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Income and Estate Tax Planning with Subchapter S Corporations

Robert J. Hipple

Barbara C. Hipple

INCOME AND ESTATE TAX PLANNING WITH SUBCHAPTER S CORPORATIONS*

ROBERT J. HIPPLE AND BARBARA C. HIPPLE

Introduction

The purpose of our brief presentation this afternoon is to review the recent changes in the Subchapter S corporation tax rules and to focus on some income and estate planning possibilities which are available with the Subchapter S corporation. To accomplish this purpose, we have divided our presentation into three broad categories. First, we will briefly summarize the history, election requirements and operating rules for Subchapter S corporations in view of the significant changes made by the Subchapter S Revision Act of 1982.[1] Second, we will compare the Subchapter S corporation with a normal corporation under Subchapter C[2] and with a partnership, mentioning some appropriate planning possibilties. Finally, we will focus on some estate planning opportunties, and problems, for stock in a Subchapter S corporation held by a decedent.

For purposes of today's presentation, we are assuming a general familiarity with the Subchapter S corporation, its requirements and its operation, and the discussion will focus primarily on the changes that have occurred in this area, the effect of the changes, and the planning methods which have continued or been created by the new legislation.

History, Election Requirements and Operating Rules

The Subchapter S corporation, also known as the "small business corporation" and the"tax option corporation", was created in 1958 with the addition of Sections 1371 through 1377 to the Internal Revenue Code.[3] The stated purpose of the addition of these provisions and the Subchapter R partnership provisions (Sections 1361 through 1365) was to eliminate, or at least to minimize ,federal income tax considerations in the choice of an appropriate form of business.[4] The

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*Due to unforeseen circumstances, the Hipples were unable to deliver their talk. Professor Glenn E. Coven, Jr. delivered an outstanding impromptu address on the same topic, for which the Tax Conference body is deeply grateful. Professor Coven's excellent presentation was enriched by the participation of Professor John W. Lee, III.

[1] P.L. No. 97-354.

[2] The reference to "Subchapter S" is derived from the location of the applicable tax rules in Title 26, Chapter 1, Subchapter S of the United States Code, and the reference to "Subchapter C" is to the normal corporate tax rules found in Title 26, Chapter 1, Subchapter C of the United States Code.

[3] P.L. 85-866.

[4] S. Rep. No. 1983, 85th Cong., 2d Sess. 87 (1958).

Subchapter R partnership, a partnership under state law which elected to be taxed as a corporation for federal income tax purposes, found little favor among tax practitioners or business owners and was ultimately repealed. The election provided by the original statutory enactment of Subchapter S became a popular election, since it permitted a corporation for state law purposes to elect to be treated, for federal income tax purposes, in a manner similar to, but not identical with, a partnership for federal tax purposes.[5] This original statute, however, created a number of artificial limitations and potential traps for the unwary, which frequently made compliance with the statutory requirements difficult and the risk of possible adverse tax effects considerable.

Among the Subchapter S corporation problem areas was the requirement that a new shareholder of an existing Subchapter S corporation file a written consent to the election to prevent automatic termination of the election.[6] The effect of this was that the new shareholder received what amounted to an absolute veto over the existing tax status of the Subchapter S corporation, which affected only the other shareholders and not himself. This consent requirement was aggravated by the fact that the termination of the Subchapter S election, even if inadvertent, resulted, among other things, in the elimination of each existing shareholder's previously taxed income left in the corporation, a result which was likely to lead to double taxation of the same income to the shareholders. Other problem areas included the limitation in the Subchapter S requirements to a single class of stock ownership in the corporation, making corporate planning difficult, particularly in view of the uncertain status of corporate debt, which could be characterized by the Internal Revenue Service as equity and then be treated as a second class of stock.[7] Finally, the limitation on the number of shareholders and the type of shareholders of the Subchapter S corporation was frequently cited as a major barrier to its use for estate or business planning.[8] As many of you will recall, originally a Subchapter S corporation could only have ten or fewer shareholders who were individual U.S. persons.[9] These restrictions led to artifices to avoid their effect and to inadvertent election terminations, which had the inevitable consequence of frequent, and sometimes inconclusive, litigation.

Finally, in response to frequent complaints from tax practitioners and because of the growing confusion resulting from the litigation in the area, Congress began modifying the substantive Subchapter S rules to ease some of the restrictions. The statutory changes, which began

[5] *See,* Sections 1371-1377 of the Internal Revenue Code of 1954, as amended (hereafter referred to as the "Code").

[6] Former Code Section 1372(e)(1).

[7] Code Section 1731(a)(4).

[8] Code Sections 1371(a)(1) and (2).

[9] Former Code Section 1371(a)(1).

with the Tax Reform Act of 1976[10] and have continued with more recent tax legislation, increased the number of authorized shareholders of the Subchapter S corporation, changed the election requirements, and expanded the group of qualified shareholders of a Subchapter S corporation to include certain kinds of trusts. These amendments, however, were "stop-gaps" and it was not until the Subchapter S Revision Act of 1982 was enacted that the reform process was considered, at least temporarily, to be completed.

At this point, it is appropriate to review the statutory requirements for qualification and election as a Subchapter S corporation and the tax consequences of the operation of a Subchapter S corporation after the recent Subchapter S Revision Act. We will refer from time to time to a "Subchapter S corporation" although the Subchapter S Revision Act of 1982 has, by statute, created different terminology. Under the Act, two different types of corporations have now been specifically identified, the S corporation and the C corporation, referring to the corporation under Subchapter S and the corporation under Subchapter C of the Internal Revenue Code, respectively.[11]

In order to qualify as an S or Subchapter S corporation for federal income tax purposes, the corporation must affirmatively elect[12] to be so treated and must meet certain statutory requirements:

1. It must be a "small business corporation", which is defined as a domestic corporation that is not an "ineligible corporation".[13] An ineligible corporation is defined[14], in turn, as a foreign corporation, a member of an affiliated group of corporations and certain specially taxed corporations such as insurance companies and domestic international sales corporations. The affiliated group limitation is, perhaps, the most important one since it prevents an S corporation from having a subsidiary corporation the stock of which is owned 80 percent or more, by the S corporation.[15]

2. In addition, in order to qualify for the Subchapter S election, the corporation must not have more than 35 shareholders.[16]

3. There can be no shareholders who are not either individuals, the estate of an individual, or certain carefully defined trusts.[17] No shareholder can be a non-resident alien.[18]

4. There still may be only one class of stock.[19]

[10] P.L. 94-455.
[11] Code Section 1361(a).
[12] Code Section 1362(a).
[13] Code Section 1361(b).
[14] Code Section 1361(b)(2).
[15] Code Section 1361(b)(2)(A).
[16] Code Section 1361(b)(1)(A).
[17] Code Section 1361(b)(1)(B).
[18] Code Section 1361(b)(1)(c).
[19] Code Section 1361(b)(1)(b).

The thirty-five shareholder limitation is fixed at that number to conform to the private offering exemption under Section 4(2) of the Securities Act of 1933 and Regulation "D" issued by the Securities and Exchange Commission under that exception. In counting the thirty-five shareholders, joint owners are considered as separate shareholders, except husband and wife, whether owning stock jointly or separately, are considered to be a single shareholder.[20] However, it should be noted that a husband and wife owning stock in a Subchapter S corporation who are later divorced, immediately are treated as separate shareholders and must be counted separately in complying with the thirty-five shareholder limitation. If, prior to the divorce, there were thirty-five shareholders of the S corporation, then the divorce would automatically terminate the Subchapter S election unless steps were taken prior to the divorce to avoid the problem.

If a corporation meets the qualification requirements, then the Subchapter S election may be made by filing Treasury Form 2553, which must be signed by each of the electing corporation's shareholders.[21] In the event you are in the process of electing Subchapter S status for a corporation and are using Treasury Form 2553 in its present form, the Internal Revenue Service may be returning it to you for the inclusion of the tax year, for federal income tax purposes, of each of the shareholders. This information is not a part of the current Form 2553, but is now being required by the Service because of the new provision added by the Subchapter S Revision Act limiting the choice of a fiscal year by new Subchapter S corporations to a calendar year or the fiscal year of its major shareholders. Therefore, if you are working with the existing Form 2553, you should add to the form, under the name of each shareholder, information regarding that shareholder's tax year for federal tax purposes.

If the corporation is eligible to make the election, and all of the shareholders consent to it by signing the election form, then the corporation will be treated as an S corporation for a particular tax year if the election has been filed either during the preceding tax year or on or before the fifteenth (15th) day of the third month of the tax year of the corporation for which the election is to be effective.[22] Thus, for example, a properly executed election filed for a calendar year corporation at any time between March 16th, 1984 and March 15, 1985 will be effective for 1985. A properly executed election filed anytime between March 16, 1983 and March 15, 1984 will be effective for the entire calendar year 1984. Note, however, if the election is filed during 1984 to be effective in 1985, the election will be effective for 1985 only if the corporation qualifies as a small business corporation in 1985 in

[20] Code Section 1361(c)(1).
[21] Code Section 1362.
[22] Code Sections 1362(a) and (b).

all other respects. Once the election has been made and has become effective, which is evidenced by a notification of effectiveness from the Internal Revenue Service, it remains in effect for the entire tax year of the election and for all succeeding tax years until the election is terminated in one of the manners provided in the Internal Revenue Code.[23]

Under the current Subchapter S rules, the corporation is regarded as a corporation for federal income tax purposes except to the extent that the Subchapter S rules overide the normal corporate tax rules of Subchapter C. The major differences are: the Subchapter S corporation is exempt from most federal income taxes and its tax treatment is analagous to, but not identical with, federal partnership taxation; the Subchapter S corporation is treated as an individual taxpayer rather than as a corporation in its status as a shareholder of another corporation[24]; a special rule exists for recognition of gain on distribution of appreciated property by a Subchapter S corporation[25]; and the S corporation itself is not subject to the corporate personal holding company tax, the accumulated earnings tax or the add-on minimum tax.[26] In fact, one of the stated purposes of the Subchapter S Revision Act was to make Subchapter S taxation closer to that of the partnership for federal tax purposes.[27] Nonetheless, there still are a number of crucial differences in the federal income tax treatment of the corporation and a partnership. The Act also had the effect of overruling a number of prior rules which had become beneficial planning devices. These included the right of the Subchapter S corporation to elect any fiscal year it desired, which has now been eliminated, as noted earlier.[28] In addition, qualified retirement plans of Subchapter S corporation have now been made identical to those for partnerships.[29] All items of income, deduction, credit and loss are passed through to the stockholders of the Subchapter S corporation on a daily basis, as is true for partnerships, which means that the old device of transferring stock in a Subchapter S corporation near the end of the corporation's fiscal year, and thereby transferring all of the income of the Subchapter S corporation allocable to the transferred stock to the transferee, is no longer available.[30]

When a Subchapter S corporation is created by the transfer of property in return for the stock, the federal income tax consequences are essentially the same as they are for any normal corporation under Subchapter C of the Code.[31] However, in the general day-to-day operations

[23] Code Section 1362(c).
[24] Code Section 1371(a)(2).
[25] Code Section 1365(d).
[26] Code Section 1363(a).
[27] S. Rep. No. 97-640, 97th Cong., 2d Sess. 1 (1982).
[28] Code Section 1378.
[29] Code Section 1372.
[30] Code Section 1366.
[31] *See,* generally, Code Section 351.

of the Subchapter S corporation, the tax consequences are significantly different since gain and loss are passed through the corporation to its shareholders on a per-day, per-share basis and the corporation generally is not subject to income tax at the corporate level. A Subchapter S corporation will compute its taxable income in generally the same manner that a partnership computes its taxable income under Subchapter K except that the S corporation is allowed to amortize its organizational expenses under Section 248 of the Code, rather than under the slightly less beneficial partnership formula.[32] The Subchapter S corporation will be liable for capital gains tax on certain capital gains and, in particular circumstances, on passive investment income realized by the Subchapter S corporation.[33] The capital gains tax rules have not been changed significantly by the Subchapter S Revision Act, and gains in excess of twenty-five thousand dollars ($25,000) annually are still subject to tax, unless a stated exception applies.

On the other hand, the taxation of passive investment income departs significantly from prior rules, which terminated a Subchapter S election if passive investment income in excess of a relatively small percentage of gross receipts was received in a taxable year by an S corporation. Under the new rule,[34] receipt of passive investment income, by itself, will not terminate the Subchapter S election (with one exception), but receipt of passive income will subject the corporation to a tax equal to forty-six percent of the net passive investment income in a taxable year, multiplied by a fraction, the numerator of which is the passive investment income exceeding twenty-five percent of gross receipts and the denominator of which is passive investment income for the year. This provision only applies, however, if the corporation possesses accumulated earnings and profits from a tax year when it was taxed as a regular Subchapter C corporation, or earned prior to December 31, 1982, the effective date of the Subchapter S Revision Act, and if more than twenty-five percent of the corporation's gross receipts for the year are passive investment income. If both of these conditions are not met, then the corporation is not subject to this "passive income" tax.

One other change made by the 1982 Act was the addition of the capital gains tax to a Subchapter S corporation on the distribution of appreciated property by the corporation to its shareholders, either in redemption of its stock or as a dividend.[35] The difference between the basis of the property and its fair market value at the time of distribution is capital gain, receiving standard capital gains tax treatment in the year of distribution.

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[32] Code Section 709.
[33] Code Sections 1374, 1375.
[34] Code Section 1375.
[35] Code Section 1365(d).

The conduit theory of taxation of the Subchapter S corporation is now applied consistently at the shareholder level so that each shareholder includes, on a pro-rata basis, each item of income, loss, deduction or credit of the Subchapter S corporation on his personal income tax return as if each item had been realized or incurred by him directly from the same source from which it was realized or incurred by the corporation.[35] To carry out this principle, the Code creates a category of "separately stated" items and "nonseparately stated" items of the Subchapter S corporation for each year.[37] In basic terms, a separately stated item is any item of income, loss, deduction or credit of the corporation which would affect the individual shareholders' returns if it were separately included on the Subchapter S return rather than included on an aggregate basis. Examples of this would be investment tax credit items, charitable deductions, and depreciation, all of which are subject to limits or minimum tax computations if they are separately included on the individual shareholder's return. To the extent that any items are not separately stated (that is, have no individual impact on the shareholder's return), then each shareholder includes a proportionate part of those items on an aggregate basis.

As was true of Subchapter S reporting prior to the 1982 Act, each shareholder of the corporation will include in his individual income tax return his pro-rata share of each item of income, loss, deduction or credit for the year in which or with which the taxable year of the S corporation ends.[37] Since most S corporations will now be on a calendar year basis, the reporting of the S items and the individual items will parallel one another and individual shareholders will include on their income tax return for their calendar year their pro-rata share of the Subchapter S items for its same calendar year. In the case of a shareholder who dies during a Subchapter S corporation year, his final individual income tax return for the period up to the date of death includes a proportionate share of the Subchapter S corporate income, on a per-share per-day basis, from the beginning of the Subchapter S corporate year through his date of death.[39]

As mentioned earlier, an old planning device—transferring S corporation stock prior to the last day of the tax year in order also to transfer taxation of that stock's proportionate share of the corporate income for the entire year—is no longer available. Under the new Subchapter S Revision Act, Section 1377 of the Code has been amended to provide that each shareholder must include in his income his pro-rata share of the income of the corporation on a per-share, per-day basis, even though

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36 Code Sections 1366, 1377.
37 Code Section 1366(a).
38 Code Section 1377(a).
39 Code Section 1366(a)(1).

the total corporate income is not ascertained until the end of the corporate tax year. An S shareholder who is contemplating selling or otherwise transferring his stock during the year therefore must give consideration to the potential income of the corporation during the period after he will have transferred his stock. If the corporation realizes substantial post-transfer income, the transferring shareholder will be taxed on a proportionate part of that income, since the income allocation is done on the corporation's year-end income figures. This is true even though the shareholder who has transferred his shares will never actually receive any distribution based on income earned after he has transferred his shares. Because of the potential problems caused by this taxation to the individual of income he will never be in a position to receive, the Act has added a provision such that, if all shareholders consent, the pro-rata allocation to a transferring shareholder may be made as if the taxable year of the corporation ended on the date of the transfer and the new shareholder will be responsible for the post-transfer income, again on a per-share, per-day basis.[40] The exact method and mechanics of the election have not yet been finalized but will be done by Treasury Regulations to be issued later.

Although the method of allocation has changed, the basic rule governing the shareholder's right to utilize deductions and losses of an S corporation has not changed significantly. Thus, a shareholder of an S corporation may claim losses and deductions of the corporation equal to his proportionate share of the total losses and deductions of the corporation for the entire year, but, under Section 1366(d)(1) of the Code, he may not deduct such losses or deductions in an amount in excess of the total of his adjusted basis in his stock in the corporation, plus his adjusted basis in any debt of the corporation owed to him. A major change from prior law, however, is that a shareholder now may carry over losses in excess of his adjusted basis in his corporate stock and debt indefinitely to future tax years until he has sufficient basis to allow the excess losses or deductions to be claimed.[41] Under prior law, if deductions or losses in one year exceeded his basis in his corporate stock and debt, the excess was lost and could never be claimed by the shareholder.[42]

Another significant change from prior law is that any disallowed losses, either from the current year or from prior years, may still be claimed by a shareholder for a period of up to one year after termination of Subchapter S status if his basis in the stock, but not in any debt owed to him by the corporation, is restored.[43] As under prior law, the shareholder's basis in corporate stock or debt held by him is subject to

[40] Code Section 1377(a)(2).
[41] Code Section 1366(d)(2).
[42] Former Code Section 1374.
[43] Code Section 1362(d)(2).

annual adjustments to reflect his proportionate share of each item of corporate income, deduction and loss for the year, and of any distribution made during the year.[44]

The rules governing taxation of distributions from a Subchapter S corporation to its shareholders were altered by the 1982 Subchapter S Revision Act to more closely parallel the partnership distribution rules. Under the Act, an actual distribution will be taxed in one of two ways, depending upon whether the Subchapter S corporation has accumulated earnings and profits at the time of the distribution. It should be noted that an S corporation organized after December 31, 1982 is never considered to have accumulated earnings and profits from its own operations and, therefore, always will be taxed under the simpler of the two methods. On the other hand, a Subchapter S corporation existing prior to December 31, 1982, or a C corporation which has subsequently elected to be treated as an S corporation, or a Subchapter S corporation, organized either before or after December 31, 1982, which has acquired another corporation resulting in a carry-over of earnings and profits, may have accumulated earnings and profits which will cause application of the more complex method of taxation of distributions. In summary, the two different methods are as follows:

1. (Simpler Method)—If the corporation does not have accumulated earnings and profits, then a distribution to the shareholder from the corporation will be tax-free so long as the distribution does not exceed the shareholder's adjusted basis in his stock in the corporation. If it does exceed his basis in the stock, the excess is treated as a capital gain.[45]

2. (More Complex Method)—If the corporation has accumulated earnings and profits, a distribution is tax-free until the corporation's "accumulated adjustment account" is fully utilized, although the corporation may elect to apply the distribution first against any accumulated earnings and profits. Any distribution in excess of the "accumulated adjustment account" is treated as a taxable dividend (under Section 301 of the Code) to the extent of accumulated earnings and profits. Any distribution in excess of these first two amounts then reduces the shareholder's basis in his stock and any excess remaining after the stock basis has been fully utilized is treated as a capital gain. For purposes of the calculation, the "accumulated adjustment account" is essentially the total net undistributed income which had been passed through the Subchapter S corporation to the shareholders during its most recent election year.[46]

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[44] Code Section 1367(a).
[45] Code Sections 1371(c), 1368(b).
[46] Code Section 1368(c).

The timing of a distribution from an S corporation is not as crucial as it once was, because under both methods the distribution is first measured against previously-taxed items, either by offsetting the accumulated adjustment account or by offsetting stock basis. However, distributions during the middle of a corporation's tax year still must be planned carefully since neither the amount of the shareholder's basis nor the amount of the accumulated adjustment account will be known until the end of the corporation's tax year. An S corporation may still make distributions, after the S election is terminated, on a tax-free basis to the extent of the corporation's accumulated adjustment account, but distributions in that case must be in cash rather than property, and must be made generally within one year of the termination of the election.[47] Any distributions after this transition period will be subject to tax in accordance with the rules dealing with Subchapter C corporations, notwithstanding the fact that such distributions may, in part, reflect income previously taxed to the shareholders under Subchapter S rules.

Unlike prior law, the Subchapter S Revision Act permits the transfer of previously taxed income from one shareholder to another. This results from the fact that distributions are measured solely against basis in the stock and the accumulated adjustment account for the year. While this rule governs the tax effect of distributions, it nevertheless does not take into consideration a practical, non-tax consideration. A shareholder transferring his stock in the corporation when there is undistributed income at the corporate level, on which he has personally paid tax, will not, after the stock transfer, receive a distribution of that income, since he will no longer be a shareholder. Therefore, he must attempt to have undistributed income reflected in the purchase price of the stock to compensate for the fact that he has paid the tax on the income.

The rules governing the revocation or termination of a Subchapter S election were changed in the Subchapter S Revision Act in an attempt to eliminate inadvertent termination or the ability of a single shareholder to terminate the election, notwithstanding the desires of all other shareholders. Therefore, generally, the election will no longer be terminated if the corporation has more than twenty percent of its gross receipts from passive investment income[48] or if it derives more than eighty percent of its gross receipts from non-U.S. source income.[49] One exception to the new rule that receipt of passive investment income in excess of twenty percent of gross receipts no longer terminates the Subchapter S election occurs if a corporation with that amount of passive investment income has accumulated earnings and profits for three consecutive taxable years

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[47] Code Section 1371(e).

[48] Code Section 1362(d)(3).

[49] Section 2, Subchapter S Revision Act, repealing former Code Section 1372(e)(4).

after the Subchapter S election, and during those three consecutive years more than twenty-five percent of its gross receipts are derived from passive investment income.[50] If Subchapter S status is terminated on this basis, the termination occurs at the beginning of the taxable year following the third taxable year. A new shareholder who does not wish to continue the election can no longer terminate the S status alone unless he or she owns a majority of the stock. Section 1362(d)(1) of the Code now provides that shareholders owning more than half of the total shares of stock outstanding may revoke the election by filing a consent to revocation. If there is a revocation of the election, it will become effective for the tax year following the year of the election to revoke unless the revocation is made on or before the fifteenth day of the third month of the tax year. If an election is made that soon, it is effective for the entire tax year in which it is made.[51]

If the election is terminated because the corporation no longer satisfies the statutory requirements for a small business corporation, then the termination will be effective from the date on which it first fails to qualify.[52] This eliminates the "last chance" planning opportunity under prior law of deliberately causing a Subchapter S corporation to fail to qualify as a small business corporation near the end of a tax year after determining that the tax consequences would be better if it were treated as a C corporation for the entire year.

If the Subchapter S election terminates, whether on a voluntary or an involuntary basis, other than at the end of the tax year, then two short tax years are created for purposes of determining the tax liability of both the corporation and its shareholders.[53] One year is termed the S short year and the other the C short year. The corporation must file separate tax returns with respect to each of the two short years,[54] using one of two methods to determine the allocation of the taxable income to the two short years, the annualized method, or, if all the shareholders elect, a method based upon the actual books and records of the corporation. If the annualized method is used, the taxable income for the full year of the termination is calculated and then allocated between the two short years on the basis of the number of days in each short year in relation to the full tax year.[55] Once the allocation is made on this basis, each shareholder includes in his personal tax return his pro-rata, per-day share of each item of income, loss, deduction or credit, under the normal Subchapter S rules, for the S short year, and the corporation determines its own tax liability for its C short year. However, in deter-

[50] Code Section 1362(d)(3).
[51] Code Section 1362(d)(1).
[52] Code Section 1362(d)(2).
[53] Code Section 1362(e).
[54] Code Section 1362(e)(6)(B).
[55] Code Section 1362(e)(2).

mining its tax liability for the C short year, it must annualize that income by computing the tax on total taxable income for the year and then multiplying that total tax liability by a percentage representing the number of days the C short year is of the entire terminating year. The other method, based on the corporate books and records, permits the corporation to close its books as of the termination date so that each shareholder will calculate his proportionate share of the corporate items, under the normal Subchapter S rules, through the date of termination.[56] The corporation itself will then pay tax for the C short year based upon the separate taxable income of the corporation as shown on the books for the balance of the year of termination, again annualizing that income by using a mechanical process which applies the corporate tax rate as if the income earned in the C short year had been earned at the same rate for the entire tax year and then allocating the resulting tax proportionately to the C short year only.

Once the Subchapter S election is terminated, whether voluntarily or involuntarily, Section 1362(g) of the Code precludes a re-election of S status for a period of five taxable years from the effective date of the termination or revocation. The Code now contains a provision, however, which permits the Internal Revenue Service to treat an election as continuing if the termination is deemed inadvertent, to prevent undue hardship.[57] Under the effective date provisions of the Subchapter S Revision Act, the five year period during which a new election cannot be made applies only to terminations covered under the amendments made by the Subchapter S Revision Act, so a corporation which terminated its election prior to December 31, 1982 could now re-elect Subchapter S status immediately, even though a similar five year prohibition period existed under the law prior to 1983.

Comparison of "S" Status With Other Business Forms

The second major area which we would like to cover briefly today is a comparison of the Subchapter S corporate form with the other common organizational structures used for business purposes: the general partnership and the normal corporation taxed under Subchapter C of the Code. Generally, non-tax considerations, such as limited liability, free transferability of interest, centralized management and continuity of life, tend to favor the corporate form over the partnership form. The Subchapter C corporate form would be preferable to the Subchapter S form in many instances due to the more rigid qualification requirements for the Subchapter S corporation. However, tax considerations would frequently outweigh non-tax considerations, despite the attempt by Con-

[56] Code Section 1362(e)(3).
[57] Code Section 1362(f).

gress to make tax considerations relatively neutral in the choice of business form. For comparison purposes, we will look at several broad general areas, including creation of the entity, operation of the business entity, the results of distributions from the entity, the treatment of the sale of an interest or the death of an owner of an interest in the entity and, finally, the estate planning considerations with the different entities.

For tax purposes, there are now only a few differences between the Subchapter S corporation and a partnership, although some of those differences should be noted. First, a partnership may permit a larger pass-through of losses since partnership debt is taken into account in determining a partner's basis[58] while borrowings of the Subchapter S corporation are irrelevent to his stock basis. For this reason, a Subchapter S corporation is relatively less attractive as a tax shelter entity than a partnership. Second, income and losses may not be specially allocated among stockholders in a Subchapter S corporation, while special allocations can be accomplished in the partnership form, although with restrictions, particularly when there is no significant economic reason for a special allocation.[59] Third, a Subchapter S corporation is also potentially liable for tax on capital gains and on passive investment income in some circumstances, while a partnership would never be subject to tax for either of these items.

Taxation of income from operations is significantly different for a Subchapter C corporation as opposed to an S corporation or a partnership. Thus, an S corporate loss or a partnership loss can be passed through to its owners while a C corporate loss is available only to the entity itself. Even when operations are on a profitable basis, Subchapter S or partnership form may be preferable in view of the reductions in the top marginal individual income tax rates since 1981. The Subchapter C corporation offers somewhat more flexibility in income and estate planning than does the Subchapter S corporation, or the partnership. Income of a regular corporation can be reallocated easily by making a gift or other transfer of the Subchapter C stock since a transfer is subject only to such general principles as the anticipatory assignment of income doctrine. There are no statutory limitations on the Subchapter C corporation which are designed to assure that reasonable compensation is paid for the donor's capital invested in the corporation or the donor's services rendered to the corporation, as is the case for both a partnership[60] and a Subchapter S corporation.[61] Subchapter S status on the other hand encourages the minimization of compensation income to reduce the social security tax burden. However, since deferred compensation plans are generally based upon corporate salaries and since

[58] Code Section 752.
[59] Code Section 704(b).
[60] Code Section 704(e).
[61] Code Section 1366(e).

state tax rules may not recognize Subchapter S treatment, it may still be advisable to pay substantial corporate salaries from the Subchapter S corporation, depending upon the circumstances. Although the changes made in the federal tax laws during 1982 have eliminated many of the advantages formerly existing for the Subchapter C corporation in the fringe benefit area, it is still generally a preferable form to the partnership or the Subchapter S corporation in that regard.

In the area of distributions, it is the general rule that a distribution from a partnership will be nontaxable to a partner[62] while distributions by a Subchapter S corporation or a Subchapter C corporation may or may not be taxable, depending upon the circumstances. A distribution of property with a value in excess of the basis of a partner is not taxable to the partner, while a distribution of property in excess of a shareholder's basis in a Subchapter S corporation will generally be taxable to him.

There are also a number of differences in the income tax treatment on the death of an owner of the entity or on the sale of an ownership interest. Death of a shareholder in either a Subchapter S or a Subchapter C corporation will have no effect whatsoever on the basis of assets held by the corporation, while death of a partner or sale of a partnership interest can have a direct effect on the partnership's basis in its assets if the partners make an election under Section 754 of the Internal Revenue Code. Differences also exist with respect to what would be included in the final income tax return of a deceased stockholder or partner since the final tax return of a deceased shareholder of a Subchapter C corporation would include only dividends and other distributions actually received by him prior to death, while the final return of a Subchapter S shareholder would include a pro-rata share of income and losses for the corporate tax year up to the date of death,[63] and the final tax return of a deceased partner would include none of the partner's proportionate share of partnership income from the beginning of the partnership year up to the date of death.[64] Rather, the partner's share of such income would be treated as income in respect of a decedent, reportable by the decedent's estate or other beneficiary receiving it.

Planning for Subchapter S Corporations

Before turning specifically to estate and family planning aspects of the Subchapter S corporation, a number of general planning comments are in order. Since termination of the S status can cause substantial hardship to its shareholders unless that termination has been planned, precautions against an inadvertent noncompliance with the statutory

[62] Code Section 731(a).
[63] Code Section 1366(a)(1).
[64] Treas. Regs. 1.706-1(c).

requirements should be taken. Consideration should be given to eliminating the risk of a transfer to an ineligible shareholder by executing buy-sell agreements and placing legends on stock certificates. It has even been suggested, although the theory has not been finally tested with the Internal Revenue Service, that the stock in a Subchapter S corporation should be restricted by a buy-sell agreement containing a power of attorney which authorizes the automatic cancellation of a stock certificate, retroactively, immediately upon its transfer to a non-qualified shareholder, with appropriate language providing for compensation to that non-qualified shareholder. Other planning concerns that must be dealt with include requiring distributions by S corporations which have accumulated earnings and profits from non-Subchapter S status years in order to avoid a termination of the Subchapter S status under the passive income rule, and providing for redemption or other termination of stock interests held by a trust or an estate which are eligible shareholders in the Subchapter S corporation only for certain periods of time. Although the old planning device of choosing a Subchapter S fiscal year is no longer available, some delay in tax reporting can still be accomplished through the use of a qualified trust as an eligible shareholder of the corporation. It should be noted that a Subchapter S corporation with a pre-1983 election can continue to report on a fiscal year for federal tax purposes so long as there are not significant shifts in the ownership of that corporation. Restrictions on, or careful planning of, the timing of any such transfers should obviously be considered. The limitation in the Subchapter S provisions to a single class of stock poses certain planning limitations, but the Subchapter S Revision Act allows division of voting rights among shareholders, so long as all other ownership rights in the stock are identical, which raises additional planning possibilities.

Although the Subchapter S corporation does offer different and unique estate and family planning opportunities, the general objectives of a stockholder in an S corporation are the same as those of any owner of a closely-held business interest and include minimization of estate taxes, probate expenses and probate delays; achievement of some income tax reduction by splitting the income of the business within a family unit; planning for the transfer and continuation of family control and ownership of the business; and, when necessary, providing financial management for beneficiaries to hold or manage property. Until the changes in the Subchapter S provisions by the Economic Recovery Tax Act of 1981 and the Subchapter S Revision Act of 1982, attainment of many of these common planning objectives was difficult, and often inconsistent with the maintenance of Subchapter S status. However, recent statutory changes have made these planning goals more attainable, although there still are some limitations which are not applicable to the regular Subchapter C corporation.

One major change in the Subchapter S rules in recent years has been the permitting of certain kinds of trusts to be shareholders in a Subchapter S corporation. Currently, a grantor trust; a trust in which a person other than the grantor may have a vested interest in the income and corpus of the trust under Code Section 678; a testamentary trust for a sixty day period after Subchapter S stock is transferred to it; a voting trust; and a qualified Subchapter S trust, are the types of trusts that can be shareholders of the S corporation.[65]

A qualified Subchapter S trust[66] offers much more opportunity for effective estate planning with the S corporation in the family context. It is a trust which owns stock in one or more Subchapter S corporations, in addition to any other assets it might own. All of its income must be distributed to a single individual who is a resident or citizen of the United States. The trust terms must require that there only be a single income beneficiary at any given time and that any corpus distributed during the trust term be distributable only to the then current income beneficiary. Each income interest in the trust must terminate on the earlier of the death of the income beneficiary or the termination of the trust and the trust must distribute all of its assets to the income beneficiary if the trust terminates prior to the death of that beneficiary. If these requirements are met, the income beneficiary or his legal representative must elect to have the trust treated as a qualified Subchapter S trust.[67]

Time does not permit discussion of a number of interesting problems raised by ownership of "S" stock by either a trust or an estate. Particular unanswered problems exist because of the difference between fiduciary income, normal taxable income concepts, and the Subchapter S rules, some of which have been touched upon already. Suffice it to say that the principal and income allocation problems which exist when an estate or a trust is a shareholder in an S corporation are considerable and raise such questions as the requirement for equiable adjustments whenever corporate distributions to the estate are less than all of the corporation's taxable income, and the estate's distributions to beneficiaries do not exceed the estate's cash income. In this case, income would be payable by the estate based on the undistributed S corporation income, raising questions of whether that tax should be a charge against principal or income.

There are a number of areas which should clearly be covered in the trust instrument or the will to avoid administration or interpretation problems which could arise when S corporation stock is a trust or estate asset. Where the possibility of either the termination of Subchapter S

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65 Code Sections 1361(c), (d).
66 Code Section 1361(d).
67 Code Section 1371(g).

status or the election of Subchapter S status exists, specific provision should be made to allow the executor or trustee to make the election or to terminate the election. Normal state law standards allowing an executor to operate a business generally would not necessarily deal with such an election and the possible tax consequences to the estate or its beneficiaries could be considerable. If an S election is made or continued after death of a shareholder, the executor, as well as the trustee, will need some assurance that there will be adequate distributions from the corporation to pay taxes on the estate's or trust's share of Subchapter S income, unless the estate or the trust has sufficient other income sources to pay these taxes. Without some provision for minimum distributions, an estate or trust could find itself in a position of having taxable income without fiduciary income and a tax liability without any cash income to pay the taxes. If an election is made or continued, the executor, for his own protection, will need some assurance that other shareholders will not cause disqualification, either deliberately or inadvertently, since an unexpected termination could cause particularly severe consequences to the estate or to a trust. Some provision or agreement also should cover a situation where an estate or a trust which is a qualified shareholder distributes the stock to a beneficiary shortly after the end of the corporation's fiscal year with the result that the estate or trust is taxed on the corporate income for the year while any corporate distributions made early in the following year would go to the beneficiaries. A similar problem arises when the executor distributes the stock in the Subchapter S corporation to a non-qualified shareholder pursuant to the terms of the will. Under the Internal Revenue Code, the Subchapter S election will continue for a sixty-day period following such a transfer, during which period the estate is treated as the shareholder of the corporation.[68] As a result, the estate is taxed on any Subchapter S earnings during the sixty-day period, despite the fact that legal ownership of both the stock and any distributions on the stock for that sixty-day period are both in the non-qualified shareholder. Since this situation most commonly arises when stock is transferred from the estate to a trust, some agreement or language in the trust instrument should permit reimbursement by the trustee to the executor for the tax on the income during the sixty-day period. In that regard, if the distribution is to a trust which could qualify as a qualified Subchapter S trust, it must be remembered that an election to be treated as a qualified Subchapter S trust must be made by the trustee within sixty days after the distribution of S corporation stock to it.[69] If, as is commonly the case, the executor is also the trustee of the trust, this election could be

[68] Code Section 1361(c)(2)(B).

[69] Code Section 1371(g).

overlooked easily, resulting in disqualification of the Subchapter S election and potential liability for the trustee.

A provision authorizing non pro-rata distributions by the trustee or executor might be appropriate. Unless the instrument provides to the contrary, it is likely that under state law the executor or trustee would be obligated to make distributions of estate assets on a pro-rata basis. If any of the beneficiaries are ineligible shareholders or if such a distribution would result in exceeding the thirty-five shareholder maximum limitation, the result of the distribution would be disqualification of the election. While consent of all the beneficiaries to a non-pro-rata distribution is always possible, the Service could take the position that such a distribution would result in a taxable exchange of the interests in the Subchapter S corporation by some beneficiaries for other estate property interests. If this situation is specifically covered in the will or in the trust, then neither consent nor a taxable exchange would be a problem.

Another benefit of the power to make non-pro-rata distributions is to give the executor or trustee flexibility to distribute the Subchapter S shares which might provide substantial income to a beneficiary in a lower income tax bracket, or who has a particular need for income, and to allocate shares where there are potential losses to high bracket beneficiaries who can make maximum use of them. This allocation power, however, is somewhat illusory if the S corporation itself is not in a position to make substantial distributions of its taxable income to the beneficiaries. Then, causing the Subchapter S income to be taxed to a low bracket beneficiary who has little other income would cause an obvious cash flow problem for that beneficiary.

Another important power both the executor and a trustee of a trust should be given is the power to allocate or distribute the stock to a beneficiary other than an ineligible shareholder. If an estate contains a marital or residuary trust which is a qualified Subchapter S trust, the executor should be given the authority to allocate that stock to other beneficiaries, or to make the distribution of that stock outright to the trust beneficiaries, rather than to place it in the trust and disqualify the Subchapter S election.

In order to preserve Subchapter S status and also to provide for some control over operations and management of the business, the executor and the trustee should be given the specific authority to enter into shareholder restrictive agreements and buy-sell agreements affecting the Subchapter S stock and should be given the power, as part of the power to make non-pro rata distributions in kind, to provide individual beneficiaries who are active in the management and control of the business with a larger share of the stock. However, since the transfer of stock to preserve control might be inconsistent with the goal of disproportionate transfers in a way that would minimize income tax liability, the executor or trustee should also be given the power to establish or enter into a voting trust, which is also an authorized Subchapter S shareholder.

Finally, consideration should be given to adding a provision to a will or a trust to specifically allocate the burden of tax or the benefit of any tax loss between principal and income, since the Uniform Principal and Income Act clearly does not cover the income or tax consequences of the Subchapter S corporation. Although each circumstance would be different, a suggested approach would be to charge the income tax against income to the extent that income is actually distributed and against principal to the extent it is not distributed. When this undistributed income is actually distributed in a subsequent year out of the accumulated adjustment account of the Subchapter S corporation, provision should be made for a reimbursement to principal by income for the tax already paid. It also might be advisable to add a provision to a will authorizing disclaimers of Subchapter S stock bequests.

With this overview of some of the changes and some of the planning possibilities and difficulties which exist with Subchapter S stock, both for income tax purposes and for estate planning purposes, you can see that the Subchapter S corporation continues to offer substantial advantages in the appropriate situation, despite the fact that there are many complex problems and unanswered questions in the use of the Subchapter S corporation.