Reg. 18.1378-1 (Jan. 26, 1983). *See also* Ann. 86-101, 1986-41 I.R.B. 14, as modified by Ann. 86-113, 1986-47 I.R.B. 46, pending new regulations, and as affected by Revenue Procedure 87-32 sections 4.02 and 4.03.

A. Automatic Calendar Year Rule

Generally, the filing of a Form 2553 election to adopt subchapter S will be treated as an automatic selection of a calendar taxable year. The new taxable year will terminate on December 31 of the first year in which the S election is effective.

B. Automatic Fiscal Year Request for New S Corporation

If a new S corporation wants a fiscal year other than a calendar year under the objective test, the filing of a Form 2553 is an automatic request for the fiscal year designated.[324]

1. If a business purpose is not established, the S election is ineffective, unless

(a) There is an alternative request for approval of a calendar year (if the fiscal year request is denied), or

(b) The Commissioner waives the alternative request.[325]

2. If a new electing S corporation desires to use a fiscal year which does not satisfy the "Natural Business" 25 percent Test or the "Ownership Tax Year" Test, the corporation must attach additional material to its Form 2553 establishing the necessary "business purpose" for a fiscal year election.[326] This request will be forwarded by the Service Center to the National Office for consideration.

¶ 105.5. Election Of Taxable Year Other Than Required Taxable Year; Section 444

A. Three-Month Deferral

An S corporation may elect a taxable year which does not cause a deferral of income longer than 3 months. (i.e., September 30, October 31 or November 30).[327]

324 Rev. Proc. 87-32, § 4.03(2).

325 Temp. Treas. Reg. 18-1378-1(b)(2)(ii)(B). *See also* Priv. Ltr. Rul. 85-25-064 (Mar. 26, 1985).

326 Rev. Proc. 87-32 § 6.03; 1987-2 C.B. 396 at 401.

327 § 444(a) and (b)(1).

B. Manner of Election

An S corporation must file its election to use a tax year other than a required tax year, by the earlier of the 15th day of the fifth month following the month which includes the first day of the taxable year for which the section 444 election is to be effective, or the due date (without extensions) for the tax return for the taxable year resulting from the section 444 election.[328] The election is filed on Form 8716.

C. Change May Not Expand Deferral Period

An S corporation cannot change to a tax year with a deferral period longer than the tax year being changed.[329] For example, if a C corporation with an October 31 fiscal year end elects subchapter S, it can only elect a taxable year ending October 31 or November 30. A calendar year C corporation electing subchapter S cannot elect a fiscal year under section 444.

D. Termination of Election

A change to a required taxable year under section 1378 may be made without the consent of the Commissioner.[330] If the election is terminated, the S corporation may not make another such election.

¶ 105.6. Required Payments Under Section 7519

A. Effect of Election

If an S corporation elects a Taxable year pursuant to section 444, it is required to make the payments required by section 7519.[331]

B. Required Payment

An electing S corporation must make a "required payment" for any taxable year for which an election is in effect by May 15 of the year following the calendar year in which the election begins.[332] The "required payment" is

---

328 I.R.S. ANN. 88-90,1988-23 I.R.B. 55 (May 24, 1988).

329 § 444(b)(2).

330 § 444(d)(2)(A).

331 § 444(c)(1).

332 § 7519(f)(2); Temp. Reg. 1.7519-2T (a)(4)(ii).

essentially "the payment of a tax imposed by Subtitle C that is due on such date".(333)

This advance tax deposit is adjusted each year to reflect annual income and when the deferral election is terminated, the corporation will receive a refund of its deposit.(334)

¶ 106. TAX TREATMENT OF INCOME, DEDUCTIONS AND CREDITS

¶ 106.1. General Tax Treatment

The tax character of each item of income, loss, deduction or credit is determined at the corporate level and each item is then passed through to the shareholders pro rata for taxation by shareholders at their individual rates. The subchapter S rules are frequently consistent with the provisions of partnership taxation.(335)

In contrast to subchapter S, the taxable income of a C corporation is all taxed to the corporate entity at corporate rates with subsequent distributions then subjected to separate taxation by the shareholders, generally as dividends.

Example 1 - Federal Rates. Income of an S corporation is subjected to a single maximum tax at the shareholder level of 39.6 percent, while income of a C corporation is first taxed at a maximum 35 percent corporate rate, followed by a 39.6 percent taxable dividend on distribution to the shareholders. With a C corporation, the shareholder would have after-tax net proceeds on distribution of 39.26 cents per dollar compared with 60.04 cents for an S corporation. The shareholder will have a 52.93 percent greater return by using an S corporation.

Example 2 - Federal and California Rates. In California, assuming a 9.3 percent corporate tax on C corporations, a 1.5 percent corporate tax on S corporations, and a 9.3 percent tax on individuals, the shareholder would net 53.96 percent with an S corporation or 32.30 percent with a C corporation, giving the shareholder a 67.06 percent greater profit with the S corporation.

---

333 Omnibus Budget Reconciliation Act of 1987, Pub. L. 100-203, Conf. Rept. on Act § 10205.

334 § 7519(b) and (c).

335 I.R.C. §§ 1366(a) and 702(a).

¶ 106.2. Taxation of S Corporation

A. General

The corporation is not generally subjected to corporate income taxes applicable to C corporations. This includes special taxes such as the accumulated earnings tax and the personal holding company tax.

B. General Exceptions

There are a number of special exceptions dealing with capital gains, investment tax credits, and passive investment income.

C. Built-In Gains

1. General Rule

If a C corporation converts to subchapter S, then the S corporation will be subject to a corporate level tax on net recognized built-in gains for a period of 10 years after the S election becomes effective.[336] The built-in gain rules do not apply to any corporation which has been an electing S corporation since its formation.[337]

The built-in gain rules do not apply to any corporation which made an S election before January 1, 1987,[338] or to certain other closely-held qualified corporations which made elections prior to 1989.[339]

The built-in gain rules were adopted as part of the 1986 plan to tax C corporations on appreciated assets at the time of liquidation. There was a fear that C corporations with substantially appreciated assets would convert to S corporation status, in lieu of liquidation, since there is generally no corporate tax for merely converting from subchapter C to subchapter S status. Thereafter, the corporation would then sell all of its assets, with a single pass-through tax at the shareholder

---

[336] § 1374.

[337] § 1374(c)(1).

[338] T.R.A. of 1986, § 633(b); *see also* Rev. Rul. 86-141, I.R.B. 1986-49 (December 8, 1986).

[339] The built-in gain provisions do not apply to disposition of built-in gain assets which were held by "qualified corporations" which elected subchapter S prior to January 1, 1989. T.R.A. of 1986, section 633(d)(8), as amended; TAMRA (1988), § 1006(g)(7).

level, and subsequent distribution of the proceeds in liquidation.[340]

2. Net Unrealized Built-In Gain ("NUBIG")

The beginning point for determining the impact of the built-in gain rule is to determine the amount of unrealized appreciation in the corporation's assets at the time of conversion, which would have been taxed if the corporation liquidated instead of electing subchapter S.

(a) Net Unrealized Built-In Gain. "Net unrealized built-in gain" means the excess of the fair market value of all assets over the aggregated adjusted basis of those assets on the first day the election is effective.[341]

(b) Determining NUBIG. Proposed Regulations[342] provide that net unrealized built-in gain is the total of the following:

(1) The amount that would be realized if on the first day of the recognition period, the corporation sold all of its assets at fair market value to an unrelated party which assumed all of its liabilities, decreased by:

(2) any liability of the corporation that would be included in determining the amount realized, but only if payment of the liability would be deductible; decreased by,

(3) the aggregate adjusted basis of the corporation's assets; increased or decreased by,

(4) any section 481 adjustments arising from a change in method of accounting; and increased by,

(5) any recognized built-in loss that would not be allowable under sections 382, 383, or 384.

(c) All Assets Included. NUBIG includes all tangible and intangible property of the

---

340 Even under prior law, old section 1374 would have imposed a corporate level tax in limited circumstances if a sale occurred within 3 years of the election.

341 § 1374(d)(1).

342 Prop. Reg. § 1.1374-3(a) (Dec. 8, 1992).

corporation, regardless of character. For example, it includes real property, machinery and equipment, inventory, accounts receivable, patents, and goodwill.

(1) Inventory. Under Proposed Regulations, the fair market value of inventory is the amount that a willing buyer would pay to a willing seller for the inventory in a purchase of all of the assets of the corporation on the first day of the recognition period.[343]

(A) Not a Distress Sale. IRS commentators have indicated that the valuation is not intended to be based on a "distress" sale. They have also indicated that by requiring a valuation of the inventory as part of a sale of all of the assets, that a greater value would be placed on the inventory as part of the value of an ongoing business. However, it is more reasonable to assume that the value is attributable to the "going concern value" of the business, which is a separate intangible asset.

(B) Identifying Inventory. The identity of inventory disposed of during the recognition period is determined by the inventory method used by the S corporation for tax purposes. For example, a corporation, using the LIFO method, does not dispose of inventory which it held on the first day of the recognition period unless the carrying value of its inventory for a taxable year during the recognition period is less than the carrying value of its inventory on the first day of the S election. The premise is that newly-acquired inventory is sold before old inventory under the LIFO method.

(C) Purpose to Avoid Built-In Gain Tax on Inventory. The Proposed Regulations indicate that if the corporation changes its method of accounting to the LIFO method for the principal purpose of avoiding the built-in gain tax on inventory, it must use the FIFO method to identify its dispositions of inventory.[344]

(d) Example of NUBIG Determination. Assume that X, a calendar year C corporation using the cash method, elects subchapter S on January 1. On that date, X has assets and liabilities as follows:

---

343 Prop. Reg. § 1.1374-7(a) (Dec. 8, 1992).

344 Prop. Reg. § 1.1374-7(b) (Dec. 8, 1992).

Assets	Fair Market Value	Basis
Factory	$ 500	$700
Accounts Receivable	300	-0-
Goodwill	200	-0-
TOTAL	$1,000	$700

Liabilities	
Mortgage	$ 200
Accounts Payable	100
TOTAL	$ 300

If on January 1 X sold all of its assets to an unrelated third party which assumed all of its liabilities, X's amount realized would be $1,000 ($700 in cash received, plus $300 liabilities assumed). The amount of X's net unrealized built-in gain is determined as follows:

Amount Realized	$1,000
Reduction for Deductible Payables (accounts payable)	(100)
Bases of X's Assets	(700)
Net Unrealized Built-In Gain	$ 200

3. *Recognized Built-In Gains or Losses*

(a) Recognized Built-In Gains. Any gain recognized during the 10-year recognition period in a transaction which is treated as a sale or exchange for tax purposes, is a "recognized built-in gain," except to the extent that the S corporation establishes that the asset was not owned at the commencement of the first S corporation year, or that appreciation occurred after the conversion.[345]

(b) Recognized Built-In Loss. A built-in loss will be recognized on the sale or exchange of any asset during the recognition period to the extent that the S corporation establishes that the asset was held at the beginning of the first S election year and the adjusted basis of the asset exceeded the fair market value at that time.[346]

(c) Accrued Income or Deduction.

(1) Accrued Income Items. Any item of income properly taken into account during the

345 § 1374(d)(3).

346 § 1374(d)(4).

recognition period is recognized built-in gain if the item would have been included in gross income before the beginning of the recognition period by a taxpayer using an accrual method of accounting.[347]

(2) Impact on Accounts Receivable.

(i) Example. Assume that X is a calendar year C corporation using the cash method. X becomes an S corporation on January 1. X has $50,000 of accounts receivable for services rendered before that date. On January 1, the accounts receivable have a FMV of $40,000 and an adjusted basis of zero. During the year, X collects $50,000 on the accounts receivable and includes that amount in gross income. The $50,000 is recognized built-in gain, since it would have been included in gross income before the beginning of the recognition period if X had been an accrual method taxpayer.[348]

(ii) Impact of "collection" vs. "sale." Under the Proposed Regulation, the entire amount of "collected" accounts receivable would be recognized built-in gain, while only the fair market value at time of conversion is recognized built-in gain if the accounts receivables are sold.

Thus, in the above example, the regulation also explains that if X had sold the accounts receivable for $45,000 on July 1 to a third party in a transaction treated as a sale or exchange, then X would have recognized built-in gain of only $40,000 on the disposition.

(iii) Impact of Total NUBIG Valuation. Since recognized built-in gains may never exceed the net unrecognized built-in gain valuation, X would recognize built-in gain on the collection of accounts receivable (e.g., $50,000) in excess of the fair market value at time of the S election (e.g., $40,000), only if the corporation had other appreciated assets at the time of conversion which caused the total NUBIG to exceed $40,000.

(iv) Planning. In some instances it may be prudent to sell the accounts receivable to a third party for collection when the

---

347 § 1374(5)(A), Prop. Reg. § 1.1374-4(b)(2) (Dec. 8, 1992).

348 Prop. Reg. § 1.1374-4(b)(3) Example 1 (Dec. 8, 1992).

accounts receivable had a discounted fair market value at time of conversion.

(3) Accrued Deduction Items. Any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed against gross income before the S election by a taxpayer using an accrual method.

Example 1 - Compensation. Assume that compensation is paid after the first of the year for a bonus declared prior to the beginning of the year. In this instance, the expense would not be a recognized built-in loss, since the item would not have been properly allowed against gross income by the corporation in the prior year as an accrual method taxpayer. The restrictions of section 267(b) prohibit an accrual method taxpayer from deducting the item until the expense has been paid.

Example 2 - Contingent Liability. Assume that a $1 Million lawsuit has been filed against the corporation before its election. After the election, the corporation loses the lawsuit and pays $500,000 in damages. If the corporation would not have been allowed a deduction with respect to the lawsuit before the recognition period under the accrual method, the payment of the $500,000 is not a recognized built-in loss.(349)

Example 3 - Deferred Payment Liabilities. The regulation explains that the accrued deduction rule is applied without regard to section 461(h) (2)(C), which restricts deductibility of tort liabilities until paid, and section 469, relating to the suspension of passive activity losses.

Assume X is a C corporation under the cash method, which elects subchapter S on January 1, 1995. In 1994, it had lost a lawsuit for $150,000 in damages. The payment in 1995 of $150,000 would be allowed as a recognized built-in loss, notwithstanding the proscription under section 461(h)(2)(C) against an accrual method taxpayer deducting the otherwise proper deduction in 1994.(350)

(d) Discharge of Indebtedness and Bad Debts. Any item of income or deduction properly taken

---

349 Prop. Reg. § 1.1374-4(b)(3) Example 3 (Dec. 8, 1992).

350 Prop. Reg. § 1.1374-4(b)(3) Example 5 (Dec. 8, 1992).

into income during the first year of the election as discharge of indebtedness income or as a bad debt deduction, is recognized built-in gain or loss if the item arises from a debt owed by or to the S corporation at the beginning of the year.[351]

(e) Installment Sales.

(1) General Rule. If a corporation sells an asset either before or during the 10-year recognition period and reports income under the installment method[352] during or after the recognition period, then the section 1374 tax is imposed on the installment income when reported, to the extent that it would have been included in net recognized built-in gain during the recognition period if the entire amount of income to be reported from the sale were reported in the year of sale, and all of the provisions of section 1374 were applied.[353] For this purpose, if the corporation sells the asset before the S election, the entire amount of income to be reported from the sale that was not reported during the recognition period is treated as having been reported on the first year of the S election.

(f) Section 481 Adjustments. Any income or deduction item properly taken into account during the recognition period under section 481 is a recognized built-in gain or loss if the item is taken into account because of a change in method of accounting effective before the beginning of the second year of the election.

(g) Partnership Interests. If the S corporation owns a partnership interest at the beginning of the S election, or transfers property to a partnership in a tax-deferred transaction to which section 1374(d)(6) applies (e.g., a section 722 contribution) during the ten-year recognition period, then the Regulations provide a set of rules for including the appreciated or depreciated assets of the partnership in the section 1374 calculation by looking to the S corporation's distributive share of partnership items.

---

351 *See* sections 61(a)(12) and 166; Prop. Reg. § 1.1374-4(e) (Dec. 8, 1992).

352 § 453.

353 Prop. Reg. § 1.1374-4(g)(1).

4. Net Recognized Built-In Gain

(a) Computation. An S corporation's "net recognized built-in gain" for any taxable year is the least of:

(1) its taxable income determined by using the rules applied to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover (the "pre-limitation amount");

(2) its taxable income determined by using the rules applied to C corporations as modified by section 1375(d)(1)(B), limiting the excess net passive investment income to the corporation's taxable income for the year (the "taxable income limitation"); and

(3) the amount by which its net unrealized built-in gain exceeds its net recognized built-in gain for all prior years (the "net unrealized built-in gain limitation").

(b) Allocation. If the corporation's pre-limitation amount for any taxable year exceeds its net recognized built-in gain for that year, the corporation's net recognized built-in gains will consist of a ratable portion of each item of income, gain, loss and deduction included in the pre-limitation amount.(354)

5. Recognized Built-In Gain Carryover

If an S corporation's net recognized built-in gain for any taxable year exceeds the taxable income limitation, the excess is carried forward as "recognized built-in gain carryover," and is included in the pre-limitation amount for the succeeding year. The recognized built-in gain carryover would consist of a ratable portion of each item of income, gain, loss and deduction which was excluded from net recognized built-in gain for the year in which the carryover arose.(355)

(a) Example. Assume that X is a calendar year C corporation which elects S corporation status

---

354 Prop. Treas. Reg. § 1.1374-1(b) (Dec. 8, 1992).

355 The carryover requirement of excess built-in gains applies only to S corporations which made elections on or after March 31, 1988. § 1374(d)(2)(B).

on January 1, 1995. X has a net unrealized built-in gain of $50,000 and no net operating loss at the time of the election. Assume that in 1995, X has a pre-limitation amount of $20,000 consisting of ordinary income items of $15,000 and capital gain of $5,000, a taxable income limitation of $9,600, and net unrealized built-in gain limitation of $50,000. Under these facts, X's net recognized built-in gain for 1995 is limited to the $9,600 taxable income. Under the allocation rules, X's net recognized built-in gain consists of recognized built-in ordinary income of $7,200 ($15,000 times ($9,600/$20,000)), and recognized built-in capital gain of $2,400 ($5,000 times ($9,600/$20,000)).[356]

Built-In Loss Carryover. Congress failed to provide for a comparable provision for the carryforward of unused excess built-in losses from the year in which incurred.

6. *Deductions for Carryforwards*

An S corporation's net operating loss and capital loss carryforward from C years are allowed as deductions against its net recognized built-in gain.[357] Other carryforward such as charitable contribution carryforwards are not allowed.

(a) Trafficking Limitations. If section 382, 383(b), or 384 would have applied to limit the use of a C corporation's net operating loss and capital loss carryforwards at the time of the S election, the sections would continue to limit their respective use of deductions against the C corporation's net recognized built-in gain.

7. *Credits and Credit Carryfowards*

The S corporation is permitted to use the special fuels credit (§ 34), business credit carryforward from C years (§ 39), and minimum tax credit from C years (§ 53) against the section 1374 tax.[358] Other tax credits such as the foreign tax credit are not allowed.

---

356 Prop. Reg. § 1.1374-2(e) Example (Dec. 8, 1992).

357 Prop. Reg. § 1.1374-5.

358 Prop. Reg. § 1.1374-6(a) (Dec. 8, 1992). The use of the business credit carryforward and minimum tax credit carryforward are further modified under Proposed Regulation section 1374-6(b).

8. *Computation of Tax*

The tax imposed under section 1374(a) for any taxable year is computed as follows:

> (a) First, determine the net recognized built-in gain of the corporation for the taxable year;
>
> (b) Second, reduce the net recognized built-in gain (but not below zero) by any net operating loss or capital loss carryfoward;
>
> (c) Third, compute a tentative tax by applying the maximum corporate rate under section 11(b) to the amount determined under (2); and
>
> (d) Fourth, compute the final tax by reducing the tentative tax (but not below zero) by any allowed credit.[359]

9. *Anti-Stuffing Rules*

If a corporation acquires assets before or during the recognition period with a principal purpose of avoiding the section 1374 tax, the asset and any loss, deduction, loss carryfoward, credit, and credit carryforward attributable to the asset is disregarded in determining the corporation's (1) net recognized built-in gain, including its pre-limitation amount, taxable income limitation, and net unrealized built-in gain limitation; (2) loss carryfoward deductions allowed against its net recognized built-in gain; and (3) credits and credit carryforwards allowed against its section 1374 tax.[360]

10. *Example of Operation of Built-in Gain Rules*

Assume at the time of the election the S corporation has the following assets and uses the cash receipts method of accounting:

	Basis	F.M.V.
Accounts Receivables	$ 0	$ 30
Equipment	150	100
Building	300	400
Goodwill	0	20
	$ 450	$ 550

359 Prop. Reg. § 1.1374-1 (Dec. 8, 1992).

360 Prop. Reg. § 1.1374-9 (Dec. 8, 1992).

Its net unrealized built-in gain is $100.

(a) In year 1, it collects the accounts receivable of $30 but has only $10 of taxable income. There is $10 of net recognized built-in gain and the excess $20 is carried forward to the next year.

(b) In year 2, equipment with a basis of $30 and FMV of $20 is sold creating a $10 recognized built-in loss. Taxable income is $40. The $10 loss may be used against the $20 of recognized built-in gain carryforward from year 1. The remaining $10 of suspended gain carryforward is taxed to the corporation, since it is less than taxable income.

(c) In year 3, the building is sold for $500. Only $70 of the $200 gain is recognized built-in gain, since the excess of the $100 net unrealized built-in gain over previously recognized built-in gain of $30 is $70.

11. Application of Built-in Gain Rules to Post-Election Acquisitions

(a) Substituted Basis Assets. If the adjusted basis of any acquired asset is determined (in whole or part) by reference to the adjusted basis of an asset held in the first election year, that asset is subject to the built-in gain rules using the initial ten-year holding period, FMV and adjusted basis of the transferred asset.[361]

(1) Example 1. Property acquired in a section 1031 exchange.

Example 2. Interest in partnership acquired on contribution of built-in gain asset.[362]

(b) Transferred Basis Assets. If an S corporation acquires any asset with a transferred basis (in whole or part) from a C corporation (such as a tax-free reorganization), the acquisition is treated as a conversion to S corporation status as to that asset, and the ten-year built-in gain rule will apply from the date the asset is acquired.[363]

---

361 § 1374(d)(6), added by TAMRA codifying Ann. 86-128, 1986-51 I.R.B. 22.

362 § 722.

363 § 1374(d)(8) added by TAMRA (1988), codifying Ann.

12. Regulating Authority

Section 1374(e) gives the Service authority to prescribe regulations to carry out the purposes of the built-in gain rules and prevent the avoidance of the abrogation of the General Utilities doctrine,[364] including the appropriate treatment of successor corporations.[365] The legislative history suggested several areas where regulations may be considered.

(a) "In situations in which an S corporation engages in a transaction that results in carryover basis of assets to a successor corporation pursuant to subchapter C of the code."[366]

(b) "To prevent the manipulation of accounting methods or alter provisions that may have the result of deferring recognition beyond the 10-year recognition period - for example, in the case of a C corporation with appreciated FIFO inventory that converts to S status and elects the LIFO method of accounting."[367] In Proposed Regulation section 1.1374-4(g), the Treasury Department has proposed prohibiting the use of the installment method to delay recognition beyond the section 1374 10-year recognition period.

(c) The Senate report also indicated that it expected that Treasury would prevent the avoidance of the section through contributions of property with built-in losses to a C corporation before it becomes an S corporation.[368]

86-128, 1986-51 I.R.B. 22; Prop. Reg. § 1.1374-8 (Dec. 8, 1992).

364 General Utilities Operating Co. v. Helvering, 296 U.S. 200 (1935) (holding that a corporation did not recognize gain on the distribution of appreciated property to shareholders on liquidation).

365 § 1374(e).

366 H.R. No. 100-795, 100th Cong., 2d Sess. 65 (July 26, 1988).

367 Sen. Rep. No. 100-445, 100th Cong. 2d Sess. (Aug. 3, 1988).

368 *See* Prop. Reg. § 1.1374-9 (Dec. 8, 1992); see ANN 86-128, 1986-51 I.R.B. 22, proposing such regulations.

13. *Corporate Tax Treated as Loss by Shareholders*

If a section 1374 corporate level tax is imposed on net recognized built-in gain, then the amount of the tax is treated as a loss sustained by the corporation for the taxable year. The character of that loss is determined by allocating the loss proportionately among the recognized built-in gains and the loss would be passed through to the shareholders under section 1366.(369)

D. Excess Passive Investment Income

1. *Corporate Taxes*

A corporate level tax is imposed on an S corporation if it has subchapter C earnings and profits at the close of the year and if more than 25 percent of its gross receipts are passive investment income.(370)

2. *Computation of Tax*

The tax is determined by multiplying the "excess net passive income" by the highest corporate tax rate (35 percent).

(a) "Excess net passive income" (ENPI) is that portion of the corporation's net passive income which bears the same ratio to the net passive income as the excess gross passive income (i.e., gross passive income in excess of 25 percent of gross receipts) bears to the gross passive income for the year.(371)

(b) "Net passive income" is the passive income less deductions directly connected with the production of that income.(372)

Example. If the corporation has gross receipts of $100,000 of which interest income is $35,000 subject to related expenses of $1,000, then the corporate tax is $3,451, computed as follows:

---

369 § 1366(f)(2).

370 § 1375; Treas. Reg. § 1.1375-1A (September 25, 1986).

371 § 1375(b)(2).

372 § 1375(b)(2).

$$\text{Excess Net Passive Income} = \text{Net Passive Income} \times \frac{\text{Excessive Passive Income}}{\text{Passive Income}}$$

$$\text{ENPI} = (35{,}000-1{,}000) \times \frac{(35{,}000-25{,}000)}{35{,}000}$$

$$\text{ENPI} = 34{,}000 \times \frac{10{,}000}{35{,}000}$$

$$\text{ENPI} = \$9{,}860$$

$$\text{Tax} = \$9{,}860 \times 35\% = \$3{,}451$$

3. *Taxable Income Limitation*

The amount subject to tax cannot exceed the corporation's taxable income as determined under section 63(a) without regard to the deductions allowed by Part VIII of subchapter B (e.g., dividends received deduction) other than the section 248 deduction for organizational expenses and without regard to the section 172 net operating loss deduction.[373]

4. *Nonrefundable Credits*

Nonrefundable credits are not allowed against the tax.

5. *Adjustments for Section 1374 Tax*

Passive investment income is determined by not taking into account any recognized built-in gain or loss for any taxable year during the 10-year recognition period.[374]

6. *Shareholder's Income*

The amount of tax will reduce the amount of items the shareholder must take into income.

7. *Waiver of Tax*

The tax may be waived if the corporation determined in good faith that it had no subchapter C earnings and profits at the close of the year, and the earnings and profits are distributable within a reasonable period after discovered.[375]

---

373 § 1375 (b)(1)(B), as amended TAMRA (1988), § 1006(f)(5)(B).

374 § 1375 (b)(i)(B), as amended by TAMRA (1988), § 1006(f)(5)(C).

375 § 1375(d); T.R.A. of 1984, § 721(v).

E. Investment Credit Recapture

The corporation will be subject to tax on investment credit recapture for the early disposition of property with respect to credits allowed prior to the subchapter S election. The election is not treated as a disposition.[376]

F. Corporate Section 291 Preferences

The corporate preference rules of section 291 will apply for the first three taxable years after a prior C corporation elects subchapter S.[377] This prevents a C corporation from making its election to avoid the preference.

G. Alternative Minimum Tax

S corporations are not subject to the alternative minimum tax.[378]

H. At Risk Rules

The "At Risk" Rules of section 465 do not apply to an S corporation at the corporate level.[379] Section 465 is applied only at the shareholder level.

I. Recapture of Inventory LIFO Benefits

If a C corporation elects subchapter S, then the corporation must recapture its "LIFO recapture amount" for the last taxable year prior to the S election.[380]

1. LIFO Recapture Amount

The LIFO Recapture Amount is the amount by which inventory under the FIFO method exceeds the LIFO method inventory.

---

376 § 1371(d).

377 § 1363(b)(4); 1984 T.R.A. § 721(p).

378 T.R.A. of 1986, § 701(e)(4)(J). Prior to 1986, the corporation was subject to the alternative minimum tax on section 1374 gain.

379 *See* § 465(a)(1)(B).

380 § 1363(d).

2. *Installment Payments*

Any increase in tax may be payable in 4 equal installments, without interest.[381]

3. *Consolidated Return Exclusion*

The recaptured LIFO benefit is not included in any consolidated return of an affiliated group. This prevents the use of consolidated return losses to affect the recaptured income.[382]

4. *LIFO Recapture on Merger*

A C corporation would trigger its LIFO reserve on a merger into an S corporation under new proposed regulation section 1.1363-2(a)(2), effective as of August 18, 1993.[383]

J. Installment Obligations

If an installment obligation is distributed by an S corporation in complete liquidation and receipt of the obligation is not treated as payment to the shareholders under section 453B(h)(1), then no gain will be recognized to the corporation.[384]

1. *Corporate Tax Liability*

Any corporate level tax imposed under subchapter S still applies.[385] For example, the corporate tax would apply to a built-in gain asset sold on the installment method.

¶ 106.3. Conduit Tax System

A. General

Subchapter S treats the S corporation as a conduit. The tax characters are determined at the corporate level and each item of income, loss, deduction, or credit is passed through to the shareholder pro rata. The

---

381 § 1363(d)(2).

382 § 1363(d)(4)(D), as added by TAMRA (1988) § 1006(f)(7).

383 Treas. Reg. § 1.1363-2(a)(2) (Aug. 18, 1993).

384 § 453B(h), added by TAMRA (1988), § 1006(e)(22).

385 § 453B(h).

subchapter S rules generally follow the provisions of partnership taxation.[386] This is contrasted to prior law which determined the taxable income of the subchapter S corporation and taxed all income to the shareholders as dividends or capital gains.

B. Computation of Tax Items

1. Taxable Income

The taxable income of the corporation will be computed in the same manner as with an individual, except that:

(a) Any item of income (including tax-exempt income), loss, deduction or credit must be separately stated if it would separately affect the tax liability of a shareholder.[387]

2. Deductions

Deductions generally allowed to individual will be allowed to S corporations.

(a) Special corporate attributes such as the dividends received deduction (§ 243) and the rules relating to corporate tax preferences (§ 291) will not apply. Section 291 will apply only to an S corporation which was previously a C corporation for the first three years of its election.

(1) An S corporation is not entitled to a dividends received deduction on stock held in a foreign sales corporation.[388]

(b) Deductions disallowed to partnerships under section 703(a)(2) are also disallowed the S corporation.[389]

(1) The standard deduction.[390]

---

386 §§ 1366(a) and 702(a).

387 § 1363(b)(1).

388 NAPORANO v. United States, ___ F.Supp. ___, No. 93-106 (D.N.J. Oct. 1, 1993).

389 § 1363(b)(2).

390 § 141.

(2) The deduction for personal exemptions.[391]

(3) The deduction for taxes under section 164(a), described in section 901 paid or accrued to foreign countries and U.S. possessions. (the shareholder may elect between a deduction or credit).

(4) The charitable deduction[392] (the shareholder applies the deduction against individual limits).

(5) The net operating loss deduction.[393]

(6) Itemized deductions under sections 212-218.

(7) The depletion deduction under section 611 with respect to oil and gas wells.

(c) The S corporation is allowed to amortize organizational expenses under section 248.

3. *Elections*

Elections are generally made at the corporate level.[394]

(a) Examples: Choice of method of accounting[395] (an S corporation may still elect the cash method of accounting); selection of method of depreciation;[396] choice of inventory method;[397] election on additional first year depreciation;[398]

---

391 § 151.

392 § 170.

393 § 172.

394 § 1363(c)(1).

395 § 446.

396 §§ 167, 168.

397 § 472.

398 § 179.

the election of taxable year;[399] election of taxable year other than a required taxable year.[400]

(b) Exceptions: Pursuant to section 1363(c)(2), the following elections are made by individual shareholders. These are similar to the rules for partnerships under section 703(b).

(1) Deduction and recapture of mining exploration expenditures.[401]

(2) Taxes paid or accrued to foreign countries and U.S. possessions.[402]

(3) Section 59(e)(4)(c) permits the shareholders to amortize certain qualified expenditures (e.g., R & D expenditures and intangible drilling and development expenditures) over 10 years, in connection with the shareholder's alternative minimum tax.

4. *Subchapter C Rules*

(a) Coordination with Subchapter C. The subchapter C provisions will apply to the S corporation except as otherwise provided or to the extent they are inconsistent with subchapter S.[403]

(b) S Corporation Shareholder as Individual. An S corporation which owns shares in another corporation is treated as an individual for subchapter C purposes (e.g., treatment of dividends received deduction).[404]

(c) Service Interpretation of Coordination Rules. On July 28, 1992, the Service released Technical Advise Memorandum 92-45-004, holding that intent of section 1371(a)(2) was to treat the S corporation, which owns shares in another corporation, as an individual only for the limited purpose of assuring that distributions to an

---

399 § 1378.

400 § 444.

401 § 617.

402 § 901.

403 § 1371(a)(1).

404 § 1371(a)(2).

S corporation are taxable under section 301 in the same manner as distributions to an individual shareholders. As a consequence, it appears that the Service would now treat the S corporation as a corporate stockholder for the purpose of applying non-distribution subchapter C rules.

(1) The Service held in Technical Advise Memorandum 92-45-004,[405] that an S corporation can make a qualified stock purchase under section 338 and participate in a section 332 liquidation, on the premise that Congress intended for S corporations to have the same business and tax liability in effectuating corporate acquisitions as C corporations. This reverses an earlier position that an S corporation which acquires control of another corporation is prohibited from making a section 338 election since the election is available only to purchasing corporations, and the S corporation as shareholder must be treated as an individual.[406]

(2) Earlier in General Counsel Memorandum 39768,[407] the service determined that section 1371(a)(2) does not prevent an S corporation from participating in corporate reorganizations or divisions.

(d) Query the current position of the Service on other section 1371(a)(2) issues?

(1) Would the S corporation shareholder would be an eligible non-corporate shareholder in a partial liquidation under section 302(b)(4)?

(2) Could the S corporation, as an "individual" shareholder, prevent the application of section 304 to a controlled corporation sale of stock?[408]

---

[405] T.A.M. 92-45-004 (July 28, 1992).

[406] Priv. Ltr. Rul. 88-18-049 (Feb. 10, 1988). *See* detailed discussion at ¶ 102.3 § A.4(d)(1), supra.

[407] G.C.M. 39768 (Dec. 1, 1988).

[408] *See* Shaw, "Subchapter S; a Fresh Start Under the Subchapter S Revision Act of 1982," 35 Major Tax Planning 10-55 (1983).

(e) In transactions with respect to its own stock, the subchapter C rules will be applied to an S corporation.

(f) Carryforwards and carrybacks from years when the corporation is not an S corporation, will not be allowed to the corporation while subject to subchapter S.(409)

However, subchapter S years will be counted as lapsed years in determining the number of taxable years an item may be carried back or carried forward (except that an S Termination Year is treated as one year).(410) Subchapter C net operating loss carryforwards, capital loss carryforwards and certain credits may be applied against section 1374 built-in gains.

(g) Subchapter C rules do not apply when inconsistent with the purpose of subchapter S to treat the corporation as a pass-through entity.(411)

C. Pass-Through of Items

The character and source of items of income, deductions, losses and credits are intended to pass through to the shareholders in the same manner as they pass through partnerships. Some items that are passed through to the shareholders separately include the following:

1. Capital Gains and Losses

Gains and losses from the sale or exchange of capital assets pass through to the shareholders. Net capital gains are not offset by ordinary losses at the corporate level.

2. Section 1231 Gains and Losses

Gains and losses from property used in the trade or business pass through separately and are aggregated with the shareholder's other section 1231 gains and losses. Section 1231 gains are not aggregated with capital gains at the corporate level and passed through as capital gains.

---

409 § 1371(b).

410 § 1371(b)(3).

411 S Rep. on H.R. 6055, supra, p.15.

3. *Charitable Contributions*

The corporate 10 percent limitation does not apply to S corporations. Contributions pass through to the shareholder where they are subject to the individual limitations of deductibility. Special corporate contribution rules for inventory and scientific research property would not be available.[412]

4. *Tax-Exempt Interest*

Tax-exempt interest passes through to the shareholder as such and increases the shareholder's basis in the subchapter S stock.

5. *Additional First-Year Depreciation*

As in the case of partnerships, under section 179 (d)(8) the additional first year depreciation limitation is first applied at the corporate level, and then passed through to the shareholders who are subject to the individual limitations.

6. *Foreign Taxes*

Foreign taxes paid by the corporation pass through to the shareholders, who claim such taxes either as deductions or credits. The corporation is not eligible for a foreign tax credit for taxes paid by a foreign corporation in which the S corporation is a shareholder. Special recapture provisions apply to a corporation electing out of subchapter S which has previously passed foreign losses through to shareholders.[413] Rules concerning the source of income, including the capital gains source rule section 904(b)(2) and the amount of creditable taxes, such as oil and gas foreign tax credit rules (section 907(a)) apply at the shareholder level.

7. *Credits*

As with partnerships, items involved in the determination of any credits pass through to the shareholders.

8. *Depletion*

The present rules governing depletion with regard to partnership interests in minerals apply to depletion of

---

412 § 170(e)(3) and (4).

413 § 904(f).

properties of an S corporation. Special rules are to be applied in the case of gas and oil properties.

9. Foreign Income and Loss

Domestic losses and foreign losses pass through separately. Thus, if a corporation has foreign losses and domestic income, each passes through separately without aggregation at the corporate level.

10. Investment Interest Limitations

Investment income and investment expenses pass through to the shareholders for purposes of section 163(d) application.

11. Separately Stated Items

If an item can affect the computation of a shareholder's tax liability, it must be separately stated by the corporation. See examples included on Schedule K of Form 1120S.

12. Section 1244 Stock

(a) Owned by S Corporation. An S corporation which owns stock in another corporation is not entitled to section 1244 ordinary loss treatment on the disposition or abandonment of the stock, since the benefits of section 1244 extends only to individuals.[414]

(b) S Corporation Shares. Stock held by an individual shareholder of an S corporation can qualify under section 1244.

(1) Treasury Regulation section 1.1244(d)(2)(a) indicates that increases in stock basis due to flow-through of income would not qualify for ordinary loss treatment. Section 1244(d)(1)(B) excludes any increase in basis obtained "through contributions to the capital of the corporation" from the section 1244 ordinary loss formula.

(2) If the shareholder's original basis has been reduced because of the pass-through of losses, the shareholder should not be permitted to use the original basis for section 1244 purposes, since the S corporation's ordinary losses will already have been made available to the shareholder under section 1366.

---

414 Rath v. Commissioner, 101 T.C. 196 (1993).

¶ 106.4. Shareholder Treatment of Items

A. General

Each shareholder will take into account separately his or her pro rata share of items of income, loss, deduction, or credit.

B. Time of Inclusion

The item will be taken into account in the shareholder's taxable year in which the corporation's year ends.[415]

Under this rule, if the corporation has a permitted fiscal year other than a calendar year, any items of income, loss, deduction and credit of the corporation accrued or incurred after the close of the corporation's fiscal year end will not be taxed to the shareholder until the shareholder's next taxable year.

Example. Assume shareholder A is on a calendar year and corporation X has a March 31 fiscal year-end. Corporation X earns $2,000 interest in March of 1994 and another $3,000 in dividends in April of 1994. The $2,000 interest received in March will be taken into the shareholder's income for his calendar year 1994 in which the corporation's year ended. The $3,000 in dividends will not be reportable by the shareholder until 1995 when the corporation's next fiscal year ends.

In the event of the death of the shareholder, the shareholder's portion of an item will be taken into account in the shareholder's final income tax return. The share of the item allocable to the corporation's taxable year after the shareholder's death will be taken into account by the estate or other person acquiring the stock.[416]

C. Allocation on Change in Ownership

In the case of transfers of stock during the taxable year, items of income, losses, deductions and credits will be allocated on a per share per day basis in the same manner as when the election is terminated during the year. Upon the termination of the shareholder's interest in the corporation, the corporation with the unanimous consent of its shareholders may elect to allocate according to the permanent records.

---

415 § 1366(a)(1).

416 § 1366(a)(1).

D. Character of Pass-Through

Under the conduit rule, the character of each item will be determined as if such item were realized directly from the source from which realized by the corporation or incurred in the same manner as incurred by the corporation.(417) Thus, there is entity level characterization for each item. The rule is similar to the partnership guidelines under section 702(b).

E. Gross Income of Shareholder

The gross income of a shareholder for general tax purposes includes the shareholder's pro rata share of the gross income of the S corporation.(418) This is also consistent with the partnership guidelines under section 702(c).

F. Loss Limitations

1. General

A shareholder's share of the corporation's loss is deductible to the extent of his adjusted basis in the stock of the corporation plus his adjusted basis in any indebtedness of the corporation to the shareholder. Any disallowed losses may be carried forward and allowed in any subsequent year in which the shareholder has adequate basis in such stock and debt.(419)

2. Passive Activity Losses

Shareholders of an S corporation which conducts a trade or business are subject to the passive activity rules of section 469. Thus excess losses and credits may be suspended for shareholders who do not materially participate (or actively participate in the case of rental property). The shareholders may offset such passive activity losses against other passive activity income.

3. Foreign Losses

The making or termination of an election will be treated as the disposition of a business for purposes of

---

417 § 1366(b).

418 § 1366(c).

419 § 1366(d).

computing the amount of foreign losses which must be recaptured under the foreign tax credit rules.[420]

(a) Accordingly, when an election is made, the corporation will be treated as having disposed of its foreign property and will include in income the amount of foreign losses not previously recaptured. Likewise, when the subchapter S election is terminated, the shareholder will be treated as if the corporation disposed of its foreign assets and the shareholder will include in income the amount of foreign losses of the corporation previously passed through to the shareholders and not recaptured.

4. Losses After Termination

Losses disallowed because of the termination of an election, will be allowed to the extent the shareholder has basis in stock one year after the date of termination (or due date for the last S corporation return, whichever is later), or within 120 days after a determination that the S corporation election had terminated in a previous year.

G. Worthless Stock

If a corporation's stock becomes worthless in any taxable year of a shareholder or the corporation, the corporate items for that year will be taken into account by the shareholders and the adjustments to the stock's basis will be made before the stock's worthlessness is taken into account under section 165(g).[421]

H. Bad Debts

The treatment of any bad debt of the corporation will be determined under section 166 in the same manner as an individual. Any partially or wholly worthless business bad debt will create an ordinary deduction. Any wholly worthless non-business bad debt will be treated as a short-term capital loss under section 166(d).[422]

I. Tax Benefit Rule

The tax benefits rule of section 111(a) must be applied at the corporate level and not at the shareholder level. If an S corporation recovers an expense that it

---

420 § 1373(b); § 904(f).

421 § 1367(b)(3). *See* Abballa v. Commissioner, 647 F.2d 487 (5th Cir. 1981).

422 Rev. Rul. 93-36, 1993-19 I.R.B. 4.

deducted when it was an earlier C corporation, the recovery will be passed through to the S shareholders to the extent that the prior C corporation benefited from the initial deduction.(423) Under section 111, gross income does not include any income attributable to the recovery during the taxable year of any amount deducted in a prior year to the extent such amount does not reduce the amount of tax imposed.

J. Family Members

If an individual, who is a member of a family of a shareholder of an S corporation, renders service to the corporation or furnishes capital to the corporation without receiving reasonable compensation, the item may be adjusted as necessary to reflect the value of such services or capital.(424) The members of the family include an individual's spouse, ancestors, lineal descendants and any trusts for the primary benefit of such persons.(425) The Senate Report for the Tax Reform Act of 1986 explains that the adjustment may be made to both the amount of compensation and the timing of compensation.

The historical estate planning technique of shifting ownership from parent to child has been affected by the special "kiddie tax" rules of the 1986 Act which tax children under the age of 14 at their parent's tax rate.(426)

K. Allocation Based Upon Economic Reality

The Service has successfully reallocated income on common law tax principles based upon economic reality and sham.(427)

---

423 Frederick v. Commissioner, 101 T.C. No. 2 (1993).

424 § 1366(e).

425 Applying § 704(e)(3).

426 § 63(c)(5) and § 1(i)(4).

427 Cases where transfers were disregarded include: Weiner v. Comm. T.C.M. (1984); Borkowski v. Comm. 43 T.C.M. 593 (1982), Bell v. Comm. 45 T.C.M. 97 (1982); Speca v. Comm. 630 F.2d 554 (7th Cir. 1980); Beine v. Comm. 61 T.C. 268 1973); Duarte v. Comm. 44 T.C. 193 (1965). Cases recognizing transfers include: Kirkpatrick v. Comm. 36 T.C.M. 1122 (1977); Britt v. United States 292 F.Supp 6 (MD Fla. 1968), Davis v. Comm. 64 T.C. 1034 (1975).

1. Former Treasury Regulation section 1.1373-1(a)(2) states:

> "A donor or purchaser of stock in the corporation 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. The circumstances, not only as of the time of the purported transfer but also during the periods preceding and following it, will be taken into consideration in determining the bona fides of the transfer. Transactions between members of a family will be closely scrutinized."

2. In determining whether a transfer between members of the family (generally to children) has economic substance the courts have looked to many factors:

(a) Whether stock was actually transferred, or just recorded on the books.

(b) Whether children were informed of their ownership.

(c) Whether the children (or their parents as guardians) exercised their rights as shareholders, or whether their parents, as guardians, on their behalf, dealt at arms length with the corporation.

(d) Whether the parent shareholders tended to disregard the transferee's interests in carrying on the business and exercising dominion and control over the business.

(e) Whether distributions were made to the children as shareholders.

(f) Whether a custodian was appointed under the Uniform Gifts to Minors Act, and the Act was complied with.

L. Compensation and FICA Taxes

1. Distributions Subject to FICA Taxes

In Revenue Ruling 74-44,*(428)* the Service held that the corporation must pay FICA taxes, FUTA taxes and must withhold income tax on any distribution made to shareholders for services whether characterized as compensation to merely as distribution to S corporation

---

428 Rev. Rul. 77-44, 74-1 C.B. 287.

shareholders. In Radtke v. United States,[429] the district court and court of appeals held that a fulltime lawyer who distributed all earnings as nontaxable dividends was required to treat it as compensation, and in 1990 the Ninth Circuit in Spicer Accounting, Inc. v. United States,[430] required an S corporation with an accountant as sole shareholder/employee to report distributions as compensation for employment tax purposes.[431]

2. *Compensation Treatment Denied When Not Designated as Compensation*

Earlier courts have refused to treat payments as compensation when not designated as compensation. In Paula Construction Company,[432] payments were treated as dividends when the election was later found to have been terminated because of the loss of its small business corporation status, even though the court found that part of the distributions amounted to reasonable compensation.

In Gregory P. Migliore,[433] the court refused to recharacterize a distribution as compensation when the taxpayer later discovered there was a lower tax rate under old section 1348 for earned income (50 percent) than for a dividend (70 percent).

M. **Restricted Section 83 Property**

Stock transferred to a person in connection with the performance of services will be subject to section 83, and its applicable restrictions if the property is subject to a substantial risk of forfeiture.[434]

---

429 Radtke v. United States, 712 F.Supp 143 (E.D. Wis. 1989) *aff'd* 895 F.2d 1196 (7th Cir. 1990) (full-time lawyer received $18,000 in dividends but no salary).

430 Spicer Accounting, Inc. v. United States, 918 F.2d 90 (9th Cir. 1990) (sole shareholder-employee accountant).

431 *See also* C.D. Ulrich, Ltd. v. United States, 692 F.Supp. 1053 (D. Minn 1988) (sole shareholder-employee accountant).

432 Paula Construction Company, 58 T.C. 1055 (1972).

433 Gregory P. Migliore, T.C. Memo, 1977-247 (1977).

434 § 83; Prop. Reg. § 1.1361(b)(3).

1. *Transferor as Owner*

Treasury Regulation section 1.83-1(a)(1) provides that "until such property becomes substantially vested the transferor shall be regarded as the owner of such property," and any income from said property shall constitute compensation to the recipient.

2. *Dividend as Wages*

An employee of a corporation who receives a dividend on restricted stock is required to report the dividend as wages.(435)

¶ 106.5. Basis Adjustment for Shareholders

A. Significance of Basis Under Subchapter S

The basis of a shareholder in stock in an S corporation and the basis of the corporation in debt to its shareholder is relevant to determine the amount of any gain or loss on the disposition of stock or indebtedness, and to limit the deductibility of losses and deductions passed through from the corporation to the shareholders under section 1366. Stock basis is also relevant to determine the tax effect of distributions made to the shareholder.

B. Initial Basis

A shareholder's original basis in stock or S corporation debt is determined under normal rules for establishing basis under the Codes. For example, stock may have a cost basis under section 1012 or a transferred gift basis under section 1014. Repayments of principal on a shareholder's loan will reduce the obligation, and therefore basis.

C. General Subchapter S Rules

Taxable and nontaxable items of income will increase, and deductible and nondeductible expenses and nontaxable distributions will decrease a shareholder's basis in the stock of the corporation.(436) These rules are analogous to those used for partnerships under section 705. These adjustments to basis assume that a shareholder who has paid tax on income as earned will be entitled to receive an equal amount of distributions without paying an additional tax.

---

435 Rev. Proc. 80-11, 1980-1 C.B. 616.

436 § 1367.

D. Special Adjustments To Basis Under Subchapter S

1. Increases in Basis

Basis is increased by the following:

(a) All income items (including tax-exempt income) and credits which are separately stated and passed through to shareholders.(437)

(b) Income of the corporation that is not separately computed.(438)

(c) The excess of deductions for depletion (other than for gas or oil) over the basis of property subject to depletion.(439) A shareholder's basis in stock is not increased for oil and gas depletion since each shareholder computes that deduction separately under section 613A(c)(11)(3).(440)

2. Decreases in Basis

Basis is decreased (but not below zero) by the following:

(a) Nontaxable distributions under section 1368 (returns on investment). Thus, basis is not reduced for distributions which are included in income such as dividends.

(b) Items of loss and deduction which are separately stated and passed through to shareholders.(441)

(c) Any non-separately computed loss of the corporation.(442)

(d) Expenses of the corporation not deductible in computing its taxable income, and not

---

437 § 1366(a)(1)(A).

438 § 1366(a)(1)(B).

439 § 1366(a)(1)(C).

440 Treas. Reg. § 1.1367-1(b)(1) (Jan. 3, 1994).

441 § 1366(a)(1)(A).

442 § 1366(a)(1)(B).

properly chargeable to the capital account ("noncapital, nondeductible expenses").[443]

(1) This prevents a shareholder from obtaining a loss on the later disposition of his stock arising from an expense which was not deductible when taken.

(2) Example. Corporation S gives $100 to a political candidate. It is nondeductible under section 162(e)(2)(A). The reduction in basis prevents the shareholder from claiming a loss of $100 on the subsequent liquidation of S, or the sale of his stock.

(3) Other noncapital, nondeductible expenses include illegal bribes and kickbacks under section 162(c), fines and penalties paid to governments under section 162(f), expenses and interest payments related to tax-exempt income under section 265, disallowed losses under section 267(a)(1), disallowed meal and entertainment expenses under section 274, and the two-thirds of treble damages paid for violating antitrust laws under section 162(g).

(4) A current reduction in basis is not allowable for items where the deduction is merely deferred to a later year.[444]

(e) The amount of the shareholder's deduction for depletion for oil and gas property to the extent the deduction does not exceed the shareholder's proportionate share of the adjusted basis of the property allocated to the shareholder under section 613A(c)(13)(B).[445]

(f) Basis is decreased for any loss or deduction allowed under section 1366(d), even though use of the loss or deduction is disallowed or deferred under another Code provision, such as the passive activity loss rules of section 469.

E. Non-Cash Property Distribution

Basis is reduced by the fair market value of property distributions. This is consistent with the requirement that the S corporation concurrently recognize gain on

443 § 1367(a)(2)(D).

444 Treas. Reg. § 1.1367-1(c)(2) (Jan. 3, 1994).

445 § 1367(a)(2)(E) as revised by T.R.A. of 1984, § 722(e)(2).

distribution of appreciated property.[446] In contrast, the partnership rule reduces the partner's basis by only the adjusted basis of the property distributed.[447]

F. Adjustments Made Under Per Share, Per Day Rule

1. General

Adjustments to basis are made on a per share per day basis. The regulations resolve prior uncertainty as to whether basis adjustments should be made on a share-by-share basis or whether adjustment should be applied to a common pool representing the shareholder's aggregate basis in all of the shareholder's stock, in a manner similar to that applied to partners.[448]

2. Increases in Basis

The basis of <u>each</u> share of stock is increased by an amount equal to each shareholder's pro rata portion of the income items described in section 1367(a)(1) which is attributable to that share on a per share, per day basis, in accordance with section 1377(a).[449]

3. Decrease in Basis

The basis of <u>each</u> share of stock is decreased by the shareholder's pro rata portion of deductible items described in section 1367(a)(2) which are attributable to that share on a per share, per day basis in accordance with section 1377(a).[450]

(a) <u>Amount in Excess of Per Share Basis</u>. If the amount of reduction attributable to a share exceeds its basis, the excess is applied to reduce (but not below zero) the remaining basis of all other shares owned by the shareholder in proportion to the remaining basis of each of those shares.[451]

---

446 § 1363(b).

447 §§ 705 and 733.

448 Treas. Reg. § 1.1367-1(b)(2) (Jan. 3, 1994).

449 Treas. Reg. § 1.1367-1(b)(2) (Jan. 3, 1994).

450 Treas. Reg. § 1.1367-1(c) (Jan. 3, 1994).

451 Treas. Reg. § 1.1367-1(c)(3) (Jan. 3, 1994).

Example 1: (per share adjustments)

Assume on November 30, 1994, A owns a block of 50 shares of S with an adjusted basis per share of $6.00 (total basis $300). On December 31, 1994, A buys an additional block of 50 shares for $8.00 per share (total basis $400). Thus, A owns 100 shares for each day of 1995 with an aggregate basis of $700. For 1995, A's pro rata share of items of income is $300 and his pro rata share of deductible expenses is $500. S makes distributions to A during 1995 of $100.

Since A owns 100 shares, A increases the basis of each share first by $3 and then decreases the basis of each share by $5 for expenses. Finally, A reduces the basis of each share for $1 of distributions.[452]

As of January 1, 1996:

A has a basis of $3.00 for each share of his initial block of 50 shares

Cost	$6.00
Plus income	3.00
Less expenses	-5.00
Less distribution	-1.00
equal	$3.00

A has a basis of $5.00 for each share of his second block of 50 shares

Cost	$8.00
Plus income	3.00
Less expenses	-5.00
Less distribution	-1.00
equal	$5.00

Example 2: (effect of adjustments in excess of per share basis)

Assume C owns one share of 10 outstanding shares at the beginning of the year. Her basis is $300. On July 2, she purchases 2 more shares for $250 each. The S corporation has a loss for the year of $3,650.

Under the per share per day rule, $10 of the $3,650 loss is allocated to each day and $1 is allocated to each of the 10 outstanding shares for each day.

Share No. 1. The one share which C owned for the entire year would have $365 of loss allocated to it. Since

---

452 Treas. Reg. § 1.1367-1(g) Example 1 (Jan. 3, 1994).

the $365 decrease in basis attributable to Share No. 1 exceeds her $300 basis, her basis is reduced to zero and the excess $65 is applied to reduce her basis in the other 2 shares.

Shares No. 2 and 3. The basis in Shares No. 2 and 3 are first each reduced by $182 for the $1 of loss allocated to each for 182 days of ownership ($250 - $182 = $68). Next, the $65 of loss in excess of the basis in Share No. 1 is reallocated to Shares No. 2 and 3 in proportion to their remaining bases. Therefore, the bases of Shares No. 2 and 3 are each decreased by an additional $32.50 from $68 to $35.50, which becomes their new basis.[453]

G. Time When Basis Adjustments are Effective

1. General Rule

Adjustments to shareholder basis are determined as of the close of the corporation's taxable year and are generally effective as of that date.[454]

2. Disposition of Stock by Shareholder

However, if a shareholder disposes of stock during the year, the adjustments with respect to the disposed shares are effective immediately prior to the disposition.[455]

(a) Example. Assume D owns 100 shares, representing all of the stock of X on January 1, with a basis per share of $1 (total basis $100). The corporation has $200 of income for the year. On July 2, D sells 50 shares for $100. Under the per share per day rule, one-half of income ($100) is allocated to the 100 shares held by D the first half of the year and $50 to the 50 shares maintained by D the second half of the year. As a result of the allocation of $1 per share of income to the 50 shares sold by D on July 2, his basis has increased from $1 to $2 per share, giving him a $100 basis in the 50 shares sold and no gain on the sale.

(b) Effect of Election to Terminate Year. If an election is made to terminate the taxable year

---

453 *See* Treas. Reg. § 1.1367-1(g) Example 2 (Jan. 3, 1994).

454 Treas. Reg. § 1.1367-1(d)(1) (Jan. 3, 1994).

455 Treas. Reg. § 1.1367-1(d)(1) (Jan. 3, 1994).

upon the termination of a shareholder's interest,[456] or in the case of a qualifying disposition of 20 percent or more of the stock,[457] then basis adjustments are made for the first short separate taxable year as of the close of the day on which the termination or substantial disposition occurs.[458] In this instance, the books are closed for the short separate taxable year and income or deduction items and distributions within the short year are allocated on a per share per day basis for that period.

3. Adjustment for Nontaxable Item

An adjustment for a nontaxable item is determined with respect to the taxable year in which the item would have been includable or deductible under the corporation's method of accounting, if the item had been subject to income taxation.[459]

H. Priority Ordering Rules

1. General Orders for Adjustments to Basis

Basis adjustments required under section 1367(a) are made in the following order:

<u>FIRST</u>: <u>Income Items</u>. Any increase in basis attributable to income items and credits, including tax-exempt income, under section 1367(a)(1)(A) and (B), and excess of depletion deductions under section 1367(a)(1)(C).

<u>SECOND</u>: <u>Nondeductible Expense Items</u>. Any decrease in basis attributable to nondeductible, noncapital expenses under section 1367(a)(2)(D) (e.g., government fines), and the oil and gas depletion deduction under section 1367(a)(2)(E).

<u>THIRD</u>: <u>Loss and Deduction Items</u>. Any decrease in basis attributable to loss and deduction items under section 1367(a)(2)(B) and (C).

---

456 § 1377(a)(2).

457 Treas. Reg. § 1.1368-1(g)(2) (Jan. 3, 1994).

458 Treas. Reg. §§ 1.1367-1(d)(3) and 1.1367-1(g) Example 3 (Jan. 3, 1994).

459 Treas. Reg. § 1.1367-1(d)(2) (Jan. 3, 1994).

FOURTH: Distributions. Finally, to any decrease in basis attributable to a distribution to shareholders under section 1367(a)(2)(A).[460]

As a result of comments to the Service, the final regulations permit the shareholder to elect to make decreases for items of loss or deductions before decreases for noncapital, nondeductible expenses and oil and gas depletion deductions, provided that the shareholder agrees that any noncapital, nondeductible expenses in excess of basis and the designated oil and gas depletion deductions will reduce basis in succeeding years.[461] Once this election is made, the shareholder must continue to use this order for decreasing basis in future years unless the shareholder receives permission from the Commissioner.

2. *Examples*

Example No. 1: Assume A has a basis of $10 at the beginning of the calendar taxable year. If corporation S distributes $40 to A in November and has income of $50 for the year, then basis is first increased for the income of $50 from $10 to $60 and then reduced for the distribution of $40 to $20. This priority prevents a distribution in excess of basis (taxable as income under section 1368) which would have occurred if the $40 distribution had been applied before the $50 of income.

Example No. 2: Assume A has a basis of $10. Corporation S has $20 of tax-exempt income and $50 of loss. S distributes $20 in November. A's $10 basis is first increased by the $20 of tax-exempt income to $30. There is now $30 of basis to absorb $30 of the $50 in losses. The excess $20 loss is suspended and carried forward. Since A basis is zero, the $20 cash distribution is a taxable gain under section 1368.

3. *Tax Simplification and Technical Corrections Bill of 1993*

A change in the order for adjusting basis has been proposed by the Tax Simplification and Technical Corrections Bill of 1993.[462] Since basis is reduced for current losses prior to adjustment for current

460 Treas. Reg. § 1.1367-1(e) (Jan. 3, 1994).

461 Treas. Reg. § 1.1367-1(f) (Jan. 3, 1994). The election is made on the shareholder's timely filed original or amended return.

462 Tax Simplification and Technical Corrections Act of 1993 (H.R. 3419) (introduced Nov. 1, 1993).

distributions, the present rule may result in shareholders being taxed on distributions which were intended to be from previously taxed income. This ordering causes uncertainty as to the tax effect of distributions during any year, when losses might occur. The amendment would adopt a standard similar to the partnership rule under which basis is first increased by items of income, then decreased by distributions and finally decreased by losses for that year.

Example: Assume A is the sole shareholder of corporation S which has a calendar year and has no accumulated earnings and profits. A has a stock basis of $1,000. During the year S distributes $600 to A, recognizes a capital gain of $200 and sustains an operating loss of $900. Under the proposed amendment to section 1368(d), A's adjusted basis in stock is increased to $1,200 ($1,000 plus $200 capital gain recognized). A's adjusted basis is then reduced for the $600 distribution ($1,200 less $600) to determine the remaining basis available to absorb losses for the year. Under section 1366(d)(1) as amended, A would have $600 in basis remaining to absorb $600 of the $900 loss and would carry forward the $300 loss in excess of basis under section 1366(d)(2).

I. Adjustment to Debt Basis

1. *General Rule for Reduction in Debt Basis*

If a shareholder's basis in stock has been reduced to zero, then the excess basis reduction will be applied to reduce (but not below zero) the basis of any indebtedness owed by the S corporation to the shareholder at the close of the corporation's taxable year.[463]

(a) Losses May Reduce Debt Basis.

(1) Debt Satisfied During Year. Any shareholder-owned indebtedness which has been satisfied by the corporation, or disposed of, or forgiven by the shareholder during the year, is not held by the shareholder as of the last day of the year and is therefore not subject to basis reduction under these rules.[464]

(2) Impact of Debt Repayment. The reduction in the shareholder's debt basis may have a significant income impact on the shareholder at the

463 § 1367(b)(2)(A), Treas. Reg. § 1.1367-2(a) (Jan. 3, 1994).

464 Treas. Reg. § 1.1367-2(b)(1) (Jan. 3, 1994).

time of repayment. The repayment of principal in excess of basis will result in gain to the shareholder instead of being treated as a nontaxable repayment of principal. Thus, a current loss pass-through may be offset by later income at the time of repayment.

(i) If the basis of debt has been reduced below the face amount, then repayments of principal are treated as nontaxable to the extent of the proportionate share determined by dividing the basis of the debt by the total outstanding amount of the debt. The balance is taxable income.(465) If the debt is evidenced by a written evidence of indebtedness which is a capital asset, the gain is capital gain.(466) If the indebtedness is measured merely by open advances to the corporation, then the creditor will have ordinary income.(467)

(ii) If there is sufficient debt basis to absorb a current loss but deduction must be deferred by the shareholder (e.g., a passive activity loss restriction) and a repayment is planned in the near future, the shareholder may want to plan on repayment before the close of the taxable year within which the loss is sustained. If the deduction is deferred, the investors would have a basis reduction for the corporate loss on the last day of the current year, even though it is nondeductible, and would have income for any repayment in future years. The effect is taxable income without the benefit of a prior or concurrent deduction.

(b) Termination of Shareholder's Interest During Taxable Year. If a shareholder terminates his shareholder interest during the taxable year of the corporation, then the reduction in basis of S corporation debt held by the shareholder will be made immediately prior to the termination of the shareholder's interest in stock.(468)

(c) Reduction in Multiple Debt. If the shareholder holds more than one debt at the close of the corporation's taxable year, then the reduction in basis will be applied to each indebtedness in the same

465 *See* Rev. Rul. 64-162, 1964-1 C.B. 304.

466 *See* Cornelius v. United States, 494 F.2d 465 (5th Cir. 1974).

467 *See* Rev. Rul. 68-567, 1968-2 C.B. 372.

468 Treas. Reg. § 1.1367-2(b)(2) (Jan. 3, 1994).

proportion that the basis of each indebtedness bears to the aggregate bases of all indebtedness owed by the corporation to the shareholder.[469]

(1) Example. Assume that shareholder A has a zero basis in his stock and has two outstanding loans to the corporation, Debt 1 for $100 and Debt 2 for $400. A loss of $100 for the current year would be allocated 1/5th ($20) to Debt 1 and 4/5th ($80) to Debt 2.

2. *General Rule for Restoring Debt Basis*

If the shareholder's basis in loans has been previously reduced by the pass-through of losses, then any "net increase" in basis adjustments under sections 1367(a)(1) and (2) will be first applied to restore the basis of debt before increasing the shareholder's stock basis.

(a) Ownership on First Day of Year. The restoration rules will apply only to outstanding debt held by the shareholder on the first day of the taxable year in which the net increase arises.

(b) Limit to Restoration. A restoration to debt basis cannot be restored to an amount in excess of the outstanding indebtedness as of the first day of the taxable year in which the net increase arises.

(c) Restoration of Multiple Debt. If the shareholder holds more than one debt on the first day of the corporation's taxable year, then any net increase must be applied first to restore the basis on any debt which was repaid (in whole or in part) during the year and which has been reduced previously and not restored. The remaining net increase, if any, is applied to restore the basis of each outstanding debt in proportion to the amount that the basis of each debt has been reduced.[470]

(1) Example. Assume that shareholder A has two loans to the corporation. Debt 1 has a reduced basis from $100 to $80 and Debt 2 has a reduced basis from $400 to $300. This year, the S corporation has income of $100. On January 31, the corporation repays $50 to A on Debt 1. Since the debt restoration rule requires that the net increase first be applied to restore the reduction in any debt repaid

---

469 Treas. Reg. § 1.1367-2(b)(3) (Jan. 3, 1994).

470 Treas. Reg. § 1.1367-2(c)(2) (Jan. 3, 1994).

during the year, $20 of the $100 net increase must first be applied to Debt 1. Debt 1 basis is restored to $100 with the result that A has no income on the partial repayment of that debt. The remaining $80 of the net increase will be applied to restore the basis on Debt 2 from $300 to $380. Debt 1 will have a basis equal to the remaining amount of the obligation, $50.[471]

	Debt 1	Debt 2
Face Amount of Loan	$ 100	$ 400
Prior Loss-Basis Reductions	(20)	(100)
Net Basis - January 1	$ 80	300
Current Year Income Allocation	20	80
Adjusted Basis	100	380
Payments During Year	(50)	--
End Year Debt Basis	$ 50	$ 380

(d) Calculation of Net Increase Adjustment. For the purpose of the restoration of basis, there is a "net increase" with respect to a shareholder only when the shareholder's pro rata share of income items and excess depletion deductions under section 1367(a)(1) exceed loss, deduction and nondeductible noncapital expense items and distributions (and certain oil and gas depletion deductions under section 1367(a)(2).[472]

It is important to recognize that distributions are deducted in determining whether there is a "net increase" available to restore debt basis. Even though the corporation has net income for the year, debt basis is not restored if distributions equal or exceed the net income. The rule has favorable consequences for the shareholder, as illustrated in the following example.

Example 1: Assume that D has a zero basis in his stock and a loan with a reduced basis from $10,000 to $8,000. During the year, the S corporation has $10,000 of income items and makes an $11,000 distribution. Since the $11,000 distribution is a permitted reduction in basis which exceeds the positive income adjustment of $10,000, there is no "net increase" and therefore no restoration on the shareholder's note. Therefore, the $10,000 increase

471 *See* Treas. Reg. § 1.1367-2(e) Example 3 (Jan. 3, 1994).

472 Treas. Reg. § 1.1367-2(c)(1) (Jan. 3, 1994).

in basis from income items is applied to increase D's basis in his S stock. Since D's basis in his S stock has been increased from zero to $10,000 for net income of the corporation, the distribution of $11,000 will be nontaxable to the extent of $10,000 and only $1,000 will be taxable as a distribution in excess of basis under section 1368.[473]

Example 2: If the distribution were $8,000 instead of $11,000, then there would have been a net increase with respect to D of $2,000 (the $10,000 income items less $8,000 distribution). Since there is a "net increase" of $2,000 with respect to D, $2,000 will be first applied to restore D's basis in the indebtedness from $8,000 to $10,000. Accordingly, D will have a basis in his note of $10,000. D's basis in his shares of S stock would be first increased from zero to $8,000 (the balance of the income available after restoration of debt), and then decreased by $8,000 for the distribution, resulting in zero basis in his stock at the end of the year.[474]

3. Open Account Advances

The final regulations provide that shareholder advances to the corporation which are not evidenced by separate written instruments and repayments on open account advances will be treated as a single indebtedness.[475]

J. No Basis Adjustment for Corporate Level Debt

In contrast to the partnership rules, an S corporation shareholder does not adjust his basis in his investment by the increase or decrease of corporate liabilities.[476]

K. Tax Planning for Loss Basis

In order to obtain a current deduction for losses the shareholder must have sufficient investment basis in his stock and debt to absorb the loss. The following are some possible courses of action:

---

473 *See* Treas. Reg. § 1.1367-2(e) Example 4 (Jan. 3, 1994).

474 *See* Treas. Reg. § 1.1367-2(e) Example 5 (Jan. 3, 1994).

475 Treas. Reg. § 1.367-2(a) (Jan. 3, 1994).

476 Compare § 752.

1. *An Additional Stock Purchase*

Additional basis can be attained by the purchase of additional stock from the corporation. However, the additional funds would be subject to the future risks of the business.

2. *A Capital Contribution*

A capital contribution is generally feasible when there are other shareholders if the contributions are pro rata. If property is contributed, the stock basis adjustment will be the adjusted basis of the property contributed plus cash.[477]

3. *A Shareholder Loan to the Corporation*

The shareholder would be entitled to additional basis in his investment by loans to the corporation. The shareholder has greater investment security as a creditor, but does not increase his allocation of future losses because losses are allocated pro rata based only upon stock ownership.

4. *Shareholder Financed Loan*

Since a corporate loan does not give a shareholder basis, the shareholder may borrow the funds and then lend the proceeds to the S corporation. Shareholder A may then apply security received from the corporation (a trust deed) as security for its bank loan, or the corporation may guarantee A's debt to the bank.

5. *Shareholder's Note*

In appropriate circumstances, the Service has refused to give a shareholder basis for his own note to the corporation.[478] The note would have a zero basis and there is no present economic investment by the shareholder.

---

[477] When making capital contributions, shares should be issued since contributions to capital are not eligible for ordinary loss treatment under section 1244.

[478] Rev. Rul. 81-187, 1981-1 C.B. 167. *See also* William H. Perry v. Commissioner, 54 T.C. 1293 (1970) (shareholders demand note exchanged for 3-year corporate note).

6. Shareholder Guarantee of Corporate Debt

(a) The Courts have consistently held that the shareholder's guarantee of a corporate debt will not give the shareholder debt basis.(479)

(b) The principal exception is E. M. Selfe v. United States,(480) where the Eleventh Circuit Court of Appeals in 1986 held the shareholder guarantor was entitled to a factual determination of whether the bank looked primarily to her for repayment. Subsequent to Selfe, other court of appeals have consistently concluded that a guarantee cannot give basis.(481)

(c) The Shareholder will obtain an increased basis upon payment of guaranteed debt to the creditor, because of the shareholder's right of subrogation against the corporation.(482) The basis adjustment occurs in the year of payment.(483)

7. Guarantor Substitution of Debt

A shareholder guarantor who substituted his note for the corporation's note to a bank has been given basis for the face amount of the note. In that instance, the bank released the corporation's liability.(484)

8. Corporate Debt to Related Third Parties

Indebtedness of the S corporation to related parties of shareholders does not give the shareholders basis. For example, a corporate obligation to a shareholder's estate

---

479 *See* Brown v. Commissioner, 706 F.2d 755 (6th Cir. 1983); William H. Perry, 47 T.C. 159, *aff'd* 392 F.2d 458 (8th Cir. 1968); Milton T. Raynor, 50 T.C. 768 (1968) (shareholder gave security to bank with guarantee); K.D. Albert, 41 T.C.M. 591 (1980).

480 Selfe v. United States, 778 F.2d 769 (11th Cir. 1986).

481 *See* Uri v. Commissioner, 949 F.2d 371 (10th Cir. 1991); Goatcher v. United States, 944 F.2d 747 (10th Cir. 1991); Harris v. United States, 902 F.2d 439 (5th Cir. 1990); Estate of Leavitt v. Commissioner, 875 F.2d 420 (4th Cir. 1989), *aff'g* 90 T.C. 206 (1988).

482 Rev. Rul. 70-50, 1970-1 C.B. 178.

483 Rev. Rul 71-288, 1971-2 C.B. 319.

484 Rev. Rul. 75-144, 1975-1 C.B. 277.

is not a debt to shareholder beneficiaries.[485] An obligation to a trust is not a debt to a shareholder remainderman.[486] An obligation to a partnership is not an indebtedness to a shareholder partner.[487]

9. Shareholder Sale for Corporate Note

An installment sale of appreciated property under section 453 will give the shareholder basis only to the extent of the basis of the corporate obligation (the shareholder's basis in the property under section 453B(b)). If the shareholder elects out of a section 453 installment sale, he must recognize gain at the time of sale.

10. Passive Activity Losses

An increase in basis may be of no current benefit if the loss is a suspended passive activity loss under section 469.

L. Basis Adjustments on Discharge of Indebtedness

There has been considerable recent dialogue on the discharge of an S corporation's debt and whether such discharge will increase shareholders' stock basis, even though the discharged income is not taxable under section 108.

Under section 108(a), gross income does not include debt discharge income if the discharge occurred while the taxpayer was bankrupt or to the extent it was insolvent. In an S corporation, the excludability of this income is determined at the corporate level. Therefore, while the shareholders themselves may be solvent, the S corporation's insolvency dictates that debt relief at the entity level is appropriate.

If the S corporation is in bankruptcy or insolvent, then the adjustments to corporate attributes are generally made at the corporate level. The subchapter S status may affect these internal adjustments. For example, S corporations which have not converted from subchapter C will not have net operating losses, business credits, minimum tax credits, or capital loss carryovers. As a

---

485 Prashker v. Commissioner, 59 T.C. 172 (1972).

486 Robertson v. United States, 3-2 U.S.T.C. ¶ 9645 (D Nev. 1973).

487 Rev. Rul. 69-125, 1969-1 C.B. 207.

consequence, adjustments would be made first to the basis of corporate assets.[488]

The primary exception arises from section 108(d)(7), which requires that any loss carryover of the shareholders which has accumulated because of corporate losses passed through in excess of basis under section 1366(d)(1), must be treated as a net operating loss for the year (a first priority adjustment). Therefore, any shareholder suspended losses would be reduced as a tax attribute to the extent of the forgiveness at the corporate level.[489] However, Code section 108(b)(4) states that this attribute reduction is not made until after the tax is determined for the year.

1. Dicharge of Indebtedness as Tax Exempt Income

Under section 1367 (a)(1) by reference to section 1366(a), shareholder basis is to be increased by all sources of income, including tax-exempt income. Therefore, cancellation of indebtedness income deemed non-taxable under Code section 108 should increase A's basis in stock. This basis may be used to deduct pass-through losses.

Example. Assume that shareholder A has a zero basis in his stock in corporation X and has excess suspended losses of $500,000, resulting from corporate losses passed through in excess of basis. In the current year, a corporate debt is reduced from $800,000 to $400,000 in a financing workout. The corporation, which has always been an S corporation, remains insolvent after the disclosure of indebtedness. The basis in X's assets is $400,000.

Under these facts the following sequence of tax consequences are applied:

1. The discharge of indebtedness of $400,000 is exempt from income tax because of insolvency.[490]

2. On the last day of the taxable year, the shareholder's basis in stock is increased from zero to $400,000 because of the tax-exempt income.[491]

3. This increase in shareholder basis to $400,000 will enable shareholder A to utilize $400,000 of

---

488 § 108(b)(2).

489 *See* I.R.C. §108(d)(7)(B).

490 § 108.

491 §§ 1367(a)(1) and 1366(a).

his $500,000 in excess losses to offset ordinary income on the shareholder's individual tax return.

4. The shareholder's basis would then be decreased from $400,000 to zero on account of the excess losses.(492) Shareholder A will have $100,000 on remaining unused excess losses.

5. After all of the above adjustments have been made, and as of the beginning of the next year, the $400,000 excluded from gross income under section 108(a)(1) would be applied to reduce tax attributes in the following order to the extent of the exclusion:

(a) The remaining $100,000 in excess losses of the shareholder are treated as net operating losses of the corporation and are reduced to zero.(493)

(b) The basis in corporation X's assets will be reduced for the $300,000 balance of the discharged debt from $400,000 to $100,000.

2. Discharge of Indebtedness as a Corporate Level Item Exdeeded as Deferred Income

The Service has taken the contra position that dishcarge of indebtedness income excluded from gross income under section 108(a) is a corporate level exclusion which is not a seperately stated item of tax-exempt income under section 1366(a). Therefore excluded discharge of indebtedness income does not pass through to the shareholders basic in stock under section 1367(a). P.L.R. 9423003 (Feb. 28, 1994).

¶ 107. DISTRIBUTIONS

¶ 107.1. General

Under subchapter S, income which has previously been taxed to the shareholders when recognized by the S corporation, may be distributed to the shareholders without the proceeds being taxed a second time. Section 1368 is structured to permit this tax-free distribution in lieu of the normal rules of section 301(c), while preserving a system which will assure dividend treatment for any distributions which have their source in accumulated earnings and profits.

492 § 1366(d)(1).

493 §§ 108(d)(7) and (b)(2)(A).

Generally, the amount of any distribution will be tax-free to the extent of the shareholder's basis in stock and any excess is treated as a capital gain, if the S corporation does not have any accumulated earnings and profits.

If the corporation is a complex S corporation which has accumulated earnings and profits, the distributions will be tax-free only to the extent of the net earnings from subchapter S operations as accumulated in the corporation's accumulated adjustments account and not previously distributed. Any distribution in excess of the accumulated adjustments account will be treated as a dividend from previously accumulated earnings and profits to the extent thereof. The dividend distribution does not reduce basis. After consumption of any accumulated earnings and profits, the corporation is treated as a simple S corporation where all distributions would reduce basis to the extent thereof and excess is a capital gain.(494)

¶ 107.2. Treatment of Earnings and Profits

An S corporation does not have earnings and profits for any taxable year beginning after 1982.(495) Instead, the undistributed net earnings of the S corporation is represented by the S corporation's Accumulated Adjustment Account (AAA), to the extent it is relevant.(496)

A. Prior Law

Under prior law, an S corporation could accumulate subchapter S earnings and profits because some items were deductible or excludable in computing taxable income which were not deductible or excludable in determining earnings and profits (e.g., tax-exempt income, excess of accelerated depreciation over straight-line depreciation).

B. Sources of Earnings and Profits for S Corporations

An S corporation may only have earnings and profits attributable to:

1. Tax years as a C corporation when an S election was not in effect; or

---

494 §§ 1367, 1368 and 1371(c).

495 § 1371(c); *see* S. Rep. No. 97-640, 97th Cong. 2d Sess. 20 (1982) reported in 1982 U.S. Code Cong. & Admin. News.

496 § 1368.

2. Tax years beginning prior to 1983 for which an S election was in effect.

(a) Although pre-1983 subchapter S earnings and profits are part of the accumulated earnings and profits used to test dividend treatment to shareholders on distributions, they are not included for taxing the corporation on excess passive investment income since only "subchapter C earnings and profits" are counted for that purpose. § 1362(d)(3)(B).

(b) If an S corporation has both subchapter C and subchapter S earnings and profits, a distribution is treated under the regulations as made first from subchapter C earnings and profits and second from subchapter S earnings and profits.[497] This provision in the regulations is an accommodation to the taxpayer and is designed to made subchapter S operate more fairly. It is probably contrary to the literal language of section 316, defining dividends, which provides that every distribution is to be made "from the most recently accumulated earnings and profits."

(c) The Proposed Tax Simplification and Technical Corrections Act of 1993,[498] would eliminate subchapter S earnings and profits. The corporation's accumulated earnings and profit would be relevant only to the extent of taxable years in which the corporation was a C corporation and the S election was not in effect.

3. A corporate acquisition of another corporation which results in a carryover of earnings and profits under section 381, or a reallocaotion under section 312(h)(2) arising from the transfer of assets in a C or D reorganization.

4. An allocation of earnings and profits in a divisive reorganization pursuant to section 312(h)(1).

---

497 Treas. Reg. § 1.1368-1(f)(2)(iii) (Jan. 3, 1994).

498 Proposed Tax Simplification and Technical Corrections ACt of 1993, section 504(c) (H.R. 3419) (introduced November 1, 1993).

¶ 107.3. Distribution by Corporation Without Accumulated Earnings and Profits

If an S corporation has no accumulated earnings and profits, any distribution is subject to a two-tier priority system.(499)

The distribution is treated first, as a tax-free return of capital to the extent of the shareholder's basis. The distribution will reduce the shareholder's basis in his stock. If the distribution exceeds the shareholder's basis in stock, then the second stage is to tax the amount of the distribution in excess of basis at capital gain rates as gain from the sale or exchange of property.

The rule is the same as that applied to distributions of C corporations under section 301(c)(2) and (3) when there are no earnings and profits subject to dividend treatment under section 301(c)(1).

Example. If corporation X distributes $50 in cash to shareholder A who has a basis of $40 in his stock, the distribution will be a nontaxable return of capital of $40 and A will have $10 in capital gain.

A. Tax Effect of Distributions Depends on Basis at the End of the Year

1. Basis is Adjusted at Close of Year for Income and Loss and Then for Distributions

The tax effect of a distribution to a shareholder is determined only after the adjustments to the bases of shares for income and loss items are made at the close of the corporation's taxable year, before taking into account distributions.(500)

2. Date of Distribution Not Determinative

Since income and loss computations are applied to basis prior to distributions under section 1368(d)(1), and basis is adjusted as of the last day of the year, the shareholder's basis on the date of distribution is not determinative of the tax consequences.

Example. Assume A has a basis of $10 on January 1 and makes a distribution of $10 on that date. If S has a $10 loss for the year, the basis will first be reduced for the

---

499 § 1368(b); Treas. Reg. § 1.1368-1(c) (Jan. 3, 1994).

500 Treas. Reg. § 1.1368-1(e) and § 1.1368-3, Example 1 (Jan. 3, 1994).

$10 loss from $10 to zero, and the $10 distribution on January 1 will be taxed as a gain under section 1368(b)(2).

3. *Termination of Shareholder's Interest During the Year*

If a shareholder terminates his interest during the taxable year, and all shareholders during the year consent, the taxable year will be closed as to that shareholder as of the termination of his interest. Basis adjustments would be made as of the close of the short year to determine the tax impact of any distributions during that period.[501]

B. Allocation of Distribution Among Shares

The amount of the distribution must be allocated among separate shares under the per day per share rule, in the same manner as adjustments to basis are made.[502]

Example. Assume that A owns all of the stock of S. A holds 10 shares with a basis of $2 per share and 10 shares with a basis of $10 per share. S has no other income or loss and distributes $100. Under the per-day per-share rule, $5 of distribution is allocated to each of the 20 shares. Since the $5 distribution per-share exceeds the $2 basis of each share of the first block of 10 shares, the excess of $30 ($3 X 10 shares) is applied to reduce basis in the second block. The basis of each share in the second block is thereby reduced from $10 to $2 ($10 -$5 -$3 = $2).

¶ 107.4. Distributions for S Corporations With Accumulated Earnings and Profits

A. Four-Tier Priority Distribution System

In the case of a distribution by a corporation which has accumulated earnings and profits, there is a four-tier priority system.

The distribution is treated under the following four tiers:

1. First, as a tax-free return of capital to the extent of the corporation's "accumulated adjustments account";

---

501 § 1377(a)(2).

502 *See* Treas. Reg. § 1.1367-1(c)(3) (Jan. 3, 1994).

2. Second, any excess amounts will be treated as a dividend to the extent of accumulated earnings and profits;

3. Third, as a nontaxable return of capital to the extent of the remaining basis of the shareholder's stock; and

4. Fourth, the excess of the distribution over basis will be taxed as a capital gain.

Example. Assume corporation X has AAA of $40,000 and accumulated earnings and profits of $5,000. The corporation distributes $50,000 to shareholder A who owns all of the shares with a basis of $44,000. The first $40,000 is a nontaxable return of capital from AAA. The next $5,000 is a dividend from accumulated earnings and profits. Of the remaining $5,000 in distributions, $4,000 reduces the shareholder's basis to zero and the $1,000 in excess of basis is a capital gain.

B. General Accumulated Adjustments Account Rule

The Accumulated Adjustments Account ("AAA") is a special account for S corporations which reflects the accumulated undistributed net income from S corporation operations during an effective subchapter S election.[503] It is the S corporation substitute for earnings and profits calculated under section 312 to determine dividend treatment for C corporations. An S corporation with subchapter C accumulated earnings and profits must maintain an AAA account in order to determine the amount of available previously taxed subchapter S earnings which are available for nontaxable distribution, before being subjected to dividend treatment on distributions attributed to subchapter C earnings and profits.

An S corporation may have subchapter C accumulated earnings and profits as a result of a conversion from subchapter C to subchapter S, or an existing S corporation may acquire subchapter C earnings and profits because of a merger or other reorganization where corporate attributes are acquired under sections 381(a) and (c)(2).[504]

---

503 § 1368(e)(1).

504 The operation of the AAA is discussed more fully at ¶ 107.7, supra.

¶ 107.5. Elections to Modify Source of Distribution Rules

A. General

If an S corporation has remaining subchapter C earnings and profits on the last day of the year, under the general rule distributions are first deemed to come from AAA until AAA is exhausted, and only then from earnings and profits.

Normally this rule is advantageous to the taxpayer, but there are circumstances where it may be important to strip out earnings and profits prior to receiving tax-free distributions from AAA. For example, if an S corporation has subchapter C earnings and profits, then excess passive income will be taxed to the corporation under section 1375 and if excessive passive investment income exists for three consecutive taxable years, the S election automatically terminates under section 1362(d)(3). In order to preserve the subchapter S election, the shareholders may desire to treat first distributions as dividends from subchapter C earnings and profits, thereby using up the earnings and profits and avoid any future problems with passive income activities.

B. Three Elections Under Proposed Regulations

There are three elections which are designed to permit the shareholders to change the priority of the source of distribution and facilitate the distribution of earnings and profits:

1. an election to bypass AAA;

2. an election to make a deemed dividend; and

3. an election to bypass previously taxed income accumulated prior to 1982.[505]

C. Election to Bypass AAA and Distribute Earnings and Profits First

Section 1368(e)(3) permits an S corporation, with the consent of all affected shareholders, to elect to treat all distributions made during the taxable year as made first from earnings and profits, and second from AAA.

A separate election is made for each year and is effective for all distributions made during the year. For this purpose, any election to terminate the taxable year for a termination of interest under section 1377, or on a

505 Treas. Reg. § 1.1368-1(f) (Jan. 3, 1994).

20 percent substantial qualifying disposition under section 1.1368-1(g)(2), will be disregarded.[506]

D. Election to Make Deemed Dividend

An S corporation that wishes to distribute C corporation earnings and profits may lack sufficient liquid assets to make an actual distribution. The regulations permit the corporation to elect to bypass AAA and distribute all or part of its subchapter C earnings through a deemed dividend.[507]

The deemed dividend election was first added to the regulations in 1994. It was uncertain whether other statutory "consent" dividend provisions of the Code permitted this election.[508] This liberal approach in the regulations will provide more flexibility for S corporations with limited cash available for distribution.

1. Limit on Deemed Dividend

The amount of the deemed dividend may not exceed the subchapter C earnings and profits on the last day of the taxable year, reduced by any actual distributions of subchapter C earnings and profits made during the taxable year.[509]

2. Deemed Dividend Followed by Contribution

The deemed dividend is considered for all purposes of the Code as if it were distributed in money by the corporation, received by the shareholders on the last day of the corporation's taxable year, and then immediately contributed by the shareholders as capital to the corporation on that day.

E. Election to Bypass PTI

If a continuing pre-1982 S corporation with earnings and profits also has PTI (previously taxed income), distributions in excess of AAA are treated as made out of PTI before they are treated as made out of earnings and profits. The proposed regulations also permit the

---

506 *See* Treas. Reg. § 1.1368-1(f)(2) and § 1.1368-3, Example 4 (Jan. 3, 1994).

507 Treas. Reg. § 1.1368-1(f)(3) (Jan. 3, 1994).

508 *See* §§ 561 and 565.

509 Treas. Reg. § 1.1368-1(f)(3) (Jan. 3, 1994).

corporation to elect to forego distributions of previously taxed income in order to cause a distribution to be treated as coming from earnings and profits.(510)

F. Time and Manner of Making Election

The corporation makes an election to change the priority of earnings and profits distributions by attaching a statement to a timely-filed original or amended return. Each affected shareholder to whom a distribution is made during the taxable year must consent to the election. Any statement of election to make a deemed dividend must include the amount of the deemed dividend that is distributed to each shareholder.(511)

¶ 107.6. Election to Terminate Year

A. Treatment of Distribution Affected by Early Year Termination

The tax treatment of a distribution during the year may be effected by the early termination of the tax year. A shareholder who disposes of all or a substantial part of his stock in the corporation cannot be certain of the tax consequences of the disposition or of the distribution to the shareholder before the end of the taxable year. Certainty may be obtained through an election to terminate the year.

B. Termination of Interest

Under section 1377(a)(2), if any shareholder terminates his interest in the corporation during the year and all persons who are shareholders during the year consent, the taxable year will be treated as if it consisted of two short taxable years, the first of which ends at the close of the day when the shareholder terminates his or her interest.

C. Election to Terminate Year on Disposition of Substantial Amounts of Stock

If a shareholder makes a qualifying disposition of 20 percent or more of the corporation's issued shares in one or more transactions during a 30-day period, the corporation may elect to treat the taxable year as if it consists of two separate taxable years, the first of which

---

510 Treas. Reg. § 1.1368-1(f)(4) (Jan. 3, 1994). *See also* Treas. Reg. § 1.1368-1(d)(2) and (f)(2)(ii) (Jan. 3, 1994).

511 Treas. Reg. § 1.1368-1(f)(5) (Jan. 3, 1994); § 1368(e)(3).

ends at the close of the day on which the shareholder disposes of 20 percent or more of the corporation's issued stock.(512)

1. "Qualifying Disposition." There is a "qualifying disposition" if there is:

(a) A disposition by a shareholder of 20 percent or more of the outstanding stock in one or more transactions during any 30-day period during the corporation's taxable year;

(b) A redemption under section 302(b) or section 303(a) of 20 percent or more of the outstanding stock from a shareholder in one or more transactions during the 30-day period; or

(c) An issuance by the corporation of an amount of stock equal to or greater than 25% of the previously outstanding stock to one or more shareholders during the 30-day period.

Any disposition of stock by a shareholder which is taken into account as part of a qualifying disposition, is not taken into account in determining whether the shareholder has made a subsequent qualifying disposition.

2. Effect of the Election. If this election is made, the corporation will treat the taxable year as separate taxable years for the purposes of allocating items of income and loss, making adjustments to AAA, earnings and profits, and basis, and for the purpose of determining the tax effect of distributions under section 1368.(513)

3. Time and Manner of Making Election. The corporation makes an election under the qualifying disposition rule by attaching a statement to a timely-filed original or amended return. Each shareholder who held stock during the taxable year must consent to the election.

---

512 Treas. Reg. § 1.1368-1(g)(2) (Jan. 3, 1994). This 20 percent qualifying disposition rule is a matter of regulatory grace designed to provide equity among shareholders and simplify the operation of subchapter S. There is no similar rule in the statute.

513 Treas. Reg. § 1.1368-1(g)(2)(ii) (Jan. 3, 1994). For an example of the effect of qualified disposition rules, *see* Treas. Reg. § 1.1368-3, Example 3 (Jan. 3, 1994).

¶ 107.7. Accumulated Adjustment Account Rules

A. General

The AAA is an account of the corporation which reflects the accumulated undistributed net income of the corporation during S corporation years. An S corporation with accumulated earnings and profits is required to maintain an AAA account to determine the tax effect of distributions during S corporation years and the subsequent post-termination transition period. An S corporation without earnings and profits is not required to maintain a AAA account. However, if a corporation without earnings and profits engages in a transaction in which there is a carryover of corporate attributes under section 381(a), such as a merger into another S corporation with C earnings and profits, the S corporation must be able to calculate its AAA at the time of the merger, to determine the tax effect of post-merger distributions.

B. Determination of Accumulated Adjustment Account

1. General

AAA is an account of the S corporation and is not apportioned among the shareholders.[514]

(a) AAA begins on the first day of the S election, with a zero balance. AAA is then increased by the following:

(1) All income items of the corporation which are separately stated under section 1366(a)(1)(A), other than exempt income;

(2) Any non-separately computed income under section 1366(a)(1)(B); and

(3) The excess of deductions for depletion over the basis of the property, subject to special rules under section 316(A)(c)(11) (where oil and gas basis is allocated to shareholders).

(b) AAA is next <u>decreased</u> by the following adjustments:

(1) Items of loss or deduction;

(2) Any non-separately computed loss;

---

514 Treas. Reg. § 1.1368-2(a) (Jan. 3, 1994).

(3) Any nondeductible noncapital expense of the corporation, other than federal taxes attributable to any year in which the corporation was a C corporation and any expenses related to tax-exempt income; and

(4) The sum of the shareholders' deductions for depletion for oil and gas property.[515]

2. Application to Outstanding Shares

As a corporate account, AAA is available to be used for benefit of any outstanding shares at the time of the distribution.

Example. In Private Letter Ruling 92-15-020, the S corporation issued new nonvoting stock to two of four outstanding QSST trusts. The Service ruled that existing AAA was not changed by the issuance of new shares, since section 1362 does not provide for any adjustment, and all future distributions to the new nonvoting shares would be nontaxable to the extent of any AAA remaining at the time of distribution.

C. Timing of Adjustments to AAA

AAA is adjusted for income or loss on the last day of the year prior to adjustments for distributions. This assures that AAA will be increased for current income in order that it may be distributed tax-free. However, a similar reduction of AAA for losses may cause a distribution to become taxable.[516]

1. Examples

(a) Assume S has $50 of accumulated earning and profits at the beginning of the year and a $10 AAA. A has a basis of $10 in his stock. Corporation S distributes $20 to A on June 30. S earns $30 for the year. Since the AAA is first increased by $30 of income there is $40 of AAA to make the $10 distribution nontaxable. (If AAA were counted in June when the $20 distribution was made there would have been a dividend of $10 because AAA was only $10.)

(b) However, if the corporation had a loss of $30 during the year, the AAA would first be reduced by $30 from $10 to a negative ($20). Then the entire

---

515 Treas. Reg. § 1.1368-2(a) (Jan. 3, 1994).

516 Treas. Reg. § 1.1368-2(a)(2) and (3) (Jan. 3, 1994).

$20 distribution would be a dividend because there was no positive AAA as of the close of the year.

The Tax Simplification and Technical Corrections Act of 1993 would change the order to test the AAA for distribution purposes after increases in income but before losses which might create a negative AAA, causing dividend treatment.[517]

D. Negative Accumulated Adjustments Account

1. Losses or Deductions

AAA may be reduced below zero if losses and deductions of the corporation exceed income. In this sense, adjustments to AAA are different than adjustments to basis, which may not be reduced below zero.[518]

AAA will be reduced to reflect the entire amount of any loss, even though a portion of the loss is disallowed to a shareholder because it exceeds his basis under section 1366(d)(1), or other provision of the Code.

No adjustment is made in the subsequent year when the shareholder obtains basis in the corporation and is permitted to use the loss carryover under section 1366(d)(2).

2. Distributions

AAA is reduced for distributions (but not below zero).[519]

3. Examples

(a) Assume at the beginning of 1995, corporation S has accumulated earnings and profits of $20,000 and an AAA of $10,000. During 1995, corporation S has losses of $30,000. There are no distributions. Because there can be a negative AAA, at the end of 1995, the $30,000 loss would cause the AAA to be decreased from a positive $10,000 to a deficit of ($20,000).

---

517 Tax Simplification and Technical Corrections Act of 1993, § 502 (H.R. 3419) (November 1, 1993).

518 Treas. Reg. § 1.1368-2(a)(3)(ii); § 1.1368-3, Example 2 (Jan. 3, 1994).

519 Treas. Reg. § 1.1368-2(a)(3)(ii) (Jan. 3, 1994).

(b) Further assume in 1996, S generates a net income of $25,000 and distributes $20,000. Under the ordering rules, AAA is increased for income prior to determining the tax effect of the distribution during the year. Thus, in 1996, the $25,000 income would recover the ($20,000) negative AAA and leave a positive AAA of $5,000. Next, the distribution of $20,000 in 1988 would be chargeable $5,000 to AAA, and $15,000 to accumulated earnings and profits.[520]

E. Distributions in Excess of AAA

If an S corporation makes more than one distribution during the year, and the distributions exceed the positive balance of AAA at the close of the year, then the AAA will be allocated among the distributions in accordance with their respective sizes.[521]

1. Formula

The amount allocated to each distribution is determined by multiplying the balance of AAA at the close of the taxable year by a fraction, the numerator of which is the amount of the distribution and the denominator of which of the amount of all distributions made during the taxable year.

2. Example

Assume that S has one shareholder, A, with a total shareholder basis of $10. On January 1, S has AAA of $20. This year there is $10 of net income, bringing total AAA to $30 on December 31. S has $100 of earnings and profits. Relying on the AAA, S makes a $20 distribution to A on April 1. A sells his stock to B on June 1. On December 31, S makes a $40 distribution to B. There is no net income or loss for the year. The $30 of AAA must be allocated 1/3 to A and 2/3 to B.

Even though A thought his April $20 distribution was a nontaxable distribution from AAA, only $10 is from AAA and the balance is a dividend.[522]

---

520 If a negative AAA were prohibited, the AAA would have been increased from zero to $25,000 in 1996 and the $20,000 distribution nontaxable from AAA.

521 Treas. Reg. § 1.1368-2(b) (Jan. 3, 1994).

522 *See* Treas. Reg. § 1.1368-3, Example 5 (Jan. 3, 1994).

3. *Distributions of Earnings and Profits or PTI*

For the purpose of this calculation, distributions which are treated as being from earnings and profits or PTI pursuant to an election to defer AAA treatment are disregarded.[523]

F. Allocation of AAA Between Money and Loss Property on Distributions in Excess of AAA

If distributions exceed AAA during the year, an additional allocation is required if the distributions consist of part money and part other loss property, the adjusted basis of which exceeds its fair market value at distribution.[524] The AAA must be allocated between the money and other property, using fair market value of the property.

1. *Formula*

The amount of AAA allocated to the loss property is equal to the amount of AAA allocated to that distribution, multiplied by a fraction, the numerator of which is the fair market value of the property and the denominator of which is the total amount of the distribution. The balance of the available AAA will be allocated to the money.

G. Redemptions and AAA

1. *General Rules*

In the case of a redemption treated as an exchange under section 302(a) or section 303(a), the AAA account will be adjusted by an amount which bears the same ratio to the total AAA as the number of shares redeemed in the redemption bear to the total number of shares outstanding immediately before the redemption.[525]

(a) Example. Assume that the corporation has 10,000 shares outstanding and that the AAA account is $10,000. If the number of shares redeemed is 2,000, the AAA must be reduced by 20 percent or $2,000 ($10,000 X 2,000/10,000 shares). The adjustment to AAA is made whether there is a negative or positive balance in AAA.

---

523 *See* Treas. Reg. § 1.1368-2(b) (Jan. 3, 1994).

524 Treas. Reg. § 1.1368-2(c) (Jan. 3, 1994).

525 § 1368(e)(1)(B).

(b) "Ratable Share" Test in Proposed Regulations. Proposed Regulation section 1.1368-2 (d)(1),[526] provides that AAA "is adjusted in an amount equal to the ratable share of the corporation's AAA (whether negative or positive) attributable to the redeemed stock as of the date of the redemption." This is the "ratable share" test used in section 312(n)(7), describing redemption adjustments to earnings and profits.

(c) Limit on Reduction to Distribution Amount. The regulation does not limit the reduction in AAA to the amount of the distribution.

(1) Assume AAA is $100,000 and that A owns 5,000 of 10,000 shares outstanding. The net worth of the corporation is $80,000. If A has all of his shares redeemed for $40,000, a proper adjustment to AAA under section 1.1368(e)(1)(B) is a reduction of $50,000 even though the actual amount of the distribution is only $40,000.

(2) Although the provision seems clear on its face, the General Explanation of the Revenue Provisions of the Tax Reform Act of 1984, 98th Cong. 2d Sess., published by the Staff of the Joint Committee on Taxation, indicated an intention to limit the reduction of *earnings and profits* (under section 312(n)(7)) to the amount of distribution. The formula in section 1368(e)(1)(B) does not seem to leave room for this staff interpretation.

The issue is significant since it generally would be desirable for shareholders to minimize the reduction of AAA in a redemption, while maximizing the reduction of earnings and profits when section 312(n)(7) is applicable.

2. Existence of AAA and Earnings and Profits

If the S corporation has both AAA and retained Subchapter C earnings and profits, there should be a ratable reduction of both as a result of a redemption, since there has been a ratable reduction of the size of the entire business.

---

526 Treas. Reg. § 1.1368-2(d)(1) (Jan. 3, 1994).

3. *Special Rule for Years When the Corporation Makes Both Ordinary and Redemption Distributions*

In any taxable year in which both ordinary distributions and redemption distributions occur, the final regulations provide that AAA is to be adjusted first for any ordinary distributions and then, secondly, for any redemption distributions.[527]

H. Adjustments in the Case of Reorganizations and Divisions

1. *Acquisitive Reorganizations*

In the case of an S corporation that acquires the assets of another S corporation in a reorganization under section 381(a)(2), the acquiring corporation will succeed to and merge its AAA with the AAA of the transferor corporation.[528] The AAA of the acquiring corporation after the transaction is the sum of the AAAs of the corporations prior thereto, whether positive or negative.

Under this test, if an S corporation with a negative AAA and an S corporation with a positive AAA are merged, the two AAAs would immediately be merged for post-merger distribution purposes. Compare this with section 381(c)(2)(B), which provides that a pre-acquisition deficit in earnings and profits in the acquired corporation is to be used only against future earnings and profits. The Service might have proposed a similar rule which would have treated future distributions as being from accumulated earnings and profits until future S corporation earnings absorb the deficit in AAA in the acquired corporation.

---

527 Treas. Reg. § 1.1368-2(d)(ii) (Jan 3. 1994). The earlier proposed regulation had required the S corporation to determine the ratable share of AAA attributable to redeemed stock under a method used to determine the pro rata portion of total earnings and profits attributable to shares redeemed by a C corporation. Prop. Reg. § 1.1368-2(d)(1)(ii)(A) (June 8, 1992); *see* Rev. Rul. 74-338, 1974-2 C.B. 101, and Rev. Rul. 74-339, 1974-2 C.B. 103. The formula was adjusted to avoid unnecessary complexity.

528 Treas. Reg. § 1.1368-2(d)(2) (Jan. 3. 1994). The regulation has no provision providing for the carryover of corporate attributes under section 381(a)(1), dealing with the liquidation of a controlled corporation under section 332. This is apparently an oversight.

2. *Corporate Separations*

In the case of a corporate division to which section 368(a)(1)(D) applies, followed immediately thereafter by a distribution of the stock of the controlled corporation in a distribution or exchange to which section 355 applies, the AAA of the distributing corporation immediately before the transactions is allocated between the distributing corporation and the controlled corporation in a manner similar to the manner in which earnings and profits are allocated under section 312(h).[529]

I. Distribution of Tax-Exempt Income

Although tax-exempt income is not taxable income to the S corporation, its distribution may be taxable to the shareholders because AAA is not increased for tax-exempt income.[530]

Example. Assume A is the sole shareholder of S with stock having a total $10 basis. S corporation has $100 of accumulated earnings and profits and no AAA. S earns $20 of tax-exempt bond interest (or receives $20 of insurance proceeds) which is distributed to A.

The following rules apply:

1. The tax-exempt income retains its character and is passed through to the shareholder tax free for the purpose of computing the S corporation's current income.[531]

2. The shareholder's basis in his stock is increased because of the exempt income from $10 to $30.[532]

3. AAA is not increased because of the tax-exempt income and remains at zero.[533]

---

529 Treas. Reg. § 1.1368-2(d)(3) (Jan. 3, 1994).

530 § 1368(e)(1)(A). *See also* § 1366(a)(1)(A); § 1367(a)(1)(A).

531 §§ 1366(a)(1)(A) and (b).

532 § 1367(a)(1)(A).

533 § 1368(e)(1)(A).

4. The distribution of the $20 will be a dividend under section 1368(c)(2) since it exceeds the zero AAA.

5. The effect of the rules is to assure that the S corporation which has converted from subchapter C will distribute its accumulated earnings and profits prior to tax-exempt income.(534)

J. Impact of AAA on Sale of Stock

The existence of a AAA or negative AAA may affect the price of stock sold by shareholders because the AAA is a corporate account not a shareholder account.

Example 1. Assume A owns all of the stock of S with $100 of AAA on January 1 and accumulated earnings and profits of $100. A sells all of his stock to B on June 30. S has no income or loss for the year, but distributes $30 to B in December, The distribution is tax free to B because of the $100 AAA. The sales price may reflect that A is transferring to B the ability to receive $100 of income previously taxed to A. Note that A's basis on sale would reflect the $100 previously taxed to him.

Example 2. Assume instead that S had a negative AAA of ($100) from prior losses. S has $40 of income in December which it distributes immediately to B. A and B will each have $20 of current income under section 1366. The $40 in income will decrease the negative AAA for ($100) to ($60). The $40 distribution will be a dividend because of the deficit AAA and application of section 1368(c)(2) priority to dividends. The sales price might be reduced to reflect this additional tax cost of operating the S corporation.

¶ 107.8. Distributions After Termination of Election

Any distribution of money by the corporation to shareholders during a post-termination transition period will be a nontaxable reduction of the adjusted basis of the stock of the shareholder to the extent the distribution does not exceed the AAA.(535)

---

534 *See generally*, Treas. Reg. § 1.1368-3, Example 2 (Jan. 3, 1994).

535 § 1371(e).

A. "Post-Termination Transition Period" includes:

1. The period beginning the date after the last day of the corporation's last taxable year as a subchapter S corporation and ending on the later of:

(a) One year after the date of termination, or

(b) The due date of the last S corporation return (including extensions); and

2. The 120-day period beginning on the day of the determination that the S corporation election has terminated for a previous tax year. A "determination" means a final court decision, a closing agreement, or an agreement between the corporation and the Commissioner.[536]

B. Distributions of Money

Since only distributions of money will qualify, corporations short of cash must be careful of making artificial distributions.[537]

C. Election to Treat Post-Termination Deductions as Dividends

An S corporation may elect not to treat cash distributions as being tax free from AAA, with respect to all distributions during the post-terminated transition period. The election requires the consent of all shareholders receiving distributions during the post-terminated transition period.[538] This permits the corporation to treat a distribution as a dividend to avoid the accumulated earnings tax or personal holding company tax.

---

536 § 1377(b).

537 *See* George A. Roesel, 56 T.C. 14 (1971) (loan back); McKelvy v. United States, 478 F.2d 1217 (Ct. Cl. 1973) (check endorsed back as loan); C.D. Foundation, 59 T.C. 696 (1973) (checks held for 2 years); Randall N. Clark, 59 T.C. 94 (1972) (demand notes); *see also* Allsworth & Shaw "Subchapter S as Bandaged by the T.R.A. of 1976," 30 Major Tax Planning 103,135-143 (1978).

538 § 1371(e)(2); 1984 T.R.A. § 721(o).

¶ 107.9. Adjustments to Earnings and Profits

A. General Rule

No adjustments are made to the earnings and profits of an S corporation.

B. Exceptions

1. However proper adjustments are made in any transaction involving the application of subchapter C to an S corporation, such as those which may arise from a redemption, reorganization, partial liquidation. Proper adjustments must be made for distributions which are treated as dividends under section 1368(c)(2). Proper adjustments will also be made for the amount of any investment credit recapture.(539)

¶ 107.10. Tax Treatment to Corporation on Distributions of Property

The S corporation is subject to the normal provisions of subchapter C affecting distributions of property.(540) The Senate Finance Committee has observed that "pursuant to section 1371 of the Code, the provisions of subchapter C of the Code apply to determine the recognition of gain and loss in the case of a distribution by an S corporation."(541)

A. Example

For example, the normal provisions of subchapter C with respect to distributions under section 311, or a complete liquidation under section 336 would apply. Thus, if an S corporation makes a distribution of property (other than its own obligation) and the fair market value of the property exceeds the corporation's adjusted basis, gain will be recognized to the corporation as if it had sold the property to the distributee shareholder at fair market value.(542) The gain would be ordinary income if depreciable property is transferred to a shareholder

---

539 § 1371(d)(3) added by 1984 T.R.A. § 721(e)(1).

540 § 1371.

541 Sen. Rep. No. 100-445, 100th Cong., 2d Sess. 78 (1988), at the time of the repeal of prior sections 1363(d) and (e) as deadwood. TAMRA, § 1006(f)(7) (1988).

542 § 311(b).

controlling 50 percent of the stock.[543] The corporate gain will be passed through to the shareholders under the conduit rule and will be taxed to them.

¶ 108. ESTIMATED TAXES

¶ 108.1. General Estimated Tax Reports Requirement

Since section 1366 passes income and losses through to the shareholders, shareholders are now required to report estimated taxes quarterly in a manner similar to that required for partnerships.[544]

¶ 108.2. Computation of Estimated Tax Obligations

A. General

The shareholder will include in his taxable income items of the corporation earned during the months prior to the month the installment is due, but only for the corporation's taxable year which ends with or within the shareholder's taxable year.

If both the corporation and shareholder are on the same taxable year, the shareholder includes items of the corporation for the months prior to the estimated tax installment date.

If the corporation has a fiscal year ending on June 30 and the shareholder is on a calendar year, the rule is more complex.

Example. Assume the corporation is on a June 30 fiscal year. Income earned during the first six months of the corporation's year (July 1 through December 31, 1987) is first reported by the shareholder in his installment due on April 15, 1988, of the next year (his calendar taxable year within which S corporation's year ends). The April 15, 1988, installment also includes the amount of the corporation income earned during the first quarter of the shareholder's calendar year.

The June 15, 1988, installment includes the corporation income through the first 11 months of the corporation's taxable year.

---

543 § 1239.

544 Priv. Ltr. Rul. 86-39-008; Priv. Ltr. Rul. 85-42-034; Priv. Ltr. Rul. 85-44-01; and Treas. Reg. § 1.6654-2(d)(2).

¶ 108.3. Estimated Taxes for S Corporations

S corporations are required to make estimated tax payments on income taxed at the corporate level, including section 1374 built-in gain, excess passive investment income, investment credit recapture.(545)

¶ 109. OTHER RULES

¶ 109.1. Treatment of Fringe Benefits

A. General Rule

For the purpose of applying tax provisions which relate to employee fringe benefits, the S corporation is treated as a partnership, and any shareholder who owns more than 2 percent of the stock of the corporation is treated as a partner of such partnership.

B. Definition of Fringe Benefits

The Code does not define the term "fringe benefits." However, the Senate Report for the 1982 Act stated that the following are fringe benefits:

1. The $5,000 death benefit exclusion.(546)

2. Exclusion from income of amounts paid for accident and health plans.(547)

3. The exclusion of amounts paid by the employer to an accident and health plan.(548)

4. The exclusion of the cost of group term life insurance.(549)

(a) The exclusion from income of meals and lodging furnished for the convenience of the employer.(550)

---

545 § 6655(g), as amended Rev. Reconciliation Act of 1989. See Ann. 90-44.

546 § 101(b).

547 §§ 105(b), (c), and (d).

548 § 106.

549 § 79.

550 § 119.

C. Tax Treatment of Fringe Benefits

1. Since a 2 percent shareholder is treated as a partner, and the S corporation as a partnership, in determining the tax treatment of fringe benefits, the payment of the benefit is treated as a guaranteed payment under section 707(c).[551]

(a) The employer-S corporation may deduct the cost of the fringe benefit under section 162.

(b) The 2 percent shareholder-employee, like a partner, must include the value of the fringe benefit in gross income under section 61(a).

(c) The 2 percent shareholder-employee is then entitled to an offsetting deduction to the extent permitted under applicable law (e.g., health premiums under section 162(l).

D. Shareholder Deductions for Health Care

1. Shareholders treated as more than 2 percent partners under section 1372(b) may currently deduct 25 percent of their health care insurance costs under section 162(l).

2. An employee-shareholder who owns 2 percent or less of the S corporation stock is entitled to exclude the employer-paid premium under an accident and health plan from gross income under section 106.

¶ 109.2. Treatment of Expenses Owed to Shareholders

A. Section 267 Accrual Payor/Cash Basis Payee Rule

1. The corporation is placed on a cash method of accounting for the purpose of deducting business expenses and interest owed to a related party cash-basis taxpayer, including a shareholder who owns <u>at least</u> 2 percent of the stock of the corporation.[552]

By being treated as a cash basis taxpayer, the corporation will have a deduction in the same year the shareholder takes the item into income (or later if the item is deductible at a later date). Also no deduction

---

551 Rev. Rul. 91-26, 1991-1 C.B. 184.

552 Note a <u>more than</u> 2 percent rule is applied for fringe benefits under section 1372.

will be lost if payment is made after the 2-1/2 month period (the deduction was lost under prior law).(553)

B. Section 267 Loss Disallowance Rule

The provision of section 267 disallowing a deduction for losses on sales or exchanges of property between related parties includes the following three groups:

1. An S corporation and a partnership, if the same person owns more than 50 percent in value of the stock of the S corporation and more than 50 percent of the capital or profit interest in the partnership.(554)

2. An S corporation and another S corporation if the same person owns more than 50 percent in value of the stock of each corporation.(555)

3. An S corporation and a C corporation if the same individual owns more than 50 percent of the value of the stock in each corporation.(556)

¶ 109.3. Tax Return of S Corporation

Every S corporation is required to file an income tax return for each taxable year using Form 1120S.(557) The return must be furnished to stockholders when the corporation's return is filed.

¶ 109.4. Statute of Limitations

A. S Corporation Shareholder

The statute of limitations for assessing the tax liability of an S corporation shareholder runs from the date on which the shareholder's return is filed.
This conclusion was reached only after an extended conflict between the Circuit Court of Appeals was resolved by the the United States Supreme Court in <u>Bufferd v. Commissioner.</u>

---

553 § 267(f).

554 § 267(b)(10).

555 § 267(b)(11).

556 § 267(b)(12).

557 § 6037.

1. *Historical Background*

The statute of limitations issue has generally arisen when an S corporation has sustained tax losses which were passed through to the shareholder. Subsequently, during an audit of the shareholder, an extension of the period of limitations has been obtained from the shareholder but not from the corporation. After the expiration of the period of limitations against the corporation, a notice of deficiency has been mailed to the shareholder asserting a reduction of the available S corporation loss to the shareholder. The issue was whether the statute of limitations with respect to subchapter S matters must be determined at the corporate level so that the shareholders' independent period of limitations is not relevant, or whether the statute of limitations for assessing the tax liability of an S corporation shareholder always runs from the date on which the shareholder's return is filed.

In Bufferd v. Commissioner,[558] the United States Supreme Court concluded that the period of limitations for assessing the tax liability of an S corporation shareholder runs from the date which the shareholder's return is filed. The opinion focused on section 6501 which establishes a three-year period of limitation for assessing the tax "after the return was filed." The taxpayer and the Ninth Circuit in Kelley v. Commissioner,[559] relied on language in section 6037 that an S corporation is a return for purposes of sections 6012(a)(2) and 6501, and argued that the Service could not make a shareholder adjustment based on an item on the S corporation's return after the statute of limitations expired for the corporation.

Justice White, writing for the Supreme Court, held that the "return" referred to in section 6501(a) is the return of the taxpayer against whom the deficiency is assessed. The Service can only determine whether the shareholder-taxpayer understated his tax obligation and should be assessed a deficiency after examining that individual's return. As a pass-through entity under section 1363, the error on the corporate return did not affect the tax liability of the corporation but only the shareholder who claimed the benefit of the error.[560]

---

558 Id.

559 Kelley v. Commissioner, 887 F.2d 756 (9th Cir. 1989).

560 The earlier Court of Appeals holdings which are consistent with the Supreme Court include Fehlhaber v. Commissioner, 974 F.2d 653 (11th Cir. 1991), Green v. Commissioner, 963 F.2d 783 (11th Cir. 1992), and Bufferd v. Commissioner, 952 F.2d 975 (2d Cir. 1992).

2. The Proposed Tax Simplification and Technical Corrections Act of 1993 would amend section 6501 by adding the following sentence: "The term 'return' means the return required to be filed by the taxpayer (and does not include a return for any person from whom the taxpayer has received an item of income, gain, loss deduction or credit)."

B. S Corporation Level Taxes

The period of limitations for the assessment and allocation of corporate level taxes, such as the tax on net recognized built-in gains as on excess passive investment income, is increased from the filing of the S corporation's tax return, Form 1120S.

C. Qualification as an S Corporation

If an improper S election is made, the Service may contest the qualification of the purported S corporation at any time, but may not assess a tax deficiency for more than three years after the corporate return has been filed.

a2.9/9904.00/65/650/WMTC2

For Comprehensive Analysis, see Shaw, "Statute of Limitations for S Corporations Resolved by Supreme Court in Bufferd v. Commissioner, 5 J.S. Corp. Tax 63 (1993).