1998

S Corporations

Bryan P. Collins
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S CORPORATIONS
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I. Introduction

The S corporation is one of the flow-through systems of taxation of corporate income that is permitted by the Internal Revenue Code. It was created by Congress in 1958 to achieve three major objectives: (i) to enable taxpayers to select the form in which to conduct business without regard to the tax consequences that would otherwise result from the choice between the corporate form and other business organizations; (ii) to eliminate the "double tax" effect created by the dual systems of corporate-shareholder taxation; and (iii) to permit the owners of a business to offset losses from their business against their other sources of income. S. Rep. No. 1983, 85th Cong., 2d Sess. (1958) at 87. However, the attractiveness of the S corporation form of business enterprise has changed repeatedly since 1958 due to changes in Subchapter S and in the basic structure of the tax system.

For example, the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (the "Sub S Revision Act"), substantially revised Subchapter S to bring its provisions more in line with its original purposes, to expand the availability of S corporation status, and to correct certain flaws in the operation of the Subchapter S rules. In addition, the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (the "1986 Act") fundamentally altered the choice-of-entity analysis by reducing the maximum individual tax rate below the maximum corporate tax rate, repealing the General Utilities doctrine, and repealing the preferential treatment of capital gain income. Further, the Revenue Reconciliation Act of 1993 altered the choice-of-entity analysis by increasing the maximum individual tax rate above the maximum rate applicable to corporations and reintroducing a significant capital gain preference.

More recent legislative and administrative actions also have had a profound impact on the attractiveness of Subchapter S status and the choice-of-entity decision. The Small Business Protection Job Act of 1996, Pub. L. No. 104-188 (the "1996 Act"), contained significant reforms to Subchapter S which have made S corporation status more appealing to a broader range of taxpayers. Among other things, the 1996 Act increased the number of allowable shareholders; expanded the types of persons that can be shareholders to include certain charities, qualified plans, and accumulation trusts; allowed S corporations to own up to 100 percent of the stock of other corporations; and allowed S corporations to elect to treat certain wholly-owned domestic subsidiaries as divisions for Federal tax purposes. In addition, the Internal Revenue Service ("IRS") recently issued regulations that permit an unincorporated business to select whether it will be taxed as a partnership or corporation by checking a box ("Check-the-Box Regulations"). Reg. §§301.7701-1-301.7701-3. These regulations also will have a significant effect on the choice-of-entity analysis and the form in which businesses operate. Finally, the Taxpayer Relief Act of 1997, P.L. 105-34, (the "1997 Act"), included provisions designed to make ownership of
S corporations by employee stock ownership plans ("ESOPs") more attractive, and increased the capital gains preference.

In general, the changes in the tax system since the 1950's, particularly those made by the 1996 Act, have caused the S corporation to take on increased significance in tax and business planning as an alternative to the more commonly-used forms of business enterprise -- partnerships and C corporations. This outline focuses on the tax issues that confront the owners and managers of a business, including an incorporated one, that is considering making, or has made, the election to be taxed as an S corporation for Federal income tax purposes. Most notably, this outline discusses: the issues that must be considered to be assured a corporation is qualified to be an S corporation; restructuring techniques to become qualified; and, the possible costs of converting to S corporation status (e.g., the application of the LIFO Recapture tax, the "Built-In Gain" tax, and the Passive Investment Income tax). Note, however, that this outline does not address state tax considerations, which can have a significant impact on the choice-of-entity decision.

All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated, or to the regulations promulgated thereunder.
II. Qualification as an S Corporation

A. Definition of S Corporation. Section 1361(a)(1) defines an S corporation as a "small business corporation" for which an election under Section 1362(a) is in effect. For tax years beginning after December 31, 1996, Section 1361(b)(1) provides that a "small business corporation" is (1) a domestic corporation, that (2) is not an "ineligible corporation," (3) does not have more than 75 shareholders, (4) does not have as a shareholder a nonresident alien or any person other than an individual (other than estates and certain trusts), and (5) does not have more than one class of stock. For tax years beginning after December 31, 1997, certain charities and qualified plans also may be S corporation shareholders. In addition, Section 1378(a) requires a corporation to have a "permitted" taxable year in order to make the election to be taxed as an S corporation. For taxable years beginning before January 1, 1997, a small business corporation could have only up to 35 shareholders.

B. Limitations on Types of Corporations. Only certain categories of corporations are permitted to elect S corporation treatment.

1. Domestic Corporation. The term "domestic corporation" means a corporation, as defined in Section 7701(a)(3), that is created or organized in the United States or under the laws of the United States or of any state or territory thereof. Treas. Reg. § 1.1361-1(c). An association taxable as a corporation, including a limited liability company ("LLC") that elects to be taxable as a corporation, is eligible to be an S corporation. Furthermore, a corporation formed under the laws of a foreign country must be reincorporated in the United States to be eligible. This transaction will be treated as a reorganization under Section 368(a)(1)(D). Under Section 367, however, this transaction will result in two levels of tax; one on the corporation and one on the shareholders. See PLR 9512001 (Sept. 30, 1994).

2. Not an "Ineligible Corporation". Under Section 1361(b)(2), certain corporations are prohibited from electing to become S corporations. See also Treas. Reg. § 1.1361-1(d).

   a. Member of Affiliated Group. For tax years beginning after December 31, 1996, there is no prohibition on an S corporation being a member of an affiliated group. The 1996 Act amended Section 1361(b)(2) to permit an S corporation to own 80 percent or more of the stock of a C corporation and to elect to treat certain wholly-owned domestic subsidiaries as divisions. (These 1996 Act provisions are discussed at Part III, below.) However, for prior tax years, an S corporation could not be a member of an affiliated group. For those prior years, an "affiliated group" was defined in Section 1504, without regard to the exceptions contained in Section 1504(b). Section 1361(b)(2)(A). The following is relevant only for those prior tax years.

      (i) Under Section 1504(a), a corporation was a member of an affiliated group if it possessed (i) at least 80 percent of the total voting power of the stock of another corporation and (ii) at least 80 percent of the total value of all classes of the stock of such
corporation (other than nonvoting nonconvertible preferred stock described in Section 1504(a)(4)).

(ii) A corporation that owned less than 80 percent of the voting power or value of the stock of another corporation would not be classified as a member of an affiliated group. Moreover, because Section 1504 contains no attribution rules, a corporation could have owned 79 percent of the stock of a subsidiary, with its shareholders owning the remaining 21 percent, without being classified as a member of an affiliated group. See TAM 9137003 (shareholder held 21 percent of corporation that held 21 percent of subsidiary, parent corporation owned the other shares of both corporations); PLR 8451049 (sale, redemption, or dividend of 21 percent of stock of wholly-owned subsidiary enabled parent to qualify as S corporation); PLR 8239155 (sale of one share of subsidiary's stock by parent owning 80 percent of stock enabled parent to qualify as S corporation); PLR 8219071 (sale or dividend distribution of more than 20 percent of stock of wholly-owned subsidiary enabled parent to qualify as S corporation). Compare PLR 8426007 (corporation eligible to make S corporation election when corporate officer bought more than 20 percent of stock of subsidiary; ruling emphasized that corporate officer had power to elect more than 20 percent of subsidiary's board of directors). It may have been possible for the parent corporation to retain rights (e.g., an option) with respect to the stock of the subsidiary held by a third party. Section 1504(a)(5) grants the IRS broad regulatory authority to treat warrants, obligations, convertible into stock, and other similar interests as stock and to treat options to acquire or sell stock as having been exercised. The regulations under Section 1504(a)(5), however, provide that options may be treated as exercised only for purposes of determining the percentage of value of stock owned by the holder. Treas. Reg. §1.1504-4(b)(2)(iii). Therefore, if the parent corporation did not directly own stock of the subsidiary possessing 80 percent of the voting power of all outstanding stock, the parent corporation's option to purchase the remaining shares of the subsidiary would not have caused the parent corporation to be affiliated with the subsidiary. This assumes that the option is not treated as stock under general principles of law. See Rev. Rul. 82-150, 1982-2 C.B. 110.

(iii) Former Section 1361(c)(6) contained a special rule pursuant to which the ownership of an inactive subsidiary would not have caused an S corporation to have been deemed an ineligible member of an affiliated group. To have qualified as an inactive subsidiary, the subsidiary (i) must not have begun business at any time on or before the close of the taxable year and (ii) must not have had any gross income for such taxable year. See Treas. Reg. § 1.1361-1A(d)(3).

(iv) The IRS disregarded transitory ownership of a subsidiary for purposes of Subchapter S in some circumstances. See Rev. Rul. 73-496, 1973-2 C.B. 312 (purchase by S corporation of all of the stock of another corporation, followed within 30 days by liquidation of subsidiary); Rev. Rul. 72-320, 1972-1 C.B. 270 (transfer of assets by S corporation to subsidiary as preliminary step in reorganization under Section 368(a)(1)(D)); PLR 9720033 (momentary affiliation in connection with a Section 355 corporate separation did not terminate the distributing corporation's S corporation election and did not preclude the controlled corporation from electing S corporation status on the first day of its tax year); PLR 8736014 (transfer of assets by S corporation to subsidiary as preliminary step in Section 355 transaction);
PLR 8522020 (transitory ownership of subsidiary at beginning of year of election); but see Haley Brothers Construction Corp. v. Commissioner, 87 T.C. 498 (1986) (disapproving Rev. Rul. 73-496, supra, in dicta as contrary to express provisions of the Code).

(v) In PLR 9626031, the IRS ruled that an S corporation did not constitute an "ineligible corporation" within the meaning of Section 1361(b)(2)(A) where the S corporation owned 92.5 percent of a limited liability company classified as a partnership for federal income tax purposes, which, in turn, owned 100 percent of a foreign entity classified as an association taxable as a corporation for federal income tax purposes. Similar conclusions were reached in PLR 9640010 and PLR 9716007.

b. **Certain Financial Institutions.**

(i) Effective for the taxable years beginning after December 31, 1996, the 1996 Act provides that a "bank," as defined in Section 581, will be an eligible small business corporation as long as it does not use the reserve method of accounting for bad debts (i.e., it must use the specific charge-off method of Section 166 to account for bad debts). There are a variety of issues presented when considering converting an existing bank into an S corporation, including changing its method of accounting for bad debts to a method other than the reserve method and the application of the built-in gain tax and the passive investment income tax. See Rev. Proc. 97-18 and Notice 97-5 for guidance on some of these bank-specific issues. Furthermore, in Rev. Proc. 97-37, 1997-33 I.R.B. 18, the Service described the procedures by which, *inter alia*, a bank (as defined in Section 581) that wants to change its method of accounting for bad debts from the Section 585 method to the Section 166 specific charge-off method, may obtain automatic consent to change its method of accounting. This guidance is inapplicable to any bank within the scope of Rev. Proc. 97-18, 1997-10 I.R.B. 53, applicable to banks making this change in 1997 to become eligible to elect S status in 1997. The bank's filing of a Form 2553 will constitute an agreement by the bank to change the method of accounting from the Section 585 reserve method to the Section 166 specific charge-off method for the election year.

(ii) For tax years beginning prior to January 1, 1997, the IRS treated banks, mutual savings banks, domestic building and loan associations, and nonprofit cooperative banks without capital stock, as ineligible to be S corporations pursuant to Section 1361(b)(2)(B). All of these are financial institutions subject to Sections 585 or 593, regarding reserves for losses on loans.

c. **Insurance Company.** Under Section 1361(b)(2)(C), an insurance company subject to tax under Subchapter L of the Code is an ineligible corporation for taxable years beginning after December 31, 1982.

d. **Possessions Corporation.** Section 1361(b)(2)(D) defines as ineligible, for taxable years beginning after December 31, 1982, a corporation to which an election under Section 936 applies. Section 936 grants a credit to certain corporations doing business in possessions of the United States.
e. **DISC or Former DISC.** A DISC or former DISC is an ineligible corporation pursuant to Section 1361(b)(2)(E).

C. **Limitations on Number of Shareholders.**

1. **Husband and Wife.** For purposes of determining the number of shareholders of a corporation, Section 1361(c)(1) provides that a husband and wife (and their estates) will be treated as one shareholder.

2. **Joint Owners.** When two or more persons (other than a husband and wife) own stock as tenants in common, both owners are considered shareholders for purposes of the limitation on the number of shareholders. See Treas. Reg. § 1.1361-1(e). The Service ruled in PLR 9803008 that the ownership of stock by shareholders as tenants-in-common does not create an ineligible shareholder under Section 1361(b)(1)(B). The Service reasoned that the mere ownership of stock by certain of its shareholders as tenants-in-common does not create an activity amounting to a trade, business, financial operation, or venture for profit. Thus, the tenancy-in-common ownership does not constitute a partnership pursuant to Sections 761 and 7701 and does not create an ineligible shareholder under Section 1361(b)(1)(B).

3. **Beneficial Owners.** The person who would be required to include dividends in gross income generally will be treated as the shareholder of an S corporation. Thus, when a nominee, agent, guardian, or custodian holds stock, the beneficial owner of such stock will be treated as the shareholder. Treas. Reg. § 1.1361-1(e). See also, Guzowski v. Commissioner, 26 T.C.M. 666 (1967).

4. **Section 83 Stock.** For purposes of determining the number of shareholders and the allocation of S corporation income or loss, a shareholder is not counted where (1) the shareholder owns stock that is issued in connection with the performance of services (within the meaning of §1.83-3(f)) and (2) the stock is substantially nonvested (within the meaning of §1.83-3(b)). Treas. Reg. §1.1361-1(b)(3). Section 1.83-1(a)(1) of the regulations provides that, until the property becomes substantially vested, the transferor (e.g., the issuing corporation) is regarded as the owner of the property. Under the Section 83 regulations, a shareholder’s stock is not vested if such stock is subject to a substantial risk of forfeiture and is nontransferable (as such terms are defined in Section 83). These rules do not apply, however, if the shareholder makes an election under Section 83(b). Id. This treatment of restricted stock generally is effective for taxable years beginning on or after May 28, 1992. However, stock issued on or before May 28, 1992, that has been treated as outstanding by the corporation (even though it is substantially non-vested), is treated as outstanding for purposes of Subchapter S, and the fact that it is substantially non-vested and no Section 83(b) election has been made with respect to it will not cause the stock to be treated as a second class of stock.

5. **Time for Determining Number of Shareholders.** An S corporation may not have more than 75 shareholders (35, for tax years beginning before January 1, 1997) at any one time during a taxable year. A corporation will not be disqualified, however, if it has, in the
aggregate, more than that number shareholders during a taxable year (e.g., because of stock transfers). See Rev. Rul. 78-390, 1978-2 C.B. 220.

6. **S Corporations in Partnerships.**

(i) In Revenue Ruling 94-43, 1994-2 C.B. 198, the IRS revoked Revenue Ruling 77-220, 1977-1 C.B. 263, in which the IRS had denied S corporation status to three corporations (each having 10 shareholders) that had formed a partnership in order to circumvent the then applicable maximum shareholder limitation (i.e., 10 shareholders). The IRS found that the purpose of the maximum shareholder limitation is to obtain simplicity in the administration of an S corporation's tax affairs by limiting the number of shareholders of the S corporation. In Rev. Rul. 94-43, the IRS reasoned that administrative simplicity is not affected by the corporation's participation in a partnership with other S corporation partners, and that a shareholder of one S corporation should not be considered a shareholder of another S corporation merely because the S corporations are partners in a partnership. Consequently, the IRS concluded that a partnership of S corporations does not increase administrative complexity at the S corporation level, and, therefore, that the purpose of the maximum shareholder limitation is not avoided by the structure set forth in Revenue Ruling 77-220.

(ii) Revenue Ruling 94-43 is consistent with a series of letter rulings issued by the IRS in recent years permitting numerous S corporations to form general or limited partnerships with other S corporations without being in violation of the maximum shareholder limitation prescribed under Section 1361(b)(1)(A). Although the IRS has taken a step in the right direction by issuing Revenue Ruling 94-43, uncertainty still exists concerning the extent to which partnerships may be used to avoid S corporation limitations other than the maximum shareholder limitation. Because the IRS relied on a "purpose" test in reaching its conclusion in Revenue Ruling 94-43, it will be necessary to analyze the purpose for other S corporation limitations in order to determine whether the use of a partnership to circumvent such limitations would violate the purpose of the particular limitation. Consequently, it will be necessary to examine the purpose for the single-class-of-stock limitation under Section 1361(b)(1)(D); the prohibition on having a nonresident alien as a shareholder under Section 1361(b)(1)(C); the prohibition on an S corporation having shareholders other than an individual, a decedent's estate, an individual's estate in bankruptcy, a qualified plan or qualifying charity (in tax years beginning after 1997), or one of the defined types of trusts set forth in Section 1361(c); and the prohibition against an S corporation being an "ineligible corporation" under Sections 1361(b)(1) and (2). The Section 701 regulations also include an example that suggests that the IRS will not attack the use of a partnership to avoid the prohibition on an S corporation having a non-resident alien as a shareholder. Treas. Reg. §1.701-2(d) Example 2. With respect to each of these particular S corporation limitations, however, it may be difficult to determine the purpose for such limitation, which will in turn make it very difficult to determine whether the use of a partnership to avoid such limitations will be respected by the IRS. Nevertheless, in practice, most tax advisors take the view that Rev. Rul. 94-43 signals broader determination by the IRS to not attack the use of partnerships to avoid S corporation eligibility limitations.
(iii) If a partnership is employed to avoid an S corporation limitation, tax advisors must also assess the effect of: (1) the recently-issued (and much criticized) partnership anti-abuse rules prescribed under Regulations Section 1.701-2; (2) general federal income tax principles relating to the existence of a partnership; and (3) the single class of stock regulations set forth under Sections 1.1361-1(b) and (l) of the regulations. Consequently, although Revenue Ruling 94-43 signals a more liberal attitude on the part of the IRS towards partnerships of S corporations, caution should still be used in structuring such transactions. Consistent with this liberal attitude, the IRS has ruled (see e.g., PLR 9626031) that an S corporation continues to be a qualified small business corporation even though it indirectly owns more than 80 percent of the stock of another corporation through a partnership.

D. Limitations on Types of Shareholders. In Section 1361(b)(1)(B) and (C), limitations are placed upon the types of persons that may own stock in an S corporation. A corporation generally will be ineligible to elect or maintain S corporation status for any year in which an ineligible shareholder owns stock, even if such ownership is merely transitory. See, e.g., Rev. Rul. 80-169, 1980-1 C.B. 188 (corporation as shareholder); Rev. Rul. 59-235, 1959-2 C.B. 192 (partnership as shareholder); but see discussion at Part D.3, below, and PLR 8739010 (6/26/87) (acquisition by C corporation of stock of S corporation, followed by distribution of such stock to shareholders of C corporation and merger of C corporation into S corporation, did not terminate S corporation election of acquired corporation).

1. No Nonresident Aliens. Section 1361(b)(1)(C) prohibits a nonresident alien from owning the stock of an S corporation. Section 1.1361-1(g)(i) of the regulations provides that if a U.S. shareholder's non-resident alien spouse has a current ownership interest in the stock by reason of applicable laws (e.g., community property laws) the corporation does not qualify to be an S corporation.

2. No Person Not an Individual (Other Than Estates, Certain Trusts, Certain Charities and Qualified Plans). Section 1361(b)(1)(B) limits the permissible shareholders of an S corporation to individuals, their estates, and certain trusts. For tax years beginning after December 31, 1997, certain charities and qualified retirement plans also can be shareholders. A corporation having another corporation, a partnership, or an IRA as a shareholder may not be an S corporation.

a. Estates

(i) A decedent's estate may be the shareholder of an S corporation under Section 1361(b)(1)(B). If the administration of a decedent's estate is prolonged unduly, however, the estate may be treated as a testamentary trust for federal income tax purposes, in which case the corporation may lose its status as an S corporation. See Old Virginia Brick Co. v. Commissioner, 44 T.C. 724 (1965), aff'd, 18 A.F.T.R. 2d 5750 and Brown v. Commissioner, 425 F.2d 1406, (5th Cir. 1989). An estate will not be deemed an ineligible shareholder, however, if it remains open to hold stock during the deferral period permitted by Section 6166 with respect to estate taxes. Rev. Rul. 76-23, 1976-1 C.B. 264.
(ii) Section 1361(c)(3) expressly provides that an individual’s estate in bankruptcy is a permissible shareholder of an S corporation. See also Treas. Reg. 1.1361-1(b)(2).

b. **Trusts**

(i) **Domestic Trusts.** Section 1361(c)(2) permits an S corporation to have as a shareholder certain domestic trusts. Foreign trusts are specifically made ineligible as shareholders.

(ii) **Grantor Trusts.** A "grantor trust," all of which is treated as owned by an individual citizen or resident of the United States pursuant to the grantor trust rules of Sections 671 through 678, is a permissible S corporation shareholder pursuant to Section 1361(c)(2)(A)(i). Section 1361(c)(2)(B)(ii) provides that the deemed owner of such a trust is treated as the shareholder of the S corporation for purposes of determining the corporation’s eligibility as an S corporation. For tax years beginning after December 31, 1996, after the death of the grantor, the trust generally may continue as an S corporation shareholder for up to two years. For tax years beginning before 1997, the trust could continue as an S corporation shareholder for up to 60 days (if the entire corpus of the trust was not included in the grantor’s gross estate) or two years (if the entire corpus of the trust was included in the grantor’s gross estate) pursuant to Section 1361(c)(2)(A)(ii); in such a case, the estate of the deemed owner was treated as the shareholder pursuant to Section 1361(c)(2)(B)(ii).

(iii) **Testamentary Trusts.** A testamentary trust, to which stock is transferred pursuant to the terms of a will, may qualify as an S corporation shareholder under Section 1361(c)(2)(A)(iii), but only for the two-year period beginning on the day the stock is transferred to the trust. The estate of the testator is treated as the shareholder for purposes of determining the corporation’s eligibility as an S corporation under Section 1361(c)(2)(B)(iii). (This permitted holding period is only sixty days for the taxable years beginning before January 1, 1997).

(iv) **Voting Trusts.** A voting trust, created primarily to exercise the voting power of the stock transferred to it, is a permissible shareholder of an S corporation under Section 1361(c)(2)(A)(iv). Under Section 1361(c)(2)(B)(iv), each beneficiary of such a trust is to be treated as a shareholder of the S corporation for purposes of determining the corporation’s eligibility as an S corporation. Thus, a voting trust cannot be used to avoid the limitation on the number of shareholders of an S corporation.

(v) **QSSTs.**

(a) Under the special rules of Section 1361(d), a "qualified Subchapter S trust" may own the stock of an S corporation if the beneficiary so elects. A qualified Subchapter S trust -- or "QSST" -- is a trust having certain characteristics delineated in Section 1361(d)(3), with respect to which a QSST election has been made, including an election to treat the beneficiary of the trust as the owner of the S corporation stock held by such...
trust. Under Section 1361(c)(2)(B)(i), the beneficiary also is treated as the shareholder of the corporation for purposes of determining its eligibility as an S corporation.

(b) In Treas. Reg. §1.1361-1(j)(8), the IRS reversed Revenue Ruling 92-84, 1992-2 C.B. 216, in which the IRS had ruled that, if a QSST sells its S corporation stock, the current income beneficiary (rather than the trust) must recognize the gain on the sale. The regulations now provide that the trust should be considered to have sold the stock. A similar conclusion was reached in PLR 9828006 with respect to gain recognized by QSST under Section 338(h)(10).

(c) In Revenue Ruling 93-31, 1993-1 I.C.B. 186, the IRS ruled that a trust was not a QSST where the trust instrument authorized the trustee to distribute the trust corpus to someone other than the current income beneficiary of the trust if necessary (after taking into account such other person's income) for such other person's health, education, support or maintenance. The other person to whom the trust corpus could be distributed had substantial income, and as such, there was only a remote possibility that the trustee would exercise his power to distribute corpus to such person. The IRS concluded, however, that even a remote possibility that the corpus of a trust will be distributed during the lifetime of the current income beneficiary to someone other than such beneficiary violates the requirement set forth in Section 1361(d)(3)(A)(ii) that the terms of a QSST require that any corpus distributed during the life of the current income beneficiary be distributed only to such beneficiary.

(d) In Revenue Ruling 93-79, 1993-2 C.B. 269, the IRS found that a state court order which retroactively reformed a trust to meet the requirements of a QSST under Section 1361(d)(3) did not have retroactive effect for purposes of determining the trust's eligibility to be a shareholder of an S corporation. Under the terms of the trust, a portion of the trust corpus could be distributed to a person other than the current income beneficiary during the life of the current income beneficiary in violation of the requirement set forth under Section 1361(d)(3)(A)(ii). The S corporation of which the trust was a shareholder filed an election to be an S corporation for its taxable year beginning January 1, 1992. On January 31, 1993, the beneficiaries of the trust executed an agreement reforming the trust to comply with the requirements of a QSST, and on February 15, 1993, the appropriate state court issued an order ruling that the trust was reformed retroactive to December 31, 1991, immediately prior to the January 1, 1992 effective date of the corporation's S election. According to the revenue ruling, because the original terms of the trust did not satisfy the requirements of Section 1361(d)(3)(A)(ii) regarding distribution of corpus, the trust was not a QSST and was therefore ineligible to be an S corporation shareholder. Consequently, the IRS concluded that the S corporation election filed on March 15, 1992, effective January 1, 1992, was not effective since the trust held shares of the S corporation at the time the election was filed.
Electing Small Business Trusts.

(a) Effective for tax years beginning after December 31, 1996, stock in an S corporation can be held by an "electing small business trust" or "ESBT." Unlike a QSST, an ESBT can have multiple beneficiaries and can accumulate income.

(b) In order to qualify to be an ESBT, all beneficiaries of the trust must be (1) individuals, (2) estates eligible to be S corporation shareholders, or (3) charitable organizations described in Section 170(c)(2), (3), (4) or (5). For tax years beginning before 1998, however, such charitable organizations can hold only contingent remainder interests. In addition, no interest in the trust may be acquired by purchase (the trust can acquire the S corporation stock by purchase). For this purpose, "purchase" means any acquisition of property with a cost basis (determined under Section 1012). Thus, interests in the trust must be acquired by reason of gift, bequest, etc. Further, the trust cannot be a QSST or a trust that is exempt from tax (such as a charitable remainder annuity trust or a charitable remainder unitrust).

(c) Each potential current beneficiary of the trust is counted as a shareholder for purposes of the 75-shareholder limitation and the shareholder eligibility rules. (If there are no potential current beneficiaries, the trust will be treated as the shareholder.) Thus, as a practical matter, a nonresident alien cannot be a potential current beneficiary. A potential current income beneficiary means any person, with respect to the applicable period, who is entitled to or, at the discretion of any person may receive, a distribution from the principal or income of the trust.

(d) The portion of the ESBT which consists of stock in one or more S corporations is treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. This separate trust is taxed at the highest individual rate on this portion of the trust's income, and is not entitled to any exemption amount under Section 55. Section 644(d). The legislative history of the 1996 Act provides that, the taxable income attributable to this portion includes, to the extent provided in regulations, any state or local income taxes and administrative expenses of the trust properly allocable to the S corporation stock.

(e) The only items of income, loss, deduction or credit taken into account with respect to this separate trust are (1) the items passed through to the trust as an S corporation shareholder pursuant to Section 1366 (cash distributions are irrelevant for this purpose), (2) any gain or loss from the disposition of S corporation stock, and (3) to the extent provided in regulations, state or local income taxes or administrative expenses allocable to the two items described above. These items are not taken into account in determining the tax imposed on the portion of the ESBT that does not hold the S corporation stock or in determining the distributable net income of the entire trust. Section 644(d)(2)(C).
(f) If an ESBT holds assets in addition to S corporation stock, it is unclear how the trustee will be required to allocate distributions from the ESBT to its shareholders as between the portion of the trust attributable to the S corporation stock and the other portion of the trust.

(g) It is unclear whether a protective election to be a ESBT may be made with respect to a trust seeking QSST status. It is also unclear whether an ESBT election can be made for a grantor trust.

(h) As of the date this document was submitted, the only guidance that had been issued on ESBTs was Notice 97-12, relating to the procedure for making an ESBT election and Notice 97-49, 1997-36 I.R.B. 8. In Notice 97-49, the Service provided certain guidance on the qualification of trusts for ESBT status and the taxation of distributions from an ESBT to its beneficiaries. For this purpose, the Service indicated that to qualify as an ESBT under Section 1361(c)(2)(A)(d), a trust must meet the requirements set forth in Section 1361(e)(1)(including the limitation on the types of beneficiaries). In this regard, the Service indicated that the ESBT's potential current beneficiaries must be qualifying shareholders of the S corporation for purposes of Section 1361(b)(1). However, the Notice indicated that the term "Beneficiary" does not include a so-called: "distributee trust" (defined as a trust that is receiving or may receive a distribution from an intended ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred), but does include those persons who have a beneficial interest in the property held by the distributes trust.

The Service also provided in the Notice that: (i) the term "beneficiary" does not include a person in whose favor a power of appointment could be exercised and that such a person becomes a beneficiary only when the holder of the power of appointment actually exercises the power in such person's favor; (ii) the term "beneficiary" does not include a person whose contingent interest is so remote as to be negligible (giving as an example that the contingent interest a State has under its laws pertaining to escheat would normally be considered negligible, and the State would not be considered a beneficiary of the intended ESBT); (iii) Section 1361(c)(2)(E)(v) provides, that each potential current beneficiary of an ESBT shall be treated as a shareholder for purposes of determining whether a corporation qualifies as an S corporation, except that the trust is treated as the shareholder for any period in which there is no potential current beneficiary; and (iv) if a distributee trust becomes entitled to, or at the discretion of any person may receive, a distribution from principal or income of the intending ESBT, and the S corporation election will terminate unless the distributee trust is also a trust described in Section 1361(c)(2)(A)(e.g., an ESBT, a QSST, etc.), in that event, the persons treated as the owner of the S corporation stock owned by such trusts are treated as the shareholders of the corporation for purposes of determining whether the shareholder restrictions under Section 1361(b)(1) are met.

The Service also indicated that a person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of a power of appointment) is not a potential current beneficiary until such time or the occurrence of
such event. Whether a person to whom a distribution is or may be made during a period pursuant to a power of appointment is a potential current beneficiary remains under study by the Service.

Finally, in light of Section 641(d)(i), which provides that the portion of an ESBT that consists of stock in one or more S corporation (the "S Portion") is taxed as a separate trust, the Service indicated that because the S Portion items are not includable in the computation of an ESBT's DNI, they are treated for purposes of determining the treatment of trust distributions in the same manner as any other item that does not enter into DNI computation (e.g., capital gains and losses allocated to corpus). For example, for the tax year an ESBT has $40 of DNI from the non-S portion, and $70 of net fiduciary accounting income from the S portion. If the ESBT makes a distribution of $100, the distributions will include $40 of DNI, notwithstanding that the trust will be taxed on $70. There is considerable question whether this approach is the only plausible interpretation of the ESBT provisions (e.g., the provisions might be interpreted to provide that S corporation income of an ESBT is distributed prior to its DNI or on a proportional basis).

(vii) Conversions From QSST To ESBT and Vice Versa. On February 19, 1998, the Service issued Rev. Proc. 98-23 addressing the requirements for conversion of a QSST to an ESBT and vice versa. The Revenue Procedure, however, does not provide guidance on whether a trust qualifies as a QSST or an ESBT. It notes that in particular, the Service is studying whether a trust qualifies as an ESBT if any portion of the trust is treated as owned by the grantor or another person under the provisions of subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code.

(a) Under these procedures, a trust is eligible to convert from a QSST to an ESBT if: (i) the trust meets all of the requirements to be an ESBT under section 1361(e), except for the requirement under Treas. Reg. §1.1361(e)(1)(B) that the trust not have a QSST election in place under section 1361(d)(2); (ii) the trustee and the current income beneficiary of the trust make the ESBT election pursuant to section 4.02 of Rev. Proc. 98-23 with respect to the stock of each S corporation held by the trust; (iii) the trust has not converted from an ESBT to a QSST within the 36 month period preceding the effective date of the new ESBT election; and (iv) the date on which the ESBT election is to be effective cannot be more than 15 days and 2 months prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. The current income beneficiary and the trustee of the trust must sign an ESBT election and file it with the service center where the S corporation files its income tax return. Furthermore, a separate election must be made with respect to the stock of each S corporation held by the trust.

(b) Under this Revenue Procedure, a trust is eligible to convert from an ESBT to a QSST if: (i) the trust meets all of the requirements to be a QSST under §1361(d); (ii) the trustee and current income beneficiary of the trust make the QSST election with respect to the stock of each S corporation held by the trust; (iii) the trust has not converted from a QSST to an ESBT within the 36 month period preceding the effective date of the new QSST election; and (iv) the date on which the QSST election is to be effective cannot be more than 15 days and 2 months prior to the date on which the election is filed and cannot be
more than 12 months after the date on which the election is filed. The Revenue Procedure provides for requirements substantially similar to those with respect to a QSST to ESBT conversion described above.

(c) A trust that wishes to convert within 36 months of a previous conversion must submit an application for consent to revoke the QSST or ESBT election to the Service in the form of a letter ruling request under Rev. Proc. 98-1, 1998-1 I.R.B. 7. The application must be signed by the current income beneficiary and the trustee.

c. **Tax-Exempt Entities**

(i) For taxable years beginning after December 31, 1997, the 1996 Act amended Subchapter S to permit tax-exempt organizations described in Sections 401(a) and 501(c)(3) ("qualified tax-exempt shareholders") to be a shareholder in an S corporation. These include ESOPs, pension plans, and certain charities. For purposes of determining the number of shareholders of an S corporation, a qualified tax-exempt shareholder will count as one shareholder.

(ii) Items of income or loss of an S corporation will flow through to qualified tax-exempt shareholders, other than ESOPs, as unrelated business taxable income, regardless of the source or nature of such income (e.g., passive income of an S corporation will flow through as UBTI.) In addition, gain or loss on the sale or other disposition of stock of an S corporation by a qualified tax-exempt shareholder, other than an ESOP, will be treated as UBTI. As a result of a provision contained in the 1997 Act, ESOPs are not subject to UBIT on S corporation items. (Special rules, however, apply in the case of S corporation ESOPs, such as unavailability of Section 1042 treatment.)

3. **Single Member LLCs as Shareholders.** In PLRs 9739014 and 9745017, the Service ruled that the transfer of S corporation stock by a shareholder to a single member LLC does not terminate the S corporation election nor effect the ability of corporation from qualifying from an S corporation. In so holding, the Service recognized that single member LLCs are disregarded as entities separate from their owners for Federal tax purposes.

4. **Momentary Ineligible Shareholders.** In PLRs 9421022 (Feb. 24, 1994), and 9422055 (Mar. 10, 1994), the IRS ruled that, in connection with the incorporation of a partnership, the transfer of all of the assets and liabilities of the partnership to an S corporation in exchange for the S corporation's stock, followed by the immediate distribution of the S corporation's stock in liquidation of the partnership to its partners, would not affect the corporation's status as an S corporation and that the partnership's momentary ownership of the corporation's stock would be disregarded for purposes of determining whether the corporation was a "small business corporation" under Section 1361(b). In reaching its conclusion, the IRS found the partnership's momentary ownership of the corporation's stock analogous to the situation presented in Revenue Ruling 72-320, 1972-1 C.B. 270, where the IRS had found that an S corporation's momentary ownership of all of the stock of another corporation in connection
with a spin-off under Sections 355 and 368(a)(1)(D) would not terminate the corporation's S
election. The IRS also has issued a number of private rulings consistent with Rev. Rul. 72-320.
See e.g., PLRs 9746047, 9730014, 9730015, 9730016, 9730025, 9742018 and 9746031.

E. **Limitations on Classes of Stock.** Pursuant to Section 1361(b)(1)(D), an
S corporation may have only one class of stock.

1. **Economic Rights Identical.**

   a. **In General.** A corporation is considered to have more than one
class of stock if the outstanding shares of the stock of such corporation do not confer identical
rights to distribution and liquidation proceeds of the corporation. Treas. Reg. § 1.1361-1(l)(1).

   b. "Non-Pro-Rata Distributions"

      (i) The regulations provide that distributions (including actual,
constructive, or deemed distributions) that differ in timing or amount are to be given the
appropriate tax effect in accordance with the facts and circumstances and do not create a second
class of stock. Treas. Reg. § 1.1361-1(l)(2)(i), See also, Treas. Reg. § 1.1361-1(l)(2)(v) Example
2 (distributions differing in timing do not cause more than one class of stock, but Section 7872
principles may apply to determine the appropriate tax consequences). For example, if an S
corporation has two equal shareholders and the compensation paid to one shareholder pursuant to
an employment agreement is excessive, the excessive compensation generally does not create
more than one class of stock. See Treas. Reg. § 1.1361-1(l)(2)(v) Example 3. For a similar
result with respect to fringe benefits provided to shareholder/employees, see Treas. Reg.
§ 1.1361-1(l)(2)(v) Example 4. (See discussion below regarding the circumstances where non-
pro rata distributions could result in more than one class of stock.)

      (ii) State laws that require a corporation to pay or withhold
state income taxes on behalf of some or all of the corporation shareholders are disregarded in
determining whether all outstanding shares of stock of the corporation confer identical rights to
distribution and liquidation proceeds, provided that, when the constructive distributions resulting
from the payment or withholding of taxes by the corporation are taken into account, the
outstanding shares confer identical rights to distribution and liquidation proceeds. Treas. Reg. §
1.1361-1(l)(2)(ii). A difference in timing between the constructive distributions and the actual
distributions to the other shareholders does not cause the corporation to be treated as having
more than one class of stock. Id.

   c. **The Governing Provisions.** The regulations provide that, for
purposes of determining whether a corporation has more than one class of stock, one must
examine the corporation's "governing provisions." The term "governing provisions" is defined to
include the corporation's corporate charter, articles of incorporation, bylaws, applicable state law
and binding agreements relating to distribution and liquidation proceeds. Treas. Reg. § 1.1361-
1(l)(2)(i). A routine commercial contractual arrangement, such as lease, employment agreement
or loan agreement, is not considered to be a binding agreement relating to distribution and
liquidation proceeds and, thus, is not a governing provision, unless such an agreement is entered into with a principal purpose of circumventing the one-class of stock requirement. However, binding agreements that are not "routine commercial arrangements" and that vary the shareholders' rights to distributions and/or liquidation proceeds will result in more than one class of stock. See, Treas. Reg. § 1.1361-1(l)(2)(v) Example 6 (agreement to gross-up shareholders' distributions for state tax liabilities). Therefore, if non-prorata distributions evidence a binding agreement among the shareholders to confer different rights to different shares, such distributions could result in more than one class of stock. In PLR 9821006, the IRS ruled that the one class of stock requirement was not violated when two shareholder groups agreed to receive different amounts at different times in a stock sale in which the parties agreed to elect under Section 338(h)(10) to treat the transaction as an asset sale followed by a liquidation.

d. **Buy-Sell Agreements and Restrictions on Transferability.** The regulations provide safe-harbors for certain buy-sell agreements among shareholders, certain restrictions on the transferability of stock, and certain redemption agreements, by excluding such agreements from the corporation's "governing provisions." In this regard, bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded. Treas. Reg. § 1.1361-1(l)(2)(iii). In addition, bona fide buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded unless (1) a principal purpose of the agreement is to circumvent the one-class-of-stock requirement and (2) such agreement establishes a purchase price that at the time of the agreement is significantly in excess of or below the fair market value of the stock. For these purposes, the regulations establish the safe harbor that the redemption price will be deemed appropriate if it is either (1) equal to book value or (2) between book value and fair market value. Treas. Reg. § 1.1361-1(l)(2)(iii). The IRS will entertain requests for private rulings in this area. See e.g., PLR 9308006 and PLR 9317009. One might question the usefulness of these rulings, however, because it appears that the taxpayers were required to make representations on all of the significant issues (e.g., the principal purpose of the agreement). In PLRs 9425023 and 9425027, the IRS ruled that a stock restriction agreement between an S corporation and its three shareholders pursuant to which the purchase price for one of the shareholder's shares was less than the purchase price for the other two shareholders' shares, would not cause the corporation to have more than a single class of stock under Section 1361(b)(1)(D). The IRS, citing Section 1.1361-1(l)(2)(iii)(B) of the regulations, found that the restrictions placed on the shareholders' shares in the stock restriction agreement would be disregarded in determining whether the corporation's shares of stock conferred identical rights to distribution and liquidation proceeds since the stock restriction agreement constituted a bona fide agreement to redeem or purchase stock at the time of death, divorce, disability or termination of employment. Similar conclusions have been reached in other private rulings based on the fact that the purchase price provided in the redemption agreement was between the stock's book value and its fair market value.

2. **Voting Rights May Differ.** Section 1361(c)(4) specifically states that a corporation will not be treated as having more than one class of stock solely because differences in voting rights exist among shares of common stock. Therefore, provided each share of stock has identical rights to distributions and liquidation proceeds, an S corporation should be able to
have: (i) voting and nonvoting stock; (ii) a "class" of stock that votes only on certain issues; or (iii) different "classes" of stock that differ with respect to rights to elect members of the board of directors. In addition, the shareholders can vary the voting rights by agreement. See, Treas. Reg. § 1.1361-1(l)(1).

3. **Definition of Stock.** In determining whether a corporation has more than one class of stock, only its issued and outstanding stock is considered. Thus, Treasury stock and authorized but unissued stock of a different class than that held by the shareholders will not affect the corporation's eligibility to be an S corporation. Treas. Reg. § 1.1361-1(l)(3).

a. **Deferred Compensation Plans.** An instrument, obligation, or arrangement is not treated as outstanding stock if it: (i) does not convey the right to vote; (ii) is an unfunded and unsecured promise to pay money or property in the future; (iii) is issued to an employee in connection with the performance of services for the corporation or to an individual who is an independent contractor in connection with the performance of services for the corporation (and is not excessive by reference to the services performed); and (iv) is issued pursuant to a plan with respect to which the employee or independent contractor is not taxed currently on income. Treas. Reg. § 1.1361-1(b)(4). A deferred compensation plan also can be eligible for this rule even though it contains a current payment feature (e.g., payment of dividend equivalent amounts that are taxed currently as compensation). Id. Therefore, phantom stock plans and similar stock equivalent plans are permissible. See e.g., PLR 9317021 (January 27, 1993). In PLRs 9421011 (Feb. 22, 1994), 9421024 (Feb. 24, 1994), 9501032 (Oct. 5, 1994), and 9626033 (Apr. 30, 1996), the IRS, citing Section 1.1361-1(b)(4) of the regulations, ruled that the respective S corporations' deferred compensation plans and phantom stock plans would not cause the respective corporations to violate the single-class-of-stock requirement.

b. **Stock That Is Substantially Nonvested Under Section 83.** Stock that is substantially nonvested (within the meaning of Reg. § 1.83-3(b)) is not outstanding stock for purposes of the one-class-of-stock requirement. Treas. Reg. § 1.1361-1(b)(3). If a shareholder holding substantially-nonvested stock makes a Section 83(b) election (to include the value of such stock in income in the year received), such stock will be considered outstanding for this purpose and will be treated as a second class of stock unless it has rights to distributions and liquidation proceeds that are identical to other shares. Treas. Reg. §§ 1.1361-1(b)(3), (l)(1), and (l)(3). As discussed above, however, the regulations also provide that restrictions on transferability will be disregarded under certain circumstances.

c. **Stock Options, Warrants, Etc.** A call option, warrant, or similar instrument ("options") issued by the corporation is treated as outstanding stock that constitutes a second class of stock if the option (1) is "substantially certain to be exercised" by the holder or a potential transferee and (2) has a strike price substantially below the fair market value of the underlying stock on the date it is issued, transferred, or modified. Treas. Reg. § 1.1361-1(l)(4)(iii)(A). Convertible debt instruments that embody rights equivalent to those of an option are required to be evaluated both under the debt rules (described below) and the option rules. Treas. Reg. § 1.1361-1(l)(4)(iv). These rules reverse the prior IRS position that stock options

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and warrants may not constitute a second class of stock for these purposes. Rev. Rul. 67-269, 1967-2 C.B. 298.

(i) **Substantially Certain to be Exercised Test.** The regulations contain several additional rules regarding the application of the “substantially certain to be exercised” test.

- First, the determination of whether an option is substantially certain to be exercised must be made by looking, not only at the holder of the option, but also at potential transferee of the holder. (A corporation may be unlikely to exercise the option and terminate the company's S election, but it may transfer a valuable option to an eligible shareholder that would exercise the option.)

- Second, the determination of whether the option is substantially certain to be exercised and has a strike price substantially below fair market value must be made on the date that the option is issued, transferred to an ineligible shareholder, or materially modified. If the option is issued in connection with a loan and the time period in which the option can be exercised is extended in connection with (and consistent with) a modification of the loan, however, the option is not re-tested at the time the loan terms are modified. Treas. Reg. § 1.1361-1(l)(4)(iii)(A).

- Third, the regulations provide that the an option will not have a strike price substantially below fair market value if, pursuant to the terms of the instrument, the price at the time of exercise cannot be substantially below the fair market value of the underlying stock at the time of exercise. *Id.* The regulations provide a safe-harbor that treats the strike price as not substantially below the fair market value of the stock if such strike price is at least 90 percent of the fair market value of the underlying stock on the testing date. Treas. Reg. § 1.1361-1(l)(4)(iii)(C). For this purpose, a good faith determination of fair market value by the corporation will be respected unless it can be shown that the value was substantially in error or the determination of the value was not performed with reasonable diligence.

(ii) **Exceptions.** Options issued by the corporation to a person that is actively and regularly engaged in the business of lending is not a second class of stock if such option is issued in connection with a loan to the corporation that is commercially reasonable. Treas. Reg. § 1.1361-1(l)(4)(iii)(B)(1). An option issued in connection with the performance of services is not a second class of stock if it was issued to an employee or independent contractor, provided the option is not excessive by reference to the services performed and the option is nontransferable (within the meaning of Reg. § 1.83-3(d)) and does not have a readily ascertainable fair market value (within the meaning of Reg. § 1.83-7(b)) at the time the option is issued. Treas. Reg. § 1.1361-1(l)(4)(iii)(B)(2). Once this latter exception ceases to apply (*e.g.*, the option becomes transferable), it is then tested under the general approach (*i.e.*, if it is modified or transferred to an ineligible shareholder, it will result in more than one class of stock if it is substantially certain to be exercised and the strike price is...
substantially below the fair market value of the stock). See Treas. Reg. § 1.1361-1(b)(4)(v)
Example 2.

d. **Straight Debt.** Debt that qualifies for the straight debt safe harbor in Section 1361(c)(5) (discussed below) is not treated as outstanding stock. Prop. Reg. § 1.1361-(b)(5).

e. **Split Dollar Life Insurance.** In PLRs 9309046 (Dec. 9, 1992), and 9331009 (May 5, 1993), the IRS ruled that an S corporation's split-dollar life insurance agreement with its shareholders would not cause the corporation to violate the single-class-of-stock requirement set forth in Section 1361(b)(1)(D). Under the corporation's split-dollar life insurance agreement, the corporation paid all of the premiums on insurance policies purchased and owned by the shareholders or their trusts, but required each shareholder or such shareholder's trust to reimburse the corporation to the extent the payment conferred an economic benefit on that shareholder. Additionally, following the final premium payment, each shareholder or such shareholder's trust was required to annually reimburse the S corporation to the extent the paid-up insurance policy conferred an economic benefit on that shareholder. The IRS concluded that the corporation's split-dollar life insurance arrangement did not alter rights to distribution and liquidation proceeds, and as such, did not create more than one class of stock within the meaning of Section 1361(b)(1)(D). See, also, PLR 9709027 (Nov. 27, 1996) (split-dollar life insurance arrangement between corporation and trust did not create a second class of stock for the S corporation.)

4. **Debt as a Second Class of Stock.**

a. **Background.** Since 1959, when the Treasury Department first adopted regulations under Subchapter S, the IRS has argued that, if an instrument purporting to be a debt instrument actually constitutes equity, it will be treated as a second class of stock for purposes of determining the corporation's eligibility as an S corporation. Following the issuance of a 1966 regulation, which stated that debt held in proportion to stock ownership would not be treated as a second class of stock, the IRS asserted deficiencies against a number of shareholders of S corporations on the ground that debt was not held by them in proportion to their stock ownership. The courts rejected the contentions of the IRS and the validity of the regulation in Portage Plastics Co. v. United States, 486 F.2d 632 (7th Cir. 1973); Amory Cotton Oil Co. v. United States, 468 F.2d 1046 (5th Cir. 1972); Shores Realty Co. v. United States, 468 F.2d 572 (5th Cir. 1972); and Stinnett v. Commissioner, 54 T.C. 221 (1970). The Treasury Department withdrew the regulation in 1980 in connection with its issuance of an early version of regulations under Section 385. T.D. 7747, 1981-1 C.B. 141. In 1983, however, the Treasury Department suspended its efforts to draft comprehensive Section 385 regulations and reinstated the 1966 regulation regarding proportionate debt of S corporations. T.D. 7920, 1983-2 C.B. 69. In May of 1992, the new one-class-of-stock regulations were finalized and replaced the 1966 regulations.

b. **The Regulations.** The current regulations provide that an instrument, obligation, or arrangement will be treated as creating a second class of stock if it: (i) constitutes equity or otherwise results in the holder being treated as the owner of stock under...
general principles of Federal tax law; and (ii) a principal purpose of issuing or entering into the instrument is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders. Treas. Reg. § 1.1361-1(l)(4)(ii)(A). The regulations also provide a safe harbor for unwritten advances, regardless of whether they satisfy this test, if such advances: (i) do not exceed $10,000 in the aggregate at any one time; (ii) are treated as debt by the parties; and (iii) are expected to be repaid within a reasonable time. Treas. Reg. § 1.1361-1(l)(4)(ii)(B)(1). Finally, the regulations provide a safe harbor for other obligations, regardless of whether they are equity and used to contravene rights, if such obligations are part of the same class of debt and are owned solely by the owners of, and in the same proportion as, the outstanding stock of the corporation. Treas. Reg. § 1.1361-1(l)(4)(ii)(B)(2).

c. **Straight Debt Safe Harbor.** Section 1361(c)(5) provides that straight debt of an S corporation will not be treated as a second class of stock.

(i) In order to qualify as straight debt, an obligation must be represented by a written unconditional promise to pay a sum certain in money on demand or on a specified date. In addition, (i) the interest rate and payment dates on such debt may not be contingent upon profits, the borrower's discretion, the payment of dividends with respect to common stock, or other factors, (ii) the debt may not be directly or indirectly convertible into stock or any other equity interest of the corporation, and (iii) the creditor must be an individual (other than a nonresident alien), estate, or trust that is a permissible S corporation shareholder. Section 1361(c)(5) and Treas. Reg. § 1.1361-1(l)(5). An instrument bearing a rate of interest dependent upon the prime rate or similar objective factor will not be disqualified under the straight debt safe harbor. See S. Rep. No. 640, 97th Cong., 2d Sess. 8 (1982). Effective for taxable years beginning after December 31, 1996, creditors that are actively and regularly engaged in the business of lending money also can hold straight debt.

(ii) The regulations allow indebtedness to qualify for the straight debt safe harbor notwithstanding that it is subordinated to other indebtedness of the corporation. Treas. Reg. § 1.1361-1(l)(5)(ii).

(iii) The regulations provide that indebtedness will cease to qualify for the safe harbor if such debt is materially modified so that it no longer satisfies the definition of straight debt or is transferred to a third party who is not an eligible shareholder. Treas. Reg. § 1.1361-1(l)(5)(iii).

(iv) Section 1361(c)(5)(C) authorizes the Secretary of the Treasury to prescribe regulations providing for the treatment of straight debt for purposes of Subchapter S and the coordination of such rules with other provisions of the Code. The regulations provide that, if the interest rate on straight debt is unreasonably high, an appropriate portion of the interest may be recharacterized and treated as a payment that is not interest, but will not result in a second class of stock. Treas. Reg. § 1.1361-1(l)(5)(iv).
F. **Limitations on Taxable Years.** Section 1378(a) provides that an S corporation must have a "permitted year" as its taxable year.

1. **Permitted Year.** The term "permitted year" is defined in Section 1378(b) as (i) a taxable year ending on December 31, or (ii) any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Secretary of the Treasury. For an S corporation election to be effective, the corporation theoretically must have a permitted year at the time of the election. As described below, however, many of the reasons supporting the use of a fiscal year are subject to review and approval by the IRS. Therefore, at the time of filing Form 2553, a corporation may not know whether its taxable year is a permitted year. Accordingly, the IRS has modified Form 2553 to allow alternative and back-up choices of a taxable year to permit the corporation to ensure that its S election is valid.

2. **Business Purpose.** Section 1378(b) specifically provides that the deferral of income to shareholders is not considered to be a business purpose for purposes of establishing an S corporation's taxable year. Moreover, the legislative history of the 1986 Act states that none of the following factors ordinarily will be sufficient to establish that the business purpose requirement has been met for a particular year: (i) the use of a particular year for regulatory or financial accounting purposes; (ii) the use of particular hiring patterns by a business; (iii) the use of a particular year for administrative purposes, such as promotion of staff or compensation arrangements; and (iv) the use of price lists, model years, or other items that change on an annual basis. H.R. Rep. No. 841, 99th Cong., 2d Sess. (1986) at II-319.

3. **Rev. Proc. 87-32.** Rev. Proc. 87-32, 1987-2 C.B. 396, provides expeditious approval procedures and notification procedures pursuant to which an S corporation or a corporation electing to become an S corporation may, under certain circumstances, adopt, retain, or change its taxable year to a year ending on a date other than December 31. Rev. Proc. 87-32 is effective for adoptions, retentions, and changes of taxable years in which the requested taxable year begins on or after January 1, 1987.

   a. An S corporation or corporation electing to become an S corporation may adopt, retain, or change to a taxable year ending on a date other than December 31 if shareholders holding more than 50 percent of the stock of the corporation have changed, or with the consent of the Commissioner change concurrently, to the taxable year to be used by the corporation.

   b. An S corporation or corporation electing to become an S corporation may retain a taxable year ending on a date other than December 31 if the taxable year selected coincides with the corporation's natural business year. In order to establish that a corporation has a natural business year other than a calendar year, such corporation generally must show that (i) 25 percent or more of its gross receipts for the twelve-month period in question has been recognized in the last two months of such period, and (ii) the requirement described in clause (i) has been satisfied for three consecutive twelve-month periods (the "25 percent test").
c. An S corporation or corporation electing to become an S corporation may change to a taxable year ending on a date other than December 31 if (i) the taxable year selected coincides with the corporation's natural business year, as determined by the application of the 25 percent test, and (ii) the taxable year selected by such corporation results in a deferral of income to the shareholders of such corporation less than that caused by its existing taxable year.

d. An S corporation may retain a taxable year ending on a date other than December 31 if (i) such corporation received permission to use such taxable year on or after July 1, 1974 and (ii) as of the date upon which permission to use such taxable year was granted, the taxable year did not result in a deferral of income to the shareholders of such corporation of three months or less.

4. Rev. Rul. 87-57. Rev. Rul. 87-57, 1987-2 C.B. 117, provides guidance as to the factors that will be considered by the Commissioner in determining whether an S corporation that cannot satisfy any of the tests set forth in Rev. Proc. 87-32, supra, has established a business purpose for adopting, retaining, or changing its taxable year.

a. Rev. Rul. 87-57 states that the tax consequences to be considered in evaluating a corporation's claim that a business purpose exists for the use of a taxable year ending on a date other than December 31 include: (i) the deferral of a substantial portion of a taxpayer's income or the shifting of a substantial portion of a taxpayer's deductions from one year to another in order to reduce substantially the taxpayer's tax liability; (ii) the causing of a similar deferral or shift in the case of any other person, such as a shareholder in an S corporation; and (iii) creating a short period in which there is a substantial net operating loss.

b. Rev. Rul. 87-57 analyzes eight factual situations in light of the requirement of Section 1378 that an S corporation establish a business purpose for the use of a taxable year ending on a date other than December 31. In general, the examples establish that the use of a particular taxable year for the convenience of the taxpayer will not satisfy the business purpose requirement. Only when a taxpayer can establish compelling reasons for the use of its requested taxable year, such as the existence of circumstances beyond the control of the taxpayer, may the taxpayer be found to have satisfied the business purpose test.

5. Section 444. Section 444, added by the Revenue Act of 1987, P. L. 100-203, 101 Stat. 1330-397 (1987), provides that, within certain limitations and assuming the satisfaction of certain conditions, an S corporation may elect to use a taxable year other than a "required taxable year." Section 444(e) defines the term "required taxable year" with respect to S corporations as the taxable year determined under Section 1378 without taking into account any taxable year that is allowable by reason of business purposes.

a. A new S corporation may elect a taxable year other than a calendar year pursuant to Section 444 only if the "deferral period" of the elected taxable year is not longer than three months. Section 444(b)(1). The term "deferral period" is defined by Section 444(b)(4) as the months between the beginning of an entity's elected taxable year and the close of
the first required taxable year ending within such elected taxable year. Furthermore, an S corporation is eligible to make a Section 444 election only if it is not a member of a “tiered structure.” Treas. Reg. 1.444-2T(a). For this purpose, a tiered structure includes any situation where a “deferral entity” owns stock in the S corporation and a “deferral entity” includes trusts other than a grantor trust or a QSST. As a result, there is risk that an S corporation with an ESBT shareholder cannot make or maintain a Section 444 election. Treas. Reg. 1.444-2T(b)(2)(ii).

b. In the case of an S corporation that changes its taxable year pursuant to the election provided by Section 444(a), such election is permissible only if the deferral period of the elected taxable year is not longer than the shorter of (i) three months or (ii) the deferral period of the taxable year that is being changed. Section 444(b)(2).

c. In addition, in the case of an S corporation's first taxable year beginning after December 31, 1986, Section 444(b)(3) provides that an election pursuant to Section 444(a) is permissible if the taxable year elected is the same as the entity's last taxable year beginning in 1986, even if the deferral period exceeds three months. In Notice 88-10, 1988-5 I.R.B. 24, the IRS clarified that the election of a taxable year other than a calendar year pursuant to the special rule provided by Section 444(b)(3) will be permitted for all taxable years beginning after December 31, 1986, and not just for the first taxable year beginning after such date.

d. An S corporation that previously established a taxable year other than a calendar year pursuant to Rev. Proc. 87-32, supra, or Rev. Rul. 87-57, supra, is not required to make an election pursuant to Section 444(a) to retain such year and is not subject to the required payment procedures contained in Section 7519, described below. See Notice 88-10, supra.

e. An S corporation that elects a taxable year other than a calendar year pursuant to Section 444(a) must make certain payments required by Section 7519, which payments generally approximate the amount of tax that otherwise would be deferred as a result of the election to use a taxable year other than a calendar year. Sections 444(c)(1) and 7519. An S corporation that willfully fails to make the payments required by Section 7519 in the case of a Section 444(a) election will lose its ability to make an election pursuant to Section 444(a) and may lose its status as an S corporation if its taxable year is other than a permitted year as defined in Section 1378.

f. The provisions of Sections 444 and 7519 are exceedingly intricate. In an effort to provide guidance to taxpayers struggling to comply with the requirements of such sections, the IRS has published a number of clarifying notices and announcements. See Notice 89-41, 1989-15 I.R.B. 16 (procedures for obtaining refund of Section 7519 payments); Information Release 88-97 (June 10, 1988) (no waiver of estimated tax underpayment penalty for underpayments of estimated tax for second quarter of 1988); Notice 88-49, 1988-16 I.R.B. 29 (waiver of certain penalties in case of S corporations that have not yet decided whether to make Section 444 elections); Notice 88-36, 1988-13 I.R.B. 27 (explaining "tiered structure" rules of

III. **S Corporation Subsidiaries**

A. **In General**

Effective for tax years beginning after December 31, 1996, the 1996 Act (1) amends Section 1361(b)(2) to permit an S corporation to own as much as 100 percent of the stock of a domestic or foreign C corporation, and (2) allows an S corporation to elect to treat certain wholly-owned domestic “qualified Subchapter S subsidiaries” as divisions.

B. **C Corporation Subsidiaries**

(i) Effective for tax years beginning after December 31, 1996, the 1996 Act repealed the prohibition on an S corporation being a member of an affiliated group. Section 1361(a)(2), as amended by the 1996 Act. However, an S corporation cannot join in the filing a consolidated return because the 1996 Act added S corporations to the list of corporations that are not includable corporations. Section 1504(b).

(ii) An S corporation parent of a C corporation subsidiary will not be able to take advantage of (1) the dividends received deduction, or (2) the “deemed paid” credit. In addition, dividends received from a C corporation of which the S corporation owns 80 percent or more will not be treated as passive investment income for purposes Sections 1362 and 1375, to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business. Treasury is expected to issue proposed regulations that will address how to determine whether dividends are attributable to earnings and profits of the active conduct of a trade or business.

(iii) Gain or income from deferred intercompany transactions, as well as excess loss accounts, may be triggered if an existing parent of an affiliated group that joins in filing a consolidated return leaves the group by electing S status and does not make Qualified Subchapter S subsidiary elections for its subsidiaries.

C. **Qualified Subchapter S Subsidiaries**

(i) One of the most dramatic changes made by the 1996 Act was to allow S corporations to elect to treat certain wholly-owned domestic subsidiaries as Qualified
Subchapter S Subsidiaries ("QSSSs" or "Qualified Subsidiaries"). A QSSS, in effect, is treated as a division of the parent. All income, loss, deduction and credits of the QSSS are treated as items of the parent S corporation and transactions between the parent and the QSSS are disregarded for Federal tax purposes.

(ii) Section 1361(b)(3)(B) generally defines a Qualified Subsidiary as a corporation that meets the following requirements:

1. It is domestic;
2. It is not an "ineligible corporation," as defined in Section 1361(b)(2) (i.e., it is not a financial institution which uses the reserve method of accounting for bad debts; an insurance company subject to tax under Subchapter L of the Code; a corporation to which an election under Code Section 936, relating to the Puerto Rico and possessions tax credit, applies; or a DISC or former DISC);
3. 100 percent of its stock is owned by its parent S corporation; and
4. The parent S corporation has made an election to treat the corporation as a Qualified Subsidiary.

(iii) The requirement that all the subsidiary’s stock be owned by the parent S corporation can be met by taking into account the parent’s Qualified Subsidiary election with respect to other corporations. Staff of Joint Comm. on Tax’n, General Explanation of Tax Legislation Enacted in the 104th Congress, 120 (Dec. 18, 1996) ("Blue Book"). This allows an S corporation to hold an uninterrupted chain of Qualified Subsidiaries. The presence of a C corporation subsidiary at some point in the ownership chain will preclude any subsidiaries underneath that subsidiary from being Qualified Subsidiaries. However, such a C corporation subsidiary itself can be a parent of an affiliated group of corporations that joins in filing a consolidated return.

(iv) Section 1361(b)(3) does not appear to preclude a subsidiary that has more than one class of stock from being a Qualified Subsidiary, as long as all its stock is owned by the parent S corporation. This is because the requirement that an S corporation have only one class of stock is contained in Section 1361(b)(1)(D), which does not apply to Qualified Subsidiaries. Nonetheless, taxpayers considering taking advantage of the Qualified Subsidiary rules should examine whether the subsidiary has any outstanding options, debt, or other arrangements that could be characterized as equity for Federal tax purposes. If these instruments or arrangements are held by other than the parent S corporation, there is a risk that the parent S corporation will not be viewed as owning all of subsidiary’s stock and that the subsidiary, therefore, cannot be a Qualified Subsidiary. Presumably, taxpayers will be able to rely on the safe harbors contained in the general “one class of stock” rules in Treas. Reg. §1.1361-1(l)(4) in determining when options and other instruments will be viewed as equity of the subsidiary for this purpose.

(v) Qualified Subsidiary status is elective and an S corporation can choose which eligible subsidiaries it wants to be taxed under Subchapter S and which it wants to be taxed under Subchapter C. If an S corporation fails to make a proper Qualified Subsidiary
election for a subsidiary for a period, that subsidiary will be treated as a C corporation for that period.

(vi) Section 1361(b)(3)(D) generally provides that, if a corporation’s status as a Qualified Subsidiary terminates, then neither it nor any “successor corporation” shall be eligible to be treated as an S corporation or a Qualified Subsidiary before the fifth taxable year beginning after the tax year for which the termination was effective, unless the corporation receives the consent of the Secretary of the Treasury. However, the Joint Committee on Taxation’s explanation of the provision makes clear that the Secretary should provide waivers of this “five-year” rule in appropriate circumstances, where no tax avoidance is involved, citing a spin-off of a Qualified Subsidiary as one such circumstance. Blue Book at p. 120. It is hoped that Treasury will provide a list of transactions, such as spin-offs, with respect to which waivers of the five-year rule will be granted automatically.

(vii) Pending the issuance of regulations, the IRS has issued interim guidance describing how to make a Qualified Subsidiary election. Pursuant to Notice 97-4, 1997-2 I.R.B. 24, the parent S corporation should file a Form 966 (relating to corporate dissolution and liquidations) with the Service Center, following certain special rules for completing that form that are contained in the notice. The parent S corporation must file a separate Form 966 for each eligible subsidiary for which it wishes a Qualified Subsidiary election to be in effect.

a. A Qualified Subsidiary election may be effective on either the day the Form 966 is filed or at any time up to seventy-five days before that form is filed. However, the subsidiary must meet the Qualified Subsidiary eligibility requirements at all times during which the election is to be in effect and the election in no event can be effective prior to December 31, 1996. Thus, an S corporation should not file a Qualified Subsidiary election at a time when the subsidiary does not meet the eligibility requirements or before the date that the S corporation desires the election to be effective. However, it can wait up to 75 days from the date it wishes an election to be effective to perform the ministerial act of filing the election. As with the S corporation election, it is advisable to file the election in such a manner as to obtain proof of timely filing (e.g., certified mail, return receipt requested).

b. Neither the Code nor Notice 97-4 precludes an S corporation from making a Qualified Subsidiary election effective as of a date in the middle of a subsidiary’s taxable year. If such a mid-year election is made, the subsidiary will have to file a short year return as a separate entity for the portion of the year preceding the Qualified Subsidiary election and should be included in the parent S corporation’s return for the period during which the election is in effect.

c. When an S corporation acquires stock sufficient to give it 100 percent ownership of a subsidiary, it is not clear who owns the acquired stock on the date of the acquisition - - the purchasing S corporation or the selling shareholders. This raises issues as to when the Qualified Subsidiary election can be effective. Moreover, when the “acquired” corporation itself is an S corporation (as would be the case, for example, if brother-sister S...
corporations decided to restructure to achieve an S Corporation-Qualified Subsidiary relationship), there is a critical question as to whether the acquired corporation’s S corporation status ends prior to such time that its status as a Qualified Subsidiary begins. Such an absurd result would have built-in gain, LIFO recapture, and other implications and would frustrate the Congressional intent underlying the Qualified Subsidiary provision. Thus, it is hoped that Treasury and IRS will clarify that no interim C corporation status is created in this situation.

d. Notice 97-4 requires an S corporation to file a Form 966 if it wishes to make a Qualified Subsidiary election with respect to a newly-formed subsidiary. In such a case, the Notice provides that the S corporation does not have to obtain a taxpayer identification number (“TIN”) for the subsidiary, but can request a TIN if it so chooses (presumably for State tax purposes). It is unclear whether certain tax consequences that follow from the formation of a new corporation could apply in this situation, notwithstanding that the newly-formed corporation will be treated as immediately liquidated as a result of the Qualified Subsidiary election. It is hoped that Treasury and IRS will treat the formation of a new subsidiary immediately followed by a QSSS election as a nonevent for Federal tax purposes.

(viii) A Qualified Subsidiary is treated as a division of the parent S corporation for all Federal tax purposes. Section 1361(b)(3)(A) provides that, for purposes of Title 26 of the United States Code, the subsidiary will not be treated as a separate corporation. Instead, all its assets and liabilities, and all its items of income, loss, deduction and credit, will be treated as belonging to, or incurred by, the parent S corporation. As a result, transactions between the S corporation parent and its Qualified Subsidiary are not taken into account and items of the Qualified Subsidiary (including accumulated earnings and profits, passive investment income, built-in gains, etc.) are considered to be items of the parent. Blue Book at 121. However, technical corrections legislation contained in the 1997 Act provides the Treasury with regulatory authority to provide instances where the separate corporate existence of a Qualified Subsidiary nonetheless may be taken into account for Federal tax purposes. Section 160(c)(3) of the 1997 Act. It is anticipated that Treasury will use this authority, at the least, to provide that a Qualified Subsidiary election will not change the status of either the parent S corporation or a Qualified Subsidiary as a bank or a nonbank for purposes of the special rules in the Code that apply to “banks” as defined in Code Section 581. See H.R. Rept. 105-48, 105th Cong., 1st Sess. 644 (1997), and S. Rept. 105-33, 105th Cong., 1st Sess. 320 (1997).

(ix) The general rule providing for disregarding the separate status of the Qualified Subsidiary applies with respect to the entire Internal Revenue Code (i.e., because Section 1361(b)(3)(A) applies for purposes of Title 26 of the United States Code). As a result, the separate status of a Qualified Subsidiary is ignored for income, estate, excise, payroll and all other Federal tax purposes.

(x) The legislative history underlying new Section 1361(b)(3) states that: “if an election is made to treat a subsidiary as a Qualified Subsidiary (whether the subsidiary’s stock was acquired from another person or was held by the S corporation), the subsidiary will be deemed to have liquidated under Sections 332 and 337 immediately before the election is effective.” H.R. Rept. 104-586 at p. 89 and Blue Book at p. 121. The legislative
history to the 1997 technical corrections legislation clarifies that Treasury has the authority to provide exceptions in appropriate cases to the general rule that a Qualified Subsidiary election is treated as a deemed liquidation under Section 332. H.R. Rept. 105-48 at p. 644.

This "deemed liquidation" language has raised a number of questions regarding whether a Qualified Subsidiary election should be treated (1) as a separate nonrecognition event in all situations, (2) as a separate liquidation, the taxation of which is subject to the generally applicable rules governing liquidations, or (3) as a liquidation that can be treated as a part of any other related transactions in determining the parties' tax consequences. The lack of resolution with respect to these issues has made it impossible for taxpayers to understand the Federal tax consequences of making Qualified Subsidiary elections in very common fact patterns - such as when a subsidiary is insolvent, when a subsidiary owes money to its parent, or when restructuring is done in order to facilitate a Qualified Subsidiary election. It is hoped that the IRS and Treasury will provide appropriate guidance in the near future. Both the ABA and AICPA have recommended that the IRS not apply the "step transaction" doctrine to treat a Qualified Subsidiary election as part of other related transactions for purposes of determining the Federal tax consequences. (For example, they have suggested that a Section 351 transaction followed by a Qualified Subsidiary election should not be recharacterized as a "D" reorganization.)

(xi) To the extent that a Qualified Subsidiary election is treated as a Section 332 liquidation of the subsidiary into the parent S corporation, the parent's basis in the Qualified Subsidiary's assets will be determined by reference to the subsidiary's adjusted basis in such assets. I.R.C. §334(b)(1); Reg. §1.334-1(b). See I.R.C. §381(a). In addition, the election in effect will eliminate the parent S corporation's basis in the stock of its subsidiary. Consequently, a parent corporation may not want to elect to treat a subsidiary as a Qualified Subsidiary if (1) its basis in the subsidiary's stock exceeds the subsidiary's basis in its assets and (2) it may want to dispose of the subsidiary's business in the future.

(xii) Debt issued by a Qualified Subsidiary to a shareholder of the parent S corporation will be treated as debt of the parent for purposes of determining the amount of losses that may flow through to shareholders of the parent under Section 1366. In situations in which shareholders of the parent hold debt of both the parent and Qualified Subsidiaries, the legislative history indicates that the Treasury may prescribe rules regarding the order that the losses pass through. H.R. Rept. 104-586 at p. 89. The legislative history of the Act also indicates that the at-risk rules of Section 465 may cause losses of a Qualified Subsidiary to be suspended to the extent that a shareholder of the parent is not at-risk with respect to losses of the Qualified Subsidiary. Id. This seemingly would apply, for example, in a situation in which losses of a Qualified Subsidiary are funded with debt for which the shareholder is not personally liable. This language would seem to suggest that whether the parent S corporation is at-risk is irrelevant.

(xiii) Section 1361(b)(3)(C) provides that, if any Qualified Subsidiary ceases to meet the Qualified Subsidiary eligibility requirements, it will be treated as "a new corporation acquiring all its assets (and assuming all of its liabilities) immediately before such
cessation from the S corporation in exchange for its stock." As a result, the subsidiary will be treated as a C corporation and will be subject to corporate-level tax on its income. Further, pursuant to Section 1361(b)(3)(D), it will not be able to elect S status, or to be treated as a Qualified Subsidiary, for five years, unless it receives the consent of the IRS. It is unclear to what extent the "step transaction" will apply to terminations of Qualified Subsidiary status. For example, it is unclear whether a sale of 100 percent of the stock of a Qualified Subsidiary will be treated as (1) a Section 351 transaction, coupled with a stock sale, or (2) an asset sale.

(xiv) The Act amended Section 1504(b) to provide that an S corporation cannot be an "includable corporation" and cannot join in the filing of a consolidated return. Thus, a consolidated group's existence will terminate if the common parent elects to be treated as an S corporation. If the parent corporation does not elect to treat any of its subsidiaries as Qualified Subsidiaries, excess loss accounts ("ELAs") and gain or income from deferred intercompany transactions ("DITs") may be triggered as a result of the deconsolidation. However, it currently is unclear whether ELAs and DITs will be triggered when Qualified Subsidiary elections are involved. The 1997 technical corrections legislation indicates that Treasury may provide guidance as to the consolidated return effects of an S corporation election in such cases. H.R. Rept. 105-148 at p. 644. See Collins, Garrett, Schneider, and Tucker, "Special Issues for Consolidated Groups Converting to S Corporation Status," 24 Journal of Corporate Taxation, No. 2 (Summer 1997), p. 212. For a discussion of the issues relating to the tax treatment of a QSSS, see Collins, Kulish, and August, Planning with Qualified Subsidiaries, Journal of S Corporation Taxation, [add remainder of cite].

D. Proposed Regulations Concerning S Corporation Subsidiaries.

1. In General. On April 21, 1998, the Service issued proposed regulations on S corporation subsidiaries. The proposed regulations generally are to be effective on the date final regulations are published in the Federal Register. However, the Service has requested comments regarding whether certain provisions should be made retroactive to tax years beginning on or after January 1, 1997 (i.e., the date the statutory provision regarding S corporation subsidiaries became effective). The proposed regulations address both QSSSs and C corporation subsidiaries of S corporations.

2. QSSS Eligibility Requirements.

a. In General. Consistent with the Code, Prop. Reg. §1.1361-2(a)\(^1\) provides that a QSSS must: (i) be domestic; (ii) not be an "ineligible corporation," as defined in Section 1361(b)(2) (i.e., not a financial institution which uses the reserve method of accounting for bad debts; an insurance company subject to tax under Subchapter L of the Code; a corporation to which an election under Section 936, relating to the Puerto Rico and possessions tax credit, applies; or a DISC or former DISC); (iii) be 100 percent

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\(^1\) Except to the extent specified otherwise, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury regulations promulgated thereunder.

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owned by its parent S corporation; and (iv) have had a proper election made for it by its parent S corporation.

b. **The Wholly-Owned Requirement.** For purposes of determining whether a subsidiary meets the requirement that its stock be 100-percent owned by an S corporation, Prop. Reg. §1.1362-2(b) generally provides that stock will be treated as owned by an S corporation if the S corporation “is the owner of that stock for federal income tax purposes.”

(i) **Indirect Ownership.** Examples in the proposed regulations indicate that an S corporation may make QSSS elections for a chain of domestic subsidiaries, as long as all such subsidiaries are treated as wholly-owned by the parent for federal tax purposes (e.g., because QSSS elections are in effect for all others above them in the chain). Similarly, an S corporation may elect QSSS status for a subsidiary all the stock of which it owns through a single-member limited liability company (“LLC”).

(ii) **Lack of Safe Harbors.** The proposed regulations do not cross-reference the one-class-of-stock regulations that were issued under Section 1361. The one-class-of-stock regulations provide certain “safe harbors” for when arrangements or instruments (such as debt and options) will not be treated as a second class of stock. It would be helpful if the final QSSS regulations were to recognize explicitly that arrangements or instruments that would not considered to be a second class of stock should not be considered to be stock for purposes of the “wholly-owned” requirement.

(iii) **Directors’ Stock.** The proposed regulations do not explicitly reference directors’ stock. Thus, it is unclear in what circumstances the Service would view bank stock that is owned by a director under local law as not owned by such director for purposes of the wholly-owned requirement.

c. **Making the Election.** As indicated above, QSSS status is elective. If an S corporation fails to make a proper QSSS election for a subsidiary for a period, that subsidiary will be treated as a C corporation for that period.

(i) **Election Procedure.** The preamble to the proposed regulations states that the Service will develop, prior to the time the regulations become final, a form to be used for making QSSS elections. However, until the proposed regulations are finalized, taxpayers should continue to follow the temporary election procedures set forth in Notice 97-4, 1997-2 I.R.B. 24. That notice generally provides that the parent S corporation must file a Form 966 (relating to corporate dissolution and liquidations) with the Service Center for each subsidiary it wishes to treat as a QSSS, following certain special rules for completing that form.

(ii) **Time Election Must Be Filed.** Prop. Reg. §1.1361-3(a)(3) provides that the effective date of a QSSS election may be up to 2 months and 15 days before the election is filed. In addition, the proposed regulations allow a taxpayer to...
choose a prospective effective date (i.e., a date up to 12 months after the date the form is filed) in certain circumstances.

(iii) **Mid-Year Elections.** Prop. Reg. §1.1361-3(a)(2) makes clear that mid-year QSSS elections are permissible. That is, a QSSS election does not have to be effective on the first day of the subsidiary’s tax year or on the first date the “wholly-owned” requirement is met. For example, Prop. Reg. §1.1361-3(a)(4) indicates that an S corporation that acquires all the stock of another corporation on April 1, 1998, can make an election to treat the acquired corporation as a QSSS effective August 10, 1998.

(iv) **Failure to Timely File QSSS Election.** Prop. Reg. §1.1361-5 generally provides that relief for failing to make a timely QSSS election may be available under Treas. Reg. §301.9100. This is the only relief mechanism provided. Thus, for example, an S corporation that fails to make a QSSS election within 75 days after the date it desires that election to be effective must file a letter ruling request with the National Office of the Service in order to seek relief.

3. **Consequences of QSSS Election.** As indicated below, if a QSSS election is made for a subsidiary, that subsidiary’s separate existence generally will be ignored for all federal tax purposes and the subsidiary will be deemed to have been liquidated into the parent S corporation. Further, the proposed regulations generally provide that the tax treatment of this deemed liquidation will be determined under general principles of tax law, including the step transaction doctrine. As a result, making a QSSS election in certain situations may be a taxable event. Other consequences of making a QSSS election also are discussed below.

a. **Separate Existence Ignored.**

(i) **In General.** Subject to an exception for banks (described below), Prop. Reg. §1.1361-4(a)(1) provides that a corporation that is a QSSS “shall not be treated as a separate corporation” and all its assets, liabilities and other items of income, deduction and credit shall be treated as those of the parent S corporation. This rule generally applies for all federal tax purposes.

(ii) **Special Rule for Banks.** Notwithstanding this general rule, Prop. Reg. §1.1361-4(a)(3)(i) provides that, if an S corporation is a bank or makes a valid QSSS election for a bank subsidiary: “any special rules applicable to banks under the Internal Revenue Code continue to apply separately to the bank parent or the bank subsidiary as if the deemed liquidation of any QSSS . . . had not occurred. For any QSSS that is a bank, however, all assets, liabilities, and items of income, deduction, and credit of the QSSS, as determined in accordance with the special bank rules, are treated as assets, liabilities, and items of income, deduction, and credit of the S corporation.” Two examples in Prop. Reg. §1.1361-4(a)(3)(ii) illustrate the application of this special rule to banks. Example 1 indicates that the rules of Section 265(b) (relating to interest expense deductions of banks) apply separately to an S corporation bank and its QSSS bank subsidiary. Example 2 indicates that the rules of Section 582 (relating to sales and exchanges of debt by banks) apply only to sales and exchanges by a
bank QSSS, and not to sales and exchanges by the parent bank holding company. (However, any
gain or loss on such a transaction by the bank QSSS that is treated as ordinary in character would
be treated as ordinary income or loss of the parent bank holding company.) Because the proposed
regulations will not be effective until final, technically this special rule for banks does not
currently apply. However, a notice released in 1997 (Notice 97-5) stated that: “Treasury and
Service believe that the special provisions of the Code that apply to banks should apply only to
the specific state-law entity that qualifies as a bank under § 581 of the Code; such special bank
treatment should not apply to nonbanks, even if the nonbank is affiliated with a bank and the
parent elects to treat the subsidiary as a QSSS.” The notice also indicated that Treasury and
Service intended to work with Congress on securing appropriate technical corrections legislation
that would be effective retroactive to the effective date of the underlying legislation that allowed
banks to be S corporations. Legislation providing Treasury with the authority to address this
issue was enacted after Notice 97-5 was issued. Banks may wish to submit comments on this
effective date issue; as indicated above, Treasury and Service have requested comments as to
whether particular provisions should have earlier effective dates.

b. Employment Tax Issues. The proposed regulations do not
provide an exception to the general rule (i.e., that a QSSS’s separate existence is disregarded) for
employment tax purposes. It is hoped that Treasury and IRS will provide appropriate guidance
on the employment tax consequences associated with QSSS elections in the near future.

c. Tax Treatment of Deemed Liquidation.

(i) In General. The legislative history underlying the
QSSS provision states that, “if an election is made to treat a subsidiary as a QSSS (whether the
subsidiary’s stock was acquired from another person or was held by the S corporation), the
subsidiary will be deemed to have liquidated under Sections 332 and 337 immediately before the
election is effective.” H.R. Rept. 104-586 at p. 89 and Blue Book at p. 121. The legislative
history to technical corrections legislation enacted in 1997 clarifies that Treasury has the
authority to provide exceptions in appropriate cases to the general rule that a QSSS election is
treated as a deemed liquidation under Section 332. H.R. Rept. 105-48 at p. 644.

(ii) Regulatory Rule. Prop. Reg. §1.1361-4(a)
provides that the tax treatment of the deemed liquidation that results from the making of a QSSS
election “will be determined under the Internal Revenue Code and general principles of tax law,
including the step transaction doctrine.”

(a) Insolvent Subsidiaries and Subsidiaries
Indebted to Their Parents. Under this proposed rule, making a QSSS election for an insolvent
subsidiary would be a taxable event, since the provision of the Code allowing for the tax-free
liquidation of a wholly-owned subsidiary into its parent only applies when the subsidiary is
solvent. Issues also may arise where a subsidiary for which a QSSS election is made owes
money to its parent.
Application of Step Transaction Doctrine in Other Situations. The application of the step transaction doctrine could raise significant tax traps for unwary taxpayers. S corporations making QSSS elections for subsidiaries will have to examine how the deemed liquidation and any related restructuring could be characterized under decades of case law and administrative guidance. For example, absent the transition relief described below, restructuring brother-sister S corporations into a parent-QSSS structure could be characterized as a “D” reorganization – which could be a taxable transaction to the extent the corporation that becomes the QSSS has liabilities in excess of its bases in its assets.

Transition Relief. Prop. Reg. 1.1361-4(a)(5) provides transitional relief from the application of the step transaction doctrine in certain circumstances. Specifically, it provides that: if an S corporation and another corporation (the related corporation) are persons specified in Section 267(b) prior to the acquisition by the S corporation of some of all of the stock of the related corporation, the step transaction doctrine will not apply to determine the tax consequences of the acquisition. This transition relief applies only to QSSS elections effective prior to the date that is 60 days after final regulations are published. The Service has asked for comments on other transactions occurring during the transitional period for which relief from the application of the step transaction doctrine is warranted.

d. Timing of Deemed Liquidation.

(i) General Rule. Prop. Reg. §1.1361-4(b)(1) generally provides that that the deemed liquidation resulting from a QSSS election occurs at the close of the day before the date the QSSS election becomes effective. Thus, when a parent corporation makes an S election effective the same day as it makes a QSSS election for a subsidiary, the deemed liquidation occurs when the parent is still a C corporation. Although the proposed regulations do not explicitly address the consolidated return consequences of making S corporation and QSSS elections, this general timing rule has practical implications for the treatment of excess loss accounts (“ELAs”) and gain or income from deferred intercompany transactions (“DITs”). For example, under the timing rule, ELAs in the stock of solvent subsidiaries for which QSSS elections are made presumably would not be triggered as a result of the parent’s S election and the QSSS elections for the subsidiaries, provided that all the elections are effective on the same day. This is because the consolidated return regulations generally provide that ELAs are not triggered if the parent liquidates a solvent subsidiary in which it has an ELA prior to deconsolidation. Since the deemed liquidation would take place before the deconsolidation resulting from the S election, the ELA in the stock of a solvent QSS presumably would not be triggered. This timing rule also has implications for the Section 1374 built-in gain tax when a C corporation simultaneously makes an S election for itself and QSSS elections for its subsidiaries. Because the deemed liquidations take place while the parent corporation is a C corporation, all the subsidiaries’ assets presumably would be treated as belonging to the parent at the time it becomes an S corporation. Thus, the subsidiaries’ assets presumably would be “pooled together” with the parent’s assets for purposes of computing the BIG tax. (The proposed regulations also would amend the Section 1374 regulations with respect to Section 1374(d)(8) transactions to provide that, if a C corporation elects to be an S corporation...
and makes a QSSS election with respect to a subsidiary (effective the same date as the S election), the assets held by the QSSS at the time of the QSSS election will be treated as assets held by the parent when it became an S corporation.)

(ii) **Exceptions.** Notwithstanding the general timing rule, if an S corporation does not own 100 percent of the stock of the subsidiary on the day before the QSSS election is effective, Prop. Reg. §1.1361-4(b)(2) provides that the deemed liquidation occurs immediately after the time at which the S corporation first owns 100 percent of the stock. Special rules for the timing of the liquidation apply when Section 338 elections are made in conjunction with qualified stock purchases and QSSS elections. Prop. Reg. §1.1361-4(b)(3).

e. **Treatment of Stock of QSSS.** Prop. Reg. §1.1361-4(a)(4) provides that the stock of a QSSS will be disregarded for all federal tax purposes (except with respect to the determination of whether all the stock of the subsidiary is owned by an S corporation). This may be an issue in cases in which a parent corporation has a higher basis in the stock of its subsidiary than the subsidiary has in its assets; the parent in effect will “lose” the higher stock basis if it makes a QSSS election for such a subsidiary.

4. **Acquisition of S Corporations.** The proposed regulations provide that, if one S corporation acquires the stock of another S corporation and makes a QSSS election for the second corporation effective on the day of acquisition, the S corporation status of the acquired corporation will terminate at the same moment as the QSSS election becomes effective. This is designed to ensure that the acquired corporation is not treated as a C corporation for any period because of the transfer of its stock. Prop. Reg. §1.1362-2(b)(4).

5. **Other Issues.**

a. **Suspended Losses.** Prop. Reg. §1.1361-4(c) appears to provide that suspended losses carry over when one S corporation acquires the stock of another S corporation in a tax-free transaction and makes a QSSS election with respect to the latter corporation. (This section of the proposed regulations apparently was drafted without regard to the potential application of the step transaction doctrine to such a transaction.)

b. **At-Risk Rules.** The proposed regulations do not address the application of the at-risk rules to QSSSs. (The legislative history of the QSSS provision indicates that the at-risk rules of Section 465 may cause losses of a QSSS to be suspended to the extent that a shareholder of the parent is not at-risk with respect to losses of the QSSS.)

6. **Terminations of QSSS Status.**

a. **In General.** Prop. Reg. §1.1361-5(a) indicates that a QSSS election may terminate (1) by revocation, (2) as a result of the parent corporation no longer being an S corporation, or (3) if the subsidiary no longer meets the QSSS eligibility requirements. The regulation section provides guidance as to when the QSSS election is terminated in each of these circumstances.
three cases. *(See Prop. Reg. §1.1361-5(b) for guidance regarding how a QSSS election may be revoked.)*

b. **Information Requirements.** If a QSSS election terminates because the subsidiary no longer meets the QSSS eligibility requirements, Prop. Reg. §1.1361-5(a)(2) provides that the S corporation must attach certain information to its return for the tax year in which the termination occurred.

c. **Effect of Termination.** Prop. Reg. §1.1361-5(b)(1) provides that, on termination of QSSS status, the subsidiary is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from the S corporation in exchange for stock in the new corporation immediately before the termination. The proposed regulations provide that the tax treatment of this transaction, or of a larger transaction that includes this transaction, will be determined under the Code and general principles of tax law, including the step transaction doctrine. The application of this rule to terminations of QSSS status can lead to results that may not necessarily be expected. For example, Prop. Reg. §1.1361-5(b)(3), Example 1, sets forth a situation where an S corporation sells 21 percent of the stock of a QSSS to an unrelated purchaser for cash, thereby terminating the QSSS election. The example notes that the S corporation may have to recognize gain on the assets deemed transferred to the subsidiary because the deemed transfer would not qualify for nonrecognition treatment under Section 351 (i.e., because the S corporation is not “in control” of the subsidiary immediately after the transfer, as a result of the sale of the stock).

7. **Re-Electing QSSS Status.** Prop. Reg. §1.1361-5(d) generally provides that a company can move from QSSS to S status, or a QSSS can become a QSSS of another S corporation, without seeking permission to waive the general 5-year prohibition on re-electings, as long as there is no intervening period as a C corporation. The proposed regulations also provide that inadvertent termination relief may be available for QSSS terminations in certain circumstances. See Prop. Reg. §1.1361-5(c).

8. **Transactions Involving QSSSs.** The proposed regulations do not address transactions (such as mergers) involving QSSSs. It is anticipated that Treasury and IRS will issue guidance on these issues as part of a separate project that deals with transactions involving other kinds of “disregarded entities,” such as single-member LLCs, as well.
IV. Taxation of S Corporation Shareholders

A. Overview. An S corporation generally is not subject to tax. Instead, an S corporation's items of income, loss, deduction, and credit are passed through to its shareholders and taxed as if received directly by them. See Section 1363(a). In certain circumstances, however, an S corporation may be liable for taxes on built-in gains, passive investment income, LIFO inventory amounts, and the recapture of investment tax credit. These corporate-level taxes are discussed in detail below.

B. Taxation of S Corporation Shareholders

1. Computation of Taxable Income of S Corporation. Section 1363(b) provides that the taxable income of an S corporation is to be computed in the same manner as that of an individual, with the following exceptions:

   a. Items of income (including tax-exempt income), loss, deduction, and credit the separate treatment of which could affect the tax liability of any shareholder are to be stated separately.

   b. The corporation is not allowed deductions for (i) personal exemptions under Section 151, (ii) foreign and possessions taxes under Sections 164(a) and 901, (iii) charitable contributions under Section 170, (iv) net operating losses under Section 172, (v) certain expenses of individuals under Sections 211 through 219, and (vi) depletion with respect to oil and gas wells under Section 611.

   c. The corporation is permitted to amortize its organizational expenses pursuant to Section 248.

   d. If the corporation was not an S corporation for any of the three immediately preceding taxable years, the limitations on certain corporate preference items contained in Section 291 will apply.

2. Treatment of Bad Debts. In Revenue Ruling 93-36, 1993-2 C.B. 269, the IRS ruled that an S corporation having a non-business bad debt within the meaning of Section 166(d)(2) must separately state the non-business bad debt under Section 1633(a)(1)(A) as a Section 166(d) short-term capital loss. The IRS found that since Section 166 is not specifically enumerated as an exception to the general rule of Section 1363(b), Section 166 applies in the same manner as it does for an individual when computing an S corporation's taxable income. Thus, an S corporation must include in its separately stated short-term capital loss, any wholly worthless non-business bad debt.
3. **Pass-Through of Items to Shareholders.**

   a. **Section 1366(a)(1)** requires that, for the taxable year of a shareholder in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies before the end of the corporation's taxable year), each shareholder of an S corporation must take into account such shareholder's pro rata share of (i) the corporation's separately stated items of income, loss, deduction, and credit and (ii) the corporation's nonseparately computed income or loss (i.e., the difference between the corporation's gross income and its allowable deductions, as determined without reference to all separately stated items).

   b. Under Section 1366(b), the character of each separately-stated item included in a shareholder's pro rata share is to be determined as if the item had been realized directly from the source from which it was realized by the corporation or had been incurred in the same manner as it was incurred by the corporation.

   c. **Section 1366(c)** states that the gross income of an S corporation shareholder includes such shareholder's pro rata share of the corporation's gross income.

   d. The legislative history accompanying the enactment of Section 1366 discusses the application of the pass-through rules to a number of specific items. S. Rep. No. 640, supra, at 15-17. The following items are among those that pass through separately: (i) capital gains and losses; (ii) Section 1231 gains and losses; (iii) tax-exempt interest; (iv) charitable contributions; (v) foreign taxes; (vi) foreign income and loss; and (vii) items involved in the determination of credits.

   e. **Section 1366(f)(2)** reduces the amount of the built-in gains that are passed through to the S corporation shareholders by the amount of any tax imposed on such gains at the corporate level. The Omnibus Budget Reconciliation Act of 1989 (the "1989 Act") amended Section 1366(f)(2) to clarify that the income that is reduced is determined by taking into account the character of the items of recognized built-in gain giving rise to the tax under Section 1374. Thus, tax imposed under Section 1374 on capital gain income cannot be used to reduce the amount of ordinary income passed through to the shareholders. Similarly, Section 1366(f)(3) reduces the amount of the items of passive investment income passed through to the S corporation shareholders by the amount of any tax imposed on the excess passive investment income of the corporation.

4. **Allocation of Items Among Shareholders.**

   a. **General Rule.** Section 1377(a)(1) provides that a shareholder's pro rata share of the items of income, loss, deduction, and credit of an S corporation is to be determined by assigning an equal portion of such item to each day of the taxable year and then dividing that portion pro rata among the shares outstanding on such day.
b. **Termination of Shareholder's Interest or "Qualifying Dispositions".** If the entire interest of a shareholder of an S corporation is terminated during a taxable year, Section 1377(a)(2) provides that the corporation may elect to close its books on the date of the termination of the shareholder's interest, provided that it obtains the consent of all persons who were shareholders in the corporation at any time during such taxable year. When such an election is made, the allocations of S corporation items of income, loss, deduction, and credit are made as if the taxable year consisted of two taxable years, the first of which ended on the date of the complete termination of the shareholder's interest. Regulations under Section 1377 set forth the manner in which such election to close the books should be made. In addition, Section 1.1368-1(g)(2)(i) of the regulations provides that, if there is a "qualifying disposition," the corporation may elect to treat the year as if it consisted of separate taxable years, the first of which ends as of the close of the day on which the qualifying disposition occurs. A "qualifying disposition" is: (1) a disposition by a shareholder of 20 percent or more of the outstanding stock of the corporation in one or more transactions during any thirty-day period during the corporation's taxable year; (2) a redemption treated as an exchange under either Section 302(a) or Section 303(a) of 20 percent or more of the outstanding stock of the corporation from a shareholder in one or more transactions during any thirty-day period during the corporation's taxable year; or (3) an issuance of an amount of stock equal to or greater 25 percent of the previously outstanding stock to one or more new shareholders during any thirty-day period during the corporation's taxable year. Section 1.1368-1(g)(2)(ii) of the regulations provides that in the case of such an election, the taxable year is treated as if it consisted of separate taxable years for purposes of allocating items of income and loss; making adjustments to the AAA, basis, and earnings and profits; and in determining the tax effect of distributions. The Section 1377 regulations address the allocation of income/loss of an S corporation between the two periods created by the election under Section 1377(a)(2) to bifurcate an S corporation's taxable year upon the complete termination of a shareholder's interest. These regulations also coordinate this election with similar elections under the Section 1368 regulations.

The 1996 Act amended Section 1377, effective for taxable years beginning after December 31, 1996, to provide that only “affected shareholders” and the corporation must join in the election to terminate the S corporation’s year as of the date of the termination of a shareholder’s interest. “Affected shareholders” are any shareholders whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the year. If the transfer of shares is a redemption, however, “affected shareholders” include all person who were shareholders during the year.

c. **Allocations Among Family Members.** If a member of the family of an S corporation shareholder renders services for, or furnishes capital to, the corporation without receiving reasonable compensation therefor, the Secretary of the Treasury may make adjustments in the items taken into account by the individual and such shareholders as necessary to reflect the value of such services or capital. Such reallocation is permissible whether or not the individual providing the services or capital is a shareholder of the S corporation.
V. Shareholder's Basis in Stock and Debt

A. Basis in S Corporation Stock. A shareholder’s initial basis in S corporation stock will be determined by the manner in which it was acquired. For example, a shareholder who purchases stock will have a cost basis under Section 1012, unless Sections 351 and 358 apply to impose a substituted basis. A shareholder who acquires stock by gift will have a carryover basis under Section 1015, whereas a shareholder who obtains stock from a decedent is entitled to a step-up in basis under Section 1014. In any case, Section 1367 provides special rules pursuant to which the basis of stock of an S corporation is adjusted in certain circumstances.

1. Increases in Basis. Pursuant to Section 1367(a)(1), a shareholder's basis in S corporation stock is increased by the shareholder's share of the following items:
   a. separately-stated S corporation income;
   b. any nonseparately-computed income of the S corporation; and
   c. the amount by which the S corporation's depletion deductions (other than depletion for oil or gas property) exceed the basis of the depletable property.

2. Decreases in Basis. Section 1367(a)(2) requires that a shareholder's basis in S corporation stock be decreased by the shareholder's share of the following items:
   a. distributions by the S corporation to such shareholder pursuant to Section 1368 that are not included in the income of such shareholder;
   b. separately-stated losses and deductions of the S corporation;
   c. any nonseparately-computed loss of the S corporation;
   d. any nondeductible expense of the S corporation that is not properly chargeable to capital account; and
   e. the amount of such shareholder's deduction for depletion with respect to the S corporation's oil and gas property (to the extent such deduction does not exceed such shareholder's proportionate share of the basis of such property).

3. Treatment of Charitable Contributions. In Private Letter Ruling 9340043 (July 8, 1993), the IRS ruled that an S corporation is a permissible donor to an otherwise qualified charitable remainder trust under Section 664. The IRS also found that any charitable contribution deduction of the S corporation resulting from the transfer of a property to the charitable remainder trust must be separately stated and passed through to the S corporation's shareholders under Section 1366(a)(1)(A). Furthermore, the ruling concludes that the
shareholders' basis is reduced by the amount of the charitable contribution deduction, not the adjusted basis of the contributed property.

In PLR 9703028 (October 22, 1996), the IRS ruled that the deductibility of a charitable contribution by an S corporation is determined at the shareholder-level, pursuant to Section 1366(a)(1)(A). Thus, the Section 170(c)(2) limitation on corporate contributions used outside the United States does not apply to contributions by an S corporation.

4. **Noncapital, Nondeductible Expenses.** This reduction in basis only applies to expenses of the corporation that are not deductible in computing its taxable income and are not properly chargeable to a capital account. Therefore, items are not included where the deduction is deferred to a late year. Treas. Reg. § 1.1367-1(c)(2).

5. **Aggregate Basis for Losses.** The regulations under Section 1367 provide rules that, in effect, treat a shareholder's basis in the S corporation's stock as a single amount rather than a separate basis in each share. This is accomplished by allocating decreases in basis to each share on a per share, per day basis, but reallocating any amount that exceeds the basis in any shares to the other shares with remaining basis. Treas. Reg. § 1.1367-1(c)(3).

6. **Ordering Rules.** The regulations under Section 1367 provide ordering rules that govern which item of increase or decrease will be applied against the stock basis first. The adjustments required by Section 1367 are made in the following order: (1) any increase in basis attributable to income items and the excess of deductions for depletion, other than oil and gas; (2) any decrease in basis attributable to noncapital, nondeductible expenses; (3) any decrease in basis attributable to items of loss or deduction; and (4) any decrease in basis attributable to a distribution. Treas. Reg. § 1.1367-1(e). This ordering rule is punitive for taxpayers because it requires a decrease in basis for nondeductible items prior to the decrease for deductible items. As a result, a taxpayer would encounter the limitation under Section 1366(d) on taking losses earlier. The regulations, however, provide that taxpayers may make an election to decrease the basis in stock for deductible losses prior to nondeductible items. Treas. Reg. § 1.1367-1(f). This ordering rule may also penalize a shareholder who receives a distribution during a loss year because the losses will reduce stock basis prior to the reduction in basis for the distribution. As a result, if the losses eliminate the shareholder's stock basis, the distribution will be taxable to the shareholders. The 1996 Act amends these ordering rules effective for tax years beginning after December 31, 1996, requiring that basis adjustments for distributions during the year be made prior to basis adjustments for losses for the year.

7. **Timing Rules.** Section 1.1367-1(d)(1) of the regulations provides that the adjustments to the basis of a shareholder's stock are to be determined as of the close of the corporation's taxable year, and generally will be effective as of such date. In the event that a shareholder disposes of his stock during the corporation's taxable year, however, the adjustments with respect to such shareholder's stock are effective immediately prior to such disposition.

Section 1.1367-1(d)(2) of the regulations provides that an adjustment for a non-taxable item is made with respect to the taxable year in which the item would have been...
includable or deductible under the corporation's method of accounting for federal income tax purposes if the item had been subject to federal income taxation.

Section 1.1367-1(d)(3) of the regulations provides that, if an election is made under Section 1377(a)(2) to terminate the year in the case of a termination of a shareholder's entire interest in an S corporation, or if an election is made under Section 1.1368-9(g)(2) of the regulations to terminate the year in the case of a qualifying disposition, the adjustments to the basis of a shareholder's stock are applied as if the taxable year consisted of separate taxable years, the first of which ends as of the close of the day on which: (1) the shareholder terminates the shareholder's interest in the corporation; or (2) the qualifying disposition occurs, whichever is applicable.

In Gubbini v. Commissioner, 71 T.C.M. 2993 (1996), the Tax Court held that the basis adjustments under Section 1367 must be applied before application of Section 165(g), regarding deductions for worthless stock, Section 166, regarding deductions for bad debts, and Section 1244, regarding ordinary loss on Section 1244 stock.

B. Basis in S Corporation Debt. When a shareholder acquires the debt obligation of an S corporation, the basis for such debt generally will be its cost pursuant to Section 1012. The initial basis of S corporation debt, however, is subject to certain adjustments pursuant to Section 1367(b)(2).

1. Reduction of Basis. A shareholder's basis in the debt of an S corporation that is outstanding at the close of the corporation's taxable year will be reduced (but not below zero) if, and to the extent that, such shareholder's share of the items that reduce the basis of S corporation stock (other than nontaxable distributions made pursuant to Section 1368) exceeds such shareholder's basis in the S corporation stock. Section 1367(b)(2)(A) and Treas. Reg. § 1.1367-2(a)(1). This basis reduction, however, does not apply to debt that is retired during the year. Id.

   a. Multiple Indebtedness. If a shareholder holds more than indebtedness at the close of the corporation's taxable year, the reduction in basis is applied to each indebtedness in the same proportion that the basis of each indebtedness bears to the aggregate bases of the indebtedness to the shareholder. Treas. Reg. § 1.1367-2(b)(3).

   b. Termination of Shareholder's Stock Interest During the Year. If a shareholder terminates his/her interest in the corporation during the taxable year, the adjustments to the basis of his/her indebtedness are made at that time. Treas. Reg. § 1.1367-2(b)(2). Otherwise, adjustments are made at the end of the corporation's year. Treas. Reg. § 1.1367-2(b)(1).

2. Restoration of Basis. If a shareholder's basis in the debt of an S corporation has been reduced by reason of the application of Section 1367(b)(2)(A) for any taxable year beginning after 1982, any subsequent net increase in basis (the excess of items that increase basis over the items that decrease basis, including distributions) is to be applied first to
restore the basis of such debt and then to restore the basis of such shareholder's stock. Section 1367(b)(2)(B).

a. **Debt Restored.** These restoration rules apply only to indebtedness held by the shareholder as of the beginning of the taxable year in which the basis increase arises. The reduction in basis of indebtedness must be restored completely before any increase is applied to restore the basis of a shareholder's stock. Treas. Reg. § 1.1367-2(c)(1). The shareholder's basis of indebtedness may not be restored above its adjusted basis, determined under Section 1016(a), without regard to the basis reductions under Section 1367.

b. **Multiple Indebtedness.** If a shareholder owns more than one indebtedness as of the beginning of the corporation's taxable year, any net increase in basis is applied first to restore the reduction in basis of any indebtedness that is repaid, in whole or in part, during the year to the extent necessary to offset any gain that would otherwise be realized on the repayment. Any remaining net increases apply to restore each outstanding indebtedness in proportion to the amount that the basis of the debt has been reduced under Section 1367. Treas. Reg. § 1.1367-2(c)(2). The allocation of restoration of basis first to indebtedness that is repaid during the year is a favorable rule for taxpayers. It apparently does not apply, however, to indebtedness that is sold or otherwise exchanged during the year. As a result, the favorable restoration rules may not apply in this circumstance.

c. **Time at Which Adjustments to Basis of Indebtedness Are Effective.** The amount of basis adjustments under Section 1367 are generally determined and effective as of the close of the corporation's taxable year. However, if the shareholder is not a shareholder in a corporation at that time, these adjustments are effective immediately before the shareholder terminates his/her interest in a corporation. Treas. Reg. §1.1367-2(d). In addition, if a debt is disposed of or repaid in whole or in part before the close of the year, the basis of the indebtedness is restored before the disposition or the first repayment. *Id.*

3. **Repayment of Debt Having Reduced Basis.** If an S corporation repays debt to a shareholder that has a reduced basis by reason of the application of Section 1367(b)(2)(A), the shareholder will recognize gain on the repayment. If the debt is represented by a written instrument and is a capital asset in the hands of the shareholder, the gain will be capital. Rev. Rul. 64-162, 1964-1 (Part 1) C.B. 304. If, however, the debt is "open account" debt, any gain resulting from its repayment will be ordinary income. Rev. Rul. 68-537, 1968-2 C.B. 372.

4. **Open Account Indebtedness.** Section 1.1367-2(a) of the regulations provides that for purposes of applying the basis adjustment rules to a shareholder's basis in indebtedness of an S corporation to the shareholder, all shareholder advances not evidenced by separate written instruments and repayments on such advances (open account debt) will be treated as a single indebtedness.

C. **Basis Limitations Upon Losses and Deductions.** As noted above, the losses and deductions of an S corporation are passed through to its shareholders to be reported by them on
their individual federal income tax returns. Section 1366(d) prescribes certain limitations, however, upon the amount of losses and deductions that may be deducted by an S corporation shareholder.

1. **General Limitations.** Under Section 1366(d)(1), the aggregate amount of losses and deductions of an S corporation that may be taken into account by a shareholder for a taxable year is limited to the sum of:

   a. The shareholder's adjusted basis in the stock of the S corporation (as determined with regard to any increases to be made to such basis for such taxable year); and

   b. The shareholder's adjusted basis in any debt of the S corporation to the shareholder (as determined without regard to any adjustments to be made to such basis for such taxable year).

2. **Carryover Rule.** Any loss or deduction of an S corporation that is disallowed by reason of the application of the basis limitation rules of Section 1366(d)(1) may be carried forward indefinitely pursuant to Section 1366(d)(2). Thus, losses and deductions of an S corporation in excess of a shareholder's aggregate basis in stock and debt are merely suspended; if an increase in such shareholder's stock or debt basis occurs in a later year, the shareholder will be able to deduct the suspended losses and deductions in the year in which such increase in basis occurs, subject to whatever other limitations may apply (e.g., Section 469, Section 465, etc.). The carryover of suspended losses has been less than certain, however, in a number of transactions such as the merger of two S corporations or the termination and reelection of S status. On September 24, 1998, however, the IRS issued proposed regulations under Section 1366 (the “Proposed Section 1366 Regulations”). These regulations provide that losses carried over under Section 1366(d) with respect to an S corporation will carry over to a corporation that acquires the S corporation. Prop. Reg. §1.1366-2(c). If the acquiring corporation is an S corporation and the acquisition is described in Section 381, the losses are available to the same shareholder as a shareholder in the acquiring corporation. It is generally understood though that a shareholder's suspended losses expire upon the transfer of all of the shareholder's stock. Nevertheless, in Private Letter Ruling 9335028 (June 4, 1993), the IRS ruled that the settlor of a trust qualifying as a grantor trust would be treated as directly owning the shares of stock of the S corporation held by the grantor trust pursuant to Section 1361(c)(2)(A)(i). The IRS also found that the settlor would be permitted to treat losses suspended under Section 1366(d)(2) during years in which the settlor directly owned the shares of stock of the S corporation as if the settlor continued to own such shares directly rather than through the grantor trust. In TAM 9552001 (Aug. 31, 1995), the IRS ruled that suspended losses attributable to a husband's shares were not transferred to the shareholder's former spouse when such shares were transferred incident to their divorce.

3. **Carryover Following Termination of S Corporation Election.** In the event that a corporation's election to be taxed as an S corporation is terminated, the Code provides a window of time within which a shareholder having losses suspended by reason of the basis limitation rules of Section 1366(d)(1) may deduct such suspended losses.
a. Section 1366(d)(3)(A) provides that if, for the last taxable year for which a corporation was an S corporation, a loss or deduction was disallowed to a shareholder by reason of the basis limitation rules, such loss or deduction will be treated as having been incurred by that shareholder on the last day of the corporation's post-termination transition period.

b. The aggregate amount of losses and deductions that may be passed through to, and therefore deducted by, a shareholder under Section 1366(d)(3)(A) must not exceed the adjusted basis of the shareholder's stock in the corporation, as determined at the close of the last day of the post-termination transition period. Section 1366(d)(3)(B). Therefore, an S corporation shareholder may not attempt to deduct suspended losses by increasing his basis in the indebtedness of the corporation during the post-termination transition period; only increases in the adjusted basis of such shareholder's stock in the corporation will enable the shareholder to deduct such suspended losses.

c. The term "post-termination transition period" has three definitions. Section 1377(b)(1).

(i) First, the post-termination transition period may be the period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of (i) one year after such last day or (ii) the due date for filing the return for such last year as an S corporation, including extensions. Section 1377(b)(1)(A). For this purpose, the last day of the corporation's last taxable year as an S corporation is considered to be the day before the date upon which the termination of the corporation's S corporation election became effective. S. Rep. No. 640, supra, at 18.

(ii) Second, the term "post-termination transition period" may mean the 120-day period beginning on the date of a judicial or administrative determination that the corporation's S corporation election has terminated.

(iii) Third, the 1996 Act expanded the post-termination transition period to include the 120-day period beginning on the date of determination in an audit of the taxpayer that adjusts an item of the S corporation. This expansion is effective for determinations after December 31, 1996. (See clarification of effective date in technical corrections to the 1997 Act.)

(iv) The regulations under Section 1377 clarify that a post-termination-transition period arises the day after the last day an S corporation was in existence if a C corporation acquires its assets in a transaction to which Section 381(a)(2) applies. Reg. §1.1377(2)(b).

(v) The 1996 Act (i) expanded the definition of the post termination transition period to include the period after an audit adjustment is made after the corporation has already terminated its s election and (ii) expanded the definition of "determination" in Section 1372(a)(2) to include the meaning of such term as defined in the
mitigation provisions of Section 1313(a), thus including an agreement between the corporation and the Service that the corporation failed to qualify as an S corporation. Section 1601(c)(2) of the 1997 Act changed the effective date for the 1996 Act changes from taxable years beginning after December 31, 1996, to determinations made after December 31, 1996. Also, Section 1601(c)(2) makes clear that the 120 day period after a determination is made for an audit of a corporation after the termination of its S election will not expire before the end of the 120 day period beginning after August 5, 1997.

D. Special Basis Issues

1. Discharge of Indebtedness Income.

   a. In Technical Advice Memorandum 9423003 (Feb. 28, 1994), the IRS ruled that discharge of indebtedness income that is excluded from gross income under Section 108(a) does not pass through to the shareholders of an S corporation as a separately stated item of tax-exempt income under Section 1366(a)(1)(A), and as such, does not increase the shareholders' stock basis under Section 1367. The IRS has reached similar conclusions in TAM 9541001 and 9541006. The IRS found that because an S corporation must apply the Section 108(a) exclusion from income at the corporate level and any reduction in tax attributes under Section 108(b) must occur at the corporate level under Section 108(d)(7)(A), to the extent that discharge of indebtedness income is excluded from the gross income of an S corporation under the provisions of Section 108(a), it is excluded at the corporate level, and as such, it is not an item that passes through to the S corporation's shareholders under Section 1366(a)(1)(A). Additionally, the IRS reasoned that amounts excluded from income under Section 108(a) do not constitute tax-exempt income, but rather, constitute tax-deferred income because Section 108(b) operates to defer taxes by reducing certain tax attributes by the amount of income excluded under Section 108(a). Although the conclusion reached by the IRS is not surprising, the reasoning used by the IRS to reach its conclusion seems questionable and subject to challenge.

   b. In Nelson v. Commissioner, USTC, No. 20811-95, 110 T.C. No. 12 (February 19, 1998), the Tax Court ruled that discharge of indebtedness income realized and excluded from gross income of an insolvent S corporation under section 108(a) does not pass through to the shareholders of an S corporation as an item of income in accordance with section 1366(a)(1)(A) and therefore does not increase the shareholder's basis in his S corporation stock under section 1367. The taxpayer had argued that the excluded COD income is tax-exempt income described in section 1366(a)(1)(A) and 1367(a), and thus it flows through to the shareholder. The taxpayer also argued that section 108(d)(7)(A) stands for the proposition that prior to the determination of an individual shareholder a income tax liability, the S corporation must be ascertained to be insolvent, but that once such determination is made, the reduction of tax attributes occurs at the shareholder level in the form of suspended losses under section 1366(d)(1). The Tax Court rejected taxpayer's argument in favor of the "plain meaning" of section 108(d)(7)(A), which specifically provides that the exclusion applies at the corporation level. If the income is thus excluded at the corporate level, it cannot pass through to the shareholders. In light of the Tax Court's holding in Nelson v. Commissioner, 110 T.C. No. 12 (discussed above), the Tax Court granted the Commissioner's motion for reconsideration of its
decision in *Winn v. Commissioner*, USTC, No. 5358-96, T.C. Memo 1998-71, (February 19, 1998), withdrew its earlier taxpayer favorable opinion at T.C. Memo. 1997-286, and granted summary judgment for the Commissioner. The author understands that one or both of these decisions are under appeal by the taxpayer to the relevant circuit court of appeals.

c. In *Friedman v. Commissioner*, USTC, 18735-96 and 18736-96, TC Memo 1998-196 (May 27, 1998), the Tax Court ruled that a discharge of indebtedness did not take place in connection with an S corporation's Chapter 11 bankruptcy because there was no identifying event or forgiveness on the part of the S corporation's creditors that gave rise to a discharge of its indebtedness.

d. The Proposed Section 1366 Regulations provide that discharge of indebtedness income is not tax exempt income for purposes of Section 1366 and, therefore, does not increase a shareholder's basis in stock. Prop. Reg. §1.1366-1(a)(2)(viii).

2. **Economic Outlay Theory.** Under Section 1366(d)(1), an S corporation shareholder is permitted to deduct losses and deductions of the corporation to the extent of such shareholder's adjusted basis in the stock of the S corporation and in "any indebtedness of the S corporation to the shareholder."

a. Numerous cases have held that only obligations owed directly to the shareholder by the corporation are considered in calculating such shareholder's basis for purposes of the Section 1366(d) limitation upon the deductibility of losses. In general, these cases have held that an actual economic outlay by an S corporation shareholder is required before such shareholder may increase his basis in the corporation. Thus, shareholders who have guaranteed the indebtedness of an S corporation to a third party or served as the co-maker, co-obligor, or surety with respect to such indebtedness generally have not been permitted to include such amounts in their basis in the corporation. See, e.g., *Wise v. Commissioner*, T.C. memo. 1997-135 (March 17, 1995); *Brown v. Commissioner*, 22 A.F.T.R. 2d 5289; *Wheat v. United States*, 31 A.F.T.R. 2d 808; *Neal v. United States*, 25 A.F.T.R. 2d 896; *Erwin v. Commissioner*, 56 CCH T.C.M. 1343 (1989); *Estate of Leavitt v. Commissioner*, 90 T.C. 2701 (1988), aff'd, 89-1 USTC 9332 (4th Cir. 1989); *Gurda v. Commissioner*, 54 CCH T.C.M. 104 (1987); *Shebesta v. Commissioner*, 53 CCH T.C.M. 824 (1987); *Bader v. Commissioner*, 52 CCH T.C.M. 1398 (1987); *Blum v. Commissioner*, 59 T.C. 436 (1972); *Raynor v. Commissioner*, 50 T.C. 762 (1968); *Borg v. Commissioner*, 50 T.C. 257 (1968); *Perry v. Commissioner*, 47 T.C. 159 (1966), aff'd, 21 A.F.T.R. 2d 1003; but see *Selfe v. United States*, 57 A.F.T.R. 2d 464. In *Keech v. Commissioner*, 65 T.C.M. (CCH) 1986, T.C.M. (RIA) ¶93,071 (1993), the Tax Court, citing *Estate of Leavitt v. Commissioner*, 875 F.2d 420 (4th Cir. 1989), aff'd 90 T.C. 206 (1988), held that the shareholders were not liable for the substantial understatement penalty imposed under Section 6661, because *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985), provided substantial authority for the shareholders' positions that the shareholders' guarantee of corporate debt increased basis at the time they filed their income tax returns.

b. Only when the shareholder of an S corporation actually makes payments pursuant to a guarantee of corporate indebtedness do such guaranteed amounts increase
such shareholder's basis in the S corporation. Rev. Rul. 71-288, 1971-2 C.B. 319; Rev. Rul. 70-50, 1970-1 C.B. 178. Likewise, if both the corporation and the shareholder are jointly and severally liable, no basis is obtained until payments on the note are made. See Reser v. Commissioner, 70 T.C.M. 1472 (1995).

c. In Selfe v. United States, supra, the Eleventh Circuit reversed the district court's grant of a summary judgment against the shareholder of an S corporation who argued that her guarantee of the corporation's bank debt increased her basis for purposes of deducting the corporation's losses. The court of appeals held that the shareholder was entitled to an opportunity to prove that the loan was in reality made to her rather than to the corporation, under the principles of Plantation Patterns, Inc. v. Commissioner, 29 A.F.T.R. 2d 1408. Although the court of appeals purported to reaffirm the proposition that economic outlay is required before an S corporation shareholder may receive an increase in basis, it disavowed the notion that a shareholder must in all cases absolve a corporation's debt in order to obtain increased basis as a guarantor of a loan to a corporation. For example, the court reasoned, a guarantor who pledges stock as security for a loan has made an economic outlay to the extent of the time value or use value of the pledged stock, because it is then unavailable for use as collateral with respect to other investments.

d. In Estate of Leavitt v. Commissioner, supra, the Tax Court specifically rejected the Eleventh Circuit's reasoning in Selfe and held that guarantees of a corporation's indebtedness to a third-party lender by multiple shareholders of an S corporation did not increase such shareholders' bases in the S corporation. The taxpayers argued that, because the corporation was insolvent at the time the loan was made and because the bank would not have advanced the funds to the corporation absent the shareholders' guarantees, the loan should in fact have been treated as a loan from the bank to the shareholders, who then advanced the proceeds of the loan as a contribution to the capital of the corporation. The Tax Court held that the traditional debt-equity analysis applicable in the context of C corporations did not apply to guaranteed loans to S corporations with respect to which the shareholder has incurred no cost and declined to include the guaranteed amounts in the shareholders' bases in the S corporation. The Fourth Circuit affirmed the Tax Court, holding that the taxpayers had made no economic outlay with respect to the guaranteed amounts and therefore were not entitled to include such amounts in their adjusted bases.


3. **Alternative Methods of Obtaining Basis.**

a. **Direct Shareholder Contributions or Loans**

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(i) The simplest and most straightforward way for a shareholder to obtain basis in an S corporation is to make a direct capital contribution or loan to the corporation. The capital contribution or loan may be funded with the shareholder's own funds or with amounts borrowed from a third party.

(ii) This direct approach has a number of drawbacks, however. First, a shareholder may not have or be willing to commit the resources necessary to make a capital contribution or loan with his own funds. Second, the use of funds borrowed by the shareholder in his individual capacity to finance a capital contribution or loan to an S corporation raises both practical and tax-related issues. The shareholder may not have or be willing to use as collateral the personal assets sufficient to secure such a loan. Additionally, the passive loss limitations of Section 469 or the investment interest limitations of Section 163(d) may limit the deductibility of the interest paid or accrued on such borrowings.

(iii) Certain variations upon the theme of making direct capital contributions and loans have met with opposition at the IRS and in the courts.


(b) Loans to an S corporation from an entity related to its shareholder generally do not create basis for the shareholder. See Shebester v. Commissioner, supra (loan from related corporation); Bader v. Commissioner, supra (same); Burnstein v. Commissioner, 47 CCH T.C.M. 1100 (1984) (same); Prashker v. Commissioner, 59 T.C. 172 (1972) (loan from estate of which shareholder was beneficiary); Wilson v. Commissioner, T.C. memo 1991-544; Rev. Rul. 69-125, 1969-1 C.B. 207 (loan from partnership of which shareholder was partner); TAM 9403003 (September 29, 1993) (same), and Foust v. Commissioner, 70 T.C.M. 928 (1995) (same). For an analysis of the Burnstein case and its reasoning, see Willson & Halverson, Recent Developments Affecting S Corporation Loss Deductions, 2 J. Partnership Tax'n 82 (1985).

(c) When the contribution to an S corporation of borrowed funds has lacked economic reality, the IRS and the Tax Court have refused to permit an increase in basis for the borrowed funds. See Pike v. Commissioner, 78 T.C. 822 (1982), (no basis increase where shareholders borrowed funds from tax shelter promoter to contribute to S corporation, which thereupon loaned funds back to promoter); Rev. Rul. 80-236, 1980-2 C.B. 240 (no basis increase where shareholders borrowed funds from bank to contribute to S corporation, under facts indicating tax-avoidance purpose and circular flow of cash). See also Aiken Industries, 56 T.C. 925 (1971).

(d) When a taxpayer characterized payments to an S corporation as equity contributions, but there was no evidence found to support the claim that the contributor intended to be a shareholder, the Tax Court has found that the payments constituted

b. **Substitution of Shareholder's Note for Corporate Debt.** As discussed above, a shareholder's guarantee of the indebtedness of his S corporation does not create additional basis in the corporation for purposes of permitting the deduction of losses passed through to the shareholder. In certain instances, however, the IRS and the courts have permitted an increase in basis when the shareholder's note was substituted for the corporate indebtedness.

   (i) In Rev. Rul. 75-144, 1975-1 C.B. 277, an S corporation borrowed funds from a third-party lender, and the shareholder of the corporation guaranteed the obligation. When the S corporation defaulted on its note, the shareholder substituted his note to the lender in satisfaction of the guarantee. The lender then released the S corporation from its original indebtedness. The IRS invoked the doctrine of subrogation to permit the shareholder to increase his basis by the face amount of his note to the lender.

   (ii) *Gilday v. Commissioner*, 43 T.C.M. 1295 (1982), also involved the substitution of a shareholder's note for the obligation of his S corporation. In *Gilday*, however, the parties agreed that the substitution was motivated strictly by the desire to increase the shareholders' basis so as to allow the deduction of a greater amount of the corporation's losses. Moreover, the corporation never defaulted on its loan to the bank and continued to make the necessary payments directly to the bank following the note substitution. The Tax Court held that, regardless of whether the shareholders were considered subrogated under state law by virtue of the note substitution, the corporation had become indebted to its shareholders in a manner sufficient to establish basis. In PLR 9811016, the IRS ruled favorably on a situation similar to that presented in *Gilday*.

   (iii) *Hitchins v. Commissioner*, 103 T.C. No. 40 (1994), the Tax Court held that a loan originally made by a shareholder to his controlled C corporation that was assumed by an S corporation in which the shareholder and his wife were 50-percent shareholders did not constitute "indebtedness of the S corporation to the shareholder" within the meaning of Section 1366(d)(1)(B) because there was no direct obligation from the S corporation to the shareholder. Consequently, the shareholder was not permitted to increase his basis in the S corporation and was therefore unable to deduct losses incurred by the S corporation during the taxable year.

   (iv) In TAM 9403003 (Sept. 29, 1993), the IRS ruled that amounts loaned by a shareholder to his wholly-owned S corporation did not constitute indebtedness of the S corporation to the shareholder within the meaning of Section 1366(d)(1)(B) where the loan originally had been structured as a loan from another S corporation controlled by the shareholder to the shareholder's wholly-owned S corporation. In the ruling, an S corporation controlled by the shareholder (S-1) borrowed $780,000 from a bank, and then loaned such funds to the shareholder's wholly-owned S corporation (S-2). S-1 also loaned an additional $910,000 to S-2 during the same taxable year as the initial loan from S-1 to S-2. Prior to the end of the
taxable year (when it was apparent that S-2 had incurred substantial losses), S-2 repaid the $780,000 and $910,000 to S-1, and such amounts were then loaned by S-1 to the shareholder, who in turn loaned such amounts directly to S-2. In this manner, the shareholder attempted to create sufficient basis to allow him to deduct the substantial losses incurred by S-2 during the taxable year.

The IRS, citing Underwood v. Commissioner, 63 T.C. 468 (1975), aff’d, 535 F.2d 309 (5th Cir. 1976), concluded that the shareholder could not treat the amounts loaned to S-2 as indebtedness of the S corporation to him under Section 1366(d)(1)(B), since the shareholder had not made an actual economic outlay in such a manner that he was poorer in a material sense after the transaction than he was before the transaction began. Specifically, the IRS stated that when a taxpayer puts himself between his controlled S corporations, it is not clear that the taxpayer will ever make demand upon himself for payment, and as such, unless there is an actual payment there is no economic outlay by the taxpayer as required under Section 1366(d)(1)(B). The IRS also distinguished Gilday v. Commissioner, 43 T.C.M. 1295 (CCH), T.C.M. ¶82,242 (RIA) (1982), and Revenue Ruling 75-144, 1975-1 C.B. 277 (in which shareholders were granted an increase in basis with respect to loan restructurings), since the obligees on the shareholders’ notes in those cases were unrelated third party banks rather than corporations controlled by the shareholders.

(v) In an unpublished opinion in Bergman, -- F. Supp.-- (D.Minn.1998), the district court rejected the IRS’ arguments in TAM 9403003, concluding that the taxpayer obtained basis on facts virtually identical to the TAM.

(vi) Some commentators have suggested that an S corporation shareholder wishing to achieve basis in the manner described in Rev. Rul. 75-144, supra, should arrange for a valid default by the corporation on its debt to the third party, which default should be followed by the substitution of the guarantor-shareholder's note. These commentators also point out the necessity of properly documenting the transaction by having the S corporation issue its note to the guarantor-shareholder following the default. Finally, the commentators recommend that, notwithstanding the facts of Gilday, a shareholder who has substituted his note for that of the corporation require the corporation to make payments to him directly, so that he in turn may make payments on his personal note to the original lender. See Harris & Maiorano, Alternative Methods of Obtaining Basis in Leveraged S Corporation Assets, 64 Taxes 203 (1986); see also Mullaney & Blau, supra; Sharp & Webster, Deductibility of S Corporation Losses: Planning Around the Pitfalls, 2 J. Partnership Tax'n 363 (1986).

(vii) In PLR 9811016, the Service set out at least one set of steps that will lead to shareholder basis in debt. In this ruling, the Service concluded that the cancellation of a note between an S corporation and a bank followed by the execution of a note between the S corporation's shareholders and the bank together with the execution of a note from the corporation to the shareholders in exchange for the relief of the corporation's liability to the bank gave the shareholders basis in the note for purposes of Section 1366(d)(1). The Service’s ruling was conditioned on the shareholders becoming the primary obligors with respect to the bank note and the existence of a legally enforceable debt running from the S corporation to the
shareholders. In this ruling, the S corporation had an outstanding liability from the bank. Two of the corporation's shareholders were co-makers on the note and the note was secured by property co-owned by three of the corporation's shareholders. The shareholders gave the bank their personal note and the bank canceled the corporation's note held by the bank. Both the shareholders' note to bank and the corporation's note to shareholders provided for market interest and terms. The Service cited Gilday v. Commissioner, T.C. Memo. 1982-242 in reaching its ruling.

c. **Back-to-Back Loans.** Back-to-back loans may provide a method of obtaining basis in an S corporation that combines the two approaches discussed above.

(i) In PLR 8443002 (7/6/84), the shareholder of an S corporation had guaranteed the indebtedness of his corporation to a bank. Near the end of the year the shareholder realized that his basis and amount at risk in the corporation were insufficient to permit the deduction of all of the corporation's losses for that year. The shareholder then borrowed funds from the same bank that had made the loan to the corporation and loaned the proceeds to the corporation, which subsequently used the funds to repay its obligation to the bank. The bank did not release its security interest in the assets of the corporation until the shareholder ultimately satisfied its notes to the bank. Based on this exchange of notes, and despite the absence of any business purpose other than the basis increase, the IRS ruled that the shareholder was entitled to deduct the losses passed through from the corporation.

(ii) Although PLR 8443002 involved the restructuring of an existing loan from an S corporation to a third-party lender, the rationale of the ruling should apply with equal force if the loans are made in a slightly different order. For example, the initial acquisition of an asset may be financed by having an S corporation shareholder borrow funds from a third-party lender and loan the proceeds to his S corporation to purchase the asset. To secure the corporation's note to the shareholder, the corporation will give the shareholder a security interest in the asset. The shareholder will then pledge to the lender the note and the security interest obtained from the corporation.

(iii) As with the note substitution technique discussed above, adequate documentation is essential when utilizing back-to-back loans. *See Harris & Maiorano,* *supra.* In addition, the loan from the shareholder to the S corporation should be structured so as to satisfy the straight debt safe harbor of Section 1361(c)(5) to ensure its treatment as debt for S corporation purposes. Further, it may be advisable to structure the loan from the shareholder to the S corporation so that is has different terms from the third-party loan. (But, see, Bolding v. Commissioner, 97 TNT 140-8, in which the Fifth Circuit found that the shareholder of a wholly-owned S corporation had basis as a result of loans or capital contributions to the corporation, notwithstanding less than ideal documentation.)

E. **Other Limitations Upon Deductibility of Losses.** In addition to the basis limitation rules of Section 1366(d), other provisions of the Code may limit the deductibility by an S corporation shareholder of the losses and deductions passed through from the S corporation pursuant to Section 1366(a). For example, pursuant to Section 465, individuals and certain

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closely held corporations may not currently deduct losses incurred in most business activities, except to the extent that such taxpayers are "at risk" in such activities. In addition, Section 469, which was added by the 1986 Act, limits the extent to which a taxpayer may use losses and credits from passive activities (that is, activities involving the conduct of a trade or business and in which the taxpayer does not materially participate) to offset income from nonpassive sources.

VI. Distributions From S Corporations

A. Overview. The basic purpose of Subchapter S is to permit a corporation and its shareholders to pay a single tax on corporate income. The rules regarding the pass-through of corporate income, deduction, loss, and credit achieve part of this purpose by taxing income of an S corporation directly to the shareholders without regard to distributions. The rules governing distributions from S corporations, found generally in Section 1368, then complete the system by allowing shareholders to receive distributions up to the amount of corporate net income without tax. A description of two corporate-level tax attributes, earnings and profits and the accumulated adjustments account, is necessary to an understanding of the S corporation distribution system.

1. Earnings and Profits.

a. An S corporation generally will generate no current earnings and profits for taxable years beginning after December 31, 1982. Section 1371(c)(1). (Special rules apply to certain qualified oil companies and qualified casualty insurance companies that "elected out" of the changes to Subchapter S made in and after 1982.)

b. Even after 1982, an S corporation may have accumulated earnings and profits ("AE&P") from several sources: (a) AE&P from taxable years during which the corporation was a C corporation; (b) AE&P from taxable years beginning before January 1, 1983 during which the corporation was an S corporation; and (c) AE&P carried over from another corporation pursuant to Section 381 in connection with a tax-free acquisition. The 1996 Act, however, generally allows S corporations to reduce their AE&P by the AE&P (if any) accumulated in any tax year beginning before 1983 for which it was an electing small business corporation under Subchapter S.

c. An S corporation's AE&P account is to be adjusted to take into account corporate redemptions, liquidations, reorganizations, investment tax credit recapture liability, and distributions that are treated as dividends under Section 1368(c)(2). Sections 1371(c)(2), (3), and (d)(3).

d. In Broadaway v. Commissioner, 97 TNT 75-15 (8th Cir. 1997), the court held that an S corporation could not adjust the amount of C corporation E&P that carried over when it elected Subchapter S status to take into account actual costs incurred by the S corporation to complete long-term contracts. These costs exceeded the estimates the corporation had used as a C corporation to calculate E&P under the percentage of completion method.
2. **Accumulated Adjustments Account.** The accumulated adjustments account ("AAA") is a corporate-level account that essentially consists of the undistributed portion of the S corporation's accumulated gross income for the most recent continuous period during which it has been an S corporation beginning after 1982, less deductible expenses. Section 1368(e)(1)(A); S. Rep. No. 640, *supra*, at 20. The purpose of the AAA is to allow S corporations to make tax-free distributions to their shareholders of undistributed income earned (and taxed to the shareholders) in taxable years beginning after 1982, before making taxable distributions of AE&P. The balance in the AAA can be distributed tax-free to the S corporation shareholders before any amount is considered to be a distribution of AE&P.

a. **Increases in the AAA.** An S corporation begins the first day of its first taxable year beginning after 1982 with an AAA of zero. As income items pass through to the shareholders and increase the shareholders' stock bases, the corporation's AAA increases as well. As a general rule, all separately stated income items and nonseparately computed income increase the AAA. Section 1368(e)(1)(A) specifically provides, however, that no adjustment is to be made to the AAA for tax-exempt income items (and related expenses) or for federal taxes attributable to any taxable year in which the corporation was a C corporation. In addition, AAA is increased by the excess of deductions for depletion over the basis of the property (other than oil and gas property) subject to depletion. Treas. Reg. § 1.1368-2(a)(2).

b. **Decreases in the AAA.** The balance of the AAA is decreased by the same items that cause a reduction in the basis of the shareholders' stock and debt of the S corporation. AAA can be reduced below zero by losses and similar items but not by distributions. Treas. Reg. § 1.1368-2(a)(3)(ii). The AAA also is decreased to reflect the redemption of S corporation stock in an "exchange" transaction under Sections 302(a) or 303(a). Section 1368(e)(1)(B). Section 1.1368-2(a)(3)(ii) of the regulations provides that the AAA must also be decreased by noncapital, nondeductible expenses even though a portion of the noncapital, nondeductible expenses is not taken into account by a shareholder due to the shareholder's election under Section 1.1367-1(f) of the regulations. Additionally, the regulations provide that the AAA is adjusted to reflect the entire amount of any loss or deduction even though a portion of the loss or deduction is disallowed to a shareholder for the taxable year under Section 1366(d)(1) or is otherwise not currently deductible under the Code. No further adjustment is made to the AAA, however, in any subsequent taxable year in which the loss or deduction is treated as incurred by the corporation with respect to the shareholder under Section 1366(d)(2) or Section 1.1367-1(f) of the regulations, or in which the loss or deduction is otherwise allowed to the shareholder.

c. **Negative AAA Balance.** Although a shareholder's basis in S corporation stock and debt may not be less than zero, *See* Section 1367(a)(2), (b)(2)(A), the corporation's AAA may have a negative balance. Section 1368(e)(1)(A). For example, because the AAA balance is initially zero, an S corporation that incurs and passes through losses to its shareholders in its first taxable year will have a negative AAA.
d. **Ordering Rules.** Section 1.1368-2(a)(3)(iii) of the regulations provides that the AAA is decreased (but not below zero) by any portion of a distribution to which Sections 1368(b) or 1368(c) apply. Section 1.1368-2(a)(4) of the regulations provides that for any taxable year, the adjustments to the AAA are made in the following order: (1) increases under Section 1.1368-2(a)(2) of the regulations are made before decreases under Section 1.1368-2(a)(3) of the regulations are made to the AAA; (2) the AAA is decreased for items of loss and deduction before it is decreased for distributions; (3) the AAA is decreased (but not below zero) by any portion of an ordinary distribution to which Sections 1368(b) or 1368(c) apply; and (4) the AAA is adjusted (whether negative or positive) for redemption distributions under Section 1.1368-2(d)(1) of the regulations. As described above, the 1996 Act has amended these ordering rules to require adjustments for distributions prior to adjustments for losses.

**B. Distributions From S Corporations Without AE&P.** The tax treatment of distributions from an S corporation having no AE&P is quite straightforward.

1. To the extent that a distribution to a shareholder does not exceed the adjusted basis of such shareholder's stock (taking into account the adjustments to such basis required by Section 1367), the distribution is not taxable to the shareholder, but instead reduces the basis of such shareholder's stock. Sections 1368(b)(1), (d)(1), and 1367(a)(2)(A).

2. To the extent that a distribution to a shareholder exceeds the adjusted basis of such shareholder's stock (adjusted as described above), such excess will be treated as gain from the sale or exchange of property. Section 1368(b)(2).

**C. Distributions From S Corporations With AE&P.** The system of taxation of distributions from S corporations having AE&P is somewhat more complex than the distribution scheme described above with respect to S corporations having no AE&P.

1. To the extent that distributions by an S corporation having AE&P do not exceed the balance of the AAA, they are treated as if the corporation had no AE&P. Thus, a distribution not in excess of the AAA is not taxable to the recipient shareholder to the extent that it does not exceed the shareholder's adjusted basis in the S corporation stock; the basis of such stock is then reduced in an amount equal to the amount of such distribution. The amount of any distribution not in excess of the AAA that exceeds the shareholder's adjusted stock basis will be treated as gain from the sale or exchange of property. Sections 1368(c)(1) and (b).

2. To the extent that distributions by an S corporation having AE&P exceed the balance of the corporation's AAA, such excess is treated as a dividend to the extent of the corporation's AE&P. Section 1368(c)(2).

3. To the extent that distributions by an S corporation having AE&P exceed the sum of the corporation's AAA and AE&P, such excess is nontaxable to the recipient shareholder to the extent of any remaining stock basis and causes a corresponding reduction in such basis. Any remaining portion of the distribution is treated as gain from the sale or exchange of property. Sections 1368(c)(3), 1368(b), and 1367(a)(2)(A).
4. Section 1368(d) provides that adjustments to the basis of S corporation stock and adjustments to the AAA are to be made prior to the application of these distribution rules.

5. Section 1368(e)(3) permits an S corporation having AE&P to elect to treat distributions as being made first from AE&P and then from the AAA. Such election requires the consent of any shareholder to whom a distribution was made by the S corporation during the taxable year.

   a. The Section 1368(e)(3) election will enable a corporation in its first year as an S corporation to avoid accumulated earnings tax liability or personal holding company tax liability for its last year as a C corporation by obtaining a dividends paid deduction as a result of a distribution from its AE&P. H.R. Rep. No. 986, 97th Cong., 2d Sess. (1982) at 22.

   b. In addition, the election available under Section 1368(e)(3) may be used to eliminate the S corporation's AE&P so as to avoid the "sting tax" imposed by Section 1375 on the excess net passive income of an S corporation. H.R. Rep. No. 986, supra.

   c. Section 1.1368-1(f)(2)(iii) of the regulations provides that if an S corporation makes an election to distribute earnings and profits first as provided in Section 1368(e)(3) and has both subchapter C earnings and profits and subchapter S earnings and profits, the distribution is treated as made first from subchapter C earnings and profits, and second from subchapter S earnings and profits. Subchapter S earnings and profits are generally defined as earnings and profits accumulated in a taxable year beginning before January 1, 1983 for which an election under subchapter S was in effect.

Section 1.1368-1(f)(3) of the regulations provides that an S corporation that makes an election to distribute earnings and profits first may elect to distribute all or part of its subchapter C earnings and profits through a deemed dividend. The amount of deemed dividend may not exceed the subchapter C earnings and profits of the corporation on the first day of the taxable year, reduced by any actual distributions of subchapter C earnings and profits made during such taxable year. The amount of the deemed dividend is considered as if it were distributed in money to the S corporation's shareholders in proportion to their stock ownership, and immediately contributed by the shareholders to the S corporation on the last day of the corporation's taxable year.

Section 1.1368-1(f)(5)(iii) of the regulations provides that the election to distribute earnings and profits first, or to make a deemed dividend is made by attaching a statement containing certain required information to a timely filed original or amended return required to be filed under Section 6037 for such taxable year. Section 1.1368-1(f)(5)(iv) of the regulations provides that such elections are irrevocable and are effective only for the taxable year for which they are made.
D. **Additional Mechanical Rules.**

1. **Timing Rules.** Section 1.1368-1(g)(1) of the regulations provides that, if an election is made under Section 1377(a)(2) to terminate the year where a shareholder terminates his entire interest in the S corporation, or if an election is made under Section 1.1368-1(g)(2) of the regulations to terminate the year where there is a qualifying disposition, the distribution rules will be applied as if the taxable year consisted of separate taxable years, the first of which ends as of the close of the day on which the shareholder terminates his interest in the S corporation or on which there is a qualifying disposition, whichever is applicable.

   Section 1.1368-1(g)(2)(i) of the regulations provides that if there is a "qualifying disposition," the corporation may elect to treat the year as if it consisted of separate taxable years, the first of which ends as of the close of the day on which the qualifying disposition occurs. A "qualifying disposition" is: (1) a disposition by a shareholder of 20 percent or more of the outstanding stock of the corporation in one or more transactions during any thirty-day period during the corporation's taxable year; (2) a redemption treated as an exchange under either Section 302(a) or Section 303(a) of 20 percent or more of the outstanding stock of the corporation from a shareholder in one or more transactions during any thirty-day period during the corporation's taxable year; or (3) an issuance of an amount of stock equal to or greater 25 percent of the previously outstanding stock to one or more new shareholders during any thirty-day period during the corporation's taxable year. Section 1.1368-1(g)(2)(ii) of the regulations provides that in the case of such an election, the taxable year is treated as if it consisted of separate taxable years for purposes of allocating items of income and loss, making adjustments to the AAA, basis, and earnings and profits, and in determining the tax effect of distributions.

   Section 1.1368-1(g)(2)(iii) of the regulations provides that such election is made for a taxable year by attaching a statement containing certain required information to a timely filed original or amended return required to be filed under Section 6037 for such taxable year. The election to treat the year as if it consisted of separate taxable years in the case of a qualifying disposition is irrevocable once made.

2. **Distributions in Excess of Basis of Share.** The regulations provide rules that effectively aggregate a shareholder's basis in stock for purposes of determining whether distributions exceed the basis of stock. This is accomplished by reallocating distributions that exceed a share's basis to other shares that have basis remaining. Treas. Reg. § 1.1367-1(c)(3).

3. **Allocation of AAA to Distributions.** If distributions during the year exceed the amount of AAA, the AAA is allocated among the distributions on a proportionate basis. Treas. Reg. § 1.1368-2(b)(2). Section 1.1368-2(c)(1) of the regulations provides that the amount of the AAA allocated to a distribution must be further allocated if the distribution: (1) consists of property, the adjusted basis of which exceeds its fair market value on the date of the distribution, and money; (2) is a distribution to which Section 1.1368-1(d)(1) of the regulations applies; and (3) exceeds the amount of the corporation's AAA properly allocable to that distribution. Section 1.1368-2(c)(2) of the regulations provides that the amount of the AAA
allocated to the "other property" is determined by multiplying the amount of the AAA allocated to the distribution as a whole by a fraction, the numerator of which is the fair market value of the other property on the date of the distribution and the denominator of which is the amount of the distribution. The amount of the AAA allocated to the money is equal to the amount of the AAA allocated to the distribution as a whole reduced by the amount of the AAA allocated to the other property.

Section 1.1368-2(d)(1)(i) of the regulations provides that in the case of a redemption that is treated as an exchange of stock under Section 302(a) or 303(a), the AAA of the corporation is adjusted in an amount equal to the ratable share of the corporation's AAA (whether negative or positive) attributable to the redeemed stock as of the date of the redemption.

Section 1.1368-2(d)(1)(ii) of the regulations provides that in the case of a taxable year in which both ordinary distributions and redemption distributions occur, the AAA is first adjusted for any ordinary distributions and then for any redemption distributions. Section 1.1368-2(d)(1)(iii) of the regulations further provides that earnings and profits are adjusted under Section 312 independently of any adjustments made to the AAA.

4. **Treatment of Acquisitions/Dispositions.** Section 1.1368-2(d)(2) of the regulations provides that an S corporation acquiring the assets of another S corporation in a transaction to which Section 381(a)(2) applies, will succeed to and merge its AAA (whether negative or positive) with the AAA (whether negative or positive) of the transferor S corporation as of the close of the date of the transfer.

Section 1.1368-2(d)(3) of the regulations provides that in the case of a corporate separation to which Section 368(a)(1)(D) applies, the AAA is allocated among the distributing and controlled corporations in a manner similar to the allocation of earnings and profits under Section 312(h) and the regulations promulgated thereunder.

5. **Treatment of Certain Redemptions.** In Revenue Ruling 95-14, 1995-6 I.R.B. 29, the IRS ruled that where an S corporation shareholder receives proceeds in a redemption that does not qualify as a sale or exchange under either Section 302(a) or Section 303(a), but rather is treated as a distribution under Section 301, the proceeds of the redemption are treated as a distribution under Section 1368 and the corporation's accumulated adjustments account must be reduced by the full amount of the distribution to the extent the distribution is not included in the shareholder's income under the distribution rules of Section 1368. The IRS recently reached a similar conclusion in PLR 9607003 (Nov. 3, 1995).

E. **Distributions from Former S Corporations During the Post-Termination Transition Period.** Section 1371(e) permits a former S corporation to make certain nontaxable distributions of cash to its shareholders for a limited period after the termination of the corporation's S corporation election.

1. **General Rule.** Any distribution of money by a corporation with respect to its stock during the post-termination transition period is applied against and reduces the adjusted
basis of the stock, to the extent that the amount of the distribution does not exceed the AAA.
Section 1371(e)(1). Thus, the favorable treatment of distributions during the post-termination
transition period afforded by Section 1371(e)(1) is available only to the extent of the lesser of the
AAA or the shareholder's stock basis. The Code does not indicate whether cash distributions not
in excess of the AAA that exceed stock basis will be taxed as dividends or as gain from the sale
or exchange of property. As described above, the 1996 Act has expanded the definition of post-
termination transition period to generally include the 120-day period after a determination on
audit of the taxpayer regarding the S corporation's items of income or loss.

2. **Election.** Section 1371(e)(2) permits a former S corporation to elect to
have the rules of Section 1371(e)(1) not apply to all distributions made during the
post-termination transition period, provided that all shareholders who receive distributions during
such period consent to such treatment. The effect of such an election would be for distributions
made during such period to be treated as provided in Section 301. Temp. Reg. § 18.1371-1
provides procedures for making such an election.

3. **Regulations.** As described above, the regulations permit post-termination
transition period distributions following a tax-free acquisition of the assets of an S corporation by
a C corporation, provided that the acquisition is described in Section 381(a)(2). Reg. 1.1377-
2(b). This treatment, however, is only provided for the former shareholders of the S corporation,
not the shareholders of the acquiring corporation.

4. **The 1996 Act Expansion of the PTTP.** The 1996 Act (i) expanded the
definition of the post termination transition period to include the period after an audit adjustment
is made after the corporation has already terminated its S election and (ii) expanded the definition
of "determination" in Section 1372(a)(2) to include the meaning of such term as defined in the
mitigation provisions of Section 1313 (a), thus including an agreement between the corporation
and the Service that the corporation failed to qualify as an S corporation. Section 1601(c)(2) of
the 1997 Act changed the effective date for the 1996 Act changes from taxable years beginning
after December 31, 1996, to determinations made after December 31, 1996. Also, Section
1601(c)(2) makes clear that the 120 day period after a determination is made for an audit of a
corporation after the termination of its S election will not expire before the end of the 120 day
period beginning after August 5, 1997.
VII. Tax on Excess Passive Investment Income - Section 1375

A. In General. Section 1375 imposes a "sting tax" upon certain S corporations having "passive investment income". The sting tax on passive income applies only if (i) an S corporation has earnings and profits from years in which the corporation was a C corporation ("Subchapter C earnings and profits") and (ii) more than 25 percent of the gross receipts of such corporation are passive investment income. Section 1375(a).

B. Definition of Passive Investment Income. The term "passive investment income" is defined in Section 1362(d)(3)(D) to mean gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of the gains therefrom). These six categories of passive investment income are subject to significant exceptions that are contained in Treas. Reg. § 1.1362-2(c)(5) (described below).

1. Royalties. For this purpose, "royalty" income includes all royalties, including mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, and other similar property. The gross amount of royalty income is included in gross receipts without reduction for any amortization of the cost of the license or other intangible. Treas. Reg. § 1.1362-2(c)(5)(ii)(A)(1). The regulations, however, exclude the following royalties from the definition of passive investment income.

   a. Royalties Derived in the Ordinary Course of a Trade or Business. The term royalties does not include royalties derived in the ordinary course of a trade or business of franchising or licensing property. For this purpose, a royalty is treated as derived in the ordinary course of a trade or business if the corporation created the property or performed significant services or incurred substantial costs with respect to the development or marketing of the property. Treas. Reg. § 1.1362-2(c)(5)(ii)(A)(2).

   b. Copyright, Mineral, Oil and Gas, and Active Business Computer Software Royalties. Passive investment income includes neither copyright royalties, nor mineral, oil, and gas royalties if the income from those royalties would not be treated as personal holding company income under Sections 543(a)(3) and 543(a)(4) if the corporation were a C corporation. In addition, passive investment income does not include amounts received from the disposal of timber, coal, or domestic iron ore with respect to which the special rules of Section 631(b) and (c) apply. Finally, active business computer software royalties, as defined in Section 543(d), are also excluded from the definition of passive investment income. Treas. Reg. § 1.1362-2(c)(5)(ii)(A)(3).

2. Rents. For purposes of the definition of passive investment income, the term "rent" means amounts received for the use of, or right to use, property (whether real or personal) of the corporation. Treas. Reg. § 1.1362-2(c)(5)(ii)(B)(1). The regulations, however, provide the following exclusions from the definition of passive investment income.
a. **Rents Derived in the Active Trade or Business of Renting Property.** Passive investment income does not include rents derived in the active trade or business of renting property. For this purpose, rents are treated as derived in the act of conduct of a trade or business of renting property if the corporation provides significant services or incurs substantial costs in the rental business. The regulations provide that significant services generally are not rendered and substantial costs are not incurred in connection with "net leases." The IRS has issued a number of private letter rulings concerning this exception and expanded significantly on the meaning of these terms. See e.g., PLR 9404016 (October 27, 1993); PLR 9345048 (August 17, 1993) (cancellation of triple net leases that are not net leases); PLR 9311011 (December 16, 1992); PLR 9320018 (February 18, 1993) (significant services rendered); PLR 9321041 (February 25, 1993) (partnership rendered significant services and flow-through income retains its character); PLR 9323033 (March 17, 1993); PLR 9325012 (March 19, 1993); PLR 9341010 (July 14, 1993); and PLR 9404010 (October 25, 1993). In PLRs 9417012 (Jan. 27, 1994) (involving rental income from various commercial properties, including shopping centers, office buildings, light industrial facilities, service stations, a car wash and a parking lot), 9418005 (Jan. 27, 1994) (involving rental income from commercial and residential real estate), 9419029 (Feb. 15, 1994) (involving rental income from a full-service storage facility and from the rental of trucks, trailers and tows), 9420014 (Feb. 15, 1994) (involving rental income from a large shopping center), 9421023 (Feb. 24, 1994) (involving rental income from a commercial office complex with attached warehouse space), 9421007 (Feb. 17, 1994) (involving rental income from various commercial and light industrial use buildings, a warehouse with limited office space, a commercial use building and a fenced parking lot), 9421045 (Mar. 1, 1994) (involving rental income from a mobile home park), 9422049 (Mar. 9, 1994) (involving rental income from a shopping center), 9423012 (Mar. 9, 1994) (involving rental income from various shopping center complexes, a flea market, apartment buildings, retail complexes, commercial office buildings and other real estate), and 9423023 (Mar. 14, 1994) (involving rental income from a commercial office, warehouse and covered storage space), the IRS ruled that the revenues received by the respective S corporations did not constitute passive investment income within the meaning of Section 1362(d)(3)(D). In several other Private Letter Rulings, including PLRs 9828019, 9828023, 9828028, 9825014, 9824018, 9824019, 9824023, 9824029, 9824031, 9824032, 9823011, and 9823019, the Service has continued to find that S Corporations involved in the development, ownership and management of commercial real estate, in which the S Corporation provides significant services and incurs substantial costs in the development, leasing, financing and management of real estate property, will not receive rental income that is taxed as passive investment income under of Section 1362.

b. **Produced Film Rents.** Passive investment income does not include produced film rents as defined in Section 543(a)(5). Treas. Reg. § 1.1362-2(c)(5)(ii)(B)(3).

c. **Income from Leasing Self-Produced Tangible Property.** Passive investment income does not include compensation (whether designated as rent or otherwise) for the use of, or right to use, any real or tangible personal property developed,
manufactured, or produced by the taxpayer, provided that during the taxable year the taxpayers engaged in substantial development, manufacturing, or production of real or tangible personal property of the same type. Treas. Reg. § 1.1362-2(c)(5)(ii)(B)(4). This exception is difficult to rely on because it requires the corporation to perform substantial development or similar activities each year.

3. **Dividends.** Passive investment income includes dividends which are defined as amounts to be included in gross income under Section 316, Section 551, and consent dividends is provided in Section 565. Treas. Reg. § 1.1362-2(c)(5)(ii)(C).

4. **Interest.**
   a. **In General.** Passive investment income includes interest, which is defined to mean any amount received for the use of property (including tax-exempt interest and amounts treated as interest under Sections 483, 1272, 1274, or 7872). Treas. Reg. § 1.1362-2(c)(5)(ii)(D)(1).
   
   b. **Interest on Obligations Acquired in Ordinary Course of a Trade or Business.** Passive investment income does not include interest on any obligation acquired from the sale of inventory or the performance of services in the ordinary course of a trade or business of selling the property or performing the services. Treas. Reg. § 1.1362-2(c)(5)(ii)(D)(2).
   
   c. **Special Rules for Banks.** Notice 97-5 provides guidance on the application of the passive investment rules to interest income of a bank.

5. **Annuities.** Passive investment income includes annuities which is defined to mean the entire amount received as annuity under an annuity, endowment, or life insurance contract, if any part of the amount would be includable in gross income under Section 72. Treas. Reg. § 1.1362-2(c)(5)(ii)(E).

6. **Options and Commodities Dealers.** In the case of an option dealer or commodity dealer, passive investment income does not include any gain or loss (in the normal course of the taxpayer's activity of dealing in or trading Section 1256 contracts) from any Section 1256 contract or property related to the contract. Treas. Reg. § 1.1362-2(c)(5)(iii)(A).

7. **Other Dealers in Property.** The regulations also include an exception from the definition of passive investment income for gross receipts that are directly derived in the ordinary course for trade or business of dealing in property. Treas. Reg. § 1.1362-2(c)(5)(iii)(B)(1). This exception applies to gross receipts that are treated as interest, dividends, or gain from the sale of the property. This exception does not apply, however, to gain or income with respect to property held for investment any time before the income or gain is recognized. This provision makes it clear that securities brokers and dealers are dealers in property for purposes of applying the passive investment income rules and property held by such businesses

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for sale in the ordinary course of business will not be treated as passive investment income. See, Treas. Reg. § 1.1362-2(c)(6), Example 6.

8. **Trade or Business of Lending or Financing or Servicing Mortgages.** The regulations provide that passive investment income does not include gross receipts that are directly derived in the ordinary course of a trade or business of lending or financing or servicing mortgages. For this purpose, gross receipts are treated as directly derived in the ordinary course of business if the corporation is a dealer in debt obligations or holds obligation that it originates in the lending business. Treas. Reg. § 1.1362-2(c)(5)(iii)(B). In these situations, this exclusion from passive investment income applies with respect to the gain as well as the interest income with respect to the loans. However, interest earned from the investment of idle funds and short term securities does not constitute gross receipts directly derived in the ordinary course of business. Similarly, a dealer's income or gain from an item of property that is held for investment is not directly derived in the ordinary course of its trade or business. (See Notice 97-5 for special rules for banks.)

9. **Purchasing or Discounting Accounts Receivable, Notes, or Installment Obligations.** The regulations provide that passive investment income does not include gross receipts that are directly derived in the ordinary course of a trade or business of purchasing or discounting notes. For this purpose, gross receipts are treated as directly derived in the ordinary course of business if the corporation is a dealer in debt obligations or holds obligation that it originates in the purchasing or discounting notes business. In these situations, this exclusion from passive investment income applies with respect to the gain as well as the interest income with respect to the notes. However, interest earned from the investment of idle funds and short term securities does not constitute gross receipts directly derived in the ordinary course of business. Similarly, a dealer's income or gain from an item of property that is held for investment is not directly derived in the ordinary course of its trade or business.

10. **Partnership Income.** With respect to an S corporation's distributive share of income from a limited partnership of which it is a limited partner, it is the nature of the underlying income generated by the partnership that determines whether "passive investment income" exists. PLR 8852021 (September 28, 1988) and PLR 9321041 (February 25, 1993).

11. **Other Identified Income.** The regulations provide that passive investment income does not include income identified by the Commissioner by regulations, revenue rulings, or revenue procedures as income derived in the ordinary course of a trade or business. Treas. Reg. § 1.1362-2(c)(5)(ii)(G). At this time, no such additional items of income have been identified.

C. **Definition of Gross Receipts.** The term "gross receipts" means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income, unreduced by the cost of goods sold, returns and allowances, or other deductions. See, Section 1362(d)(3)(C); Treas. Reg. § 1.1362-2(c)(4). Gross receipts do not include: (i) amounts received in nontaxable sales or exchanges except to the extent gain is
recognized; or (ii) amounts received as a loan, as a repayment of a loan, or as a contribution to capital, or on the issuance by the corporation of its own stock. Treas. Reg. § 1.1362-2(c)(4)(iii).

1. **Gross Receipts from the Sale of Capital Assets (Other than Stock or Securities).** Gross Receipts from the sale of capital assets (other than stock or securities) are taken into account only to the extent of the capital gain net income therefrom.

2. **Gross Receipts from the Sale of Stock or Securities.** Gross receipts from the sale of stock or securities are included only to the extent of gains therefrom (i.e., losses can not be used to offset gains). The term "stock or securities" includes, among other things, stock, stock rights, limited partnership interests, and bonds. See Treas. Reg. § 1.1362-2(c)(4)(ii)(B)(3). A general partnership interest is not treated as a security for this purpose except to the extent that the partnership owns stock or securities. Treas. Reg. § 1.1362-2(c)(4)(ii)(B)(4). Therefore, gain on the disposition of a general partnership interest will be treated as gross receipts from the sale of a security to the same extent that the S corporation would have had gross receipts from the sale of stock or securities if the S corporation sold its proportionate share of the stock and securities held by the partnership.

D. **Amount of the Sting Tax.** The sting tax is computed by multiplying the excess net passive income of the corporation by the highest marginal rate of tax imposed upon corporations. Section 1375(a); Reg. § 1.1375-1A(a). No credits (other than the credit permitted by Section 34 with respect to certain uses of gasoline and certain fuels) are allowed against the "sting tax." Section 1375(c)(1).

1. **Net Passive Income.** Net passive income equals the amount by which (i) the corporation's passive investment income exceeds (ii) the allowable deductions that are directly connected with the production of such income. Section 1375(b)(2); Reg. § 1.1375-1A(b)(2).

2. **Excess Net Passive Income.** Excess net passive income equals the amount that bears the same ratio to the corporation's net passive income as (i) the amount by which the corporation's passive investment income for the taxable year exceeds 25 percent of gross receipts bears to (ii) total passive investment income. Section 1375(b)(1)(A). The amount of a corporation's excess net passive income for a taxable year is limited to such corporation's taxable income for such year, calculated as if it were a C corporation (without regard to net operating losses and deductions under Sections 241-250 (other than Section 248). Section 1375(b)(1)(B).

E. **Coordination with Section 1374 Built-In Gain Tax.** Section 1375(c)(4) coordinates the sting tax with the Section 1374 tax on built-in gains by providing that the amount of passive investment income shall be determined by not taking into account any recognized built-in gain or loss for any taxable year in the recognition period, as those terms are defined in Section 1374. This coordination rule reverses the rule applicable to the coordination of the sting tax with the capital gains tax under which the capital gains subject to tax under former Section

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1374 were reduced by the portion of the excess net passive income attributable to such gain. See Section 1375(c) prior to its amendment by the 1988 Act.

F. **Waiver of Sting Tax.** Section 1375(d) permits the Secretary of the Treasury to waive the sting tax if an S corporation establishes that (i) it determined in good faith that it had no Subchapter C earnings and profits at the close of a taxable year and (ii) it distributed such earnings and profits within a reasonable period of time after they were determined to exist. See also Reg. § 1.1375-1A(d) (procedures for obtaining such a waiver).

G. **Termination of S Corporation Election.** An S corporation subject to the "sting tax" on excess net passive income may also risk the termination of its S corporation election. If excess passive investment income and undistributed C year earnings and profits continue to be present for three consecutive years, Section 1362(d)(3) provides that the S election will be terminated as of the first day of the following year. For a discussion of strategies designed to avoid the undesirable consequences that may befall an S corporation having excess net passive income, see Lederman, *Many Options Available to Avoid Excess Passive Investment Income Tax and S Termination*, 69 Journal of Taxation 4 (1988).
VIII. LIFO Recapture Tax - Section 1363(d)

A. In General. Section 1363(d) provides that if a C corporation that makes an election to be an S corporation inventories goods under the LIFO method for its last taxable year as a C corporation, the corporation must include in its gross income for such last taxable year the "LIFO recapture amount." Section 1363(d) was added by the 1987 Act and generally is effective with respect to S corporation elections made after December 17, 1987. This tax seems to be the first time that the Congress has considered an S election to be a taxable event. Some commentators have suggested that the addition of Section 1363(d) is the first step toward treating the conversion from C to S status as a taxable liquidation. It is interesting to note that one of the first steps in the eventual repeal of the General Utilities doctrine was the addition of a LIFO recapture provision to Sections 311 and 337. In this regard, the Joint Committee on Taxation has recommended that the conversion of a C corporation into an S corporation be treated as a liquidation of the C corporation, with immediate corporate-level tax on all net built-in gain, immediate shareholder-level tax on shareholder appreciation, and the elimination of C corporation earnings and profits or other tax attributes. Written Proposals on Tax Simplification, Committee on Ways and Means, U.S. House of Representatives, 101st Cong. 2d Sess. p.27 (Committee Print, May 25, 1990).

B. Definition of "LIFO Recapture Amount." Section 1363(d)(3) defines the "LIFO recapture amount" as the amount, if any, by which the inventory amount of the inventory assets calculated under the FIFO method, as of the close of the corporation's last taxable year as a C corporation, exceeds the inventory amount of such assets calculated under the LIFO method as of such date. Special rules apply if the corporation has previously obtained consent to discontinue the use of the LIFO inventory method of accounting, but elects to be an S corporation before the end of the otherwise applicable Section 481 adjustment period for such changes (6 years). See Rev. Proc. 88-15, 1988-1 C.B. 683, 688.

C. Calculation and Payment of LIFO Recapture Tax. The LIFO Recapture Tax is equal to the increase in the corporation's tax that would result from the inclusion of the LIFO Recapture Amount in income in the corporation's final C corporation return. For an explanation of the mechanics of the calculation of this amount see Ann. 88-60, 1988-15 I.R.B. 47 and Rev. Proc. 94-61, 1994-38 I.R.B. 2. The increase in tax occasioned by the application of Section 1363(d) is to be paid by the corporation in four equal installments, with the first installment due on or before the due date (without regard to extensions) for the return relating to the corporation's last taxable year as a C corporation and the three succeeding installments due on or before the due date (without regard to extensions) for the corporation's return for the three succeeding taxable years. No interest is required to be paid with respect to the deferred installments of such tax payment if they are paid by their respective due dates. Section 1363(d)(2)(C). Rev. Proc. 94-61 makes it clear that such tax is accelerated if the corporation liquidates before the end of the four year period but does not address the situation where its S election is terminated during that period. Furthermore, Rev. Proc. 94-61 does not address how Section 1363(d) applies to a corporation that is a subsidiary member of a consolidated group, leaves such group, and makes an immediate S election. Section 1363(d)(4)(D) provides that if a corporation is a member of a
consolidated group on the last day of its final C corporation year, the LIFO Recapture Amount is not included in the income of the consolidated group. This clarification was added in the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"). The legislative history of this provision seems to indicated, however, that it was intended to clarify that the departing subsidiary is liable for the LIFO Recapture Tax, not all members of the consolidated group. Compare Treas. Reg. § 1.1502-6 (all members of a consolidated group are jointly and severally liable for the taxes of the group). This leaves open the question whether the amount of the LIFO Recapture Tax would be calculated by considering the effect on the consolidated group's tax liability if such amounts were included in income in the year the subsidiary left the group (e.g., will other member's NOLs be relevant to the calculation of the LIFO Recapture Tax. This seems logical because the purpose of Section 1363(d) is to recapture the tax benefits of using the LIFO inventory method that in this circumstance may have inured to other members of the consolidated group.

D. Adjustments to Basis of Inventory. Appropriate adjustments to the basis of inventory are to be made to take into account the amount included in gross income under Section 1363(d). Section 1363(d) does not, however, require the corporation to change to the FIFO method of inventorying goods. Rev. Proc. 94-61 confirms this conclusion. The effect of the taxation of the LIFO recapture amount on the corporation's use of the LIFO inventory method, however, is unclear. For example, it is unclear whether the corporation is to maintain its prior LIFO inventory layers or must establish a single LIFO inventory layer that includes all inventory held on the first day of its first year as an S corporation. Rev. Proc. 94-61 provides that such prior layers must be collapsed together into one layer. The Rev. Proc., however, does not clarify whether this is required or whether the other approach (i.e., leaving the layers intact) is also acceptable.

E. Other Consequences. The inclusion of the entire LIFO Recapture Amount in the corporation's income for its final C year should result in an equivalent increase in such corporation's subchapter C earnings and profits. The later payment of such tax should not result in a reduction in the corporation's AAA, but should reduce the corporation's earnings and profits. Section 1368(e)(1)(A). For a discussion of this and other issues relating to the LIFO Recapture Tax, see Jerald D. August, Technical Correction Act of 1988 and Revenue Act of 1987 Impose Toll Charge for C to S Conversions, 5 J. of Partnership Taxation 181 (1988).

F. Regulations Attack Merger Planning Technique. Unlike the Section 1374 built-in gain tax, Section 1363(d) has no explicit application to an S corporation whose predecessor was a C corporation. Compare, Section 1363(d)(1)(A) with Section 1374(c)(1). This raised the question whether the LIFO Recapture Tax applied to a C corporation that merges into an existing S corporation, particularly where such S corporation has a separate existence prior to the merger (i.e., owns other assets and conducts business). On October 6, 1994, the IRS published final regulations under Section 1363(d) that apply the LIFO Recapture Tax to a C corporation that transfers its inventory assets to an S corporation in a transaction where the S corporation's basis in the asset is determined in whole or in part by reference to the basis of the asset (or any other property) in the hands of a C corporation. This provision is intended to prevent a C corporation from avoiding the LIFO Recapture Tax by merging into an S corporation.
in a tax-free reorganization under Section 368(a)(1)(A). This portion of the regulations is effective to transfers of property made after August 18, 1993. Treas. Reg. § 1.1363-2(d)(2). These regulations provide that in this situation the LIFO Recapture Tax will be paid 25 percent in the last taxable year of the C corporation's existence and on or before the due date for the successor corporation's return for the succeeding three years. Treas. Reg. § 1.1363-2(b)(2). In addition, these regulations also apply the LIFO Recapture Tax to a situation where a C corporation distributes a portion of its business in a tax-free transaction under Section 355 and the distributed corporation makes an S election.

G. **Contribution of Inventory.** In PLR 9039005 (June 12, 1990), the IRS ruled that Section 1363(d) did not apply to an individual sole proprietor's contribution of inventory to an S corporation under Section 351. This conclusion was based, in part, on the idea that: "a literal reading of Section 1363(d) indicates that it applies only if an S corporation was a C Corporation for the last tax year before the first tax year for which the S election was effective."

In PLR 9716003 (September 30, 1996), the IRS ruled that a C corporation that contributed LIFO inventory to partnerships prior to converting to S corporation status still had to include the LIFO recapture amount in income. The IRS reasoned that, whether aggregate or entity treatment for a partnership is appropriate turns on the purpose and scope of the particular Code provision. The IRS then determined that allowing taxpayers to avoid LIFO recapture by holding LIFO inventory in a partnership would circumvent the purpose of Section 1363. Therefore, it concluded that it was appropriate to apply aggregate principles in determining the corporation's share of the partnership's LIFO inventory.

H. **Spin-Off by S Corporation.** In Private Letter Ruling 9424046 (Mar. 22, 1994), the IRS ruled that neither the distributing nor controlled corporation in a corporate separation under Section 355 would be subject to the LIFO recapture tax imposed under Section 1363(d), provided that the controlled corporation timely elected to be an S corporation for its first taxable year and otherwise met the requirements of Section 1361(b). The IRS found that the LIFO recapture tax imposed under Section 1363(d) applies only if an S corporation was a C corporation for the last taxable year before the first taxable year for which its S election is effective. Because the distributing corporation was an S corporation and the controlled corporation's shareholders will consent to the controlled corporation's election to be an S corporation for its first taxable year, neither corporation will be a C corporation for the last taxable year prior to the controlled corporation's first taxable year as an S corporation, and as such, Section 1363(d) will be inapplicable both to the distributing corporation and the controlled corporation.
IX. Built-In Gain Tax -- Section 1374

A. In General. The 1986 Act added a new corporate-level tax under Section 1374 applicable to certain built-in gains of S corporations (the "Section 1374 tax" or the "built-in gain tax"). The Section 1374 tax applies if, for any taxable year beginning in the recognition period, an S corporation has a net recognized built-in gain. The Section 1374 tax was enacted to prevent taxpayers from avoiding the corporate-level tax by converting into an S corporation. See General Explanation of the Tax Reform Act of 1986 (Joint Committee Print, May 4, 1987) Joint Committee on Taxation, at 337. For an overview of the Section 1374 built-in gains tax, see August, Technical Corrections Act of 1988 and Revenue Act of 1987 Impose Toll Charge for C to S Conversions, 5 J. Partnership Taxation 181 (1988); August, Corporate-Level Taxes on S Corporations and Built-In Gains Revisited, 67 Taxes 377 (1989); and Kramer & Kramer, New Section 1374 Tax Reduces the Attractiveness of an S Corporation Election for Closely Held Corporations, 65 Taxes 653 (1987).

B. Final Regulations Under Section 1374. On December 23, 1994, the IRS issued final regulations under Section 1374. These final regulations answer many of the questions concerning the application of Section 1374 that had been left unanswered by the statutory language, legislative history, and other previously-published guidance. These regulations attempt to provide guidance that is "relatively simple for taxpayers to understand and comply with and for the IRS to administer." The final regulations are generally effective for taxable years ending on or after December 23, 1994, but only for corporations that make an S corporation election (or a tax-free asset acquisition) after that date. Treas. Reg. § 1.1374-10(a). For a detailed discussion of the Section 1374 regulations, see Collins, Boyle, and Arthur, Proposed Regulations Under Section 1374: Long Awaited Guidance on the Built-In Gain Tax, 5 Journal of S Corporation Taxation 3 (Summer 1993); Collins and Kulish, Final Section 1374 Regulations: IRS Makes Several Favorable Changes, 7 Journal of S Corporation Taxation 103 (Fall 1995).

C. Corporations Subject To Section 1374 Tax.

1. Effective. Section 1374 is effective for taxable years of S corporations beginning after December 31, 1986, but only in cases in which the return for the taxable year is filed pursuant to an election made after December 31, 1986. Section 633(b)(1) of the 1986 Act, as amended by the 1988 Act. In certain circumstances a corporation that made an S corporation election after December 31, 1986, but before January 1, 1989, may be entitled to limited relief from the application of Section 1374. Section 633(d) of the 1986 Act, as amended by the 1988 Act (the "small corporation transition rule").

2. Always an S Corporation. Section 1374(a) does not apply to any corporation with respect to which an S corporation election has been in effect for each of its taxable years. Section 1374(c)(1).
a. **Transferred Basis Property.** In late 1986, however, the IRS issued Ann. 86-128, 1986-51 I.R.B. 22, which indicated that, among other things, the IRS intended to issue regulations pursuant to Sections 1374 and 337(d) that would limit the exception for such corporations with respect to transferred basis property acquired by an S corporation from a C corporation or a former C corporation. Announcement 86-128 stated that forthcoming regulations would operate generally to preserve any net unrealized built-in gains inherent in transferred basis property or exchanged basis property for purposes of applying Section 1374. As a result, property transferred to an S corporation from a C corporation in a tax-free merger would be subject to the Section 1374 tax. Section 1374(d)(8), added by the 1988 Act, codified the IRS position with respect to this issue. These rules and the regulations interpreting them are discussed below.

b. **Certain Transferred Basis Property Escaped Section 1374 Tax.**

In PLR 8826015 (March 30, 1988), the IRS discussed the application of Announcement 86-128 in the context of a Section 355 transaction involving two S corporations. Corporation D, which was incorporated in 1963, made an S corporation election prior to the end of 1986, to be effective as of its taxable year beginning March 1, 1987. Corporation C was formed in late 1986 as an inactive corporation in order to effectuate a reorganization intended to qualify under Section 355. Prior to the reorganization, C was not capitalized, had no shareholders, and engaged in no business activity. As part of the reorganization, D transferred assets to C and momentarily controlled C, but then immediately distributed all of its stock in C to its shareholder. Upon completion of the reorganization, C made an election to be taxed as an S corporation. The IRS ruled that the first day of C's first taxable year occurred on the date on which it first had shareholders, acquired assets, or began doing business, and not on the date of its incorporation. The IRS ruled further that the assets transferred to C by D were not subject to the Section 1374 tax because C made a timely election to be taxed as an S corporation for its first taxable year. The IRS found Announcement 86-128 inapplicable because C received assets with a transferred basis only from D, a corporation that was itself not subject to the Section 1374 tax. See also PLR 8837063 (June 22, 1988).

D. **Net Unrealized Built-In Gain.** Section 1374(c)(2) provides that the amount of the net recognized built-in gain to be taken into account for any taxable year under Section 1374 is limited to the amount, if any, by which the S corporation's "net unrealized built-in gain" (NUBIG) exceeds the net recognized built-in gains for prior taxable years beginning in the recognition period. Therefore, the corporation's NUBIG operates as an overall limitation on the total amount of gain that can be subject to the Section 1374 tax.

1. **Definition of NUBIG.** Section 1374(d)(1) defines "net unrealized built-in gain" as the amount, if any, by which the fair market value of the assets of the S corporation as of the beginning of the first taxable year for which an S election was in effect exceeded the aggregate adjusted bases of such assets of such date. All assets, including intangible assets such as goodwill and going concern value, are relevant for this purpose. Compare PLR 9137049 (June 18, 1991) (goodwill included under similar language in Section 382(h)). The Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) (the "1989 Act") clarified that this amount

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will be adjusted for built-in income and deduction items (discussed below), regardless of whether such items are recognized during the recognition period.

2. **Fair Market Value.** As discussed above, the fair market value of the assets of the corporation as of the effective date of its S election will define the corporation's maximum exposure to the Section 1374 tax. In addition, as discussed below, the value of each asset will also operate as a limit on the amount of the Section 1374 tax that results from the sale of such asset. *See Section 1374(d)(3).* For these reasons, the determination of the value of the corporation's assets as of the effective date of its S election is extremely important. A corporation may wish to obtain third party appraisals of its assets to aid in the substantiation of their value. Neither the Code nor the legislative history of Section 1374 furnish insight as to how fair market value is to be determined. The Section 1374 regulations, however, do provide guidance on the general construct for the valuation of the business and its inventory. It remains unclear whether a contemporaneous independent appraisal is required or whether some (hopefully less expensive) alternative procedure may suffice.

3. **Section 1374 Regulations' Definition of NUBIG.**

   a. **In General.** Prior to the issuance of the Section 1374 regulations, many practitioners believed that NUBIG was determined by looking at each individual asset, measuring the gain or loss inherent in the asset, and aggregating these amounts for all of the corporation's assets. Under this approach, adjustments for built-in income and deduction items would be required because they may not otherwise be taken into account in determining NUBIG, particularly if they are not "assets" (e.g., a Section 481 adjustment). The Section 1374 regulations adopt an entirely different approach. Under the Section 1374 regulations, a corporation's NUBIG is equal to (1) the amount that would be the amount realized if, on the first day of the recognition period, the corporation sold all of its assets at fair market value to an unrelated party (that assumed all of its liabilities); decreased by (2) the amount of any liability of the corporation that would be included in the amount realized, but only if the corporation would be allowed a deduction on payment of the liability; decreased by (3) the aggregate adjusted basis of the corporation's assets on the first day of the recognition period; increased or decreased by (4) the amount of the corporation's Section 481 adjustments on the first day of its recognition period; and increased by (5) any recognized built-in loss that would not be allowed under Section 382, 383, or 384. *Treas. Reg. § 1.1374-3(a).* This definition results in the inclusion of built-in income items in NUBIG only to the extent of their value. The Section 1374 regulations apparently do not require the adjustment of NUBIG if such income items are realized after conversion in an amount in excess of their value at the time of conversion.

   b. **Policy Considerations.** Conditioning the imposition of the built-in gain tax on the presence of NUBIG is consistent with Congress' rationale for the built-in gain tax. A corporation with net unrealized built-in gain generally would have been subject to two levels of tax if it had liquidated on the effective date of its S election because the fair market value of its assets would have exceeded the adjusted basis of its assets on that date. Conversely, an S corporation that lacks net unrealized built-in gain generally would have avoided two levels
of tax upon liquidation because the fair market value of its assets would have been less than the adjusted bases of its assets.

c. **Example.** Converted C corporation X filed an election to be an S corporation effective January 1, 1990. On that date, its balance sheet reflects the following assets:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$300</td>
<td>$400</td>
</tr>
<tr>
<td>Building</td>
<td>200</td>
<td>250</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$500</td>
<td>$650</td>
</tr>
</tbody>
</table>

Because the aggregate fair market value of its assets on January 1, 1990 exceeds the aggregate adjusted basis of its assets on that date by $150, X has net unrealized built-in gain of $150.

d. **Example.** Assume the same facts as in the prior example, except that the basis of the land owned by X on January 1, 1990 is $600. Because the aggregate adjusted bases of its assets ($800) exceeds the aggregate fair market value of its assets ($650), X lacks unrealized built-in gain and is, therefore, generally exempt from the built-in gains tax.

e. **Example.** As of the first day of its first S year, a former C corporation has two assets: land and an account receivable. The land has a value of $100 and an adjusted basis of $40. The face amount of the account receivable is $150, but it has a value of $120 (adjusted basis is zero). Therefore, the NUBIG is $180 ($100 + $120 - $40). If the corporation succeeds in collecting all $150 of the account receivable in its first year as an S corporation, there is no adjustment in NUBIG for the additional $30 of income relating to the account receivable.

4. **Definition of NUBIG Where C Corporation Assets Acquired in Tax-Free Transaction.** Presumably, an S corporation without a C history which is subject to the built-in gain tax because it acquires carryover basis assets from a C corporation has NUBIG if, as of the date of the acquisition of the assets, the aggregate fair market value of the acquired assets exceeds the aggregate adjusted basis of the acquired assets.

a. **Example.** On January 2, 1990, Y, an S corporation without a C history, acquires the assets of C corporation Z in a merger. On January 1, 1990, Y's balance sheet reflects the following assets:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$500</td>
<td>$350</td>
</tr>
<tr>
<td>Building</td>
<td>250</td>
<td>250</td>
</tr>
</tbody>
</table>
On January 1, 1990, Z's balance sheet reflects the following assets:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivables</td>
<td>-0-</td>
<td>$100</td>
</tr>
<tr>
<td>Land</td>
<td>$400</td>
<td>$450</td>
</tr>
</tbody>
</table>

TOTAL $400 $550

Y will apparently have net unrealized built-in gain of $150, reflective of the excess of the fair market value of the carryover basis assets acquired from Z in the merger. The fact that (a) preliminary to the merger, the fair market value of Y's assets did not exceed the adjusted basis of the assets or that (b) following the merger, the aggregate fair market value of Y's assets do not exceed the aggregate adjusted basis of the assets appears to be irrelevant.

b. If carryover basis assets are acquired from a converted C corporation, the transferee corporation should have NUBIG with respect to the acquired assets only if the aggregate fair market value of the assets exceeds aggregate adjusted basis of the assets as of both (a) the effective date of the transferor's conversion to S status and (b) the date the assets were acquired from the transferor.

5. Contribution of Loss Assets. The contribution of depreciated assets to a C corporation before its S election (or possibly before an acquisition of assets by an S corporation from a C corporation in a carryover basis transaction) might appear to be an effective method to avoid NUBIG. The IRS previously cautioned taxpayers, however, that future regulations under Section 1374 in "appropriate cases" will prohibit the elimination of net unrealized built-in gain through contributions of depreciated assets if the contributions are made to avoid the built-in gains tax. Announcement 86-128, 1986-51 I.R.B. 22. The Section 1374 regulations make good on this promise by providing that, if a corporation acquires an asset before or during the recognition period with a principal purpose of avoiding the built-in gain tax, the asset and any loss, deduction, loss carryforward, credit or credit carryforward attributable to the asset is disregarded in determining the S corporation's net recognized built-in gain, NOL carryforwards, and credit carryforwards with respect to the determination of the Section 1374 tax. Treas. Reg. § 1.1374-9.

E. Amount of the Tax.

1. In General. The Section 1374 tax is computed by applying the highest corporate tax rate to the net recognized built-in gain ("NRBIG") of the S corporation for the year. Section 1374(b)(1). However, to the extent that capital gains and/or losses are included in the corporation's NRBIG, such corporation will be subject to the limitations on the use of capital gains tax.
losses and the preferential rate applicable to capital gain income, if any. Section 1374(b)(4). The Section 1374 regulations also clarify how this rule will operate where the NRBIG for the year is less than the amount of the capital gains and/or losses included therein; a proportionate part of the NRBIG will be treated as capital gain income. Treas. Reg. § 1.1374-2(b).

2. **The Section 1374 Regulations’ Approach to the Calculation of the Section 1374 Tax.** The Section 1374 regulations reduce the calculation of the built-in gain tax to four steps. First, the S corporation must determine its NRBIG for the taxable year (this determination includes the application of the net unrealized built-in gain limitation). Second, the corporation reduces its NRBIG (but not below zero) by any allowed net operating loss (NOL) or capital loss carryforwards. Third, the S corporation computes its tentative built-in gain tax by applying the appropriate tax rate to the excess of its NRBIG over the allowed losses. Finally, the corporation computes its final built-in gain tax by reducing the tentative tax by any allowed credit carryover. Treas. Reg. § 1.1374-1.

3. **Limitations on Built-In Losses (Section 382, Section 383, or Section 384).** The Section 1374 regulations provide that, if Section 382, Section 383, or Section 384 would have applied to limit the use of the corporation's recognized built-in loss on the first day of the recognition period, these sections will limit the use of the losses in determining the corporation's NRBIG and, therefore, its built-in gain tax. Treas. Reg. §1.1374-1(b).

4. **Minimum Tax Inapplicable.** The S corporation's tax liability under Section 1374 is determined without regard to the corporate minimum tax.

5. **Effect on Flow-Through to Shareholders.** If a Section 1374 tax is imposed, the shareholders are taxed on the net amount of the corporation's income (after reduction for the Section 1374 tax) under the normal pass-through rules. See Section 1366(f)(2).

F. **Code's Definition of Net Recognized Built-In Gain.** The term "net recognized built-in gain" --NRBIG-- is defined in Section 1374(d)(2)(A) as the lesser of (i) the amount that would be the taxable income of the S corporation for the taxable year in question if only "recognized built-in gains" and "recognized built-in losses" were taken into account or (ii) such corporation's taxable income for such taxable year, as determined under Section 1375(b)(1)(B).

1. For this purpose, the corporation's taxable income for the year is defined by reference to Section 1375(b)(1)(B). Under Section 1375, taxable income is determined under Section 63 as if the corporation were a C corporation rather than an S corporation, except that deductions are not allowed for (i) net operating losses otherwise permitted by Section 172, and (ii) deductions otherwise permitted by Sections 241-250, other than Section 248. See former Section 1374(d) and Reg. § 1.1374-1A(d).

2. **Carryover of Certain Recognized Built-In Gains.** In the case of any corporation treated as an S corporation pursuant to an election made on or after March 31, 1988, Section 1374(d)(2)(B) provides a carryover rule pursuant to which the excess, if any, of the amount described in paragraph (a) above over the amount described in paragraph (b) above is

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carried forward and treated as a recognized built-in gain in the succeeding taxable year. The effect of the carryover rule of Section 1374(d)(2)(B) is to prevent an S corporation to which the rule applies from avoiding the imposition of the tax imposed by Section 1374 in a taxable year in which such corporation's taxable income is less than the net recognized built-in gain for such year, unless such corporation has no taxable income for the entire recognition period. The treatment of carryover amounts in corporate reorganizations and liquidations is unclear. In addition, it is not clear what would happen to the carryover amount if the corporation revoked its S election.

3. **Section 1374 Regulations’ Definition of NRBIG.** The Section 1374 regulations combine the statutory definition of "NRBIG" with the NUBIG limitation by defining "NRBIG" as the least of three numbers: (1) the "pre-limitation" amount; (2) the "taxable income limitation"; or (3) the "NUBIG limitation." Treas. Reg. § 1.1374-2(a)

   a. **Pre-Limitation Amount.** The Section 1374 regulations define "pre-limitation amount" as the corporation's "taxable income determined by using the rules applicable to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover." Treas. Reg. §1.1374-2(a) This formulation generally corresponds to the first statutory limitation described above, except that it adds the phrase "determined by using the rules applying to C corporations."

   b. **Taxable Income Limitation.** The second limitation on the amount of a corporation's NRBIG is its taxable income limitation (i.e., the corporation's taxable income for the year determined as provided in Section 1375(b)(1)(B)). Section 1374(d)(2)(a)(iii). The regulation leaves unanswered many of the issues regarding the rules to be used in calculating taxable income, because the regulation simply repeats the statutory language. Treas. Reg. §1.1374-2(a)(2).

   c. **Treatment of Carryover Amount.** Under the Section 1374 regulations, if a corporation's NRBIG is equal to the taxable income limitation, the amount by which its pre-limitation amount exceeds the taxable income limitation (i.e., the carryover amount) is included in the pre-limitation amount for the succeeding year. Treas. Reg. §1.1374-2(c). Therefore, any carryover amount will increase only the pre-limitation amount and not the taxable income limitation.

   (i) **Example.** A C corporation makes an election to be taxed as an S corporation for 1994. In 1994, the corporation has a pre-limitation amount (i.e., recognized built-in gain) of $60 and a taxable income limitation of $50. In 1994, only $50 would be subject to the built-in gain tax, and there would be a carryover amount of $10. In 1995, assume that the S corporation has no taxable income (determined without regard to the carryover amount). Under the Section 1374 regulations, the corporation would not be subject to the built-in gain tax in 1995, because the carryover amount would increase only its pre-limitation amount to $10 (its taxable income limitation would still be zero). If the carryover amount were instead added to both the pre-limitation amount and the taxable income limitation, then the corporation would have $10 that is subject to the built-in gain tax in 1995.
(ii) It is appropriate not to add the carryover amount to the corporation's taxable income. The taxable income limitation is intended to be a rough measure of the corporation's ability to pay the built-in gain tax. It would therefore be inappropriate to add the carryover amount to the taxable income limitation in the next year, because it does not increase the corporation's ability to pay in that year. The statutory language, however, is unclear because it provides only that the carryover amount is treated as a recognized built-in gain in the next year.

G. Recognized Built-In Gain and Loss.

1. Statutory Definitions.

   a. Recognized Built-In Gain. The term "recognized built-in gain" is defined by Section 1374(d)(3) as any gain recognized by an S corporation on the disposition of any asset during the recognition period, except to the extent that the S corporation establishes that either (i) such asset was not held by the S corporation as of the beginning of the first taxable year for which an S election was in effect or (ii) the gain recognized exceeds the amount, if any, by which the fair market value of such asset as of the beginning of the first taxable year for which an S election was in effect exceeded its adjusted basis as of such date.

   b. Recognized Built-In Loss. The term "recognized built-in loss" is defined by Section 1374(d)(4) as any loss recognized by an S corporation on the disposition of any asset during the recognition period, to the extent that the S corporation establishes that (i) such asset was held by the S corporation as of the beginning of the first taxable year for which an S election was in effect and (ii) the loss recognized does not exceed the amount, if any, by which the adjusted basis of such asset as of the beginning of the first taxable year for which an S election was in effect exceeded its fair market value as of such date.

   c. Fair Market Value Determination. The fair market value of each asset of a corporation is important in determining the applicability of the built-in gain tax because this value will establish a limit on the amount of recognized built-in gain or loss from the sale of that asset. Neither the Code nor the legislative history of Section 1374 furnish insight as to how fair market value is to be determined. The Section 1374 regulations, however, do provide guidance on the general construct for the valuation of the business and its inventory. It remains unclear whether a contemporaneous independent appraisal is required or whether some (hopefully less expensive) alternative procedure may suffice.


   a. In General. Generally, the value of an asset is "the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy or sell, and both being reasonably informed as to all relevant facts." Jack Daniel Distillery v. United States, 379 F.2d 569, 574 (Ct. Cl. 1967).
Although this standard is the only guidance regarding the valuation of most assets, there is significant authority addressing the valuation of inventory.

b. **Valuation of Inventory.**

(i) The Section 1374 final regulations make clear that the value of the inventory on the first day of the recognition period is based on an orderly sale of all of the assets of the corporation to a buyer engaged in the same business (i.e., the net realizable value) — not on a bulk-sale or fire-sale value. Specifically, the value of the inventory is determined by reference to a sale of the entire business to a buyer who expects to use the assets to continue to operate the business of the corporation. Treas. Reg. §1.1374-7(a). Further, the buyer and seller are presumed not to be under any compulsion to buy or sell and to have reasonable knowledge of all relevant facts. Id.

The preamble to the final regulations explains that “[i]t is expected that the value of an S corporation’s inventory as determined under the final regulations will generally be less than its anticipated retail price, but greater than its replacement cost.” 1995-4 I.R.B. at 33-34. Presumably, this statement is based on the theory that the seller would bargain for a return on its investment in the inventory that is based on its previously-expended selling efforts, carrying costs, and similar items. If this assumption is accurate, this profit element would mean that the seller is able to obtain a value for its inventory that exceeds the cost of purchasing similar inventory from the manufacturer. Of course, this assumption will often prove inaccurate, particularly when similar inventory is readily available and selling, carrying, and other costs are not material.

The preamble of the final regulations also indicates that the relevant facts that the hypothetical buyer and seller are presumed to know include:

1. The replacement cost of the inventory;
2. The expected retail selling price of the inventory;
3. The seller’s incentive to demand a price for the inventory that would compensate for and provide a fair return for expenditures the seller incurred to obtain, prepare, carry, and dispose of the inventory before the sale of the business; and
4. The buyer’s incentive to pay a price for the inventory that would compensate for and provide a fair return for similar expenditures the buyer expects to incur. Id.

(ii) In Reliable Steel Fabricators, Inc. v. Commissioner, 69 T.C.M. 3051 (CCH), T.C.M. ¶95,293 (RIA) (1995), the Tax Court held that a manufacturing corporation’s work-in-process inventory was subject to the built-in gains tax upon the sale of such inventory following the corporation’s conversion to S corporation status. The IRS
calculated the profit allocable to the S corporation's work-in-process inventory by subtracting the estimated total cost of each project from the sales price, and then by multiplying the estimated total profit on each project by the percentage of completion of that project as of the date of the corporation's conversion to S corporation status. The IRS determined the percentage of completion of each project by dividing the costs incurred up to the date of conversion to S corporation status, by the estimated total cost for each project.

In reaching its decision, the court expressly rejected the taxpayer's argument that the corporation's work-in-process inventory should be valued at its replacement cost or its scrap value for purposes of the built-in gains tax imposed under Section 1374. Rather, the Tax Court, citing *Jack Daniels Distillery v. United States*, 379 F.2d 569 (Ct. Cl. 1967), *Knapp King-Size Corp. v. United States*, 527 F.2d 1392 (Ct. Cl. 1975), and *Zeropack Co., v. Commissioner*, 47 T.C.M. 181 (CCH), T.C.M. ¶83,652 (RIA) (1983), found that the appropriate standard for determining the fair market value of the work-in-process inventory is what a willing buyer would pay a willing seller for the work-in-process inventory in similar contexts. As such, the court held that the fair market value of the work-in-process inventory should be less than the full retail price of the inventory, but more than the replacement cost of such inventory, since a willing buyer would not forego all profits inherent in the work-in-process inventory, nor would a willing seller forego all profits inherent in the work-in-process inventory. The court concluded that because the taxpayers had submitted no evidence as to the fair market value of the work-in-process inventory, and because the IRS's computations used something less than the full retail sales price of the inventory, the IRS had correctly determined the fair market value of the work-in-process inventory for purposes of computing the built-in gains tax imposed under Section 1374.

3. **Section 1374 Regulations' Definition of Built-In Gain and Loss.**

a. **Sale or Exchange Limitation.** The Section 1374 regulations provide that gain or loss recognized during the recognition period with respect to an asset will be treated as recognized built-in gain or loss if such gain or loss is recognized in a transaction treated as a sale or exchange for federal income tax purposes. If an item of income is not treated as recognized built-in gain because it does not result from a transaction that is treated as a sale or exchange, presumably, it is not subject to the built-in gain tax unless it is treated as a built-in income item (described below). It is unclear whether this formulation will result in the exclusion of certain income from the built-in gain tax (e.g., condemnation income). The above-described limitations on recognized built-in gain mean that gain from the sale of inventory will not be treated as subject to the built-in gain tax to the extent the corporation establishes that the inventory sold during the year was not held by the corporation at the beginning of its first S year or that the gain inherent in the inventory at such time.

b. **Application to Oil and Gas and Timber Companies.** The Section 1374 regulations provide that, if a corporation owns an interest in an oil and gas property on the first day of its first S year but has not produced any of the oil, the Section 1374 tax will not apply to the oil that is subsequently produced and sold. The rationale for this conclusion is that the tax only applies to assets held by the corporation on the first day of its first S year and, at
that time, it did not own the oil -- it owned an interest in the mineral property that entitled it to produce the oil subject to many contingencies and other considerations. Treas. Reg. §1.1374-4(b) Example 1. The IRS has applied this theory to the cutting of timber by lumber companies that own standing trees. See PLRs 9802005, 9739046 9727001, 9732030, 9729017, 9726015, 9719032, 9430026, 9519024, and 9520044 (Feb. 21, 1995). The IRS, however, recently announced that it will no longer grant these rulings and the area is under "intensive study." See Rev. Proc. 98-56, 1998-46 I.R.B. The author understands, however, that the position of these rulings is under reconsideration and further rulings may not be granted at this time.

c. **Inventory Sale Assumptions.** Announcement 86-128 (1986-51 I.R.B. 22) states that "[t]he IRS will issue regulations providing that, for purposes of Section 1374(d)(2)(A), the inventory method used by the taxpayer for tax purposes (FIFO [first in, first out], LIFO [last in, last out], etc.) shall be used to identify whether goods disposed of following conversion to S corporation status were held by the corporation at the time of conversion." The Section 1374 regulations adopt this approach, unless a corporation changes to the LIFO method with a principal purpose of avoiding the built-in gain tax. Treas. Reg. §1.1374-7(b). In such event, a LIFO taxpayer must use the FIFO inventory method for purposes of the built-in gain tax. It is unclear how a corporation will prove that it did not have a principal purpose of avoiding built-in gain tax when it adopted the LIFO inventory method. Presumably, it would be sufficient if the corporation were using the LIFO method for its regular books and changed its inventory method in order to have conformity between the two.

The Section 1374 regulations also provide that a corporation using the LIFO inventory method will not be deemed to have sold inventory held at the beginning of its first S year unless the "carrying value of its inventory for a taxable year during that period is less than the carrying value of its inventory on [the first day of that year]." Treas. Reg. §1.1374-7(b). Therefore, unless a LIFO taxpayer has a "decrement" in its LIFO layers (i.e., invades its LIFO layers) that existed as of its last day as a C corporation, it has no recognized built-in gain with respect to its inventory. It is important to note that such a decrement can occur through either a sale of inventory or falling prices.

See preceding Section (regarding statutory definitions) for discussion of the final regulations’ approach to inventory valuation.

H. **Items of Income (Deduction) Attributable to C Years.** Section 1374(d)(5) provides that "recognized built-in gain" and "recognized built-in loss" shall include items of income and deduction that are properly taken into account during the recognition period but which are attributable to periods before during which the corporation was a C corporation. For example, the collection of accounts receivable by a cash method taxpayer and the completion of a long-term contract performed by a taxpayer using the completed contract method of accounting will be included in recognized built-in gain (and unrealized built-in gain) to the extent that the income was earned when the corporation was a C corporation.

1. **Legislative History.** The legislative history of TAMRA states that:
As an example of these built-in gain and loss provisions, in the case of a cash basis personal service corporation that converts to S status and that has receivables at the time of the conversion, the receivables, when received, are built-in gain items. At the same time, built-in losses would include otherwise deductible compensation paid after the conversion to the persons who performed the services that produced the receivables, to the extent such compensation is attributable to such pre-conversion services. S. Rep. No. 445, 100th Cong. 2d Sess. 65 (1988).

The Section 1374 regulations generally use the accrual method of accounting as prescribed in the Code as the touchstone for determining whether an item is attributable to a prior C year. Using established rules in this manner reduces interpretive difficulties but can create inequalities and potential pitfalls.

2. **The Section 1374 Regulations' Definition of Built-In Income and Deduction Items.**

   a. **Built-In Income Items.** Under the Section 1374 regulations, any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been included in gross income before the beginning of the recognition period by a taxpayer using an accrual method (as principally described under Sections 446 and 451). Treas. Reg. §1.1374-4(b)(1). The Section 1374 regulations treat the entire amount of such income as recognized built-in gain regardless of the value of such item as of the beginning of its first S year. In contrast, a sale or exchange of an asset results in recognized built-in gain only up to the amount of the gain inherent in the asset at the time of conversion.

   b. **Built-In Deduction Items.** Any item of deduction properly taken into account during the recognition period is recognized built-in gross loss if such item would have been properly allowed against gross income before the beginning of the recognition period by a taxpayer using an accrual method (as principally described under Sections 446 and 461). Treas. Reg. §1.1374-4(b)(2). For this purpose, Section 461 (h)(2)(C) and Treas. Reg. §1.461-4(g) (relating to certain payment liabilities) do not apply.

   The final Section 1374 regulations favorably expanded the definition of “built-in deduction item” relative to the definition that was in the proposed regulations. Under this expanded definition, a deduction item that could not be accrued prior to the first day of the first S year because of Section 267(a)(2) is treated as a built-in deduction item as long as (1) the fact and exact amount of the liability are established at the time of conversion to S status and (2) payment is made either (a) to a related party owning less than 5 percent of the corporation’s stock (by vote and value) both at the time of conversion to S status and when the payment is made or (b) within two and one-half months of the first day of the first S year. Treas. Reg. §1.137404(c). For accrual basis corporations, this definition seems to mean that a liability that cannot be accrued at the time of conversion to S status because of Section 267 will never
qualify as built-in because, if it is paid during the first two and one-half months of the succeeding year, the deduction is accrued in the prior tax year (i.e., the corporation’s last C year).

The second expansion of the definition of “built-in deduction item” permits a deferred compensation item that could not be accrued prior to conversion to S status because of Section 404(a)(5) to be treated as a built-in deduction item as long as four conditions are satisfied. First, the fact and exact amount of the liability must be established at the time of conversion. Second, Section 267(a)(2) must not apply to the item (i.e., the deferred compensation must not be payable to a shareholder-employee). Third, the item must not relate to an interest element that accrued with respect to the deferred compensation. Fourth, the deferred compensation payment must be traceable directly to services performed prior to the beginning of the first day of the first S year of the corporation. Id.

Finally, the final regulations provide that, in determining whether an item would have been properly allowed as a deduction by an accrual method taxpayer, Section 461(h)(2)(C) and Treas. Reg. §1.461-4(g) do not apply. The exception for Section 461(h)(2)(C) relates to tort damages and workers’ compensation. The exception for liabilities described in Treas. Reg. §1.461-4(g) relates to liabilities for rebates and refunds; insurance, warranty, and service contracts; state and local taxes; licensing fees; and other liabilities arising out of the provision of services or property to the corporation. Under the Section 461 regulations, these so-called payment liabilities may not be accrued prior to the time of their payment.

The corporation’s deduction items will reduce its prelimitation amount only if the items are included within the definition of “built-in deduction item.” However, the final regulations provide, in effect, that a corporation’s NUBIG is determined by reducing the corporation’s aggregate built-in gain in its assets by any liability of the corporation if the corporation would be allowed a deduction on payment of the liability. Treas. Reg. §1.1374-3(a)(2). As a result, a liability whose payment would give rise to a deduction will reduce NUBIG even if it is excluded from the definition of “built-in deduction item” (e.g., deferred compensation owed to a controlling shareholder that is not paid within the first two and one-half months of the corporation’s first S year). Therefore, whether a liability is included in the definition of “built-in deduction item” will be significant only if the other limitations, such as NUBIG, are not relevant.

c. **Section 481 Adjustments.** The Section 1374 regulations include positive and negative Section 481 adjustments as built-in income and deduction items, respectively, regardless of when the change in method occurred, if the item is attributable to the corporation’s C corporation years. Treas. Reg. § 1.1374-4(c). In *Argo Sales Co. v. Commissioner*, 105 T.C. No. 7 (1995), the Tax Court held that a Section 481(a) adjustment included in an S corporation’s income that was attributable to the corporation’s C corporation years was built-in gain subject to the Section 1374 tax. The court reached this conclusion without relying on the Section 1374 regulations. The court reached a similar conclusion in *Rondy, Inc. v. Commissioner*, 70 T.C.M. 332 (1995), *aff'd per curiam*, 80 AFTR2d. Para. 97-5040 (6th Cir. 1997).
d. **Discharge of Indebtedness and Bad Debts.** The Section 1374 regulations treat as built-in income an item of discharge-of-indebtedness income under Section 61(a)(12) if such item is taken into account during the first year of the recognition period, provided the debt is owed by the S corporation at the beginning of the recognition period. Treas. Reg. § 1.1374-4(e). In addition, the Section 1374 regulations treat as built-in deduction item a bad-debt deduction under Section 166 recognized in the corporation's first S year if it arises from a debt owed by an S at the beginning of the recognition period. If an item of discharge-of-indebtedness or bad-debt deduction is not included in the definition of "built-in income or deduction items" under this portion of the regulations, it can be included as such under the general accrual rules described above.

The ability to treat a bad debt deduction as a built-in deduction item only if it is recognized in the corporation's first S year places a premium on a corporation positioning itself to claim either a partially worthless bad debt deduction under Section 166(a)(2) or a write-off for a wholly worthless bad debt under Section 166(a)(1) in its first S year. If a bad debt write-off cannot be claimed in the corporation's first S year, the corporation should consider selling the debt rather than writing it off as worthless. By structuring the transaction as a sale or exchange, a built-in loss can be recognized notwithstanding the fact that a bad debt write-off after the corporation's first S year would not give rise to a built-in deduction item.

e. **Completion of Contract.** An item of income reported under the completed-contract method of accounting (see Reg. Section 1.451-3(c) and (d)) during the recognition period is treated by the Section 1374 regulations as built-in income if the performance of the contract began before the beginning of the recognition period and the item of income would have been included in gross income prior to the beginning of the recognition period under the percentage-of-completion method of accounting. Treas. Reg. § 1.1374-4(f). Therefore, if the contract is completed after the end of the recognition period, none of the income should be treated as recognized built-in gain. The Section 1374 regulations do not address whether changes in the contract (costs, assumed profit margin, and/or percentage completed) that occur after the end of the corporation's last C corporation year will be taken into account where such changes are relevant to the original calculation of the percentage of income from the contract that was earned prior to the beginning of its first S corporation year.

f. **Other Items.** The Section 1374 regulations include special rules for installment sales and partnerships. These rules are discussed below.

I. **Recognition Period.**

1. Section 1374(d)(7) defines the recognition period as the 10-year period beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation. Taxpayers will not be able to shorten this period by using short-taxable years. Treas. Reg. §1.1374-1(d) makes clear that this period is ten calendar years, not ten taxable years. Compare Section 1374(d)(7) with former Section 1374(c)(1) (using the term "taxable year"). See also PLR 8651019 (September 19, 1986).
2. With respect to an S corporation that is subject to the built-in gains tax because it acquired carryover basis assets from a C corporation, the recognition period refers to the 10-year period beginning on the date the assets are acquired. Section 1374(d)(8)(B)(i), (d)(7).

3. With respect to an S corporation that is subject to the built-in gains tax because it acquired carryover basis assets from a converted C corporation, the recognition period presumably is the 10-year period following the acquisition date, less the period of time the transferor was an S corporation and was itself subject to the built-in gains tax.

   a. **Example.** Newly-organized corporation Z files its S election on April 3, 1991. On January 1, 1995, Z acquires assets in a merger with A, a converted C corporation, that filed its S election effective January 1, 1992. Z's recognition period presumably extends from January 1, 1995 to January 1, 2002 (a period of ten years from the date it acquired the assets less the 3-year period during which A was an S corporation and was itself subject to the built-in gains tax).

J. **Carryover Basis Transfers.**

1. **Statutory Provisions.** Section 1374(d)(8) provides that, if an S corporation acquires any asset the basis of which is determined, in whole or in part, by reference to the basis of such asset (or any other property) in the hands of a C corporation, a tax will be imposed on any net recognized built-in gain attributable to such asset for any taxable year beginning in the ten-year period beginning on the date upon which the asset was acquired by the S corporation. The tax imposed by Section 1374(d)(8) will apply to asset acquired by a corporation even if such corporation has had S election in effect for each of its taxable years. This set of rules can cause incredible complexity if an S corporation subject to Section 1374 merges into another S corporation that is subject to Section 1374. There may be two recognition periods, but will the combined corporations be required to separately apply Section 1374 to each group of assets?

2. **Section 1374 Regulation Provisions Governing Carryover Basis Transfers.** The Section 1374 regulations provide that a separate determination of tax under Section 1374 must be made with respect to the assets the S corporation acquires in each Section 1374(d)(8) transaction (and a separate determination for the S corporation's original assets). Further, the final regulations clarify that an S corporation's Subchapter C attributes, such as NOL carryovers, may be used to reduce only the built-in gain tax imposed on dispositions of assets the S corporation held at the time of its conversion to S status; they may not be used to offset the built-in gain tax on assets subsequently acquired in a Section 1374(d)(8) transaction. Treas. Reg. §1.1374-8(b). Provision is made for allocation of the overall taxable-income limitation between the various "pools" of assets created by this separating determination requirement. No provision is made, however, for the treatment of NUBIG.

K. **Exchanged Basis Assets.** Section 1374(d)(6), added by the 1988 Act, in effect provides that, if an asset held by an S corporation is subject to Section 1374 and such asset is
exchanged in a tax-free transaction for other property (e.g., Section 1031 exchange), the property received in the exchange will be subject to Section 1374 to the same extent as the property transferred. This rule would also apply to the stock or partnership interest received in exchange for property contributed to a corporation or partnership under Sections 351 or 721.

L. **Anti-Avoidance Rules.**

1. **Installment Sales.**

   a. **Sales Prior to March 26, 1990.** Since the Section 1374 applies only to recognized gains, it was possible to avoid the Section 1374 tax by postponing the recognition of gain on the sale of an asset by entering into an installment sale the payments on which were not due until after the expiration of the 10-year recognition period. This was a commonly used technique to avoid the 3-year recognition period in former Section 1374. See PLR 8243169 (July 28, 1982). The IRS, however, determined that it was inappropriate to permit the use of installment sales to avoid the Section 1374 tax. Therefore, on March 26, 1990, the IRS issued Notice 90-27 1990-15 I.R.B. 21, which served notice that the IRS intends to issue regulations to prevent the use of installment sales to avoid the Section 1374 tax. Notice 90-27 is effective for installment sales occurring after March 25, 1990 (the date of the binding contract for the sale controls for this purpose).

   b. **Sales After March 25, 1990 -- Notice 90-27.** Notice 90-27 provides that, if a taxpayer sells an asset either prior to or during the recognition period and recognizes income (either during or after the recognition period) from the sale under the installment method, when the income is recognized it will be taxed under Section 1374 to the extent it would have been taxed in prior taxable years if the selling corporation had made the election under Section 453(d) not to report the income under the installment method. Notice 90-27 suggests that the regulations will attempt to measure the extent to which the income would have been subject to tax if recognized currently and tax such amount whenever recognized. This would deny taxpayers the benefit of postponing the recognition of income even if it is recognized within the 10-year recognition period. See Notice 90-27, Section 3, Example 2.

   c. **The Section 1374 Regulations.** Generally, the Section 1374 regulations follow the interim guidance contained in Notice 90-27 although, as noted below, some questions remain. The Section 1374 regulations provide that, if a corporation sells an asset before or during the recognition period and reports income from the sale using the installment method, a tax is imposed under Section 1374 on that income, when reported, "to the extent it would have been included in net recognized built-in gain during the recognition period" if the entire amount of income was reported in the year of sale.

   The final regulations provide that, for a year after the end of the recognition period in which income is reported under the installment method, the corporation’s Subchapter C attributes may be taken into account in determining the amount of the built-in gain tax (to the extent their use is allowed under all applicable provisions of the Internal Revenue Code). Treas. Reg. §1.1374-4(h)(4). However, this new rule, read literally, only applies to...
income reported under the installment method after the ten-year recognition period, and does not fix the apparent problem associated with the use of NOLs to offset installment income reported during that period. Thus, incongruous as it may seem, under a literal reading of the final regulations, NOLs from C years apparently cannot be used to reduce the built-in gain tax attributable to income reported under the installment method during the recognition period.

In addition, the final regulations clarify that an S corporation's losses recognized in taxable years after the recognition period may not be used in determining the built-in gain tax even if they would have been treated as recognized built-in losses if recognized during the recognition period. Id. Thus, such losses cannot be used to reduce the built-in gain tax attributable to reporting income from an installment sale after the recognition period.

2. **Accounting Methods.** The Section 1374 regulations provide that, if a corporation changes its method of accounting to the LIFO method with a principal purpose of avoiding the Section 1374 tax, it must use the FIFO method to identify its disposition of inventory for purposes of Section 1374.

3. **Partnerships.** The application of the built-in gain tax to partnership interests held by an S corporation has been an issue since the enactment of the built-in gain tax in TRA '86. Two underlying theories for developing a scheme for applying the built-in gain tax to partnership interests are available: an entity approach (in which a partnership is viewed as an entity separate from its partners), or an aggregate approach (in which each partner is viewed as owning its share of the partnership's assets directly). Under an entity theory, a built-in gain or loss triggering event would generally not occur until the partnership interest was sold. Applying the aggregate theory calls for a "look-through" approach, in which Section 1374 would be applied as if the S corporation were conducting the operations of the partnership directly. Simplicity calls for adoption of the entity approach. The entity approach could, however, allow built-in gains to escape taxation, since items of income and gain recognized by a partnership increase a partner's basis in its partnership interest, thereby reducing or eliminating the gain to be reported on an eventual disposition of the partnership interest. The legislative history to the Revenue Act of 1987 suggests, however, that Congress believed that Section 704(c) would generally prevent the use of the partnerships to avoid the built-in gains tax. S. Rept. 100-76, 100th Cong. 1st Sess, 298 (October 16, 1987). While simplicity may call for an entity approach buttressed by Section 704(c), the IRS has generally shown a bias to using a look-through or aggregate approach in applying many of the provisions enacted in 1986. See Notice 88-99, 1988-2 C.B. 422, which used a "look-through" approach in applying the avoided interest rules under Section 263A. The look-through approach has as it advantage the restriction of tax avoidance opportunities, but its cost is much more additional complexity. Perhaps not surprisingly the IRS adopted the look-through approach in the proposed Section 1374 regulations.

a. **The Section 1374 Regulations - Treatment of Partnerships.** Section 1.1374-4(h) of the Section 1374 regulations provides a special rule for S corporations that either own a partnership interest at the beginning of the ten-year recognition period or
transfer property to a partnership in an exchanged-basis transaction (e.g., a transaction under Section 721) during that period. In general, the special rule would "look through" the partnership in which the S corporation owns an interest for purposes of Section 1374. Thus, the computation of an S corporation's NRBIG would include income, deductions, gains, and losses recognized by the partnership and passed through to the S corporation as if such items had been recognized directly by the S corporation. Subject to an anti-abuse rule, however, the look-through rule would be limited to the built-in "outside" gain or loss with respect to the S corporation's partnership interest, i.e., the gain or loss on a hypothetical sale by the S corporation of the partnership interest on the date the corporation converted to S status.

(i) Difficulty in Administration. Compliance with and administration of the look-through rule adopted by the Section 1374 regulations will, in many cases, be extremely difficult. One example is the necessity of ascertaining the fair market value of the assets of the corporation at the time it converts to S status. Where the corporation owns a partnership interest, this burden would be very difficult to bear under the Section 1374 regulations. This is because the corporation would be required to ascertain the value of each of the partnership's assets, the situation regarding each of the partnership's income and deduction items, and details of the partnership's inventory as of the date its S election became effective. It is extremely unlikely that the partnership itself would have arranged for an appraisal of each of its assets as of the date on which the S election of one of its partners became effective. In any event, it would be difficult in many cases for an S corporation to obtain the necessary information unless it controls the partnership. The Section 1374 regulations reduce some of the harsh results of the look-through approach by limiting the amount of the recognized built-in gain (RBIG) and recognized built-in losses (RBIL) which can flow through from a partnership to the difference between the S corporation's "outside" basis in its partnership interest and the value of its partnership interest.

(ii) The Rules of the Section 1374 Regulations. The Section 1374 regulations provide that (1) an S corporation's partnership RBIG for a taxable year (i.e., the excess, if any, of the S corporation's NRBIG for such year including partnership items over its NRBIG for such year without partnership items) cannot exceed the excess of its RBIG limitation over its partnership RBIL for prior years. Treas. Reg. §1.1374-4(h)(2). The RBIG or RBIL limitation of an S corporation is, generally, the gain or loss, respectively, that the S corporation would recognize if it sold its partnership interest at fair market value on the effective date of its S election.

Treas. Reg. §1.1374-4(h)(5) provides that the look-through rule does not apply to a year if (1) on the first day of the first S year, the fair market value of the S corporation's partnership interest was less than $100,000 and (2) at all times during the year at issue, the partnership interest represents less than 10 percent of the partnership capital and profits. This de minimis rule would not apply in abusive situations. This small interest exception is extremely limited and will not provide much relief for taxpayers because the partnership interest will cease to qualify for this exception if its value exceeds $100,000 at any time during the 10-year recognition period. Furthermore, regardless of when the partnership interest ceases to qualify for this exception, the S corporation needs to know the value of the partnership's assets.
as of the first day of the corporation's first S year. The *de minimis* provision is also ambiguous as to S corporations holding more than one partnership interest.
X. Termination of the S Corporation Election and Invalid Elections

A. Causes of Termination. Section 1362(d) provides for the termination of a corporation's S corporation election under three sets of circumstances.

1. Termination by Revocation.

a. General Rule. Under Section 1362(d)(1), the election to be taxed as an S corporation may be revoked with the consent of shareholders owning more than 50 percent of the stock on the day on which the revocation is made. Reg. §1.1362-2(a)(1) clarifies that holders of more than 50 percent of the issued and outstanding shares of stock (including nonvoting stock) must consent to the revocation. Reg. §1.1362-6(a) provides procedures to be used in the case of revocation of an S corporation election. An election to be taxed as an S corporation may be revoked for any taxable year of the corporation, including the first taxable year for which the election is effective. Reg. §1.1362-2(a)(1).

b. Effective Date

(i) A revocation made on or before the fifteenth day of the third month of a taxable year will be effective on the first day of such taxable year. Section 1362(d)(1)(C)(i).

(ii) A revocation made after the fifteenth day of the third month of a taxable year will be effective on the first day of the following year. Section 1362(d)(1)(C)(ii).

(iii) If a revocation specifies a date for revocation on or after the date on which the revocation is made, the revocation will be effective on and after the date specified. Section 1362(d)(1)(D).

c. Rescission of Revocation. A revocation of an S corporation election may be rescinded by a corporation at any time before the revocation becomes effective with the consent of each person who consented to the revocation and each person who became a shareholder of the corporation during the period beginning on the first day after the date the revocation was made and ending on the date on which the rescission is made. Treas. Reg. §1.1362-2(a)(4) permits such a rescission and sets forth the procedures for effectuating the rescission.

2. Termination by Corporation Ceasing to be a Small Business Corporation.

a. General Rule. An S corporation election will be terminated whenever such corporation ceases to be a small business corporation, as such term is defined in Section 1361(b). Section 1362(d)(2)(A).
b. **Effective Date.** A termination of the election by reason of the corporation's ceasing to qualify as a small business corporation will be effective on and after the date of such cessation. Section 1362(d)(2)(B).

c. **Notification of IRS.** Reg. §1.1362-6(a)(3) requires that, in the event of the termination of an S corporation election by reason of the corporation's ceasing to be a small business corporation, the corporation must immediately notify the IRS Service Center with which the Form 2553 was filed setting forth certain specified information, including the cause of the termination and the date thereof.

3. **Termination Due to Excess Passive Investment Income.**

   a. **General Rule.** An election to be taxed as an S corporation will be terminated whenever (i) the corporation has Subchapter C earnings and profits at the close of each of three consecutive taxable years and (ii) more than 25 percent of the corporation's gross receipts for each of such three taxable years are passive investment income. Section 1362(d)(3)(A)(i). For purposes of Section 1362(d)(3), a prior taxable year will be taken into account only if (iii) such taxable year began after December 31, 1981 and (iv) the corporation was an S corporation for such year. Section 1362(d)(3)(A)(iii).

   b. **Effective Date.** The termination of an S corporation election under Section 1362(d)(3) will take effect on the first day of the first taxable year beginning after the third consecutive year in the three-year period described above. Section 1362(d)(3)(A)(ii).

B. **Tax Accounting Rules Relating to Termination.** Section 1362(e) provides the tax accounting rules used to allocate income, loss, deduction, and credit of an S corporation for a taxable year in which the termination of an election takes effect on a date other than the first day thereof (the "S termination year"). See Section 1362(e)(4). For example, a termination by prospective revocation or by a corporation's ceasing to be a small business corporation may take effect on a date other than the first day of the corporation's taxable year.

1. **Short Taxable Years.** Section 1362(e)(1) provides that an S termination year will be divided into two portions:

   a. The portion of the S termination year ending before the first day for which the termination is effective is treated as a short taxable year for which the corporation is an S corporation (the "S short year"); and

   b. The portion of the S termination year beginning on the first day for which the termination is effective is treated as a short taxable year for which the corporation is a C corporation (the "C short year").
2. **Allocation of Items.**

   a. As a general rule, Section 1362(e)(2) prescribes a pro rata allocation method, pursuant to which the corporation's items of income, loss, deduction, and credit are determined for the entire S termination year and then allocated by assigning an equal portion of each item to each day of the S termination year. The effect of this pro rata allocation method is that each item of the corporation's income, loss, deduction, and credit for the S termination year is deemed to have occurred ratably over the entire S termination year, regardless of the date upon which such item was actually incurred.

   b. In an apparent effort to ameliorate the distortions that may occur as a result of the use of the pro rata allocation method described above, Section 1362(e)(3) provides that a corporation may instead elect to close its books on the day before the day on which its S corporation election terminates. Such an election essentially causes all items incurred during the corporation's S short year to be isolated in the S short year, while all items incurred during the corporation's C short year will be isolated in the C short year. The election to close the books of an S corporation upon the termination of its election is valid only if consented to by all persons who were shareholders at any time during the S short year and all persons who were shareholders on the first day of the C short year. Section 1362(e)(3)(B).

   c. If a sale or exchange of 50 percent or more of the stock of an S corporation occurs during an S termination year, the pro rata allocation method of Section 1362(e)(2) does not apply, and the corporation will be required to close its books upon the termination of the election. Section 1362(e)(6)(D).

C. **Inadvertent Terminations and Inadvertently Late or Invalid S corporation Elections.**

1. **Inadvertent Terminations.** Section 1362(f)(1)(B) provides that if (i) a corporation's S corporation election was terminated, (ii) the Secretary of the Treasury determines that the termination was inadvertent, (iii) steps were taken to correct the reason for the termination within a reasonable period of time after it was discovered, and (iv) the corporation and its shareholders agree to make the necessary adjustments, the Secretary of the Treasury may treat the corporation as continuing to be an S corporation for a specified period. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation notwithstanding its due diligence in the course of its business to safeguard itself against such an event, tends to establish that the termination was inadvertent. Treas. Reg. § 1.1362-5(a). The legislative history accompanying the enactment of Section 1362(f) expressed Congress' wish that the Secretary be reasonable in granting such waivers. S. Rep. No. 640, supra, at 12-13. See, e.g., Rev. Rul. 86-110, 1986-2 C.B. 150 and a multitude of private letter rulings. Treas. Reg. § 1.1362-5 sets forth the procedures for seeking a determination that the termination of an S corporation election was inadvertent. (The 1996 Act provides a similar relief mechanism in the case of invalid and late S corporation elections.)
2. **Inadvertently Late or Invalid S Corporation Elections.** The 1996 Act added Sections 1362(b)(5) and 1362(f)(1)(A) to the Code to provide the Service with the authority to treat certain late S corporation elections as timely and inadvertently ineffective S corporation elections as effective. In Rev. Proc. 97-48, 1997-43 I.R.B. 19, the Service described special procedures which permit taxpayers in certain situations to obtain automatic late S corporation election relief. The Revenue Procedure applies in the following two situations: (i) a corporation intends to be an S corporation, the corporation and its shareholders reported their income consistent with S status for the taxable year the S election should have been made and for every subsequent year, and the corporation did not receive notification from the Service regarding any problem with the S corporation status within six months from the date on which the Form 1120S for the first year was timely filed; and (ii) for periods prior to January 1, 1997, a corporation intends to be an S corporation; however, due to a late S election the corporation was not permitted to be an S corporation for the first taxable year specified in the election and the corporation and the shareholders treated the corporation as an S corporation for all succeeding years and all relevant open tax years. In those situations, the corporation must file with the applicable Service Center (or District Director if under examination) a completed Form 2553, signed by an officer of the corporation authorized to sign and all persons who are shareholders at any time during the period that the corporation intended to be an S corporation. The Form 2553 must state at the top "filed pursuant to Rev. Proc. 97-48" and attached to the Form 2553 must be a dated Declaration signed by an officer of the corporation and all persons who were shareholders during the requested S period attesting that the corporation and the shareholders reported their income consistent with such S status and that the statements are signed under penalties of perjury.

(i) In PLR 9811046, A, the corporation's sole shareholder and president, intended that it be taxed as an S corporation effective with its initial taxable year. As a result of miscommunication between his CPA and attorney, however, a Form 2553 was not filed. The corporation filed a Form 1120S (the income tax return of an S corporation) for its initial taxable year, but the IRS service center informed the corporation that it did not have a Form 2553 on file and that it was therefore taxable under Subchapter C. The Service concluded that the corporation established reasonable cause for failing to make a timely election to be an S corporation for X's first taxable year. See also PLR 9812023 (president instructed accountant and attorney to prepare and file the forms necessary to elect to be an S corporation, but the Form 2553 was not filed); and PLR 9812029 (sole shareholder failed to timely file Form 2553).

D. **Election After Termination.** Under Section 1362(g), if a corporation's S corporation election has terminated, neither the corporation nor any successor corporation generally will be eligible to make an S corporation election for any taxable year until the fifth year following the first taxable year for which the termination is effective, without the consent of the Secretary of the Treasury.

1. **Successor Corporation.** The term "successor corporation" means a corporation (i) 50 percent of the stock of which is owned, directly or indirectly, by the same persons who owned 50 percent of the stock of the former S corporation on the date the
termination became effective and (ii) (A) that acquires a substantial portion of the assets of such former S corporation or (B) a substantial portion of the assets of which were assets of such former S corporation. Reg. § 1.1362-6(b).

2. **Consent to Reelection.**

   a. Consent is typically granted when (i) more than 50 percent of the stock in the corporation is owned by persons who did not own any stock in the corporation on the date on which the previous election was terminated or (ii) the event causing termination was not reasonably within the control of the corporation or shareholders having a substantial interest in the corporation and was not a part of a plan to terminate the election. Treas. Reg. § 1.1362-5(a). See Rev. Rul. 78-364, 1978-2 C.B. 225; Rev. Rul. 78-333, 1978-2 C.B. 224; Rev. Rul. 78-332, 1978-2 C.B. 223; Rev. Rul. 78-307, 1978-2 C.B. 222; Rev. Rul. 78-275, 1978-2 C.B. 221; Rev. Rul. 78-274, 1978-2 C.B. 220; PLR 8652008 (9/22/86); PLR 8645009 (8/5/86); PLR 8631042 (5/2/86); PLR 8625076 (3/26/86).

   b. In addition, the IRS has permitted the making of a new S corporation election, prior to the expiration of five years from the revocation of a prior election, by a corporation that retroactively revoked an S election made during its first taxable year. PLR 8831048 (5/11/88) involved a corporation that was incorporated on May 16, 1986. On June 2, 1986, the corporation filed a Form 2553 for its first taxable year, stating that the corporation would use a taxable year ending on September 30. On July 30, 1986, however, the corporation revoked its S corporation election, with such revocation to be effective as of May 16, 1986. The corporation also adopted a taxable year ending on January 31 for its first year of operation. In March 1988, the corporation filed a new S corporation election to be effective on February 1, 1988. The IRS consented to the corporation's second S corporation election, reasoning that the policy of Section 1362(g) is to prevent corporations from electing in and out of Subchapter S in order to avail themselves of its tax advantages. The corporation involved in PLR 8831048, however, did not receive any tax benefits in connection with its first S corporation election because it did not exist as an S corporation during its first taxable year; accordingly, the IRS held that the second S corporation election should not be prohibited by reason of Section 1362(g). See also Treas. Reg. § 1.1362-5(b); PLR 8922016 (2/28/89); PLR 8913018 (12/28/88).

   c. In Private Letter Ruling 9418005 (Jan. 27, 1994), the IRS granted an S corporation's request to reelect S corporation status prior to the expiration of the five-year waiting period prescribed under Section 1362(g), even though the S corporation's shareholders had not changed since the termination of the corporation's S status and the S corporation could not show that the terminating event was outside of its control. The S corporation previously terminated its S election because its S status would have terminated automatically pursuant to the provisions of Section 1362(d)(3) based on the definition of "passive investment income" in effect at such time. The IRS concluded that because the corporation did not revoke its S election in an attempt to manipulate the Code, and because the S corporation's rental income would no longer be considered passive investment income under Section 1362(d)(3)(D)(i), the S corporation would be permitted to reelect S corporation status prior to the expiration of the five-year waiting period prescribed under Section 1362(g). In a similar ruling, the IRS ruled in PLR 9628006.
than an S corporation could re-elect S corporation status prior to the expiration of the five-year waiting period where the termination occurred as a result of a minority shareholder transfer of the stock to an ineligible shareholder without the knowledge or consent of the other shareholders.

3. **Termination Prior to 1986 Act.** In Notice 88-134, 1988-52 I.R.B. 30 (Dec. 26, 1988), the Secretary of the Treasury granted consent pursuant to Section 1362(g) to the making of an S corporation election by any small business corporation that previously had terminated its status as an S corporation, if the following conditions are satisfied: (i) either (A) the corporation made an S corporation election prior to January 1, 1987, or (B) in the case of a qualified corporation, as defined in Section 633(d) of the 1986 Act, the corporation made an S corporation election before January 1, 1989; and (ii) the revocation or termination of the corporation's previous S corporation election occurred before October 22, 1986, the date of enactment of the 1986 Act. See Rev. Rul. 86-141, supra (predecessor to Notice 88-134, supra); PLR 8741023 (7/10/87) (corporation not eligible for relief under Rev. Rul. 86-141, supra, because revocation occurred as of November 1, 1986); PLR 8729047 (4/21/87) (application of Section 1362(g) and relief provision of Rev. Rul. 86-141, supra, in the case of mergers of S corporations into C corporation).

4. **Termination Prior to 1997.** The 1996 Act generally provides that a corporation may re-elect S status after August 2, 1996, without the 5-year rule applying, if the termination of its S status occurred in a tax year beginning before January 1, 1997.
XI. Miscellaneous Problems in Converting a C Corporation to an S Corporation

A. Net Operating Loss Carryovers. Pursuant to Section 1371(b)(1), no carryforward or carryback arising for a taxable year for which a corporation is a C corporation may be carried to a taxable year for which such corporation is an S corporation. Moreover, pursuant to Section 1371(b)(3), a taxable year for which a corporation is an S corporation is treated as a taxable year for purposes of determining the number of taxable years to which an item may be carried back or carried forward. Thus, an existing C corporation that has net operating loss carryovers will be unable to use such carryovers during any taxable year after its S corporation election becomes effective and, as a consequence, may lose the benefit of such net operating loss carryovers altogether.

B. Percentage Depletion. Section 613A(c)(13)(C)(ii) treats the making of an S corporation election by an existing C corporation as a transfer of all the corporation's properties as of the effective date of such election. A transfer of proven oil and gas properties may prevent the use of percentage depletion pursuant to Section 613A(c)(9). Compare PLR 8510054 (12/11/84) (transfer of oil and gas interests to new S corporation owned by transferor did not end use of percentage depletion); PLR 8350088 (9/14/83) (same).

C. Recapture of Foreign Losses. Section 1373(b) provides that the making of an S corporation election is treated as the disposition of the business of the electing entity for purposes of Section 904(f). Such an election may therefore trigger the recapture of overall foreign losses previously taken into account by the electing corporation.

D. Loans by Qualified Plans. Section 4975 imposes certain taxes upon prohibited transactions involving plans defined in Section 4975(e)(1). Section 4975(d)(1) exempts from the definition of prohibited transaction certain loans made by a plan to a participant in such plan, provided generally that such loans are made available on a nondiscriminatory basis and on commercially reasonable terms. The exemption provided by Section 4975(d)(1) does not apply, however, to any loan to an "owner-employee," which term includes an employee or officer of an S corporation who owns, directly or indirectly, more than five percent of the stock of the corporation on any day of the taxable year. Thus, the election by an existing C corporation to be taxed as an S corporation may result in the imposition of taxes under Section 4975 and will foreclose the ability of the corporation's plan to make loans to certain participants therein.

E. Fringe Benefits. Under Section 1372(a), an S corporation is treated as a partnership for purposes of the income tax provisions that relate to employee fringe benefits. Any person who owns, directly or indirectly by reason of the application of Section 318, more than two percent of the outstanding stock or the total combined voting power of the corporation will be treated as a partner for these purposes. Section 1372(b).

1. Effect of Section 1372. The effect of Section 1372 is to prevent the shareholders of an S corporation from excluding from income fringe benefits such as death
benefits, accident and health plan payments, group term life insurance, and employer-provided meals and lodging, all of which are excludable only by an "employee." See Sections 79(a), 101(b)(1), 105(a), 106, and 119(a); see also S. Rep. 640, supra, at 22.

2. **IRS Ruling.** The Revenue Ruling 91-26 addressed the application of Section 1372 to an S corporation's payment of its shareholders' accident and health insurance premiums. This ruling concludes that, with respect to payments for a "2-percent shareholder," such payment constitutes a deductible expenditure by the corporation and income to the shareholder. In addition, the IRS, analogizing to guaranteed payments by a partnership, ruled that such amounts can not be excluded from the income of the shareholder under Section 106 (which permits an employee to exclude from income accident or health coverage provided by the employer) because such income is more in the nature of a distributive share of the corporation's income. The shareholder, however, is treated as having paid for such insurance coverage, which, in turn, may give rise to a deduction (e.g., see Section 162(l)).

3. **Effect on One Class of Stock Requirement.** Revenue Ruling 91-26 makes it clear the payment of health insurance premiums on behalf of a 2-percent shareholder-employee will not be considered a distribution for purposes of the one class of stock requirement.

**F. Dividends Received Deduction.** Section 1371(a)(2) provides that, for purposes of Subchapter C, an S corporation in its capacity as a shareholder of another corporation is to be treated as an individual. By reason of Section 1371(a)(2), an S corporation that owns stock in another corporation is not entitled to avail itself of the dividends received deduction provided by Section 243.

**G. Application of Passive Loss Rules.** Section 469 generally limits the extent to which certain taxpayers may use losses from passive activities to offset income from nonpassive sources. In general, the activities of an S corporation that is engaged in a trade or business will be considered passive activities with respect to any shareholder who does not materially participate in such activities; as a consequence, such a shareholder will be able to deduct any losses generated by such activities for a taxable year only to the extent of such shareholder's income from passive activities for such year. Although Section 469 applies to certain closely held C corporations, as defined in Section 465(a)(1)(B), the limitations placed upon the deduction of passive activity losses of C corporations to which Section 469 applies are less restrictive than those applied to individuals. In particular, losses from the passive activities of a closely held C corporation may be used to offset the nonpassive income of such corporation other than portfolio income. Section 469(e)(2).

In *St. Charles Investment Co. v. Commissioner*, USTC, No. 579396, (February 5, 1998), the Tax Court considered two questions: (1) whether suspended passive activity losses (PALS) incurred by a closely held C corporation that later elects to be an S corporation may be deducted by the then S corporation in the year the corporation disposes of its entire interest in the activity generating the losses, and if not, (2) whether the basis of the assets used in the activity may be recomputed to restore amounts for portions of the suspended PALS attributable to
depreciation (and the gain or loss from the disposition thus recalculated). The Court found in the negative with respect to both issues and granted summary judgment.

H. **Method of Accounting.** For taxable years beginning after December 31, 1986, Section 448 generally prohibits the use of the cash receipts and disbursements method of accounting by any C corporation, any partnership having a C corporation as a partner, and any tax shelter within the meaning of Section 461(i)(3), with certain exceptions available to farming businesses, certain personal service corporations, and certain entities having average annual gross receipts of $5,000,000 or less. By contrast, Section 448 imposes no such restriction upon the accounting method that may be used by an S corporation (provided such S corporation is not a tax shelter for purposes of Section 448).

I. **State Taxes.** A number of states do not recognize a pass-through corporate entity such as the S corporation, but instead treat such corporations as C corporations. See Maule, *Effect of State Law on the Use of S Corporations*, 37 Tax Law. 535 (1984); Willson, *State Taxation of S Corporations*, J. Partnership Tax'n 163 (1984).