

1991

## Subchapter S: Operational Issues

Peter L. Faber

---

### Repository Citation

Faber, Peter L., "Subchapter S: Operational Issues" (1991). *William & Mary Annual Tax Conference*. 230.  
<https://scholarship.law.wm.edu/tax/230>

Copyright c 1991 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.  
<https://scholarship.law.wm.edu/tax>

**SUBCHAPTER S:  
OPERATIONAL ISSUES**

**Peter L. Faber  
Kaye, Scholer, Fierman, Hays & Handler  
New York, New York**

**December 7, 1991**

PLANNING FOR THE USE OF S CORPORATIONS

Table of Contents

	<u>Pages</u>
I. Introduction . . . . .	1
A. General pattern of subchapter S . . . . .	1
B. Effect of the Tax Reform Act of 1986. . . . .	1
II. Eligibility to use subchapter S. . . . .	1
A. Type of corporation . . . . .	1
B. May not have more than 35 shareholders. . . . .	2
C. Eligible shareholders . . . . .	2
D. Corporation may have only one class of stock. . . . .	6
III. Subchapter C attributes. . . . .	12
A. Earnings and profits. . . . .	12
B. Net operating loss carryovers . . . . .	16
IV. Gains on Sales of Assets . . . . .	16
A. Built-in gains for former C corporations. . . . .	16
B. Capital gains that are not subject to the tax on built-in gains may be subject to the tax on capital gains that was in existence before amendment by the 1986 T.R.A . . . . .	19
V. Taxable year . . . . .	20
A. Limits on the use of a taxable year other than a calendar year. . . . .	20
B. Circumstances in which an S corporation can use a taxable year other than a calendar year . . . . .	20
VI. Current operations . . . . .	22
A. Taxation of S corporations and their shareholders . . . . .	22
B. Corporate income: special problems. . . . .	29

C.	Current distributions . . . . .	31
VII.	Stock redemptions. . . . .	36
A.	Definition of a stock redemption. . . . .	36
B.	Uses of stock redemptions . . . . .	36
C.	Problems typically encountered in planning stock redemptions for C corporations. . . . .	36
D.	Stock redemptions for S corporation . . . . .	36
VIII.	Passing of control within the shareholder group. . . . .	38
A.	Need for a shareholders' buy-sell agreement . . . . .	38
B.	Problems that must be addressed in a shareholders' agreement for a C corporation must also be addressed in the S corporation context . . . . .	38
C.	Special problems of a shareholders' agreement for an S corporation. . . . .	38
D.	Estate freezes. . . . .	40
IX.	Terminating the S election . . . . .	42
A.	Voluntary termination . . . . .	42
B.	Involuntary termination . . . . .	43
C.	Treatment of year of termination. . . . .	45
D.	Re-election of S corporation status . . . . .	46

**SUBCHAPTER S:  
OPERATIONAL ISSUES**

**Peter L. Faber  
Kaye, Scholer, Fierman, Hays & Handler  
New York, New York**

**December 7, 1991**

**I. Introduction.**

**A. General pattern of subchapter S.**

1. The corporation is not subject to federal income tax.
2. The shareholders are taxed on their shares of the corporation's income and can deduct their shares of the corporation's losses.

**B. Effect of the Tax Reform Act of 1986.**

1. The maximum individual federal income tax rate (31%) is now lower than the maximum corporate federal income tax rate (34%).
2. C corporations and their shareholders are now subject to a double tax on gains realized on the liquidation or liquidating sale of the corporation. In effect, the double tax on current corporate earnings has been extended to liquidation proceeds. S corporations can still distribute or sell their assets with only a single tax.

**II. Eligibility to use subchapter S.**

**A. Type of corporation.**

1. Need not be a "corporation" under local law. Can be an association taxable as a corporation. See Regs. § 301.7701-2 (in some states, professional corporations are really associations).
2. Must be a domestic corporation. I.R.C. § 1361(b)(1).

3. May not belong to an affiliated group as determined under I.R.C. § 1504. I.R.C. § 1361(b)(2)(A).
    - a. Exceptions in I.R.C. § 1504(b) do not apply (e.g., DISCs, foreign corporations).
    - b. May have a dormant subsidiary that has never conducted business and that has no taxable income for the year. I.R.C. § 1361(c)(6).
  4. Ineligible corporations.
    - a. Financial institutions. I.R.C. § 1361(b)(2)(B).
    - b. Insurance companies. I.R.C. § 1361(b)(2)(C).
    - c. Possessions corporations. I.R.C. § 1361(b)(2)(D).
    - d. DISCs or former DISCs. I.R.C. § 1361(b)(2)(E).
- B. May not have more than 35 shareholders. I.R.C. § 1361(b)(1)(A).
1. Spouses and their estates count as one shareholder. I.R.C. § 1361(c)(1).
    - a. This rule applies even if the stock is not jointly owned.
    - b. Qualified subchapter S trusts that have spouses as beneficiaries are treated as one shareholder. Ltr. Rul. 9052048.
  2. Limit cannot be avoided by using trusts. Most qualifying trusts may have only one beneficiary. Each beneficiary of a voting trust is treated as a separate shareholder. I.R.C. § 1361(c)(2)(B)(iv).
  3. No similar limit for partnerships.
- C. Eligible shareholders.
1. Shareholders may be:
    - a. Individuals.

- b. Estates (including estate of a bankrupt individual. I.R.C. § 1361(c)(3)).
- c. Trusts, but only if one of the following.
  - (1) Voting trust. I.R.C. § 1361(c)(2)(A)(iv).
  - (2) Grantor trust, including one "owned" by the beneficiary, but only if all of the trust is deemed owned by a qualified shareholder. I.R.C. § 1361(c)(2)(A)(i). Exemption continues 60 days after grantor's death (2 years if entire corpus is included in his gross estate). I.R.C. § 1361(c)(2)(A)(ii).
  - (3) Trust receiving stock under a decedent's will, but only for 60 days. I.R.C. § 1361(c)(2)(A)(iii).
  - (4) Qualified subchapter S trust. I.R.C. § 1361(d).
    - (a) Trust owns stock in one or more S corporations.
    - (b) All of the income must be distributed or be required to be distributed currently.
      - (i) It is sufficient that the trust's accounting income is distributed, even if it is less than its taxable income. Ltr. Ruls. 9025011, 8839006 (S corporation did not distribute all of its taxable income).
      - (ii) The trust qualifies if all of the income is distributed, even if the trust agreement does not require distribution. Ltr. Rul. 8926019.
      - (iii) The trustee should not be given the power arbitrarily to shift items from income to principal.

- (iv) The trustee should not be able to borrow from income for the benefit of principal without paying reasonable interest.
  - (v) The creation of a depreciation reserve from income should not be permitted.
  - (vi) If a minor is the trust's beneficiary, distributions to the child, for the child's benefit, to the child's legal guardian (Ltr. Rul. 9032007), or to a custodian under the Uniform Gifts to Minors Act (Ltr. Rul. 9001010) will meet the requirement.
- (c) Only one income beneficiary, who is a qualified shareholder.
- (i) The trust agreement should prohibit payments or distributions that would discharge any person's obligation to support the beneficiary. Ltr. Rul. 9028013.
  - (ii) A single trust with separate beneficiaries can qualify as separate trusts. I.R.C. § 1361(d)(3). Ltr. Rul. 8931060.
  - (iii) Distributions may not be made to a grantor trust established for the benefit of the qualified subchapter S beneficiary. Ltr. Rul. 9014008.
- (d) During life of current income beneficiary there can be only one income beneficiary.
- (e) Any corpus distributed during the life of the income beneficiary must be distributed to him.



- (f) The income interest of the current income beneficiary terminates on the earlier of his death or the termination of the trust.
- (g) If the trust terminates during the life of the income beneficiary, all of its assets must be distributed to him.
  - (1) This test was not met when a trust could distribute corpus to the beneficiary's sibling on termination but only if the terminating event was the failure of the trust to own S corporation stock. Rev. Rul. 89-55, 1989-1 C.B. 268.
  - (2) A trust does not qualify when during the lifetime of the income beneficiary some of the corpus can be used to fund a new trust for an "after-born" grandchild of the grantor. Rev. Rul. 89-45, 1989-1 C.B. 267.
- (h) Beneficiary must elect to have this provision apply. Substantial compliance with the election rules will suffice. See Ltr. Rul. 8719028 (beneficiary signed corporation's election form as trustee and individual shareholder); Ltr. Ruls. 8835012, 8835038 (beneficiaries signed form but failed to file it). Separate election for each S corporation. Election continues for successive income beneficiaries unless one affirmatively refuses to consent.
- (i) If a trust does not qualify, it may be possible to have the trust agreement amended by a court to remove the disqualifying provision. Ltr. Ruls. 9040031, 9040019, 9032007, 9111029 (removal of a diversion of corpus if the beneficiary remarries).

2. Shareholders may not be:
    - a. Nonresident alien.
    - b. Corporation, including an S corporation.  
Ltr. Rul. 9028016.
    - c. Partnership.
    - d. Trust other than one indicated above.
  3. See Ltr. Rul. 8819040 for an example of how a joint venture between an S corporation and a prohibited shareholder can be used to give the other entity an equity interest in the S corporation's business.
  4. No limit on eligible partners for a partnership.
- D. Corporation may have only one class of stock. I.R.C. § 1361(b)(1)(D).
1. Prevents special allocations of income. Partnerships can make special allocations if they have substantial economic effect. I.R.C. § 704(b).
  2. Differences in voting rights are permitted. I.R.C. § 1361(c)(4).
  3. Phantom stock compensation plan for employees does not create a second class of stock. G.C.M. 39750. Ltr. Ruls. 9109025, 8907032, 8834085, 8838049 (current payments of amounts equal to dividends paid on stock).
  4. The right of one class of stock to be redeemed at any time for a stated redemption price does not necessarily result in its being considered a second class of stock. Ltr. Rul. 8933021.
  5. Proposed regulations (August 8, 1991).
    - a. On October 5, 1990, the I.R.S. proposed regulations interpreting the one-class-of-stock requirement.
      - (1) The regulations would have found a second class of stock as a result of many ordinary business transactions, such as the inadvertent payment of

excessive compensation to an employee-shareholder or the making of distributions on different dates.

- (2) Debt that was reclassified as equity and that did not meet the statutory safe harbor of I.R.C. § 1361(c)(5) was automatically treated as a second class of stock. To qualify for the safe harbor, the debt had to provide for a reasonable interest rate.
  - (3) Redemptions that did not qualify as sales or exchanges under I.R.C. § 302 created a second class of stock unless they were pro rata.
- b. The proposed regulations were controversial. On August 8, 1991, they were replaced by a new set of proposed regulations.
- c. The August 8, 1991 proposed regulations, Prop. Regs. §§ 1.1361-1(b) and (1).
- (1) General rule: a corporation will not have more than one class of stock if all classes confer identical rights to distributions and liquidation proceeds.
    - (a) Rights are based on the corporation's governing documents, including the charter, articles of incorporation, bylaws, and agreements relating to distributions and liquidation proceeds.
    - (b) Rights are also based on applicable state law.
    - (c) Actual or constructive distributions (e.g., excess compensation paid to an employee-shareholder) that differ as to timing or amount do not result in a second class of stock as long as all shareholders have equal rights to distributions. They are given appropriate tax effect.

(d) Routine commercial arrangements (e.g., leases, employment contracts, loan agreements) do not create a second class of stock unless they are entered into to circumvent the one class requirement.

(2) Stock redemptions.

(a) The characterization of a redemption as a distribution or a sale or exchange under I.R.C. § 302 is irrelevant.

(b) Agreements to redeem stock at the holder's death, disability, or termination of employment are disregarded.

(c) Bona fide buy-sell agreements and "general" redemption agreements are normally disregarded.

(i) Such agreements are not disregarded if they are intended to circumvent the one class rule and the price when the agreement is signed is "significantly" different from the stock's fair market value.

(ii) A "general" redemption agreement is one that applies to "substantially all" of the corporation's outstanding stock and provides for the redemption of all of a shareholder's stock upon a triggering event at a price that is "uniform" for all shares. Query: is a uniform formula permissible?

(d) A redemption agreement other than a "general" redemption agreement is ignored unless the redemption price is significantly different from the stock's fair market value when the agreement is signed.

(e) Operating rules.

(i) A price that is equal to book value or that is between book and fair market value will not be treated as significantly different from fair market value. Query: accounting book value? tax book value?

(ii) A good faith determination of value will be respected unless it is "substantially in error" or it "was not performed with reasonable diligence."

(3) Compensation arrangements.

(a) Substantially unvested stock will not be treated as outstanding unless an election has been made under I.R.C. § 83(b).

(b) A deferred compensation arrangement will not be considered if it does not involve the transfer of property under I.R.C. § 83 and it does not confer voting rights (e.g., a typical phantom stock plan).

(4) Debt obligations.

(a) A debt obligation will ordinarily not be treated as a second class of stock unless it is:

(i) treated as equity, and

(ii) used to contravene the rights conferred by the stock to distributions or liquidation proceeds or the limitations on eligible shareholders.

(b) Regulatory safe harbors. Debt obligations will not be treated as a second class of stock under the following circumstances.

- (i) Unwritten advances from a shareholder that do not exceed \$10,000 at any time, are treated as debt by the parties, and are expected to be repaid in a reasonable time.
  - (ii) Obligations that are proportionate to shareholdings.
- (c) The statutory safe harbor of I.R.C. § 1361(c)(5).
- (i) The proposed regulations track the language of the statute.
  - (ii) The requirement added by the 1990 proposed regulations that the debt provide for a reasonable rate of interest has been deleted.
  - (iii) Debt that is reclassified as equity and that does not meet the statutory safe harbor will not automatically be treated as a second class of stock, as it was under the 1990 proposed regulations.
- (5) Call options.
- (a) A call option issued by the corporation will be a second class of stock, even if to purchase shares of the single outstanding class of stock, if it:
    - (i) is substantially certain to be exercised, and
    - (ii) has a strike price that is substantially lower than the stock's fair market value when the option is issued.

(b) Safe harbors. An option will not be treated as a second class of stock under the following circumstances.

(i) The option was issued to a person who is in the lending business in connection with a loan the terms of which are commercially reasonable.

(ii) The option was issued to an employee or to an independent contractor in connection with the performance of services, is nontransferable (within the meaning of Regs. § 1.83-3(d)), and does not have a readily ascertainable fair market value (within the meaning of Regs. § 1.83-7(b)).

(iii) The option price is at least 90% of the stock's fair market value when the option is issued. ( A "good faith determination of fair market value by the corporation will be respected unless it can be shown that the value was substantially in error [?!] or the determination of the value was not performed with reasonable diligence [?!] to obtain a fair value.")

(6) Effective dates.

(a) The proposed regulations will generally be effective with respect to corporate taxable years starting after 1991.

(b) Debt obligations and arrangements that were entered into before August 9, 1991, will not be subject to the new regulations. Query: effect of material modifications or new parties?

6. Effect of debt that is reclassified as stock.
  - a. If debt meets the straight debt safe harbor, it will not be treated as a second class of stock for subchapter S purposes. I.R.C. § 1361(c)(5).
    - (1) Written unconditional promise to pay a sum certain in money on demand or on a specified date.
    - (2) Interest rate not contingent on profits, the borrower's discretion, or "similar factors."
    - (3) Not convertible into stock.
    - (4) The creditor must be qualified to be a shareholder.
  - b. If safe harbor is not met, effect of reclassification as stock is unclear. I.R.S. attempts to disqualify election under pre-1983 law were rejected by courts. W.C. Gamman v. Commissioner, 46 T.C. 1 (1966); Portage Plastics Co. v. U.S., 486 F.2d 632, 31 AFTR2d 864, 73-1 USTC ¶ 9261 (7th Cir. 1973).

### III. Subchapter C attributes.

#### A. Earnings and profits.

1. The concept of earnings and profits is ordinarily used to determine the extent to which distributions from a corporation are dividends to the shareholder or a return of capital. I.R.C. § 316.
  - a. Earnings and profits generally reflect economic income, not taxable income. The phrase is not defined in the Internal Revenue Code, although § 312 describes many of the rules used in calculating it.
  - b. Earnings and profits are increased by many items that are not included in gross income (e.g., life insurance proceeds, state and local bond interest).



- c. Earnings and profits are reduced by many items that are not deductible in computing taxable income (e.g., dividends, U.S. income taxes).
- 2. An S corporation does not have earnings and profits from years during which the S election is in effect, but it may have earnings and profits left over from years during which it was a C corporation.
- 3. Consequences of an S corporation having subchapter C earnings and profits.
  - a. Excess passive investment income ("EPII") is taxed to the corporation at the highest corporate tax rate. I.R.C. § 1375.
    - (1) EPII is defined as the excess of passive income over 25% of the corporation's gross receipts.
    - (2) The tax is imposed on net passive income (i.e., gross passive income less deductions directly connected with its production).
    - (3) Passive income includes rents, royalties, interest (except on sales of inventory and from active finance company operations), dividends, annuities, and gains on sales of stocks and securities.
      - (a) Rents are sometimes hard to distinguish from service income. See Ltr. Rul. 8916057 (charter boat operation treated as sale of services).
      - (b) The performance of active services in connection with a lease may remove the rental income from the passive investment income category. Ltr. Rul. 8950020 (installation and servicing of leased equipment).
      - (c) A "lease" may be treated as a conditional sale. Ltr. Rul. 8926044.

- (d) A partnership's passive income was passed through to an S corporation that was a partner. It is not necessary that the income be distributed to it. Rev. Rul. 71-455, 1971-2 C.B. 318; Ltr. Ruls. 9034058, 8950053, 8917043.
    - b. If an S corporation has EPII for each of 3 consecutive taxable years and has subchapter C earnings and profits at the end of each of those years, the S election terminates for the next year. I.R.C. § 1362(d)(3).
    - c. Distributions may be taxed to the shareholders at ordinary income rates to the extent that they exceed the corporation's accumulated adjustments account (generally, the amount of the corporation's retained earnings from subchapter S years). I.R.C. § 1368(c)(2).
  - 4. An S corporation can elect to have a distribution treated as a dividend taxable at ordinary income rates to the extent of subchapter C earnings and profits. I.R.C. § 1368(e)(3). This has the effect of eliminating the subchapter C earnings and profits so that the passive income rules described in III.A.3. no longer apply.
    - a. The income resulting from the distribution is in addition to the shareholder's share of the corporation's taxable income for the year.
    - b. All shareholders receiving distributions from the corporation during the taxable year must consent to the election.
      - (1) This includes people who are no longer shareholders at the time of the election.
      - (2) The I.R.S. has not prescribed procedures for making the election.
    - c. The election must apply to all distributions during the taxable year and not just to part of them. Ltr. Rul. 8935013 (permission to have some distributions treated as coming from the accumulated adjustments account denied).

5. The tax under § 1375 can be waived by the I.R.S. if the corporation meets certain requirements. I.R.C. § 1375(d).

a. Requirements

(1) The corporation determined in good faith that it had no subchapter C earnings and profits at the end of the year (or that it had distributed them all). This probably requires a showing that a calculation was made.

(2) It distributed the earnings and profits within a reasonable time after a determination of their existence was made.

(a) The determination can be made by the I.R.S. in an audit. Regs. § 1.1375-1A(d)(1).

(b) The I.R.S. has not indicated what a "reasonable time" will be.

b. Procedures for applying for a waiver are prescribed in Regs. § 1.1375-1A(d)(2).

6. The I.R.S. can waive a termination of the S election resulting from excess passive investment income. I.R.C. § 1362(f).

a. Requirements.

(1) The I.R.S. determines that the termination was inadvertent (e.g., the corporation thought that it had no subchapter C earnings and profits).

(2) Steps are taken within a reasonable time to restore subchapter S status (e.g., a distribution of the newly discovered earnings and profits).

(3) The corporation and its shareholders agree to make such adjustments as are required by the I.R.S.

b. Regulations specifying the waiver procedure have not yet been adopted.

**B. Net operating loss carryovers.**

1. An S corporation cannot use net operating loss carryovers generated while it was a C corporation (I.R.C. § 1371(b)(1)), but the years during which it is an S corporation count in determining the number of years forward that those carryovers can be carried under I.R.C. § 172 (I.R.C. § 1371(b)(3)). Rosenberg v. Commissioner, 96 T.C. No. 15 (1991) (passthrough of carryovers disallowed; tax benefit rule does not override § 1371(b)(1)).
2. A C corporation contemplating an S election should try to generate income in its last year as a C corporation that will use up its net operating loss carryovers.
3. Techniques to accelerate income into the last C corporation year.
  - a. Get customers to prepay (e.g., rents).
  - b. A cash basis corporation can sell its receivables.
  - c. Sale and leaseback of corporate property.
  - d. Defer deductible items.
4. Subchapter C losses can be used against the tax on built-in gains of former C corporations (see IV below) but not against the tax imposed on nonrecurring capital gains under I.R.C. § 1374 before amendment by T.R.A. 1986.

**IV. Gains on Sales of Assets.**

**A. Built-in gains for former C corporations. I.R.C. § 1374.**

1. A C corporation that elects S status will be taxed on any recognition during the first 10 years of the election of gain that represents unrealized appreciation in the value of its assets when the election became effective.

Purpose: to prevent the use of an S election to avoid the double tax on C corporations and their shareholders resulting from General Utilities repeal.

2. The total amount of gains taxed to the corporation cannot exceed the aggregate net unrealized gain when the election became effective.
  - a. Losses are netted against gains. I.R.C. § 1374(d)(2)(A).
  - b. The I.R.S. will ignore contributions of loss assets done for the purpose of offsetting gains. Ann. 86-128, I.R.B. 1986-51, 22.
3. Effect of carryovers from C corporation years.
  - a. Net operating and capital loss carryovers reduce recognized built-in gains. I.R.C. § 1374(b)(2).
  - b. Business credit carryovers reduce the tax.
4. The gain taxed to the corporation under this provision cannot exceed the corporation's taxable income for the year determined as if it was not an S corporation. I.R.C. § 1374(d)(2)(A). Operating losses and losses from the sale of other assets can reduce the gain that is taxed to the corporation. Under the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), net recognized gains that are not taxed because of the taxable income limit are carried forward to the next year. I.R.C. § 1374(d)(2)(B).
5. The corporation is taxed whenever an asset owned on the election's effective date is sold and gain is recognized during the next 10 years.
  - a. The taxpayer will have the burden of proving that a sold asset was not owned on the election's effective date.
  - b. Assets acquired by the corporation in a carryover basis transaction in exchange for an asset owned on the election's effective date will be subject to the tax. Ann. 86-128, I.R.B. 1986-51, 22. TAMRA makes clear that this applies to assets received in a tax-free reorganization, extending for 10 years after receipt. I.R.C. § 1374(d)(8).
  - c. Although the statute provides that the tax applies only if gain is "recognized" within the first 10 years of the S election, the I.R.S. has exercised its regulatory authority

under I.R.C. § 1374(e) to hold that gain recognized after the end of the 10-year period pursuant to an installment sale made during the 10-year period will be subject to the tax. Notice 90-27, 1990-1 C.B. 336.

- d. The tax is not limited to sales of businesses, capital gains, or to sales of assets in the conventional sense. It applies to, among other items:
    - (1) Occasional sales of individual assets.
    - (2) Sales of inventory in the ordinary course of business (although LIFO inventory could, as a practical matter, escape the tax before the Revenue Act of 1987 required the corporation to pay a tax on LIFO inventory reserves.
    - (3) The collection of receivables by a cash basis corporation.
  - e. It is not clear whether the tax applies to the receipt of assets upon the termination of an overfunded defined benefit pension plan.
6. The taxable gain with respect to each asset will be the excess of the asset's value over its basis on the election's effective date.
- a. The burden of proof will be on the taxpayer. Appraisals should be made when feasible and records should be established at the outset.
  - b. It is not clear whether grouping of assets will be permitted.
  - c. I.R.S. agents are apparently allowing inventory to be valued at its wholesale price rather than its resale price.
7. The tax does not apply if the sale was made before January 1, 1989 to the extent that the corporation is eligible for the small corporation exception to General Utilities repeal. T.R.A. 1986 § 632.
- a. The value of the corporation is less than \$5,000,000 (a partial exemption is available for corporations worth between \$5,000,000 and \$10,000,000).

- b. More than 50% of the corporation's stock must have been held by 10 or fewer individuals on August 1, 1986 and for at least 5 years.
  - c. The exemption does not apply to inventory and other ordinary income assets. Rev. Rul. 86-141, 1986-2 C.B. 151.
  - d. TAMRA makes clear that a qualifying corporation that files its S election before January 1, 1989 is eligible for the exemption. See T.R.A. 1986 § 633(d)(8), as amended by TAMRA § 1006(g)(7).
- B. Capital gains that are not subject to the tax on built-in gains may be subject to the tax on capital gains that was in existence before amendment by the 1986 T.R.A. Old I.R.C. § 1374.
- 1. The tax was designed to prevent C corporations from making a one-shot S election to pass through unusual gains.
  - 2. Circumstances under which the tax is imposed.
    - a. The corporation's net capital gain exceeds \$25,000 and exceeds 50% of its taxable income for the year.
    - b. The corporation's taxable income exceeds \$25,000.
    - c. The S election was not in effect for the 3 preceding taxable years (or for the corporation's existence if it was in existence for a shorter period). A short taxable year resulting from a change of taxable year counts as a full year. Ltr. Rul. 9001048.
    - d. The tax applies only to capital gains. Sales of inventory and other ordinary income items are not affected.
    - e. Unlike the tax on built-in gains of former C corporations, the tax is not limited to assets held on, or appreciation as of, the effective date of the S election.
  - 3. An installment sale may reduce or avoid the impact of the tax.

- a. Gain recognized more than 3 years after the S election's effective date is not subject to the tax, even if the sale occurred within the 3-year period.
  - b. Spreading the gain over several years may bring the gain recognized in any one year below \$25,000 or 50% of that year's taxable income.
4. The corporate-level tax applies to sales or distributions that are taxable events to the corporation under the repeal of General Utilities and that are not subject to the tax on gains of former C corporations, subject to the transitional rules. Rev. Rul. 86-141, 1986-2 C.B. 151.

V. Taxable year.

- A. Unlike a C corporation, an S corporation is subject to limits on its ability to use a taxable year other than a calendar year.
- B. Circumstances in which an S corporation can use a taxable year other than a calendar year.
  1. An S corporation can use a taxable year other than the calendar year if it establishes a business purpose for using a different period. I.R.C. § 1378.
    - a. A fiscal period may be used as the taxable year if at least 25% of the corporation's gross receipts fall into the last two months of the period for at least three consecutive years. Rev. Proc. 87-32, 1987-2 C.B. 396.
    - b. The Conference Committee Report for the T.R.A. 1986 indicates that the following factors will not establish a business purpose.
      - (1) The use of a particular year for regulatory or financial accounting purposes.
      - (2) The time of the year at which hiring occurs.



- (3) The use of a particular year for administrative purposes such as admitting or retiring partners or shareholders, staff promotions, and compensation changes.
  - (4) Changes of prices, model years, and similar items.
2. An S corporation can elect to use a taxable year other than the calendar year, without regard to business purpose, under some circumstances. I.R.C. § 444, added by the Revenue Act of 1987.
- a. The taxable year must end at the end of September, October, or November. I.R.C. § 444(b)(1).
  - b. The S corporation must pay an excise tax. I.R.C. §§ 444(c)(1), 7519.
    - (1) The amount of the tax is intended to approximate the value of the tax deferral.
    - (2) The tax is paid by the corporation, not by the shareholders.
    - (3) The tax is not deductible and it may not be credited against the individual income tax liability of any shareholder. Notice 88-10, 1988-1 C.B. 478.
  - c. Election procedures.
    - (1) The election for the 1987 taxable year must be made by July 26, 1988 (60 days after the publication of temporary regulations in the Federal Register).
    - (2) A corporation making an S election after September 26, 1988 must state its intention to make a § 444 election on its Form 2553. If it does not, the § 444 election can be ignored.
    - (3) An election must generally be made by the 15th day of the fifth month following the month in which the first day of the year for which the election is effective occurs.

3. Grandfather rule.

- a. A corporation using a noncalendar taxable year beginning in 1986 can continue to use that year for the year beginning in 1987. I.R.C. § 444(b)(3).
- b. Although the statute suggests that the grandfather rule is limited to the year beginning in 1987, the I.R.S. will allow the old year to be used for all future years. Notice 88-10, supra.
- c. The grandfather rule allows the retention of a prior year even if its deferral period is for longer than three months.

VI. Current operations.

A. Taxation of S corporations and their shareholders.

1. Taxation of corporation.

- a. An S corporation is ordinarily not taxed on its income. I.R.C. § 1363(a). The corporation files an information return reporting its items of income, deductions, and credit, and these items are passed through to the shareholders.
- b. Calculation of the corporation's taxable income.
  - (1) An S corporation's taxable income is generally calculated in the same manner as that of an individual. I.R.C. § 1363(b).
    - (a) An S corporation may amortize its organizational expenses under I.R.C. § 248. I.R.C. § 1363(b)(3).
    - (b) Other deductions peculiar to corporations (e.g., the dividends received deduction of I.R.C. § 243) are not available.
    - (c) Certain deductions peculiar to individuals are not allowed. I.R.C. §§ 1363(b)(2), 703(a)(2).

- (i) Personal exemptions. I.R.C. § 151.
    - (ii) Individual itemized deductions. I.R.C. §§ 211-220.
  - (2) Items that could separately affect the tax liability of shareholders are passed through separately and do not affect the corporation's taxable income.
    - (a) Capital gains and losses.
    - (b) Charitable contributions.
    - (c) Tax-exempt interest.
    - (d) Foreign taxes.
    - (e) Depletion.
    - (f) Base for credits.
    - (g) Investment interest.
  - (3) Elections are generally made by the corporation and not by the shareholders. I.R.C. § 1363(c)(1).
- c. Corporate-level taxes.
- (1) Tax on excess passive investment income of former C corporations. I.R.C. § 1375. See III.A.3.a. above.
  - (2) Built-in gains for former C corporations. I.R.C. § 1374. See IV.A. above.
  - (3) Capital gains under certain circumstances. Old I.R.C. § 1374. See IV.B. above.
  - (4) Installment payments on LIFO reserves recaptured at the time of the S election. I.R.C. § 1363(d).

- (5) An S corporation that claimed investment tax credits while it was a C corporation is liable for tax on recapture if the property is disposed of prematurely. I.R.C. § 1371(d)(2). The mere fact of an S election is not a recapture event. I.R.C. § 1371(d)(1).
- (6) Excise tax on corporation electing to use noncalendar taxable year. I.R.C. §§ 444, 7519. See V.B.2.

2. Taxation of shareholders.

- a. Shareholders are taxed on their shares of the corporation's income and, within limits, can deduct their shares of the corporation's losses. I.R.C. § 1366. Items are reported on the shareholders' income tax returns for the year within which the S corporation's taxable year ends. I.R.C. § 1366(a)(1).
- b. The pass-through of items generally follows the partnership model.
  - (1) Items that could affect the shareholders' individual liabilities because of their character are passed through separately. I.R.C. § 1366(a)(1)(A). Although the statute (with the exception of tax-exempt income) does not list these items, the committee reports to the Subchapter S Revision Act of 1982 ("SSRA") indicate that they include capital gains and losses, charitable contributions, foreign taxes, depletion, and similar items. S. Rep. No. 97-640, 97th Cong., 2d Sess. (1982), 1982-2 C.B. 718, 725.
  - (2) The residual items pass through to the shareholders as a single item. I.R.C. § 1366(a)(1)(B).
  - (3) The character of any item passed through to a shareholder is determined as if it were realized or incurred by the corporation. I.R.C. § 1366(b).

- c. Allocation of corporate items among the shareholders.
- (1) Generally, items of income, loss, and credit are allocated among shareholders on a per-share-per-day basis. I.R.C. §§ 1366(a), 1377(a).
    - (a) The date on which an item is in fact realized or incurred is immaterial.
    - (b) Before the SSRA, income (but not loss) remaining after distributions was allocated based on shareholdings at the end of the year. This enabled income shifting by year-end transfers. This is no longer possible.
    - (c) Distributions do not affect the allocation of income and loss among shareholders.
    - (d) Special allocations (following the partnership model) are not allowed.
  - (2) If a shareholder's interest in the corporation terminates, an election can be made to terminate the corporation's taxable year on the termination date for allocation purposes. I.R.C. § 1377(a)(2).
    - (a) Although the statute refers to a termination of the shareholder's "interest" in the corporation, leaving open the treatment of debt and other interests, the Temporary Regulations indicate that the election is available whenever a person's "shareholder interest" is terminated. Temp. Regs. § 1.1377-1. See I.R.C. § 302(c)(2).
    - (b) Constructive ownership rules apparently do not apply. See I.R.C. §§ 318(a) and (b).

- (c) All persons who are shareholders at any time during the taxable year must consent to the election.
  - (d) The possibility of making an I.R.C. § 1377(a)(2) election should be considered in negotiating a buyout. If it would be desirable for other reasons (e.g., because of shareholding changes), consider buying out a shareholder in order to qualify for it.
- d. Adjustments to basis of a shareholder's stock. I.R.C. § 1367.
- (1) Increases in basis.
    - (a) Items of the corporation's income that are allocated to the shareholder.
    - (b) The shareholder's share of the excess of percentage depletion over the basis of depletable property.
    - (c) Additional capital contributions.
  - (2) Decreases in basis.
    - (a) Distributions to the shareholder that are not included in income under I.R.C. § 1368.
    - (b) Corporate losses that are allocated to the shareholder.
    - (c) Corporate expenses that are neither deductible nor chargeable to capital account.
    - (d) The shareholder's share of depletion of oil and gas property to the extent that it does not exceed the property's basis that is allocated to the shareholder.

- (3) If items that reduce stock basis (other than distributions) exceed the shareholder's basis in his or her stock, they reduce the shareholder's basis in his or her debt from the corporation (but not below zero).
- e. A shareholder's deduction of corporate losses is limited to the basis of the shareholder's stock and debt of the corporation. I.R.C. § 1366(d).
- (1) Basis increases of stock under I.R.C. § 1367(a)(1) (special items passed through to shareholder) for the year are included in determining stock basis, but basis decreases under I.R.C. § 1367(a)(2) (distributions, etc.) apparently are ignored.
- (2) Basis adjustments to debt under I.R.C. § 1367(b)(2) (items that reduce debt basis after stock basis is exhausted and their restoration) are ignored.
- (3) A shareholder's share of the corporation's debt owed to others does not give rise to basis that can support losses.
- (a) A shareholder's guarantee of the corporation's debt to a third party does not produce basis. Erwin III. v. Commissioner, T.C. Memo. 1989-80; Uri, Jr. v. Commissioner, T.C. Memo. 1989-58; Estate of Leavitt v. Commissioner, 90 T.C. 206 (1988), aff'd, 875 F.2d 420, 63 AFTR2d 89-1437, 89-1 USTC ¶ 9332 (4th Cir. 1989), cert. den., \_\_\_ U.S. \_\_\_, 110 S.Ct. 376 (1989); Brown v. Commissioner, 706 F.2d 755, 52 AFTR2d 83-5080, 83-1 USTC ¶9364 (6th Cir. 1983); Harris v. United States, 902 F.2d 439, 66 AFTR2d 90-5104, 90-2 USTC ¶ 50,341 (5th Cir. 1990); Rev. Rul. 71-288, 1971-2 C.B. 319; Rev. Rul. 70-50, 1970-1 C.B. 178. If the lender primarily relies on the guarantor's credit, the trans-

action may be treated as a loan to the shareholder followed by a loan from the shareholder to the corporation. Selfe v. United States, 778 F.2d 769, 57 AFTR2d 464, 86-1 USTC ¶9115 (11th Cir. 1985).

- (b) A shareholder can borrow from another lender and relend the money to the corporation. If the corporation is engaged solely in active business operations, the interest on the shareholder's borrowing will not be subject to the limits on deducting investment interest. I.R.C. § 163(d). Ann. 87-4, I.R.B. 1987-3, 17.
  - (c) A partner can include his or her share of partnership debt in partnership interest basis. I.R.C. § 752. The inability to use "inside" basis to support loss deductions may be a significant disadvantage of subchapter S relative to the partnership form of doing business.
- (4) A shareholder's loss that cannot be used in a given year because of the basis limitation is carried forward indefinitely. I.R.C. § 1366(d)(2).
- (a) If the shareholder transfers his or her stock, the right to use previously disallowed losses disappears. There is no provision for allowing it to offset any gain realized on the sale of the stock.
  - (b) If the S election terminates, carried forward losses can be deducted as of the last day of the "post-termination transition period" (generally one year after the end of the last S year) to the extent of the shareholder's stock (but not debt) basis.



I.R.C. § 1366(d)(3). A corresponding reduction in the basis of the shareholder's stock must be made.

**B. Corporate income: special problems.**

**1. Permissible income.**

**a. Passive investment income.**

- (1) A new corporation that makes an S election for its first taxable year can have unlimited amounts of passive investment income.
- (2) An S corporation that has subchapter C earnings and profits can be penalized for excess passive investment income.
  - (a) Corporate-level tax on excess net passive investment income. I.R.C. § 1375.
  - (b) Termination of S election if excess passive investment income is received for 3 consecutive years. I.R.C. § 1362(d)(3).

**b. Foreign source income.**

- (1) There is no limit on the amount of foreign income that can be received by an S corporation, even if it has subchapter C earnings and profits. Prior limits were repealed by the SSRA.
- (2) Foreign income is passed through to shareholders as a separate item and is taken into account by them in calculating foreign tax credits. Reporting to shareholders will be complicated by the foreign tax credit provisions of the 1986 T.R.A.

**2. Passive activity loss rules.**

- a. The 1986 T.R.A. contained complex rules intended to limit tax shelters by providing that losses from passive activities could be applied only against income from similar

activities and not against compensation, portfolio investment income, and active business income. I.R.C. § 469.

- b. Passive activity losses ("PALs") are generally defined as losses from a business activity in which the taxpayer does not materially participate. I.R.C. § 469(c)(1).
- c. Losses sustained by an S corporation will generally be PALs as to its shareholders.
  - (1) The characterization of income at the corporate level will pass through to the shareholders. I.R.C. § 1366(b).
  - (2) An S corporation shareholder who materially participates in a corporate activity as a corporate employee would not be treated as having a PAL with respect to the activity.
    - (a) Compensation income from an S corporation cannot be offset by PALs from the corporation. The I.R.S. may require S corporation shareholders to take out reasonable compensation.
    - (b) The statutory rule that requires losses from a limited partnership interest to be PALs regardless of whether the partner participates in the activity does not apply to S corporation shareholders. I.R.C. § 469(h)(2). (The impact of the statutory rule applicable to limited partners has been mitigated by the regulations. Temp. Regs. § 1.469-5T(e)(2))
- d. A C corporation that is subject to the PAL rules (i.e., one whose stock is closely held) can apply PALs against active business income. I.R.C. § 469(e)(2). An S corporation cannot.

- e. Income from an S corporation with respect to which a shareholder does not materially participate should be treated as passive activity income against which PALs can be applied.
  - (1) The I.R.S. may impute compensation and dividend income to the shareholders to prevent abuse.
  - (2) The I.R.S. has broad regulatory authority to provide that income that would otherwise be treated as passive income will not be so treated. I.R.C. § 469(k)(3). See Temporary Regulations (T.D. 8175) February 19, 1988.
- f. A shareholder's basis in his or her stock is reduced even if losses cannot be used because of the PAL rules. Hudspeth v. Commissioner, 914 F.2d 1207, 66 AFTR2d 90-5582, 90-2 USTC ¶50,501 (9th Cir. 1990).

C. Current distributions.

- 1. Current distributions are made for a variety of reasons.
  - a. Provide shareholders with funds to pay taxes on corporate earnings.
  - b. Provide shareholders with a return on their investments.
  - c. Distribute proceeds of nonrecurring sales or refinancings.
  - d. Distribute business assets in connection with a restructuring of the business.
- 2. Taxation to the shareholder.
  - a. Distributions do not affect the allocation of the corporation's income and losses among the shareholders (unlike pre-SSRA law).
  - b. The amount of any distribution is the sum of cash and the fair market value of any property distributed.

- c. The tax consequences to the shareholder will depend on whether the corporation has accumulated earnings and profits ("AE&P").
- (1) If the corporation has no AE&P.
    - (a) The distribution is applied against the basis of the stock and has no immediate tax impact until the basis is exhausted. I.R.C. § 1368(b)(1).
    - (b) Any excess of the distribution over the stock basis is treated as gain from the sale of the stock. I.R.C. § 1368(b)(2).
  - (2) If the corporation has AE&P.
    - (a) To the extent of the corporation's accumulated adjustments account ("AAA"), amounts are treated as a recovery of basis with any excess treated as gain from the sale of the stock. I.R.C. §§ 1368(c)(1), (e)(1).
      - (i) The AAA is similar to earnings and profits.
      - (ii) The AAA is based generally on the basis adjustments of I.R.C. § 1367 (income items except for capital contributions; loss items and tax-free distributions).
      - (iii) No adjustments are made for tax-exempt income and related expenses. This means that distributions of tax-free income at the corporate level can be taxable to the shareholders.
      - (iv) No adjustments are made for U.S. taxes attributable to C corporation years.

- (v) A redemption that is treated as a sale or exchange will carry with it a proportional share of the AAA.
  - (vi) Adjustments to the AAA are made for the most recent continuous period during which the corporation has been an S corporation, excluding taxable years beginning before January 1, 1983.
  - (vii) The amount of the AAA is determined as of the end of the corporation's taxable year in which the distribution occurs, not at the time of the distribution. Ltr. Rul. 8842024.
- (b) Distributions in excess of the AAA are treated as dividends to the extent of the AE&P. I.R.C. § 1368(c)(2).
  - (c) Amounts remaining after the application of the AAA and AE&P limits are treated as a recovery of basis and are treated as gain from the sale of the stock to the extent that basis is exceeded. I.R.C. § 1368(c)(3).
  - (d) The corporation, with the consent of all shareholders receiving distributions during the year, can elect to have distributions treated first as dividends to the extent of AE&P and next as a return of capital. I.R.C. § 1368(e)(3). This will be used principally to clean out AE&P so that the corporation will not be subject to the excess passive investment income rules.

- (3) A shareholder receiving property will take a basis in the property equal to its fair market value at the time of the distribution.

d. Tax consequences to the corporation.

- (1) The corporation's AAA and AE&P will be adjusted as provided in VI.C.2.c.(2). above.

- (2) Distributions of property.

- (a) Appreciated property.

- (i) The corporation is treated as if it sold the property to its shareholders for its fair market value and gain is recognized. I.R.C. § 311.

- (A) The exception for complete liquidations was repealed by the 1986 T.R.A.

- (B) An exception is made for property that is distributed in a reorganization (other than "boot").

- (ii) The resulting gain is treated like any other gain realized by the corporation.

- (A) It is taxed to the corporation to the extent provided in I.R.C. §§ 1374 and 1375.

- (B) It is allocated among all the shareholders (not just the ones receiving the distribution) under the normal rules.

(C) It will be treated as ordinary income if I.R.C. § 1239 applies.

(iii) Distributions can be used to absorb net operating loss carryovers and business credit carryforwards from C corporation years that would otherwise be wasted.

(A) Net operating loss carryovers can be used against the gain that would otherwise be taxed under new I.R.C. § 1374 (built-in gains of former C corporations) although not against the gain that would be taxed under old I.R.C. § 1374. I.R.C. § 1374(b)(2). S corporation years count as years under I.R.C. § 172 in using up net operating loss carryovers.

(B) Unused business credits from subchapter C years can be applied against the I.R.C. § 1374 tax.

(C) Capital loss carryovers from C corporation years can be applied against I.R.C. § 1374 gains. See I.R.C. § 1374(b)(2), as amended by TAMRA.

(b) Depreciated property.

(i) Losses are not recognized. I.R.C. § 311(b). (Losses are recognized on distributions in complete liquidation, subject to certain limitations.

- (ii) Consider selling the property to a third party.
  - (A) The corporation can deduct the loss and pass it through to the shareholders.
  - (B) The shareholders can buy similar property with the proceeds (although a prearranged purchase of the same property from the person who bought it from the corporation will be ignored).

#### VII. Stock redemptions.

- A. A stock redemption is a purchase by a corporation of its own stock.
- B. Uses of stock redemptions.
  - 1. Buy out a shareholder using corporate funds.
  - 2. Distribute corporate earnings or assets to shareholders.
- C. Problems typically encountered in planning stock redemptions for C corporations.
  - 1. If the redemption does not significantly reduce the interest in the corporation of the shareholder relative to those of other shareholders, the entire proceeds (not just the gain) will be treated as a dividend and taxed at ordinary income rates to the extent of the corporation's earnings and profits. I.R.C. §§ 302, 301, 316.
  - 2. Distribution of appreciated property results in recognized gain for the corporation. No loss is recognized on a distribution of depreciated property. I.R.C. § 311(b).



- D. Stock redemptions for S corporations.
1. Subchapter C concepts generally apply to S corporations and their shareholders. I.R.C. § 1371(a)(1).
  2. Significance of a determination under I.R.C. § 302 as to whether a redemption is a current distribution or a sale or exchange.
    - a. If the redemption is treated as a sale, only the shareholder's gain is taken into account. If it is treated as a distribution, the entire distribution is taken into account.
    - b. Under the October 1990 proposed regulations (§ 1.1361-1(1)), a redemption that is treated as a dividend would have resulted in the corporation being deemed to have more than one class of stock if it was not pro rata. This has been deleted in the August 1991 proposed regulations.
    - c. A current distribution to the extent that it is treated as a dividend has no independent tax significance other than its effect as a return of capital. It does not affect the allocation of the corporation's taxable income or loss among the shareholders. The shareholder is taxed only to the extent required under the AAA and AE&P rules.
    - d. A redemption that is treated as a distribution carries out subchapter C earnings and profits to the extent of the full proceeds. A redemption that is treated as a sale carries out only a pro rata portion of earnings and profits. I.R.C. § 312(n)(7).
  3. A redemption that reduces a shareholder's stock interest to less than two-thirds of what it was when the corporation acquired property with respect to which an investment tax credit was claimed may result in recapture of the credit. Regs. § 1.47-4.
  4. The rules applicable to current distributions of property also apply to distributions of property in redemption of stock. See VI.C. above.

5. When a redemption is used to buy out the interest of a shareholder, the shareholders can elect under I.R.C. § 1377(a)(2) to treat the taxable year as ending for purposes of allocating tax items among shareholders. This is a matter for negotiations among the parties.
6. Interest on a loan incurred by an S corporation to redeem a shareholder's stock is allocated among the different classes of interest under any reasonable method, including fair market value of the corporation's assets. Notice 89-35, 1989-1 C.B. 675. Ltr. Rul. 9116008.

VIII. Passing of control within the shareholder group.

- A. S corporations, like other closely-held businesses, require planning to ensure that control remains within the shareholder group and that an orderly transition occurs when control passes from one generation to the next. A shareholders' buy-sell agreement should be used to help accomplish these objectives.
- B. Many problems that must be addressed in a shareholders' agreement for a C corporation must also be addressed in an S corporation context. These include:
  1. Cross purchase v. stock redemption approach.
  2. Funding of buyout.
  3. Mandatory buyout v. option approach.
  4. Handling of disability.
- C. Special problems of a shareholders' agreement for an S corporation.
  1. An agreement for a C corporation might contain S corporation provisions that would take effect automatically when an S election becomes effective.
  2. Preserving the S election.
    - a. The agreement should prohibit the transfer of stock to an ineligible shareholder.

- (1) Types of prohibited shareholders should be mentioned in the agreement. A general reference should also be included in case the law changes.
  - (2) Transfers should be void and not merely voidable. Ltr. Rul. 7716014, revoked by Ltr. Rul. 7748034.
  - (3) The prohibition might be mentioned on the stock certificates and in the corporation's certificate of incorporation and bylaws.
  - (4) Shareholders should be required to notify other shareholders of proposed transfers so that the eligibility of the transferees can be determined.
- b. A shareholder who proposes to become an ineligible shareholder should be required to sell his stock to the corporation or other shareholders (e.g., an individual plans to become a nonresident alien).
  - c. If a beneficiary of a qualified subchapter S trust proposes to revoke consent to the S election, the trust should be required to sell its stock.
  - d. Restrictions on transfer imposed on some shareholders should not create a second class of stock. Rev. Rul. 85-161, 1985-2 C.B. 191.

3. Price formula.

- a. To the extent that the price is based on earnings, it should take into account the fact that the corporation is not subject to U.S. (and, perhaps, state and local) income taxes. Earnings should be reduced by applicable taxes (presumably at the individual rates).
- b. To the extent that the price is based on asset value, it might treat expected future distributions to cover shareholder taxes on current earnings as a liability.

4. The agreement might require the shareholders to consent to an I.R.C. § 1377(a)(2) election to close the corporation's books for income allocation purposes when a shareholder is completely bought out.
5. The agreement might require current distributions to shareholders at a certain level to help them meet their tax liabilities on the corporation's income. The distributions should be the same to all shareholders to avoid creating a second class of stock.

D. Estate freezes.

1. An estate freeze is a technique by which members of an older generation convert their interests in a business into ones that cannot appreciate in value so that future growth benefits only members of a younger generation whose interests are not similarly restricted. The use of estate freezes was severely limited by I.R.C. § 2036(c), added by the Revenue Act of 1987, but § 2036(c) was retroactively repealed by the Omnibus Budget Reconciliation Act of 1990.
2. Types of estate freezes.
  - a. Operating corporation is recapitalized and common stock of older generation members is converted into preferred stock that cannot receive more than its par value on liquidation. Common stock with only a nominal present value but which will benefit from all future growth in the corporation's business is then given or sold to members of the next generation.
  - b. Operating corporation is not recapitalized but its stock is transferred to a new holding corporation and the older generation members receive preferred stock of the holding corporation. The younger generation receives common stock of the holding corporation. (This is useful when there are nonfamily shareholders of the operating corporation.)
  - c. Operating corporation stock is transferred to a partnership. Older generation members receive partnership interests with rights analogous to those of corporate preferred

stock. Younger generation members receive partnership interests with unlimited growth potential. (This technique may be preferred over the holding company technique because of the repeal of the General Utilities principle.)

3. Some subchapter S rules may make it difficult to use a conventional estate freeze.
  - a. An S corporation may have only one class of stock.
  - b. An S corporation may not have a corporation or a partnership as a shareholder.
4. Estate freeze techniques that may be used with an S corporation.
  - a. Operating the business in a partnership owned by two S corporations.
    - (1) An S corporation owned by members of the older generation transfers its business assets to a partnership in exchange for a partnership interest that has rights similar to those of preferred stock (i.e., preferred return, fixed and limited rights on liquidation).
    - (2) Members of the younger generation form a new S corporation that transfers cash to the partnership in exchange for a partnership interest that has rights similar to those of common stock (i.e., no preferred return, unlimited interest in future growth).
    - (3) The partnership agreement can allocate voting power and generally be similar to that used in a conventional partnership freeze.
    - (4) New §§ 2701-2704, adopted by OBRA 1990 to replace § 2036(c), require the preferred interest to provide for a specified rate of return and meet certain other requirements to avoid immediate gift tax liability.

(5) Although a partnership cannot own stock in an S corporation, an S corporation can be a partner in a partnership. See, e.g., Ltr. Rul. 9050021.

b. The members of the older generation can give the members of the younger generation an option to buy their stock at the present value.

(1) The option should be paid for. Determining a value may be difficult.

(2) The I.R.S. may view this arrangement as a disguised gift. Dorn v. U.S., 828 F.2d 177, 60 AFTR2d 87-6135, 87-2 USTC ¶ 13,732 (3d Cir. 1987), rev'g 59 AFTR2d 87-1198, 86-2 USTC ¶ 13,701 (D.C. Pa. 1986).

## IX. Terminating the S election.

### A. Voluntary termination.

#### 1. Requirements.

a. The corporation must elect to revoke the S election. Temp. Regs. § 18.1362-3. Prop. Regs. § 1.1362-3(b)(1).

b. Shareholders holding more than 50% of the corporation's stock on the date on which the corporation revokes the S election must consent to the revocation. I.R.C. § 1362(d)(1)(B).

#### 2. Effective date.

a. A revocation made before the 16th day of the third month of the corporation's taxable year is effective as of the first day of the year. I.R.C. § 1362(d)(1)(C)(i).

b. A revocation made after the 15th day of the third month of the corporation's taxable year is effective on the first day of the next following year. I.R.C. § 1362(d)(1)(C)(ii).

c. The revocation may specify that it will be effective on any prospective date. I.R.C. § 1362(d)(1)(D). It must refer to a specific date and not to the day on which an event occurs. Prop. Regs. § 1.1362-3(b)(3).

3. A revocation can be rescinded before it becomes effective. Prop. Regs. § 1.1362-3(b)(5). The I.R.S. believes that it lacks statutory authority to allow a revocation to be rescinded after it becomes effective. Ltr. Ruls. 8927043, 8524024, 8336029, 8252147.

B. Involuntary termination.

1. Cause of involuntary termination.

a. Excess passive investment income. See VI.A. above.

b. Failure to meet the eligibility requirements for S corporation status.

(1) The termination is effective on the date on which the requirements are no longer met. I.R.C. § 1362(d)(2)(B).

(2) It is no longer possible (as it was before 1983) to terminate an S election retroactive to the first day of the year by arranging a disqualifying event.

2. I.R.S. waiver of inadvertent termination.

a. The I.R.S. may disregard a termination and treat the S election as continuing under certain circumstances. I.R.C. § 1362(f).

(1) The I.R.S. determines that the termination was inadvertent (e.g., resulting from error of a professional advisor. See Ltr. Ruls. 9108007, 9108017).

(2) Within a reasonable time after the terminating event is discovered, steps are taken to restore S corporation status.

- (3) The corporation and all affected shareholders agree to adjustments required by the I.R.S. The adjustments will generally be those necessary for the corporation and its shareholders to be treated as if the S election was continuously effective. Prop. Regs. §§ 1.1362-5(e) and (f).
  - (4) This procedure applies only to a termination of a valid S election. It is not available to save an invalid S election. Ltr. Rul. 9115003 (corporation had two classes of stock at time of initial election).
- b. The I.R.S. has ignored terminations under this provision under circumstances such as the following:
- (1) Transfer of stock to ineligible shareholder. Ltr. Ruls. 9107018, 9036027, 9028016, 9003017, 8911017, 8839025, 8839034, 8839040.
  - (2) Failure to distribute earnings and profits from C corporation years (Ltr. Rul. 8848065) or when unexpected decline in active business income caused passive income to be excessive (Ltr. Rul. 9038046).
  - (3) Failure of qualified subchapter S trust beneficiary to consent to election. Ltr. Ruls. 9007012, 9003055, 8847082, 8848029, 8848056.
  - (4) Failure of qualified subchapter S trust to distribute all of its income currently. Ltr. Ruls. 9026024, 9018008, 8850035.
  - (5) Purchase or organization of 80% subsidiary. Ltr. Ruls. 9034013, 9022031, 9018044, 8838046, 8842022, 8842023, 8914033, 8917038.
  - (6) Surrender of "green card" by nonresident alien shareholder. Ltr. Ruls. 8926057, 8926058.



C. Treatment of year of termination.

1. If the S election terminates during the S corporation's taxable year, the year is divided into two short taxable years: an S year and a C year. I.R.C. § 1362(e)(1).
2. Allocation of income and loss between the S and C years.
  - a. If there is a sale or exchange of 50% or more of the corporation's stock during the year, each short year is allocated those items that would normally fall within it under the corporation's normal accounting method (the "closing the books" method). I.R.C. §§ 1362(e)(6)(D).
  - b. If there is not a sale or exchange of 50% or more of the corporation's stock during the year, items are allocated between the S and C years based on the number of days in each (the "pro rata method") unless the corporation elects to use the closing the books method and all persons who were shareholders at any time during the S short year and on the first day of the C short year consent. I.R.C. §§ 1362(e)(2) and (3).
    - (1) Election procedures are set forth in Prop. Regs. § 1.1362-4(c)(2).
    - (2) In any event, the pro rata method does not apply to income resulting from an I.R.C. § 338 election. Prop. Regs. § 1.1362-4(c)(3).
    - (3) An extension of time to make the election may be allowed under Regs. § 1.9100-1 if good cause is shown. See Ltr. Rul. 9115002 (extension allowed where election was not filed because of accountant's oversight).
3. The corporation's income for the C short year is taxed on an annualized basis. I.R.C. § 1362(e)(5)(A).

4. The S short year is disregarded in determining any carryback or carryforward period. I.R.C. § 1362(e)(6)(A).
5. The tax return for the S short year is due on the same date as is the return for the C short year. I.R.C. § 1362(e)(6)(B).

D. Re-election of S corporation status.

1. If an S election terminates (voluntarily or involuntarily), the corporation or any successor may not make another S election until the fifth taxable year beginning after the first termination year without I.R.S. consent. I.R.C. § 1362(g).
2. Definition of successor corporation.
  - a. The regulations under old § 1372(f) provided and the Proposed Regulations provide that a successor is any corporation:
    - (1) 50% or more of the stock of which is owned by persons who owned 50% or more of the S corporation's stock at any time during the first termination year, and
    - (2) acquires a substantial portion of the S corporation's assets or of the assets of which were assets of the S corporation. Regs. § 1.1372-5(b). Prop. Regs. § 1.1362-6(b).
  - b. A corporation that bought the stock of an S corporation from unrelated shareholders and liquidated it under old § 334(b)(2) was held not be a successor to the S corporation. Rev. Rul. 77-155, 1977-1 C.B. 264.
3. The I.R.S. has been willing to consent to re-elections within the five-year period when it is satisfied that taxpayers are not deliberately moving in and out of S for tax avoidance purposes. Rulings have been granted when there was a 50% or more change in ownership (Ltr. Ruls. 8910076, 8847004, 8847038) and when the

original S election was revoked retroactively to its first day (Ltr. Ruls. 9034036, 9022023, 9005018, 9003019, 8930010).

4. The I.R.S. has indicated that it will consent to an S election under I.R.C. § 1362(g) in the case of a corporation whose S election was revoked or terminated before October 22, 1986 and which elects subchapter S before January 1, 1987 or, in the case of a corporation qualifying for the small business exception to General Utilities repeal under T.R.A. 1986 § 633(d), before January 1, 1989.
5. A termination will not be deemed to occur and no new election will be necessary if an S corporation reincorporates in another state in a reorganization under I.R.C. § 368(a)(1)(F).  
Ltr. Rul. 8914003.