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## Subchapter S - Joint Committee Staff Recommendations

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## SUBCHAPTER S—JOINT COMMITTEE STAFF RECOMMENDATIONS

JAMES F. DRING

Those provisions of the tax law comprising Subchapter S, sections 1371 through section 1379,<sup>1</sup> were enacted in order to permit owners of small businesses to determine the form in which their operations would be conducted without having that choice controlled by its Federal income tax consequences.<sup>2</sup> The treatment afforded Subchapter S corporations and their shareholders is often analogized to the treatment of partners. However, except for the fact that in both cases no tax is imposed at the entity level (with some limited exceptions for Subchapter S corporations), there is little resemblance between the treatment of partners and the treatment of Subchapter S shareholders under the tax law. A Subchapter S corporation must determine its taxable income in the same manner as any other corporation and the distinctly corporate concept of earnings and profits is just as relevant in the case of a Subchapter S corporation as in the case of any other corporation. With the exception of the pass-through treatment for capital gains under section 1375 (a), the character and source of items of income and loss of a Subchapter S corporation are not passed through to the shareholder level, in contrast to the treatment of partners under section 702(b).

Subchapter S has been with us for over 22 years and the mechanisms adopted under it for passing through corporate income and losses, the limitations on the class and number of persons eligible to be shareholders, the passive income limitation, and the consequences of disqualification have produced by now a number of well-known pitfalls and a few unwarranted advantages. The staff of the Joint Committee on Taxation has published recommendations<sup>3</sup> for modification of Subchapter S that would deal with these problems and that in general would move the treatment of Subchapter S corporation shareholders much closer to the treatment of partners.

It may be well to review some of the advantages and disadvantages of Subchapter S status under existing law in order to place the recommendations in proper perspective.

### *Advantages*

The overriding advantage of a Subchapter S election under existing law is the opportunity to combine a single tax on corporate income

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<sup>1</sup> All references unless otherwise indicated are to the Internal Revenue Code of 1954, as amended.

<sup>2</sup> S. Rep. No 1983, 85th Cong, 2nd sess, p 87 (1958).

<sup>3</sup> Staff recommendations for simplification of tax rules relating to Subchapter S corporations. (April 30, 1980)

with the non-tax advantages of corporate form such as limited liability, centralized management, and any desired mix of active and inactive investors. Permitting the tax benefit of corporate losses to be enjoyed directly by the shareholders is a concomitant advantage and enables the owners of a newly incorporated business to deduct "start-up" losses on their individual returns and, if they choose, to avoid the imposition of individual tax rates on the corporation's income when it turns profitable by revoking the Subchapter S election.

It was early perceived upon enactment of Subchapter S that it offered a unique opportunity for an operating company anticipating a large capital gain to assure a single capital gain tax by a "one-shot" Subchapter S election. When the property had been sold and the resulting capital gain passed through to the shareholders under section 1375(a), the Subchapter S election could be revoked. Congress met this problem by the enactment in 1966, of section 1378.<sup>4</sup> When applicable, section 1378 imposes a corporate level tax on net capital gain in excess of \$25,000 and, under section 58(d), attracts the imposition of a corporate level minimum tax as well. Section 1378 generally has no application if the Subchapter S election has been in effect for the three years preceding the realization of the capital gain or if the election has been in effect since commencement of the corporation's existence even if less than three years. Thus, section 1378 does not affect a continuing Subchapter S corporation and the opportunity to pass through capital gain status with respect to amounts realized and distributed is a major advantage over corporations which are subject to the imposition of the corporate tax and which are not in the process of liquidation. After-tax capital gains of such corporations merely increase earnings and profits taxable as dividends if distributed to shareholders.

However, the pass-through treatment of capital gains under Subchapter S is not the full equivalent of the treatment of partners, and there is no special treatment for net capital losses of a Subchapter S corporation. As in the case of other corporations and unlike partnerships, net capital gain of a Subchapter S corporation is absorbed by ordinary losses at the corporate level and thus the pass-through treatment for capital gain falls short of full parity with partnership treatment. Under section 702, partnership capital gains and losses are always passed through separately from ordinary income or loss and thus a partner may enjoy capital gain treatment for partnership capital gains while deducting ordinary partnership losses against income from non-partnership sources. Net capital losses of a Subchapter S corporation, as in the case of other corporations, may be carried forward under section 1212(a)<sup>5</sup> and applied only against corporate capital gain, unlike partnership capital losses, which are passed through separately under

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<sup>4</sup> Section 1378 was added by section 2(a) of P.L. 89-389.

<sup>5</sup> The three year carryback of net capital losses of a corporation does not apply to a Subchapter S corporation Section 1212(a)(3).

section 702 and may, to the limited extent permitted by section 1211(b), be deducted against the partners' ordinary income.<sup>6</sup>

For a liquidating corporation, section 337 provides the same opportunity for a single capital gain tax at the shareholder level as does Subchapter S.<sup>7</sup> However, Subchapter S provides additional flexibility in that the liquidation need not be completed within one year, as section 337 mandates. Section 337 does not apply to a collapsible corporation, a problem that can be finessed by a Subchapter S election since gain from disposition of the collapsible property can be realized at the corporate level while assuring a single capital gain tax at the shareholder level and literally avoiding the section 341(b) definition of a collapsible corporation. This advantage would apply where the provision of section 341(e) might not serve to insulate the corporation from collapsible status, i.e. where capital assets or assets used in the trade or business as described in section 1231(b) might be assets that would produce ordinary income in the hands of a principal shareholder. Pertinent to this is a provision in the Subchapter S regulations, § 1.1375-7(d), that purports without readily apparent statutory support to make the character property would have in the hands of a shareholder relevant in determining whether the corporation realizes capital gain or ordinary income from its disposition.

Assuming the corporation is not collapsible, a Subchapter S election may perhaps be combined with a section 337 election to obtain, for a liquidating corporation, the same advantage that applies to a partnership concurrently realizing capital gain and ordinary losses. At least outside the context of Subchapter S, the Internal Revenue Service has held that gains unrecognized by virtue of a section 337 election do not serve to dilute a net operating loss realized in the course of liquidating. Rev. Rul. 56-448, 1956-2 CB/130. The section 337 election would also avoid any tax under section 1378 or section 58(d) that might otherwise be imposed at the corporate level.

When regulations under Subchapter S were originally proposed, they purported to make the election unavailable to corporations either con-

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<sup>6</sup> Ordinarily capital losses reduce a corporation's current earnings and profits, section 1.312-7(b)(1) of the regulations. While undistributed taxable income of a Subchapter S corporation is taxable to its shareholders only to the extent of its earnings and profits, section 1377(b) precludes the reduction of current earnings and profits by any amount not deductible in computing the taxable income of a Subchapter S corporation. Thus, the sale of capital assets at a loss does not serve to reduce the shareholders' tax liability.

<sup>7</sup> One advantage of Subchapter S over section 337, recently neutralized by adoption of P.L. 96-471, the Installment Sale Revision Act of 1980, was the ability to sell the corporation's assets without incurring any immediate tax by having the corporation elect the installment method. By keeping the corporation alive and avoiding the passive investment income limitation of section 1372(e)(5), collections would be taxed to the shareholders when received and, if capital gain to the corporation, would be capital gain to the shareholders. The installment method is now available to shareholders receiving installment obligations from the corporation in a section 337 liquidation, under new section 453(h).

templating liquidation or in the process of liquidation.<sup>8</sup> This rule, lacking statutory support, was abandoned when the regulations were adopted and the issue was thereafter litigated and resolved against the Service.<sup>9</sup> It appears to be clear that a Subchapter S election is an available option to a qualified corporation contemplating liquidation for whatever advantages it may offer.

A Subchapter S corporation offers flexibility for distributing income among family members, particularly advantageous in deciding late in the year whether to make intra-family transfers since it is those who are shareholders at the end of corporation's taxable year who must include the corporation's undistributed taxable income on their returns. Dividends may be reallocated by the Internal Revenue Service among shareholder members of a family under section 1375(c) where it is determined that such reallocation is necessary to reflect the value of services rendered to the corporation by such members. This rule, unlike the analogous partnership rule in section 704(e), applies whether or not the service provider transferred his stock to another family member. Literally, section 1375(c) has no application where the service provider is not a shareholder. In such cases, assignment of income principles may thwart inappropriate efforts to divert corporate income, but the section 704(e) rule which requires an allowance of reasonable compensation for services, constitutes a superior statutory standard.

There are other commonly confronted situations where a Subchapter S election may provide an attractive alternative to a corporation. For example, Subchapter S provides such an alternative for a corporation that may otherwise be concerned about imposition of the accumulated earnings tax, or a corporation with a substantial shareholder retiring from active participation in the corporate business but with a continuing need for periodic receipt of corporate income. In the latter cases, the only alternatives to Subchapter S may be a double tax on distributed corporate earnings or a large capital gains tax from liquidating the corporation.

### *Pitfalls*

Under existing law, a Subchapter S corporation may have not more than 15 shareholders, who must be individuals other than nonresident aliens, estates, or trusts described in section 1371(e), i.e. grantor trusts, voting trusts, and trusts serving as temporary conduits for stock transferred under a will. In determining the number of shareholders, a husband and wife and their estates are treated as one shareholder, and each beneficiary of a voting trust is treated as a separate shareholder. Further, the electing corporation may not be a member of an affiliated group as defined in section 1504 although there is an exception to this limitation for ownership of stock in a corporation which

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<sup>8</sup> Proposed reg. section 1.1372-1(a)(2).

<sup>9</sup> *Hauptman*, 309F2d62 (CA2,1962), cert den 372US909(1963).

has not commenced business. Ownership of stock in the electing corporation by another corporation, a partnership, a trust not described in section 1371(e), or a nonresident alien causes termination of the election commencing with the taxable year in which the disqualifying change in ownership takes place. A person who is a permissible owner may, within 60 days after acquiring stock in the corporation, affirmatively repudiate the election and cause disqualification.

These restrictions on ownership may lead to inadvertent disqualification of the corporation through acquisition of its stock by an impermissible shareholder or through dispositions causing the number of shareholders to exceed the statutory limit.<sup>10</sup> Further, because a new shareholder can cause termination of the election by affirmatively repudiating it, continuing qualification is outside the control of the corporation and its original shareholders.

A Subchapter S corporation with more than 20 percent of its gross receipts during a taxable year from royalties, rents, dividends, interest, annuities and gains from the sale or exchange of stocks or securities has its election terminated for the taxable year in which such limitation is exceeded and subsequent years, section 1372(e)(5). This provision has been a principal cause of inadvertent terminations. Its scope is uncertain. For example, section 1.1372-4(b)(5)(vi) of the regulations excludes from the term "rents" as used in section 1372(e)(5), receipts for the use or occupancy of space or rooms where significant services are also rendered to the occupant. The statutory heading of section 1372(e)(5) is entitled "passive investment income" but the provision does not explicitly embody any such limitation and literally limits any income from the enumerated categories, even if derived from an active business. The "significant services" standard governing the classification of receipts for occupancy of space as rent or not is an attempt at definition and not the adoption of an active business versus passive receipt standard. It offers no comfort with respect to the receipt, for example, of interest by a small loan company or gains from the sale of stock included in inventory by a securities dealer.<sup>11</sup> Doubts as to the scope of the limitation increase the likelihood in inadvertent disqualification.

Section 1372(e)(5)(B) prevents disqualification for the first two taxable years during which a corporation engages in active business if the amount of "passive investment income" during the year is less than \$3,000. But for that limited exception, a corporation that has a bad

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<sup>10</sup> Exceeding the permitted number of shareholders, absent a substantial change in the Subchapter S shareholder population, is unlikely. See p. 9 of the staff pamphlet indicating that approximately 97 percent of Subchapter S corporations have 7 or fewer shareholders.

<sup>11</sup> *Zychinski v Comr.*, 506F2d637(CA8,1974) (dealer in securities disqualified); *Winn v Comr.*, 595F2d1060 (CA5,1979) (proceeds from bareboat charter passive investment income); *Marshall v Comr.* 510F2d259(CA10,1975) (interest from a small loan business passive investment income).

year may find that interest from a savings account is a sufficiently large percentage of its overall receipts to cause disqualification.

An unintended disqualification resulting from violation of either the shareholder limitations or the passive investment income limit may not be discovered until the corporation is audited several years after the event. Once an election is terminated, under section 1372(f), the corporation must comply with the same requirements that govern an original election in order to make a new election and further must wait for five years unless the Internal Revenue Service permits an earlier election. Under section 1.1372-5(a) of the regulations, the likelihood that an early election will be permitted is enhanced where the termination was outside the control of the corporation or shareholders with a substantial interest. A minimum of one taxable year of qualification is lost in any event and more if the disqualification was inadvertent and not discovered for several years.

Net operating losses of a Subchapter S corporation are prorated on a daily basis to its outstanding stock and passed-through to its shareholders, in whose hands they are treated as deductible losses incurred in a trade or business. They are allocated to a shareholder only for those days on which he was a shareholder but the limitation on his deduction is his total investment, i.e. his aggregate basis for both stock and indebtedness of the corporation, under section 1374(c)(2). Any portion of the loss allocable to a shareholder which exceeds his investment may not be carried over by either the shareholder or the corporation, but is simply lost as a deduction, in contrast to the treatment of partners under section 704(d) who may carry forward excess losses and deduct them in a year in which they acquire additional basis. Undistributed taxable income of the corporation for a later year or contributions to capital will serve to increase the shareholders' basis for their stock, but if the basis of the shareholders' interest in the corporation's obligations was reduced because of the utilization of corporate net operating losses, that basis is never restored. Thus, there may be taxable gain to the shareholders when the corporation's obligation is redeemed or sold even though undistributed corporate income taxed to the shareholders has fully restored the net operating loss.

The Subchapter S corporation's undistributed taxable income, unlike its operating losses, is not prorated to shareholders throughout the year, but is the subject of a constructive dividend to those who are shareholders on the last day of the corporation's taxable year. They are subject to tax to the extent the distribution of such amount on such day would constitute a dividend. Undistributed taxable income is defined as taxable income reduced by distributions of current earnings and profits in cash during the year and by any tax imposed on the corporation pursuant to section 1378 and section 58(d). Under section 1375(f), distributions of cash made within 2½ months after the close of a taxable year to those who were shareholders at the end of the year are treated as distributions, to the extent thereof, of undistributed

taxable income. Constructive dividends taxed to a shareholder increase his basis for his stock and become previously taxed income which may thereafter be distributed to him as a tax-free recovery of basis. Under the regulations, section 1.1375-4(b), a distribution is to be considered a distribution of previously taxed income only if it is made in cash and would otherwise be treated as a distribution of accumulated earnings and profits. Under this ordering rule for distributions, there must be cash distributions during the taxable year in excess of current earnings and profits before any amount will be considered a distribution of previously taxed income. The likelihood of distributions reaching the previously taxed income level is further diminished because cash distributions within the first 2½ months of the year, under section 1375(f), might have been considered distributions of the previous year's earnings. Further, property distributions, which do not reduce undistributed taxable income and are not treated as distributions of previously taxed income, may constitute dividend distributions of accumulated earnings and profits notwithstanding that previously taxed income remains undistributed. Finally, previously taxed income is not transferable, section 1.1375-4(e) of the regulations. Thus, for example, the estate of a deceased shareholder, as a new shareholder, would not succeed to the decedent's previously taxed income amount.

It has been suggested that because of the restrictions on previously taxed income and the resulting locked-in character of undistributed Subchapter S income, it is advisable to distribute the corporation's full current earnings in cash every year within the year or the 2½ month grace period. This alternative would not be possible unless the corporation could operate without retained earnings. A prearranged plan to distribute cash and have the shareholders lend the money back to the corporation will probably be treated as a distribution of the corporation's obligation rather than a distribution of cash. *George A. Roesel* 56TC14 (1971); *McKelvy v. U.S.* 478F2d1217 (Ct.Cl.1973).

The locked-in income of a Subchapter S corporation is, of course, a problem only for corporations with accumulated earnings and profits since all distributions will constitute a distribution of current earnings to the extent thereof in any case, and only distributions in excess of that will be recharacterized as dividends if they do not qualify as distributions of previously taxed income and then only if the corporation has accumulated earnings. Hence, it is a greater problem for a corporation that had a successful corporate history before it elected Subchapter S treatment. However, because there may be an excess of current earnings over undistributed taxable income, Subchapter S corporations may also accumulate earnings and profits during the election period.

### *Unintended Benefits*

There are no rules under Subchapter S analogous to those in section 706(b) requiring the corporation to adopt a taxable year conforming

to that of its principal shareholders although, as in the case of partners, the corporation's undistributed taxable income is taxable to the shareholders in their taxable years within which the corporation's year ends. This permits a corporation with calendar year shareholders to adopt a taxable year ending with January and accomplish an 11 month deferral of the shareholders' tax. It is also possible under existing law to produce an unwarranted bunching of income through variation in taxable years because actual distributions are taxed to shareholders in their taxable years in which they are received.

The other principal unwarranted advantage permits the benefit of hindsight in year-end planning, in that a disqualifying event can be made to terminate the election retroactively if the shareholders decide in December that they do not want to pay tax at individual rates on corporate income earned since January. Closely allied with this is the ability to divert income to other family members through transfers of stock during the year. As previously indicated, the rule of section 1375(c) appears to be inadequate in that it literally permits reallocation only of dividends within a family and only if there were shareholder-provided services to the corporation.

#### *Staff Recommendations*

Under the staff recommendations, there would be a full pass through to the shareholders of all items of corporate income, loss, deduction and credit, separately where a separate computation could affect a shareholder's tax liability, otherwise aggregated at the corporate level. The character and source of all items would be retained. Thus, capital gains would be passed through separately without being offset by ordinary losses at the corporate level. Capital losses would be treated by the shareholders in the same manner as individual losses. To this extent, the proposals adopt the treatment of partners under section 702. However, the corporate level tax on capital gains under section 1378 and the section 58(d) tax would be retained to prevent "one-shot" elections.

Corporate items of income and loss would be reflected in adjustments by the shareholders of their stock basis in the same manner as the basis of partnership interests are adjusted under section 705. For a corporation coming under the proposed regime from its inception, there would be no earnings and profits and all distributions to shareholders would be applied against their basis for their stock and any excess treated as gain. For other corporations, with a history outside Subchapter S or existing Subchapter S corporation with earnings in excess of undistributed taxable income, income earned under the new regime would be deemed distributed first and reduce stock basis to that extent. Thereafter distributions would be deemed to come from accumulated earnings and profits and would be taxed as dividends before the shareholders' remaining basis could be recovered. The previous income account would be maintained by the corporation and all distributions from that source

would be free of tax whether or not shares had been transferred. Unlike the previously taxed income amount of a Subchapter S shareholder under present law, the previous income account would reflect amounts excluded from gross income, such as interest on state and local obligations, as well as non-deductible expenses of the corporation.

While the proposal permits a qualifying corporation to elect Federal income tax treatment for itself and its shareholders substantially similar to the tax treatment of partners and partnerships, as proposed in the staff recommendations, it does not entail the same cost of a tax to the shareholders that application of section 331 would produce for a business going from the corporate to the partnership form. This liberality preserves the attractiveness of a Subchapter S election for a corporation that may be concerned about exposure to the accumulated earnings tax or about providing income to a retiring shareholder without the cost of a two-level tax. It also preserves the complexity of the continued relevance of earnings and profits and possible dividends to shareholders, which could perhaps be eliminated if the election to come under the new regime were treated as a taxable event.<sup>12</sup>

The proposal departs from the partnership model with respect to distributions of property, which would be measured by fair market value in all cases. Except for distributions in liquidation, gain would be recognized at the corporate level as if the property were sold to the shareholders, capital gain or ordinary income as the case may be which would be passed through and taxed to the shareholder and result in adjustments to their stock basis. If basis rules analogous to those in section 732 were to be adopted, it would be necessary to adopt rules analogous to the complex collapsible partnership rules and it might induce gamesmanship revolving around whether partnership basis rules or fair market value (available by terminating the Subchapter S election) was considered more desirable for property distributions. Recognition of gain was considered a necessary corollary to the fair market value standard for property distributions to prevent appreciation in the distributed property from escaping tax permanently or at least for an indefinite period. Without gain recognition, the only adjustment would be a downward adjustment to the shareholders' stock basis which might or might not result in an increased tax at some time.

Operating losses would pass through and be deductible by the shareholders but deductibility would continue to be limited by a shareholder's total investment in the corporation's equity and debt. However, unused losses would be treated as sustained in the succeeding taxable year with respect to the shareholder subject to the limitation so that, as in the case of a partner under section 704(d), the loss would become deductible when the shareholder had sufficient basis. When the basis of a corporate obligation owned by a shareholder has been reduced

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<sup>12</sup> It would be possible for a Subchapter S corporation under the new regime to acquire earnings and profits under section 381(c)(2) by being the acquiring corporation in an acquisitive reorganization.

because of the deduction of corporate losses, subsequent corporate income will restore the basis of the debt before affecting stock basis so that artificial gain will not be recognized upon redemption of its obligations by a corporation that has recouped its losses.

After a Subchapter S election has been terminated, there would be a grace period within which both cash contributions would be treated as distributions from the previous income account and operating losses subject to limitation could be deducted by restoration of a shareholder's basis in the corporation's stock. This transition period would end one year after termination of Subchapter S status or, if later, 120 days after a determination, by court decision or agreement with the Internal Revenue Service, that the corporation's Subchapter S status had terminated.

The number of permitted shareholders would be increased to 25 and the categories of permitted shareholders would be expanded to include trusts treated as owned by a person other than the grantor under section 678. The one class of stock requirement would be retained but variations in voting rights would be deemed not to violate the requirement. These restrictions on classes and ownership of stock facilitate allocation of corporate income and loss and the determination of tax liability of Subchapter S shareholders. Inherent in the decision to retain this simplicity and certainty for Subchapter S is another departure from the partnership model in that the discretion available to partnerships under section 704 to allocate items among partners and the election permitted under section 754 to adjust the basis of partnership property will not be adopted for Subchapter S purposes. Another distinction of present law between Subchapter S corporations and partnerships that would be unaffected by the staff recommendations would be the treatment of the entity's indebtedness to third parties, which is reflected in a partner's basis for his partnership interest but is not reflected in a shareholders' basis for stock and debt of a Subchapter S corporation.

The power of a new shareholder to terminate the Subchapter S election by repudiating it would be eliminated. In the interest of corporate democracy, the existing rule which requires 100 percent shareholder approval to revoke a Subchapter S election would be modified to permit revocation with the consent of 66⅔ percent of the corporation's voting stock.

The section 1375(c) rule would be replaced by a rule more analogous to that in section 704(e), requiring an allocation to reflect the value of services rendered to the corporation by any family member.

All items of income, expense, credit, etc. would be allocated on a per-share, per day basis in the manner that corporate losses are allocated under existing law. Anyone who was a shareholder at any time during the year would have taxable consequences for his taxable year within which the Subchapter S corporation's year ends .

An election effective for the taxable year in which it is made could be made by the 15th day of the third month of the year. A later

election would be effective for the following year. Even if an election were timely made for the current year, it would be treated as made for the following year if at any time during the year the stock ownership rules weren't satisfied or a shareholder whose interest was disposed of before the election is made, refused to consent to the election. This is a variation from existing law necessitated by imposing taxable consequences on all shareholders. Under existing law, only those persons who are shareholders on the last day of the corporation's taxable year can be adversely affected by an election.

Revocation of an election would be effective for the taxable year following that in which it is made unless made by the 15th day of the third month of the year, in which case it would be effective for the year of election. However, any effective date within the taxable year could be specified in the election as long as it is not before the date on which the election is made. Termination of an election other than by revocation would be effective on the day on which the disqualifying event occurs. These rules are designed to eliminate the present law discrepancy between termination through disqualification and termination by revocation and to eliminate the premium on year-end planning attributable to present law's sanction of intentional disqualification if retroactive termination for the full year seems desirable.

The year within which a termination is effective, whether through revocation or disqualification, will be treated as two short taxable years, for the first of which the Subchapter S election continues to be effective. The returns for both short years will be due on the date on which the Subchapter S corporation's return would be due if there were no termination, and the corporation's items of income, loss, etc. will be determined on a per-day basis for the full year and allocated accordingly to each of the short years. However, the corporation can elect, with the consent of all who are shareholders at any time within the full year, to have income or loss determined for the two short years in accordance with the corporation's books and records. The two short years would count as one carryover year. For the nonqualifying short year, the corporation would be required to annualize its taxable income in determining its tax liability.

Since a shareholder who sells or otherwise disposes of his stock during the corporation's taxable year will be taxable on part of the corporation's income, in lieu of the per share, per day allocation for the full year, an alternative allocation would be permitted as if there were two taxable years of the corporation, determined by reference to the date the stock was transferred. The election of this alternative allocation would be permitted only if all those who were shareholders during the corporation's full year consent.

To mitigate the severity of the results sometimes experienced when an inadvertent termination is later discovered, the staff recommends that upon a finding of inadvertence and reasonably timely action to reestablish qualification under Subchapter S and any other corrective

adjustments by the corporation and its shareholders required by the Internal Revenue Service, the Service could treat the election as continuing.

Special rules would be devised for such items as: (i) additional first-year depreciation under section 179 where, as in the case of partnerships, the limitation would be applied at both the entity level, and after pass-through from the corporation, the shareholder level; (ii) investment credit recapture, where a Subchapter S election would be considered a mere change in the form of conducting business and, under section 47(b), not a recapture event, but the Subchapter S corporation would be made liable for recapture tax attributable to pre-election investment credits; (iii) the eligibility and limitations on shareholders for the foreign tax credit and the application of the recapture provisions of section 904(f); and (iv) the mechanism for applying the 1000 barrels per day limitation on oil and gas percentage depletion under section 613A. Specific recommendations with respect to items (iii) and (iv) require further study.

The corporation would be required to adopt the calendar year as its taxable year or a taxable year for which it could establish a business purpose. Existing Subchapter S corporations would be required to conform their taxable year to the new rule after a change in ownership of 50 percent of the corporation's outstanding stock on the date of enactment, not including as a change an acquisition of stock by inheritance. This would bring the Subchapter S rule closer to the partnership taxable year requirement under section 706(b) and prevent Subchapter S elections for the purpose of deferring tax.

The passive investment income limitation would no longer cause termination of the election but would be retained to prevent use of a Subchapter S corporation to obtain access for a person's investment income to the maximum tax on earned income and corporate fringe benefits plus eligibility for contributions to a qualified plan. If the limitation is exceeded, a shareholders' compensation would be reduced for maximum tax and contributions to a qualified plan by the percentage of gross receipts that consists of passive investment income and all more than 5-percent shareholder-employees would be ineligible for certain corporate statutory fringe benefits.

The elimination of the passive investment income limitation as a test the qualification coupled with the permitted variation in voting power of the corporation's stock causes concerns that have been discussed elsewhere.<sup>13</sup> One of these concerns involves the appropriate consequences of terminating corporate status. If a corporation's shareholders seek to conduct their business as a partnership, normally they cannot do so without liquidating the corporation and paying a shareholder level tax. Analogous treatment can be obtained under the staff recommendations without incurring a liquidation tax by having the corporation

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<sup>13</sup> Kadens—*Proposed Subchapter S Amendments—A Boon to Private Investment Corporations?* 58 Taxes 379 (June, 1980).

make a Subchapter S election. With retention of a passive investment income limitation, the corporation would be forced to liquidate and cause the shareholders to pay the liquidation tax in order to convert a corporate business to an investment portfolio combined with a one-level tax.<sup>14</sup> Alternatively, the corporation can dispose of its business, remain in existence and become an investment company. Under this alternative, tax-exempt interest would lose its status by entering corporate earnings and profits taxed to the shareholders when distributed, and other investment income would be subject to double taxation except to the extent that double tax consequences were mitigated for dividend income eligible for the 85 percent dividend received deduction. In addition, if the stock ownership test of section 542(a)(2) were satisfied, the corporation would be a personal holding company required to distribute its income in order to avoid imposition of the penalty tax.<sup>15</sup> These results could be avoided if access to pass-through treatment could be attained by converting the corporation to a regulated investment company, which requires a minimum of 100 shareholders, or have it acquired by such a company in a tax-free organization. The latter course would require compliance with the investment diversification standard of section 368(a)(2)(F) and satisfaction of the "historic business" requirement under the continuity of business enterprise test of regulation section 1.368-1(d) as recently amended.

Elimination of the passive investment income limitation provides an alternative route through a Subchapter S election to convert a corporate business to an investment portfolio combined with a one-level tax on investment income and without the imposition of a shareholder tax on liquidation or personal holding company status for the corporation. Because it is a complete pass-through entity, the personal holding company provisions have no relevance to a Subchapter S corporation. For a Subchapter S investment company, pass through treatment combined with the income character retention rules and elimination of earnings and profits would mean that the after-tax return on other investments would match the return on dividend income and tax-exempt interest would fully escape tax.

Elimination of the passive investment income limitation is likely to

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<sup>14</sup> A recently enacted amendment to the income tax regulations, adopting new section 1.368-1(d), defines the continuity of business enterprise requirement as requiring continuation of a corporation's historic business or use in a business of a significant portion of a corporation's historic business assets. In 1978, the IRS had sanctioned as a valid reorganization the transfer by a corporation of cash to a tax-exempt bond fund, after terminating the corporation's business, for shares qualifying for pass-through treatment under section 852. Private letter ruling 7825045 (March 23, 1978). Subsequent reversal of the IRS position culminating in the amendment of the regulations forecloses what would have been an easy road from active corporate business to investment portfolio without a shareholder level tax.

<sup>15</sup> If the corporation invested in tax-exempt obligations, the interest on which does not enter gross income, it could achieve freedom from personal holding company problems.

foster Subchapter S elections for newly incorporated investment portfolios in addition to those that are derived from the termination of an active corporate business. In addition to the advantages of Subchapter S status already outlined, gifts of minority interests to family members in the form of nonmarketable stock may be made in the hope of obtaining a substantial reduction, for estate and gift tax valuation, from the aggregate value of the incorporated assets. Incorporation for this purpose would be greatly facilitated by eliminating the exposure to double taxation and personal holding company status. Further, permitted variations in voting rights could enable one person to retain control while permitting most of the corporate income to go to minors or other family members without substantial income from other sources. It has been suggested that several Subchapter S corporations could be used, with one investing in tax-exempt obligations to be owned by family members with other sources of income and another investing in securities yielding taxable income to be owned by members without other substantial income.<sup>16</sup>

The problem of Subchapter S investment companies may require further consideration.

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<sup>16</sup> Kadens, *supra*, p392.