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"A ROADMAP OF SUBCHAPTER S"*

ROBERT S. BERSCH**

Subchapter S,¹ added to the Code in 1958, affords small business corporations,² the privilege of avoiding income tax at the corporate level, passing the liability on to shareholders instead, much like the tax on partnership income is transferred to the partners. What are the basic requirements? Under what circumstances might this election be advisable? How is the election actually made? What are the operative effects of making it? How is the election terminated? These are the questions to be discussed herein.

Basic Requirements

To make the election under Subchapter S a corporation must first meet the definition of a "small business corporation" as set forth in section 1371 (a). It must be a domestic corporation which is not a member of an affiliated group.³ There must be fewer than eleven shareholders,⁴ all of these being either in-

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¹Subchapter S of the Internal Revenue Code of 1954, as amended, consists of sections 1371-1377, inclusive.

²See I.R.C. § 1371(a).

³By "affiliated group" is meant a group of corporations eligible to file a consolidated return.

⁴Generally speaking, and except for stock owned by husband and wife, if stock is owned by tenants in common, joint tenants, or tenants by the entirety, each tenant in common, joint tenant, or tenant by the entirety is considered a shareholder. However, effective for taxable years beginning after 1959, stock which is community property of a husband and wife and stock which is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common, is to be treated as owned by one shareholder. (See Code § 1371(c), as added by P.L. 86-376, 86th Cong.) The regulations (Reg. § 1.1371-1(d)(2)), say if a husband and wife own stock in a corporation *individually*, and the husband and wife own other stock in the corporation *jointly*, the husband and wife will be con-

dividuals or estates⁵ and none being nonresident alien shareholders. Only one class of stock is allowed.⁶ In addition, the election will be terminated effective with the current year under section 1372, if more than eighty percent of the year's gross receipts⁷ is derived from foreign sources or if more than twenty percent of its gross receipts is personal holding company income,⁸ if any new shareholder fails to give consent, or if any of the six requirements of § 1371(a) fail to be met.

Should the Election Be Made?

Assuming that the mechanical tests for qualification under Subchapter S are either already satisfied or could be met with reasonable ease, the really difficult question is whether a corporation *should* make the election. There are numerous operating intricacies to discourage it, but on the other hand, there may be substantial tax opportunities to encourage it. At least, several basic considerations can be set forth:

The decision to elect should not be made unless at least one of the following is true:

(1) The business actually is a small one anticipating a relatively steady income over the next several years and stockholders do not have substantial outside incomes, or

sidered one shareholder. But if the husband and wife each owns stock in the corporation individually, they will be treated as two shareholders.

⁵But not trusts.

⁶The Code is silent on the question of whether or not the limitation means one class of "issued," or one class of "authorized," stock. The Regs. adopt the position that only issued and outstanding stock is to be considered. The test is that if the shares are not identical with respect to the rights and interests which they convey in the control, profits and assets of the corporation, then the corporation is considered to have more than one class of stock. (Reg. § 1.1371-1(g)). See, also, TIR No. 113, November 26, 1958, where a corporation had authorized but unissued preferred stock with only one class of common outstanding. *Held*: Only one class of stock and therefore the election is permitted. But election will be terminated in any year in which any of the authorized preferred stock is issued.

⁷Distinguish clearly here between gross receipts and gross income. The former is the correct test.

⁸Section 1372(e)(5) defines personal holding company income as receipts derived from royalties, rents, dividends, interest, annuities and gains from sales or exchanges of stock or securities.

(2) Stockholders have substantial outside incomes, but the corporation in question expects a sizeable loss for the year, or

(3) Competent tax advice has been given shareholders and they now wish to take advantage of one of Subchapter S's tax opportunities allowed, perhaps unintentionally, by Congress.

Low Bracket Shareholder:

In general, if the individual shareholder's tax rate is about the same as, or less than, the rate of tax imposed on the corporate income, it would appear advisable to make the election, even though the corporation does not intend to distribute its earnings for a number of years.⁹

High Bracket Shareholder:

If the corporation usually distributes all its earnings after taxes, there will be a mathematical advantage in most cases no matter what the income tax bracket of the shareholder,¹⁰ due to elimination of the so-called double tax.

Benefit Reducing Factors:

There may, however, be other consequences which reduce the real saving. If the corporation does not distribute dividends until after the close of the taxable year, the individual tax will nevertheless have been accelerated to the year in which the corporate income was earned.¹¹ State income taxes of the individual shareholder may be larger due to the actual or constructive dividend, and franchise taxes of the corporation may be increased in states which allow deductions to corporations for Federal corporate income tax paid.

Where Retention of Earnings Possible:

Where the corporation needs its earnings for expansion or some other legitimate purpose and hence is in a position to safely

⁹Mathematical proof is given by Landis, Wm. B., Jr., N.Y.U. 18TH ANN. INST. ON FED. TAX., pp. 723-4 (1960).

¹⁰*Ibid.*

¹¹I.R.C. § 563(a) and I.R.C. § 1373(b).

retain income, the factor of the shareholders having to pay tax on money not yet in their pockets may be a vital factor, overcoming any but a major saving of tax under Subchapter S. In this expansion — or any sound business purpose situation — the comparison should be between the straight individual and the corporate tax rates. Only if the income of the shareholders is low enough so that the individual rates on corporate income taxed to the shareholders are lower than the corporate rates will there be an inducement for the shareholders of a corporation which expects earnings and plans to retain them to make the election. Usually, the election becomes proportionately more attractive, at least to high bracket shareholders, if a sizeable portion of earnings are distributed rather than retained.

Avoidance of Accumulated Earnings Tax Problem:

Since § 1372(a) exempts an electing corporation from Chapter 1 taxes, including accumulated earnings tax¹² and personal holding company tax,¹³ where either of these is a threat, this factor should enter the computations and may make the difference in favor of an election.

Avoidance of Excessive Salary Problem:

Excessive salaries paid to officer-stockholders in a closely held corporation may make the "S" election attractive even though corporate taxable income is low. The corporation could presumably avoid IRS attack on its salaries by making the election, reducing salaries and increasing dividends. If the election is made and the corporation goes merrily on its way paying excessive salaries, an attack by IRS is invited which could be quite detrimental. Reg. § 1.162-8 provides the tool with which the Service may treat excessive amounts as dividends income to the recipients and deny the deduction to the corporation. This latter step might result in taxation of the same amounts a second time, pro rata to the shareholders as undistributed taxable income.¹⁴

¹²I.R.C. § 531.

¹³I.R.C. § 541.

¹⁴Valentine, Richard H., *Taxation of Shareholders of Subchapter S Corporations During the Election Period*, N.Y.U. 18TH ANNUAL INSTITUTE ON FEDERAL TAXATION, pp. 696-7 (1960).

Operating Losses Anticipated:

Where the corporation expects substantial losses in the early years of operation or where losses from a recessionary period are anticipated, the election under Subchapter S may be profitably availed of, where there is no way of offsetting these losses at the corporate level, but shareholders have outside income which can be used to offset against these losses.¹⁵ Aside from the fact that such losses cannot be carried back to a period to 1958,¹⁶ there is only one important limitation on the net operating loss pass-through enjoyed by "S" corporation shareholders. Each shareholder's portion of the loss may not exceed and, of course, serves to reduce, the adjusted basis of his stock plus any corporate indebtedness to him.¹⁷ Thus, where stockholders' interests in stock and corporate indebtedness is likely to be wiped out by loss-offsets, additional loans or capital contributions might be made by shareholders, if at all, during the loss year in order to obtain a pass-through of the full operating loss.¹⁸ If this is not done, the loss will be lost since it is not carried over by the corporation for a subsequent pass-through.¹⁹ In any event, tax benefits of the election to the shareholders as individuals should be weighed against the advantages of having the corporation use the loss as a carryback or carryover. In this regard note that there is no carryback allowed the corporation of losses in a non-electing year to an electing year. If the election was not in effect during the carryback years, the advantages of the corporate carryback must be weighed against those to the shareholders reducing their taxable income from outside sources by their pro rata shares of the corporation's loss. Where a net operating loss carryover exists, the election probably should not be made. No carryover from a non-election year will be allowed for the duration of the election and should the election remain in force five years, the carryover will be lost forever.²⁰

¹⁵Senate Report No. 1983, 85th Congress, 2d Session, 1958 C.B. 922, 1008.

¹⁶I.R.C. § 1374(d)(2); Regs. § 1.1374-1(a).

¹⁷I.R.C. §§ 1374(c)(2) and 1376(b).

¹⁸I.R.C. § 1374(c)(2).

¹⁹Wright, L. Hart and Libin, Jerome B., *Impact of Recent Tax Stimulants on Modest Enterprises*, 57 MICHIGAN LAW REVIEW 1131, 1143 (1959).

²⁰I.R.C. § 1374 and the Regulations thereunder. Also see 60-4 C.C.H. Explanation, ¶ 4849.021, pp. 55,080-1.

Trapping Capital Gains:

Election under Subchapter S for a single year may enable a corporation to "trap" a long-term capital gain. For example, if the corporation has a net long term capital gain in an election year and actually distributes money in the amount of the gain to its shareholders, there will be only one capital gains tax, and that at the shareholder level. This is possible using the capital gain pass-through provision in section 1375(a),²¹ and may now be used as an effective alternative to section 337 tax-free one-year liquidations, since the final regulations do not withhold the election privilege from corporations contemplating or in the midst of complete or partial liquidation. Tax on corporate capital gains may be avoided entirely where shareholders have individual long-term capital losses, by making the election and, upon distribution, offsetting the gains and losses against each other.

Deferring Income and Tax:

Frequently, an incentive for making the election will be the deferral of income and the tax thereon up to 11 months. This is done by selecting a taxable year for the "S" corporation different from that of the shareholders. While the advantage gained may equal only the value of the interest on the taxes ordinarily due, this may be quite worthwhile at a time where working capital is badly needed.²²

Income Splitting Possibilities:

One final situation favorable for making the election will be mentioned (the foregoing list is by no means exhaustive). This is the income shifting situation. Under § 1373, each person who is a shareholder on the last day of a taxable year is taxed on the amount he would have received as a dividend, if on such last day the corporation had distributed its undistributed taxable income,²³ pro rata to its shareholders. By making a bona fide transfer of shares, a stockholder may shift portions of income

²¹Moore, James A. and Sorlien, Richard C., *Adventures in Subchapter S and Section 1244*, 14 TAX L. REV. 453, 461 (1959).

²²I.R.C. § 1372 and the Regulations thereunder. See also Regs. § 1.442-1 (d); Goodson, Marvin, *Election to Tax Corporate Income to Shareholders*, 11TH TAX INSTITUTE, U.S.C. SCHOOL OF LAW, 1959, p. 102.

²³I.R.C. § 1373(c) defines "undistributed taxable Income."

otherwise to be attributed to him to his transferees. The only limitation to watch here is that the Commissioner may re-allocate income among family members to properly reflect the value of services by a family member to the corporation. Care should be taken to insure that the new shareholders give timely consent to the "S" election.

How to Make and Keep the Election

Time for Making the Election:

Once the decision to elect Subchapter S treatment has been made, the practical mechanical question of how to do it arises. Generally speaking, the election must be made, with respect to any taxable year, during a two-month period beginning one calendar month before the taxable year begins and ending one calendar month after the beginning of the taxable year. No extension of time is permitted. The first month of the taxable year of a new corporation does not begin until the corporation has shareholders or acquires assets or begins doing business, whichever is the first to occur.²⁴

Who Must Make the Election:

In making the election action is required by both the corporation and the shareholders. The corporation files Form 2553 or a statement containing the information required by that form. In addition, consents must be filed by all who are shareholders on the first day of the corporation's taxable year or on the day of election (whichever is later). The election will not be valid if the consents are filed after the last day prescribed for filing the election. The place for filing is with the District Director for the district in which the corporation's principal place of business or principal office or agency is located.

When a New Shareholder Enters:

Once the election has been made, due diligence must be exercised to maintain it. If a new shareholder comes in after an election has been made and after the first day of the first taxable year for which the election is effective, thirty days from the date he became a shareholder are allowed for filing his consent,

²⁴Regs. § 1.1372-2.

thereby avoiding termination of a valid election.²⁵ A copy of this consent must accompany the electing corporation's information return.

When a Shareholder Dies:

If an S shareholder dies, his estate becomes a new shareholder. The consent of the executor of the estate must be filed within thirty days from the date of his appointment and not later than sixty days following the close of the corporation's taxable year in which the estate became a shareholder.²⁶ It is wise to utilize restrictive clauses in the charter and by-laws and in agreements to insure remaining shareholders the right to purchase shares of a departing owner. Likewise, each shareholder in his will ought to grant his executor the power to consent to the election.

Vigil on Character of Income:

Constant review of the foreign income and personal holding company income receipts should be made to make sure the percentage requirements referred to above are not exceeded.

Operative Effects of Subchapter S

The election having been made, the electing corporation may now be observed and analyzed as it wends its uncertain way down the trail of Subchapter S. Since what has really been done is to elect an alternate method of taxation, it would perhaps be proper to consider first how income is taxed to the shareholders.

How Income is Taxed to Shareholders:

Cash Distributors: While the electing corporation pays no tax on its "taxable income," a shareholder includes in his gross income the full amount of "dividends" received during his taxable year.²⁷ In addition, in his individual taxable year with or within which the corporation's taxable year ends, he must include his pro rata share of the corporation's "undistributed taxable income." This inclusion may or may not coincide with the year in which he included the dividends actually received. Whether the cash dis-

²⁵Regs. § 1.1372-3(b).

²⁶*Id.*; Willis, Arthur B., *Incorporate and Elect Subchapter S?*, 11 J. TAX. 66, 69-70 (1959).

²⁷Cash distributions out of earnings and profits of an electing corporation are governed by the usual rules of § 301 and § 316.

tribution is a dividend or not will depend upon whether there are *current* "earnings and profits" out of which a dividend could be paid. This follows the usual corporate rule. The amount of *cash* actually distributed from "current e & p" will reduce the corporation's "taxable income" as well as "Undistributed Taxable Income" for the same period, but *property* distributions will not. "Taxable income" for purposes of S corporations is taxable income computed in the normal manner and then adjusted by adding back any deductions that were made for: (1) the net operating loss; (2) the 85% dividend deduction; (3) partially tax exempt interest on certain U. S. obligations; and (4) dividends on preferred stock of certain public utilities. If the cash distribution is not in excess of taxable income for the year, it does not qualify for the four percent dividend received credit, the \$50 dividend exclusion, or the retirement income credit.²⁸ However, all three are allowed to the extent they are paid out of earnings and profits accumulated prior to the corporation's election.²⁹

Undistributed Taxable Income: The portion of taxable income not distributed by the corporation before the end of its taxable year is called "undistributed taxable income."³⁰ It is often referred to as "U.T.I." or "P.T.I." (previously taxed income). This U.T.I. is taxed pro rata to those owning shares on the last day of the corporation's taxable year. U.T.I. which has been previously taxed to the shareholders is withdrawn from accumulated earnings and profits and is placed in a special surplus account. It does not go into accumulated earnings and profits in the tax sense of the term. Later on, as will be more fully explained below, U.T.I. can be withdrawn tax-free by, and only by the shareholders who originally included the U.T.I. in their income.³¹ Any withdrawals by a decedent shareholder's estate or transferee are taxable to them in the same manner as dividends from an ordinary corporation.³²

²⁸I.R.C. § 1375(b).

²⁹Regs. § 1.1375-2(b) Example 1.

³⁰I.R.C. § 1373(c).

³¹Regs. § 1.1375-4(e).

³²Goodson, M., Scheifly, J. E., and Thompson, R. E., *Planning with Subchapter S in 1960*, 12TH TAX INSTITUTE, U.S.C. SCHOOL OF LAW, pp. 181-2 (1960).

Order of Distribution: While an election is in effect cash distributions are deemed to have been made first from "current e & p," then secondly, from U.T.I. and thirdly, from "accumulated e & p." Therefore, U.T.I. cannot be withdrawn until "current e & p" is exhausted.³³ Should the election be terminated or lost, U.T.I. becomes even harder to get to. Both current and accumulated e & p will then have to be distributed, in that order, as taxable dividends before U.T.I. may come out tax-free. The following table³⁴ summarizes the treatment:

<i>While Election is in Effect</i>			<i>After Termination of Election</i>		
TAXABLE EFFECT	ORDER OF WITHDRAWALS		TAXABLE EFFECT	ORDER OF WITHDRAWALS	
Dividends	1st	Current E & P	Dividends	1st	Current E & P
Tax Free	2nd	U.T.I.	Dividends	2nd	Accumulated E & P
Dividends	3rd	Accumulated E & P	Tax Free	3rd	U.T.I.

After initially increasing his basis for stock when U.T.I. is included in his income, the shareholder likewise reduces his basis when U.T.I. is later drawn out tax-free.

In view of the personal nature of the right to U.T.I. and the way in which it may get locked in by accumulated e & p or current earnings in excess of taxable income, the S corporation would be well advised to avoid the problem by distributing, before the close of each taxable year, the full amount of its current taxable income. This may create practical problems when the corporation is short of funds, and shareholders may be requested to return distributions through various loan arrangements. A capital contribution would be inconclusive, for it would not remove dividend possibilities inherent in distributions or redemptions, when there are current or accumulated earnings. The creation of bona fide indebtedness offers the best solution to the problem, assuming tax recognition is given to the transaction.³⁵

³³Note here that if all shareholders desire to have a distribution come from accumulated e & p before U.T.I. the corporation may do so after current e & p is fully distributed.

³⁴Goodson, *Planning in 1960*, op. cit., p. 186.

³⁵Caplin, Mortimer M., *Subchapter S and its Effect on the Capitalization of Corporations*, 13 VAND. L. REV. 185 at 192 (1959).

E & P Problems: In conjunction with U.T.I. there is the problem of determining to what extent distributions are out of "e & p" of the taxable year. The Regulations³⁶ set up the following rules in the form of a three-tier system: (1) Current "e & p" is first allocated to the actual distributions of money; (2) second, on a ratable basis to the constructive distribution of U.T.I. and actual distributions of property other than money (at fair market value) which are *not* in exchange for stock; and (3) third, to distributions which *are* in exchange for stock of the corporation, such as under § 302 (redemptions) and § 331 (liquidations). In view of the numerous tax consequences, modification of the current e & p account may have, it is important to notice that current e & p will be increased by the excess of percentage depletion over cost depletion³⁷ and by receipt of exempt income,³⁸ such as interest on municipal bonds³⁹ and life insurance proceeds.⁴⁰ A net capital loss will usually decrease e & p, but will not affect current e & p for Subchapter S purposes as it is not an allowable tax deduction.⁴¹

Capital Gains: The conduit rule applies to net capital gains of an S corporation, passing them through to shareholders to be taxed pro rata to stock holdings. Such capital gains are passed through after any net capital loss carry-forward from a prior year (even a non-election year) has been applied.⁴² But the gains passed through shall not exceed the S corporation's specially computed taxable income for the year.⁴³ Each distribution made by the corporation prior to the end of its fiscal year must be apportioned between ordinary income and capital gains. An allocation is made based on the proportions of ordinary income and capital gains. If shareholders have a different taxable year,

³⁶Regs. § 1.1373-1(e)(1),(2),(3).

³⁷Regs. § 1.312(c)(1); Regs. § 1.376-2(e). Also see I.R.C. § 1373(c); Regs. § 1.1373-1(d)-(e). Exceptions are set out in Regs. § 1.1372-1(c)(7).

³⁸Regs. § 1.312-6(b); Regs. § 1.1377-2(b).

³⁹I.R.C. § 103(a)(1).

⁴⁰I.R.C. § 101(a)(1).

⁴¹I.R.C. § 1377; Regs. § 1.1377-2(a)(2) Ex. 1.

⁴²I.R.C. § 1212 sanctions this, but neither §§ 1371-1377 nor the Regs. thereunder mentions it.

⁴³I.R.C. § 1375(a)(1).

problems in shareholder reporting arise because of the difficulty in telling how much to report as capital gain and ordinary income. About all the shareholder can do is to request an extension or file an amended return when the corporation's tax year is over and the respective amounts are established.

Capital Losses: It is perhaps surprising that capital losses for S corporations do not follow the capital gain pattern. If the corporation has capital losses in excess of capital gains, the excess losses cannot be used by the shareholders to offset their individual capital gains. The net capital loss does not decrease the amount of income which will be taxed to the shareholders since, in computing the taxable income of a corporation, capital losses are deductible only to the extent of capital gains. Nor does a net capital loss increase the net operating loss which will be allowed as a deduction to the shareholders pro rata, since for this purpose, too, capital losses are deductible only to the extent of capital gains.⁴⁴

A net capital loss can be carried over for five years as a *short-term capital loss*. Whether there is or is not an election in effect for either the year from or to which the loss is carried over is apparently immaterial. If not used up in five years, the tax benefit of the capital loss is lost.

§ 1231 *Gains and Losses:* Net gains of the corporation on sales of depreciable and real property used in a trade or business held for more than six months pass through to the shareholders as *long-term capital gains* and need not be netted against § 1231 losses of the individual shareholder. This is a real advantage because the shareholder is getting ordinary loss treatment for his individual § 1231 losses. In addition, corporate § 1231 losses are ordinary losses and may contribute to the net operating loss which passes through to shareholders.⁴⁵

Benefits or Deductions Created or Lost:

Certain writers have described the S corporation as a "hybrid" — lying somewhere between partnerships and corporations. This is definitely true in the treatment of the various benefits and

⁴⁴61-5 C.C.H. Explanation, ¶ 4849.023 and I.R.C. § 1212.

⁴⁵18TH ANN. N.Y.U. INSTITUTE, pp. 703 and 729 (1960).

deductions. In the case of special corporate deductions, the S corporation is not allowed the usual 85% credit⁴⁶ against dividends received from other corporations, nor is it allowed the deduction for partially exempt interest⁴⁷ on certain U. S. obligations. On the other hand, it may elect to amortize organizational expenses over a five-year period, in conformity with the usual corporate rule.⁴⁸ As to sickness and accident benefits, the S corporation again follows the usual rules. Contributions to the plan are deductible by the corporation,⁴⁹ and are not taxable to the employees.⁵⁰ In addition, wages or payments in lieu of wages received by employees under the plan during a period of absence from work as a result of personal injury or sickness would be eligible for the "sick pay" exclusion under Code section 105(d). Deductions for charitable contributions in an "S" situation may be taken at both the corporate level (up to 5% of taxable income) and at the shareholder level (up to 30% [or 20%]).⁵¹ A corporation making the "S" election may likewise continue to deduct "salary" payments made to an employee's widow for a limited period, even though the widow or heirs are large shareholders. The recipients may exclude the amounts received as gifts provided the deceased employee did not have a non-forfeitable right to them. If these payments are treated by I.R.S. as "death benefits," the maximum exclusion will be \$5,000.⁵² Additional first-year depreciation⁵³ and pension and profit sharing benefits⁵⁴ would continue to be available to S corporations as to regular ones, but stock-bonus plans,⁵⁵ while available, should be left alone because of the danger of effecting a termination of the S election with too many shareholders or lack of 100% consents from new shareholders.

⁴⁶I.R.C. § 243; § 1373(d)(2).

⁴⁷I.R.C. § 242; § 1373(d)(2).

⁴⁸I.R.C. § 248; § 1373(d)(2).

⁴⁹I.R.C. § 162.

⁵⁰I.R.C. § 106.

⁵¹I.R.C. § 170(b).

⁵²I.R.C. § 101(b).

⁵³I.R.C. § 179.

⁵⁴I.R.C. §§ 401-404.

⁵⁵*Ibid.*

Returns by Electing Corporations and Shareholders:

Shareholders continue to file their usual Form 1040. The portion of corporate income coming from current earnings and profits is taxed to them as ordinary income and is reported in Schedule H ("Other Income and Losses"), at the bottom of page 3, Form 1040. The portion coming from accumulated earnings and profits as distinct from "undistributed taxable income" is taxed as ordinary income, but is eligible for the dividend exclusion and credit. This amount is reported in Schedule A ("Income from Dividends"), at the top of page 3, Form 1040. Capital gains, retaining their character in the shareholders hands are reported on separate Schedule D which accompanies Form 1040. According to *Rev. Rul. 59-221, 59-1 C. B. 225*:

Where a small business corporation elects under § 1372 of the Internal Revenue Code of 1954 not to be subject to Federal Income Tax, the amounts of its income which are required to be included in each shareholders' gross income do not constitute "net earnings from self-employment" to such shareholder for Self-Employment Contributions Act purposes.

This means this income, therefore, does not have to be reflected in the computation of self-employment tax on page 3 of Schedule C, Form 1040.

The electing corporation, no longer liable for any tax, files only an information return, Form 1120-S. Gains and losses from the sale of property are reported on separate Schedule D, Form 1120-S. Each shareholder's share of income is broken down in detail on Schedule K, page 3, Form 1120-S. The S corporation does not have to file a declaration of estimated tax,⁵⁶ but it is not excused from filing information returns usually required of corporations such as Form 1099 on total annual payments to any person in excess of \$600 and ordinary dividends of \$10 or over.

Termination of the Election

At some point in nearly every trip, a traveler turns and heads back from whence he came. In this study of the provisions of Subchapter S, we first considered the "fitness" requirements for

⁵⁶I.R.C. § 6016(a).

making the "trip." Then, we weighed the pros and cons of "going," and once on the trail, we looked at what effects our journey would have upon us. Just like the traveler, we have several routes available for returning to the point from which we began. This analysis of Subchapter S is concluded with an examination of the alternatives and the tax effect of each.

Formal Revocation:

Code § 1372(e)(2) and Regs. § 1.1372-4(b)(2) allow the "S election" to be terminated by the corporation by formal revocation, if all shareholders at the beginning of the day of revocation consent. The revocation will not apply to the first taxable year covered by the election nor will it apply to the taxable year in which it is made if made after the first month thereof. To make the revocation, the corporation must file a statement with its District Director to the effect that it revokes the election made under § 1372(a). The statement must be signed by any person authorized to sign the corporation's tax return and must indicate the taxable year for which the revocation is intended to take effect. Attached to the statement must be a consent signed by all stockholders as of the beginning of the day of revocation.

Termination by Disqualifying Acts:

In situations where the revocation procedure is not effective (i.e., (1) it is the first year covered by the election, (2) it is not possible to get consents from all stockholders, or (3) it is later in the year than the first calendar month) the election still may be terminated by a disqualifying act. This is done by failing to continue to meet the basic requirements of qualification mentioned early in this paper. Perhaps the easiest of these is to transfer stock to an individual (or an estate) who does not file a consent to the election within the 30-day period beginning on the day he becomes a shareholder. Other practical methods are: (1) increase the number of shareholders to more than ten; (2) transfer shares to a stockholder other than an individual or an estate; and (3) transfer shares to a non-resident alien or have a resident alien shareholder change his residence to outside the United States.⁵⁷ Violation of any of the remaining qualification requirements would also achieve termination, but the difficulty of doing so makes them impractical methods.

⁵⁷Stinson, George, *Terminating the Election under Subchapter S*, N.Y.U. 18TH ANN. INST. ON FED. TAX., pp. 709-10 (1960).

Effects of Termination:

The termination, whether by revocation or disqualifying act, takes effect for the taxable year in which it occurs, except in the case of a formal revocation filed after the first month of that taxable year. In this latter instance the termination is effective with the next taxable year.⁵⁸

Once terminated, the election cannot be made again by the corporation or "any successor corporation"⁵⁹ until the fifth taxable year after termination unless the Commissioner gives prior consent.⁶⁰ The Regulations show that the Commissioner, before consenting to an earlier election, will look to see if more than half the stock has changed hands since termination, or if the event causing termination was reasonably within control of the corporation or its shareholders and used as part of a plan.

Distribution made by the corporation during the tax year for which termination is effective are treated according to § 301 and not under Subchapter S. The possibility of getting U.T.I. out tax-free is lost with termination of the election,⁶¹ assuming that accumulated earnings and profits are present. This U.T.I. does not increase accumulated earnings and profits, however.⁶² The shareholder included U.T.I. in his taxable income and was allowed to increase his basis by the amount included.⁶³ Therefore, if no current or accumulated "e & p" are present, a tax-free distribution under § 301(c)(2) is possible. A subsequent new election by the same corporation will not change this result since the new election applies only to income earned after the new election.⁶⁴

⁵⁸I.R.C. § 1372(e); Regs. § 1.1372-4(c).

⁵⁹For definition see Regs. § 1.1372-5(b).

⁶⁰I.R.C. § 1372(f).

⁶¹Regs. § 1.1375-4(a).

⁶²I.R.C. § 1377(a).

⁶³I.R.C. § 1376(a).

⁶⁴Stinson, Geo., *Terminating the Election under Subchapter S*, N.Y.U. 18TH ANNUAL INSTITUTE ON FED. TAXATION (1960), p. 716.