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Subchapter S Distributions and Pseudo Distributions: Proposals for Revising the Defective Blend of Entity and Conduit Concepts

GLENN E. COVEN *

Subchapter S was enacted to relieve some incorporated businesses of the burden of double taxation that is nominally imposed upon corporate profits.¹ If its provisions are elected, the corporation is generally exempted from federal income taxes.² Instead, the income of the corporation is includable directly on the income tax returns of its shareholders.³ While this regime generally resembles the conduit approach used in taxing partnership income,⁴ the original version of subchapter S in no sense allowed conduit taxation of corporations. While subchapter K largely eliminates the effect of the partnership entity upon the taxation of partners, subchapter S, as first enacted in 1958, used most of the entity concepts that fashion the taxation of nonelecting corporations.⁵

Widespread dissatisfaction with subchapter S resulted in its complete revision in 1982.⁶ The objectives of the revision were to improve the

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¹ S. REP. NO. 1983, 85th Cong., 2d Sess. 87 (1958). See also J. EUSTICE & J. KUNTZ, *FEDERAL INCOME TAXATION OF S CORPORATIONS* ¶ 1.02[3] (1982) [hereinafter EUSTICE & KUNTZ].

Since dividends of a nonelecting corporation are not deductible to the corporation but are taxed to the recipient, two levels of tax are imposed upon the distributed income. Closely held corporations often minimize the doubling by distributing cash to shareholders in the form of deductible payments, such as salary or rent, rather than dividends.

² I.R.C. § 1363(a). Corporations that previously were nonelecting corporations (C corporations) are taxed on some forms of income. I.R.C. §§ 58(d), 1371(d), 1374, 1375.

After 1986, corporations making midstream S elections are subject to far more extensive double taxation. See *infra* text following note 101.

³ I.R.C. § 1366(a).

⁴ Cf. I.R.C. §§ 701-02.

⁵ Originally, subchapter S merely created a constructive year-end dividend of the taxable income of the corporation. For a discussion, see Coven & Hess, *The Subchapter S Revision Act: An Analysis and Appraisal*, 50 TENN. L. REV. 569, 676-79 (1983).

⁶ Pub. L. No. 97-354, 96 Stat. 1669 (1982).

taxation of electing corporations (now called S corporations) by conforming subchapter S more completely to the conduit model, and by eliminating the numerous flaws and unanticipated technicalities that had victimized so many taxpayers.⁷ The revision, however, falls far short of extending full conduit treatment to S corporations. What emerged instead was a revised blend of entity and conduit concepts. Unfortunately, Congress' synthesis of these concepts is not satisfactory; the blend does not work well.⁸ Moreover, the complexity and irrationality of the blend was needlessly heightened in 1986.

Not surprisingly, the provisions governing distributions to shareholders contain the least satisfactory combination of these inconsistent concepts—these inconsistencies are the focus of this article. Congress' desire to make subchapter S freely available to previously incorporated businesses led it to permit corporations to elect subchapter S status without immediate tax cost.⁹ An election by a corporation that has operated as a nonelecting corporation (a C corporation) is not treated as a constructive liquidation or otherwise subjected to a compensatory tax. Rather, the corporation's earnings and profits account, a relic of its days as a taxable entity,¹⁰ is preserved,¹¹ and distributions from the account are subject to double taxation as if subchapter S had not been elected.¹² Distributions of post-election earnings, in contrast, are generally not taxable.¹³ The distribution provisions of subchapter S are thus designed to accommodate both entity based distributions of pre-election earnings and profits and conduit based tax-free distributions of post-election income. In effect, within the structure of an S corporation lies a dormant C corporation.

⁷ See, e.g., STAFF OF THE JOINT COMM. ON TAX'N, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE SUBCHAPTER S REVISION ACT OF 1982, at 1 (Comm. Print 1983).

⁸ Entity and conduit concepts are more successfully blended in the taxation of partnerships, but in a very different way. Sections 754 and 743, for example, allow an election in determining the effect on the basis of partnership assets of a sale or exchange of a partnership interest or the transfer of an interest at death.

⁹ This desire was somewhat modified in 1986. Notwithstanding the tax on unrealized built-in gains imposed by the 1986 revision of § 1374, however, it remains the case that no tax is imposed at the time of the election or thereafter with respect to the earnings and profits of the corporation prior to an actual distribution.

¹⁰ Under § 301, distributions from nonelecting corporations are taxed at ordinary income rates if they are dividends within the meaning of § 316. Section 316 defines a dividend as a distribution out of earnings and profits as defined in § 312.

¹¹ I.R.C. § 1371(c).

¹² I.R.C. § 1368(c)(2). See also the text following note 47.

¹³ I.R.C. § 1368(b)(1).

In 1986, incident to the repeal of the so-called *General Utilities* doctrine, Congress amended section 1374 in a way that extends the concept of a continuing C corporation within the structure of an S corporation. This extension, however, is not merely an additional application of the pattern of treating distributions attributable to C corporation income as dividends out of earnings and profits. Rather, gain inherent in assets held when an S election takes effect is subject to double taxation when the gain is recognized by the S corporation. The resulting burden of taxation is harsher than the normal C corporation burden (where the second tax is deferred until shareholders receive dividends or dispose of their shares), and is entirely unwarranted.

This article examines the synthesis of entity and conduit features in the distribution rules. The examination establishes that the use of major elements of entity taxation continues to cripple the S corporation. The pattern of taxing S corporations will remain unsatisfactory until those elements, which are extraneous to conduit taxation, are replaced, and the taxation of S corporations more nearly conformed to the taxation of partnerships.

The ideal solution to the worst problems of subchapter S would be to require the elimination of earnings and profits as a precondition to the election. Nevertheless, the operation of subchapter S could be substantially improved without abandoning the existing ease of entry if certain elements of entity taxation were eliminated. Of particular importance, the corporate level accounts, including the earnings and profits account, must be replaced with shareholder level accounts that are compatible with conduit taxation.

I. SEPARATION OF STOCK AND DEBT BASIS

The first step in determining how distributions from conduit entities will be taxed is the computation of the shareholder's basis. Distributions that are deemed to constitute a recovery of basis will be free of tax, while distributions in excess of basis must be subject to tax.¹⁴ Basis, of course, has a second crucial significance: Losses allocated to the shareholder by the entity may not be claimed to the extent that they exceed basis.¹⁵ The computation of the basis of stock in an S corporation for the purpose of measuring the amount of loss that may be claimed has greatly complicated the taxation of distributions.

True conduit treatment requires that the basis of a partner or shareholder in an S corporation correspond to the basis the investor would

¹⁴ See I.R.C. §§ 731, 1368.

¹⁵ See I.R.C. §§ 704(d), 1366(d)(1).

have obtained had he become the sole owner of the assets in his individual capacity. In the taxation of partnerships, that optimum computation of basis is very nearly achieved. A partner's basis for his partnership interest not only includes the partner's direct investment in the partnership, but also a ratable share of partnership liabilities.¹⁶ A borrowing by the partnership is statutorily reconstructed as a borrowing by the partners in the aggregate followed by a contribution of the proceeds by them to the partnership. As a result, the partners as a group obtain a basis for their partnership interest that includes the full amount of an entity level borrowing.

The same result occurs when the partnership borrows from a partner. A partner, in his capacity as lender to the partnership, is treated as if he were acting in a nonpartner capacity. Thus, to the extent the other partners are obligated to repay the loan, the loan is reconstructed as if it were made to them and then contributed to the partnership. The balance of the loan is treated as if made from the partner-lender to himself and contributed to the partnership. As a result, the basis for the lender's partnership interest is increased to the same extent as if the partnership had borrowed from an unrelated third party. A fully recourse borrowing by a general partnership from a partner,¹⁷ for example, would result in a basis increase for the partner equal to the fraction of the borrowed amount that corresponded to the partner's loss ratio in the partnership.

The effect of this conduit approach to a partnership level borrowing is to give each partner a unitary basis for his partnership interest equal to the amount that he has agreed to place at the risk of the business. To the extent that the partner's loan increases the amount so at risk, a basis adjustment is made to his interest in the partnership. The resulting basis thus becomes the appropriate limitation upon the partnership losses that may be claimed by any partner, and, under the scheme of subchapter K, losses can only be claimed against that basis.¹⁸ Thus, the tax consequences of all losses allocated to a partner, and of distributions from the partnership, are measured against a single, unitary basis.

In the partner's capacity as creditor, he retains a full basis in his loan to the partnership.¹⁹ Since losses cannot be claimed against his basis in the loan as such, the partner's basis for his loan is not reduced by losses

¹⁶ I.R.C. § 752(a).

¹⁷ The allocation of the increase in basis is governed by § 1.752-1(e) of the regulations, and varies depending upon whether the partner is general or limited and whether the loan entails personal liability.

¹⁸ I.R.C. § 704(d).

¹⁹ The basis of the debt remains available for other purposes such as offsetting gain on a sale of the security or supporting a loss if the loan is not repaid.

in excess of the basis for his interest in the partnership. Consequently, the repayment of a loan to a partnership rarely produces taxable gain. Rather, only transactions affecting the partnership interest produce tax consequences.

Under the rules of subchapter S, an entity rather than a conduit approach determines the effects of a corporate borrowing upon the basis of a shareholder.²⁰ The borrowing of the separate corporate entity is not reconstructed as a shareholder borrowing and does not affect the basis of any shareholder. This rule has a wide variety of adverse consequences upon S corporations that are not of present concern.²¹ One corollary of the rule, however, is that a loan to an S corporation by a shareholder is not treated as a part of his or any other shareholder's contribution to capital. Rather, the loan is an entirely separate investment by the shareholder in the S corporation,²² which has its own distinct tax basis. Losses from the corporation can be applied against,²³ and reduce, the basis of either investment and, at least after 1982, income of the corporation can increase the basis of either security.²⁴ Also, distributions with respect to either security may result in taxable gain.

A. Effect of the Separation: Double Taxation

Under the taxation of S corporations prior to the 1982 revision, the separation of the stock and debt basis caused by the entity treatment of a corporate level borrowing produced a series of horrifying traps for unsuspecting shareholders. If losses were allocated to a shareholder in an amount that exceeded the basis for his stock, the excess nevertheless could be deducted to the full extent of the shareholder's basis for any loan to the corporation. To the extent of the losses so applied, the basis for the debt was reduced.²⁵ Income thereafter earned by the S corpora-

²⁰ For a discussion of the entity and conduit approaches to entity debt in the analogous context of a limited partnership, see Coven, *Limiting Losses Attributable to Nonrecourse Debt: A Defense of the Traditional System Against the At-Risk Concept*, 74 CAL. L. REV. 41 (1986).

²¹ Most important, an S corporation shareholder cannot claim losses attributable to the expenditure of the proceeds of the corporate level borrowing. As a result, those shareholders may be unable to claim start-up losses in excess of their investment in the corporation and may be unable to obtain the tax incentive benefits of accelerated deductions. While under § 1366(d)(2) the disallowed losses may be carried forward and used in future years, the deferral of the tax benefit reduces its value.

²² I.R.C. § 1366(d)(1)(B).

²³ I.R.C. § 1367(b)(2).

²⁴ I.R.C. § 1367(b)(2)(B).

²⁵ I.R.C. § 1376(b) (before amendment by the Subchapter S Revision Act of 1982).

tion, however, did not increase the basis of that debt; only stock basis was increased by undistributed corporate income.²⁶ As a result, if the debt were retired, the lender would be subject to tax to the extent payments in satisfaction of the debt exceeded the reduced basis.²⁷ This tax could not be avoided, and was imposed even if the shareholder-lender had already been taxed on the corporate income used to pay the debt. Thus, the shareholder was subject to two levels of tax on an investment that would only be subject to a single level of tax if made through either a partnership or a nonelecting corporation.²⁸ Moreover, under the Service's less than generous ruling policy, some tax was imposed even if the debt was only partially retired and the payments did not exceed the remaining basis in the debt.²⁹ Finally, for purely technical reasons, the tax was likely to be at ordinary income rates notwithstanding that the income was an artificial gain on a corporate loan.³⁰

B. The 1982 Solution

The 1982 legislation addressed only the first of these hardships. To prevent to the maximum extent possible a double tax upon the retirement of low basis debt, the Code was amended to provide that any basis increase attributable to corporate income shall first be made to the basis of any debt to the extent that basis had been reduced by allocated losses.³¹ The long overdue permission to restore the basis of debt that had been eroded by losses has eliminated the double tax incurred under prior law on the retirement of the debt. The debt basis restoration provision of the 1982 legislation is mandatory, however,³² and that has created a new, and perhaps worse, problem.

If the basis of debt has been reduced by losses, the basis of the shareholder-lender's stock must of necessity be zero. If, instead of using current income to retire shareholder debt, the S corporation makes a distribution on its stock, the distribution is a taxable dividend to the zero basis shareholder even though he is also taxed under the regular

²⁶ See I.R.C. § 1376(a) (before amendment by the Subchapter S Revision Act of 1982) (increase basis of stock, but not debt).

²⁷ See *Cornelius v. Commissioner*, 494 F.2d 465 (5th Cir. 1974).

²⁸ If the partner or shareholder of a nonelecting corporation actually loans funds to the entity, the repayment will not be taxable because the lender's basis will not have been reduced.

²⁹ Rev. Rul. 68-537, 1968-2 C.B. 372.

³⁰ *Cornelius v. Commissioner*, 494 F.2d 465 (5th Cir. 1974). Unless the loan is pursuant to a "certificate or other evidence of indebtedness" within the meaning of § 1275(a)(1)(A), the repayment is not treated as an exchange under § 1271(a)(1), and thus is not eligible for capital gains taxation.

³¹ I.R.C. § 1367(b)(2)(B).

³² *Id.*

pass through scheme of subchapter S on the distributed income. The distribution, therefore, causes precisely the same double tax on distributions on stock that occurred under prior law for distributions on debt. Thus, the 1982 solution merely prevented a double tax potential in one situation by shifting it to another. The problem created by this amendment may be worse than the one solved. Since debt retirements are generally within the control of the corporation and its shareholders, the double tax under prior law often could be minimized or avoided by controlling the repayment of the debt. Omitting the payment of pro rata dividends until the basis of one shareholder's debt is fully restored, however, can be far more difficult.

Under prior law, double taxation on the distribution of dividends did not occur because the basis produced by the pass through of current income was applied to the stock and thus sheltered the distribution from a second tax.³³ This aspect of prior law was entirely sound. Taxing income as earned by the corporation and again when distributed is simply a technical flaw in subchapter S, and is as improper when the distribution is a dividend as it was when the distribution was in retirement of debt.

C. An Interim Approach

The double tax on dividends created by the debt basis restoration provision could be mitigated by borrowing more heavily from the concepts of entity taxation. Generally, shareholder basis under subchapter S is first increased or decreased by income or loss of the corporation allocated to the shareholder, and distributions are tax free to the extent of this enhanced or diminished basis. In the taxation of partnerships,³⁴ from which this approach was copied, the system works satisfactorily because partner basis is a unitary account.³⁵ The system does not work in subchapter S because of the separation of basis between stock and debt. If the adjustment for current income or loss is not made to the same security on which a distribution is received, an improper double tax can occur. The double tax could be avoided if distributions on stock were always considered to come first out of current income, and only the excess of current income over distributions were treated as an addition to basis. The reasons for and operation of this proposal are described more fully in the paragraphs that follow.

Under the separation of basis mechanism, the application of losses to

³³ I.R.C. §§ 1376(a), 1375(d) (before amendment by the Subchapter S Revision Act of 1982).

³⁴ Reg. § 1.704-1(d)(2).

³⁵ See *supra* text accompanying notes 16-19.

the basis of debt is analogous to the creation of a deficit in the stock basis account. When there is no remaining balance in the stock basis account, losses are allowed against the basis of the debt. Basis adjustments for subsequent income are first applied to eliminate the stock basis deficit, and only when a positive balance is created can distributions on stock be tax free.

In this respect, the stock basis account in an S corporation is analogous to the earnings and profits account of a C corporation. A distribution to shareholders of a C corporation is a taxable dividend only to the extent of the corporation's earnings and profits.³⁶ Should there be a deficit in the earnings and profits, distributions are not taxable as dividends until income of the corporation restores the deficit. If the earnings and profits account were a single cumulative account, such as the basis of an S corporation appears to be, a C corporation with current income, but an accumulated deficit, could distribute the income to its shareholders free of tax. As long as the income did not fully restore the deficit, the distribution would be a return of capital even if it was made from current earnings.

This result is prevented by dividing earnings and profits into two categories: current and accumulated.³⁷ Current income is reflected in a current account, against which distributions are first applied. Distributions thus are fully taxable to the extent of current earnings and profits even if there is a deficit in accumulated earnings and profits that exceeds the positive balance in the current account.³⁸ Any balance remaining in the current account at year end is added to the accumulated account.

The distinction between current and accumulated earnings and profits reflects a similar state law concept. Under traditional corporate law, a dividend distribution is lawful only if supported by retained earnings.³⁹ In most jurisdictions, however, dividends may be distributed from current earnings even if a deficit exists in the historic retained earnings account.⁴⁰ Such a dividend is commonly called a nimble dividend because the corporate officials must act quickly to catch it. Subchapter S requires the addition of a nimble dividend concept.

Such an approach could be implemented as follows: Current income of an S corporation would create a current basis account against which distributions would first be applied. If distributions exceeded the current basis account, the taxation of the excess would be determined by

³⁶ I.R.C. § 301(c)(1).

³⁷ I.R.C. § 316(a)(1), (2).

³⁸ See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 7.02 (4th Ed. 1979) [hereinafter BITTKER & EUSTICE].

³⁹ See, e.g., DEL. CODE ANN. § 170 (1982).

⁴⁰ *Id.* See also B. MANNING, *LEGAL CAPITAL* 77 (2d Ed. 1981).

the normal stock basis account. Conversely, if distributions were less than the current basis account, the balance remaining in the account would be added to the accumulated basis account as under present law.

If a shareholder's stock basis were zero and his debt basis had been reduced by losses, a distribution on the stock would thus not be taxable unless it exceeded current income. As a result, the double tax created by present law would be eliminated. If, on the other hand, the corporation retired a shareholder loan instead of distributing a dividend, the payment would not deplete the current basis account, which would therefore be added to the normal basis account at year end. Under the debt basis restoration rules, this addition would go first to the debt, to the extent of debt basis previously consumed by loss deductions, and thus would offset any gain that might otherwise have been recognized on retirement of the debt.

In effect, a nimble dividend rule for S corporations would give shareholder-lenders the option of choosing between a tax-free dividend or a tax-free debt retirement, a choice that would offend no principle of tax policy. The double taxation of current income under the present rules is an unintended result of the entity treatment of debt in an S corporation. A mechanism for avoiding that result is entirely consistent with the basic notions underlying conduit taxation.

D. Toward an Ultimate Solution

Borrowing more heavily from entity concepts to resolve the double tax problem works because the problem is created by entity concepts. The ultimate solution to the inadequacies in subchapter S, however, requires just the opposite, a fuller adoption of conduit principles.

There is no structural reason why the basis of stock in an S corporation cannot be adjusted to reflect liabilities of the entity, as is done for partners' bases by section 752. The mechanism for computing basis adjustments for S corporation stock was copied almost intact from the partnership rules, and the addition of an analogue to section 752 poses no technical difficulties.

That conclusion is not altered by the ability to move between S and C corporation status. When a C corporation makes an S election, an allocable share of the corporation's debt could be added to the basis of each shareholder's stock. The corporation would be treated as having discharged its debt when the election took effect, while the shareholders borrowed an equivalent amount and contributed it to the corporation. Conversely, the termination of an S election would be treated as if the corporation had distributed to its shareholders an amount equal to their share of the corporate debt on the day of the termination. If the debt

exceeded the basis of the shareholder's stock, the excess would be subject to tax in the same manner as an actual distribution. The tax on the constructive distribution would be entirely appropriate because it would represent a recapture of an excess of corporate deductions allocated to shareholders over the shareholder's equity investment. Adoption of the partnership basis rule for S corporations would permit the computation of a unitary basis and eliminate the problem of double taxation in the most rational manner.

It might be objected that S corporation liabilities should not be included in shareholders' bases because shareholders have no personal obligation to repay corporate debt.⁴¹ The limited liability of corporate shareholders, however, is not a sound basis for differentiating between partnerships and S corporations. The economic positions of a shareholder and a partner of a partnership having nonrecourse debt are not distinguishable; neither has personal liability. Nevertheless, the partner's basis includes a portion of the nonrecourse debt. Arguably, the error is in the treatment of nonrecourse partnership debt, not the treatment of S corporation liabilities. The widely differing treatment of these economically comparable forms of investments, however, is not justifiable.

Furthermore, since the practical effect of the subchapter S basis rule is to deny to shareholders the benefit of accelerated deductions that frequently are not accompanied by economic loss, the absence of personal liability seems immaterial.⁴² In practice, the question is not so much whether deductions for tax losses not accompanied by economic loss are proper, but whether S shareholders should be denied the tax incentives of accelerated deductions that are available to partners and individual investors.

Moreover, it is often untrue that a shareholder is not exposed to personal liability in the same manner as is a general partner. S corporations tend to be small, closely held corporations, and their major creditors

⁴¹ That objection, of course, underlies the at risk limitations on deductions imposed by § 465. See H.R. REP. NO. 426, 99th Cong., 1st Sess. 292 (1985) (proposing an extension of those rules to real property). The Supreme Court has recently indicated some sympathy for the view that a nonrecourse debt should not be added to the basis of property. See *Commissioner v. Tufts*, 461 U.S. 300, 308 n.5, 309 n.7 (1983).

⁴² The objection to claiming losses against a basis that includes the amount of nonrecourse debt is largely based on the assumption that tax losses reflect economic losses and that, because of those economic losses, the value of the security will be insufficient to repay the loan. In fact, however, tax losses often reflect accelerated deductions granted as tax incentives by such provisions as § 168 and are not accompanied by economic losses. Thus, the tax losses do not imply that the loan will not be repaid.

frequently require personal guarantees from their shareholders. A guaranteeing shareholder is exposed to personal liability in a manner that is not meaningfully different from the liability of a shareholder who invests borrowed funds in the corporation. The shareholder thus should be allowed deductions for corporate losses to the extent of his personal obligation.⁴³ Throughout the history of subchapter S, shareholders have asserted that one or another configuration of shareholder guarantee should be sufficient to increase the basis of S corporation stock. In recognition, perhaps, of the merits of the argument, both the Commissioner⁴⁴ and the courts⁴⁵ occasionally agreed. Expressly permitting the adjustment of stock basis for entity level liabilities thus would not change present law as greatly as might be thought. In any event, adoption of the partnership rule would have the collateral benefit of concluding the continuing and unproductive litigation over S corporation shareholder guarantees.

Finally, the addition of entity debt to a shareholder's basis is not the equivalent of permitting the shareholder to claim losses in excess of his investment. In practice, the ability of a limited partner to deduct losses against a basis created by a nonrecourse borrowing is limited by the at risk and passive activity loss rules.⁴⁶ While there is some question as to the need or desirability of the at risk limitations,⁴⁷ those rules can be

⁴³ In partnership taxation, the effect of partner guarantees upon basis is very different from their effect on an S corporation. All debt is added to the bases of partners' interests; the only issue is how the basis increase is to be allocated. In subchapter S, the issue is whether any basis increase is allowable. In partnership taxation, the rules governing the allocation are in transition. The position of the Commissioner has been ambivalent. *Compare* Block v. Commissioner, 41 T.C.M. (CCH) 546 (1980), with *Raphan v. United States*, 3 Ct. Cl. 457 (1983), *rev'd*, 759 F.2d 879 (Fed. Cir. 1985). However, Congress has instructed the Treasury Department to issue revised regulations on the issue that presumably will take partner guarantees into account in the allocation of basis. Pub. L. No. 98-369, § 79(a), 98 Stat. 4494 (1983).

⁴⁴ In Revenue Ruling 75-144, 1975-1 C.B. 277, a shareholder converted a guaranteed loan to an S corporation into a loan to himself by substituting his note for the corporate note with the lender. The S corporation thereupon became liable to the shareholder for that amount. The Commissioner ruled that the shareholder thereby obtained a basis for claiming losses in the amount of the corporate debt to him. Whatever commercial law distinctions attach to this conversion, the economic position of the shareholder was wholly unchanged.

⁴⁵ *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985) (guaranteed loan to thinly capitalized corporation treated as loan to shareholder plus contribution to corporation, which created basis). *Compare* Bader v. Commissioner, T.C. Memo. 1987-30.

⁴⁶ I.R.C. §§ 465, 469.

⁴⁷ See Coven, *Limiting Losses Attributable to Nonrecourse Debt: A Defense of the Traditional System Against the At-Risk Concept*, 74 CAL. L. REV. 41, 62-79 (1986).

applied to S corporation shareholders in the same manner as they are applied to partners.⁴⁸ The rationality of the Code would be improved by restricting the deductibility of partnership and S corporation losses in the same way.

II. DISTINGUISHING BETWEEN S AND C EARNINGS

A C corporation can elect to be an S corporation without triggering any immediate tax consequence to itself or its shareholders. The privilege of switching tax free from subchapter C to subchapter S is the root of most of the complexity and inadequacy of subchapter S. In providing ease of entry, Congress' intention was not to forgive the second tax on prior earnings and profits, but to defer that tax until the earnings are distributed.⁴⁹ Thus, it became necessary for S corporations to maintain earnings and profits accounts. It also became necessary to develop tracing rules for distinguishing distributions of earnings and profits from distributions of income earned while the S election is in effect. The general principle for making that distinction adopted in the original legislation and continued in 1982 is simple and straightforward: Distributions are deemed to come first from income recognized under the S election, and are traced to earnings and profits only when S period income is exhausted. The implementation of that principle, however, has been anything but straightforward.

A threshold issue in the application of the distinction is the question of whose subchapter S income must be exhausted before earnings and profits are reached. Earnings and profits constitute a corporate level account. Under the entity approach to the taxation of C corporations, that account represents income on which the corporation has been taxed, but which has not been allocated to particular shareholders. Indeed, there is no connection between the account and the particular shareholders. A distribution of earnings and profits is taxed as a dividend, for example, even if the shareholder receiving it acquired his stock after the earnings and profits were accumulated.⁵⁰

An S corporation's income is different. It is immediately allocated to, and taxed to, particular shareholders.⁵¹ Each shareholder's basis is increased by the amount of the income taxed to him, and the amount the shareholder is entitled to withdraw from the corporation free of tax

⁴⁸ Actually, the at risk rules are applied to shareholders of S corporations today in the same manner as they are applied to partners. The distinction is in the nature of the debt that becomes subject to those rules.

⁴⁹ See S. REP. NO. 1983, 85th Cong., 2d. Sess. (1958), reprinted in 1958-3 C.B. 922, 1009, 1140, 1146.

⁵⁰ See BITTKER & EUSTICE, *supra* note 38, at ¶ 7.01.

⁵¹ I.R.C. § 1366.

risers in like amount.⁵² These mechanics effectively treat the parties as though the corporation had distributed its income to the shareholders and the shareholders had immediately returned it to the corporation as capital contributions. The shareholder is entitled to a return of that amount free of tax before distributions are treated as attributable to the corporate earnings and profits.⁵³

Presumably because of the connection between the accumulated income of an S corporation and particular shareholders, the original version of subchapter S accounted for accumulated S income in individual shareholder accounts.⁵⁴ The income taxed to the shareholder, and not distributed, was maintained in a "previously taxed income" account that was personal to the shareholder. The account represented a portion of the shareholder's stock basis that he was entitled to recover before distributions were treated as out of the accumulated earnings and profits of the corporation.

That original mechanism for distinguishing between distributions of S income and earnings and profits was uniformly criticized.⁵⁵ It was exceedingly difficult to obtain tax-free distributions from the previously taxed income account, and this greatly impaired the usefulness of an S election (or so it was repeatedly said). The criticisms, however, were not addressed to the inherent nature of a shareholder level account but rather to the manner in which the concept was implemented.⁵⁶ Nevertheless, the 1982 revisions of subchapter S made the previously taxed income account a corporate level account.

One of the primary objectives of the 1982 legislation was to conform the taxation of S corporations more closely to the conduit based system

⁵² I.R.C. § 1367.

⁵³ I.R.C. § 1368(c).

⁵⁴ Pub. L. No. 85-866, § 64(a), 72 Stat. 1606, 1655 (1958) (enacting § 1375(d) (repealed 1982)). Under § 1379(c), the former version of § 1375(d) continues to apply to distributions of S corporation income accumulated prior to 1983. Thus, in addition to the problems discussed in the text, regulations must be promulgated to describe how to integrate distributions from the corporate level post-1982 income account with distributions from these pre-1983 shareholder level accounts. The scheme currently adopted by the Service is to not treat distributions as dividends until the AAA and the recipient shareholder's previously taxed income account (PTI) has been exhausted. See I.R.S. Pub. No. 589, *Tax Information on S Corporations* 12 (1985), which provides: "The distribution from PTI, comes after a nontaxable distribution from AAA and before a dividend distribution from earnings and profits."

⁵⁵ For a discussion of the problems, see EUSTICE & KUNTZ, *supra* note 1, at ¶ 9.01[1].

⁵⁶ The objectionable features of prior law included the following: The distribution had to be in cash (corporate notes in particular would not suffice), the distribution had to be prior to the termination of the election (even if the termination were unintended and retroactive), the account was not transferable (even to a donee), and current earnings and profits had to be actually distributed first.

of taxing partnerships. In the computation and allocation of income, that objective was largely achieved. The shift to a corporate level account for identifying S income, however, was a step in the opposite direction, a nod in the direction of entity taxation. The inconsistency appears not to have been a wise choice.

The fundamental distinction between corporate and shareholder level accounts lies in the connection between the accumulated S income and particular shareholders. Under the corporate level accounting used for earnings and profits, and now used for S income, no such connection exists. As a result, distributions from the account need not be made to the shareholder to whom the income that produced the account was taxed but rather may be shifted among shareholders, sometimes to their regret and sometimes to their pleasure. That feature of the 1982 solution produces endless difficulties.

A. Corporate Level Account

Under the scheme for taxing distributions contained in section 1368, all S corporations having earnings and profits are required to maintain a corporate level account called the accumulated adjustments account, the AAA.⁵⁷ With a few statutory exceptions,⁵⁸ the AAA is computed under the same principles used in the computation of basis.⁵⁹ Thus, the account consists of the net income of the corporation earned after 1982, less the amount of all distributions from the account, that is, tax-free distributions. That the account should mirror the computation of basis is entirely correct because the account is measuring at the corporate level the same accumulations of income that produce an increase in basis. In a simple case, the AAA should equal the aggregate basis increases for all shareholders after 1982.

Section 1368 seeks to distinguish between distributions of earnings and

⁵⁷ Although neither the Code nor I.R.S. Publication 589 (*supra* note 54, at 11) requires an S Corporation to maintain an AAA when the corporation has no earnings and profits, the Instructions for Form 1120S (at page 11) specifically provide that an S Corporation must maintain an AAA regardless of whether the corporation has accumulated earnings and profits.

⁵⁸ Unlike basis, losses may cause the AAA to become negative. I.R.C. § 1368(e)(1)(A); IRS Pub. No. 589, *supra* note 54, at 12. Thus, the corporation must derive income equal to the amount of such losses before further tax-free distributions can be made. While the AAA is not necessarily related to the separation of basis problem considered above, the concept of a negative AAA is inconsistent with the suggestion of a nimble dividend approach for subchapter S.

The second difference between the AAA and basis computation is that tax-exempt income (municipal bond interest exempt under § 103(a), for example) does not increase the AAA. I.R.C. § 1368(e)(1)(A). As a result, the corporation cannot distribute this income before distributing all of its earnings and profits. This rather harsh treatment of tax-exempt income may not be justifiable.

⁵⁹ I.R.C. § 1368(e)(1)(A).

profits and of AAA through a three tier system. The first tier consists of all distributions that do "not exceed the accumulated adjustments account." Thus, the principle is established, or so it seems, that the post-1982 S income is the source of all distributions from the corporation until the accumulated income is exhausted. Distributions in excess of the AAA are second tier distributions and are regarded as attributable to the accumulated earnings and profits of the corporation. Further (third tier) distributions represent a return of basis and thereafter a capital gain—exactly as would a distribution in excess of earnings and profits from a nonelecting corporation.⁶⁰

B. Discontinuity Between Shareholder Basis and AAA

On simple facts, the scheme of section 1368 works simply and rationally. When the portion of the AAA distributed to a shareholder does not exceed the basis for his stock, the definition of the first tier distribution is unambiguous, and the line between the AAA and earnings and profits is understandable. The essential flaw in the corporate level account appears when a shareholder's proportionate interest in the AAA exceeds basis. Because each shareholder has a proportionate interest in the AAA, regardless of how the basis of his shares is determined, that discontinuity can arise in a variety of ways. If an S corporation with a substantial AAA account issues stock in a tax-free section 351 exchange, for example, the shareholder's basis for the stock received in the exchange (which equals the basis of the property he transferred in exchange) may be much smaller than his share of the AAA account.⁶¹ Similarly, a dividend that is not pro rata may reduce or eliminate the basis of a shareholder's stock while his interest in the AAA will correspond to his remaining stockholdings.

The authors of section 1368 anticipated such discontinuities, and provided a seemingly appropriate response. First tier distributions (those not exceeding the AAA) are free of tax to a shareholder only to the extent they do not exceed stock basis. Any excess is treated as gain from the sale of the stock, a capital gain.⁶² Although the Code is somewhat vague on the point, the AAA is only reduced by the portion of the first tier distribution that is in fact free of tax, and not by the portion that is taxed as gain.⁶³

⁶⁰ I.R.C. § 1368(c).

⁶¹ For an extreme example, the transfer of properties to the corporation subject to liabilities in excess of the tax basis of the properties results in a zero basis for the stock or debt received. I.R.C. §§ 357(c), 358(d).

⁶² Section 1368(b)(2) provides that the gain is treated as gain from the sale of property. Presumably, the property is the stock in the S corporation.

⁶³ This is apparently the result because the AAA is computed in a manner

The taxation of S income therefore is not entirely controlled by a corporate level account. Unlike the treatment of the earnings and profits account, where all distributions are treated as from the account even if they exceed the shareholder's proportionate interest in the corporation, an S shareholder cannot receive tax-free distributions from the account that exceed his basis, so that basis is an upper limit on what the shareholder is entitled to receive free of tax.⁶⁴ There is no other acceptable result; shareholders cannot be permitted to receive tax-free distributions in excess of their investments. Nevertheless, the concurrent application of two dissimilar limitations upon distributions from the AAA creates a wholly irrational gap in the line between AAA and earnings and profits. Not too surprisingly, the tax effect of that gap is wholly unresolved.

The problem is best understood by an illustration. *Essco* is an old S corporation with \$200 of earnings and profits accumulated while it was a C corporation and an AAA of \$300. It has two equal shareholders: *Al*, who has a basis of \$125 for his stock, and *Bee*, who has a basis of \$1,000 for her stock.⁶⁵ A distribution of \$100 to each poses no difficulties because it does not exceed *Al*'s tax-free entitlement; the distribution is a nontaxable first tier distribution, the basis of each shareholder's stock is reduced by \$100, and the AAA is reduced by \$200.

A distribution of \$175 to each, however, creates monumental problems. Only \$125 of the distribution to *Al* is free of tax; the balance of \$50 is taxed as a capital gain. Accordingly, the AAA is only reduced by \$125 by virtue of the \$175 distribution to him, and the remaining \$175 of the account fully covers the \$175 distributed to *Bee*. The first tier distribution amounts to \$350, notwithstanding that the AAA was only \$300, because \$50 of the distribution to *Al* does not diminish the account. Somewhat perversely, the lower *Al*'s basis, the larger the first tier becomes. Had *Al*'s basis been zero so that none of the distributions to him would have reduced the AAA, that account would not have been exhausted until \$600 had been distributed pro rata to the two shareholders.

On these facts, the use of the corporate level account does not increase

similar to basis and basis is reduced only by tax-free distributions under § 1367(a)(2)(A).

⁶⁴ A shareholder may be entitled to receive more than his share of the AAA because a distribution is treated as attributable to the AAA to the full extent of the shareholder's basis, even if only a portion of that basis is attributable to the accumulation of S income. That excessive receipt of AAA has no effect upon the shareholder but may deprive the other shareholders of the tax-free distributions to which they are entitled.

⁶⁵ For those who like to understand the context, assume that the corporation was owned by *Bee*, and, in order to allow the corporation to expand, *Bee* contributed cash and *Al* contributed low basis property to the corporation in a transaction that qualified under § 351.

the amount that can be distributed free of tax, but rather defers the point at which a distribution is treated as a second tier distribution of earnings and profits. The lack of congruence between the corporate and shareholder accounts inserts a gap between the distribution of S income and of earnings and profits that has no theoretical justification. It is simply not logical to permit *Al* to realize a portion of the gain in his stock in an ordinary, pro rata distribution before being taxed on earnings and profits.

The deferral of the second tier distribution can be greatly expanded. Assume the corporation distributes \$1,000 to *Al* in a redemption of a portion of his stock. Assume, further, that the redemption is not treated as a sale under section 302, but rather as an ordinary dividend. Because the distribution cannot reduce the AAA by more than the \$125 basis of *Al*'s stock, the account cannot be reduced below \$175. Thus, the entire amount of the dividend is a first tier distribution, and none of it is treated as a distribution of earnings and profits.

A second effect of the corporate level account is to shift the benefit of the AAA to *Bee*. On the facts of the example, that shift may not appear improper. Given *Al*'s low stock basis, he is plainly not entitled to distribution from the AAA in excess of \$125. *Bee*'s entitlement, however, may be no greater than *Al*'s. Both the earnings and profits and the AAA of *Essco* may have been accumulated before either of them acquired their stock. If, for example, *Bee* had purchased all of the previously outstanding stock of *Essco* when she and *Al* acquired stock by a section 351 exchange, the two shareholders would have equal claims on the AAA, and the shift of the account to *Bee* would be traceable to nothing other than her higher basis. This shift of the AAA is particularly odd in light of the rules preserving the shareholder's ratable interests in the earnings and profits account since neither shareholder has any logical connection to either account.

There is an alternative interpretation of the definition of the first tier distribution that would avoid both of these objections to the corporate level account. That interpretation, however, would introduce other problems and, on balance, is inferior. Under the alternative interpretation, the portion of a distribution deemed to come from the AAA would be limited to the amount of the AAA. In the example, this interpretation would limit the first tier distribution to \$300. Of the \$175 distributed to *Al*, \$125 would be free of tax as before, but only \$25 would be taxed as a capital gain. The balance of \$25 would be a second tier distribution of earnings and profits, taxed as ordinary income. Similarly, only \$150 of the distribution to *Bee* would be free of tax, and \$25 would be a second tier distribution. Under this interpretation, the second tier distribution would not be deferred, and the shift of AAA to *Bee* would be limited.

Immediately after the distribution, however, the corporation would still have an AAA of \$25. The alternative interpretation thus would provide a second tier distribution of earnings and profits before post-1982 S income had been fully distributed, a result inconsistent with section 1368. Furthermore, that interpretation would create rewards for the well advised and traps for the unwary of the type that the 1982 revision was intended to eliminate.

If the parties had been better advised, for example, they might have limited the distribution to a total of \$300, thus avoiding any second tier distribution. In the following year, a further distribution of \$25 (the remaining balance in the AAA) might be made. Even if there is no addition to the account for this year, the distribution would be a first tier distribution. Only the \$12.50 distributed to *Bee* would reduce the AAA. Because *Al* has no remaining basis, the amount he receives would be a taxable first tier distribution, and would not reduce AAA. In the third year, an AAA account of at least \$12.50 would remain, and the process could be repeated at one half the size of the second year's distribution.

In short, by employing some care in the timing of distributions, second tier distributions could still be avoided under this interpretation notwithstanding that a great deal more than \$300 has been distributed by the corporation. Because of its theoretical and practical improprieties, this interpretation of section 1368 seems no better, and perhaps worse, than the first interpretation.

It is difficult to see how section 1368 could be revised to produce a sound result while saving the notion of a corporate level account. The gap between the first and second tier distributions could be eliminated by defining the first tier distribution as the lesser, rather than the greater, of the AAA or the respective shareholder's bases. That shift towards a shareholder level account, however, would leave little significance to the corporate level account other than to permit the shifting of the benefits of the account, the subject of the following section. It would be preferable to abandon the AAA altogether.

C. Shifting the Benefits of the AAA

Because a corporate level account is not connected to any particular shareholder, its benefits can be shifted from one shareholder to another with great freedom. As a result, the adoption of the corporate level AAA has created marvelous opportunities to abuse subchapter S—as well as dangers of self abuse.

As developed below, there is little reason to object to a transfer of the benefits of the AAA incident to a transfer of stock, the circumstance in which Congress intended the benefits of the AAA to be transferable.

In fact, it would be unduly harsh not to permit a donee the same rights of tax-free withdrawal of funds that were held by the donor. In some situations, however, the transfer of the AAA to a purchaser can create serious traps for the parties that bring into question the very notion of transferability.

In a further dubious adherence to the principles of entity taxation, subchapter S contains no concept of change in ownership.⁶⁶ A purchaser of a controlling interest in an S corporation stands in essentially the same relationship to the corporation as did the sellers.⁶⁷ Whatever AAA exists on the date of the purchase is fully available for withdrawal by the purchaser. In addition, the AAA, like earnings and profits (another corporate level account), is adjusted at year end, and is allocated ratably over all distributions during the year.⁶⁸ In combination, these attributes of the AAA can produce unacceptable consequences for a midyear sale of a controlling interest in an S corporation.

Commonly, a seller of stock of an S corporation withdraws from the corporation the entire amount of the AAA in anticipation of the sale, thereby reducing the amount the purchaser must borrow to make the purchase and placing tangible property in the hands of the seller. Nothing prevents the purchaser, however, from also withdrawing an equivalent amount immediately after the purchase. Should he do so, the AAA, determined at the end of the year, will be allocated ratably over both distributions. The seller will discover that instead of receiving a wholly tax-free first tier distribution, one half of his distribution exceeded the AAA, and thus was a fully taxable second tier distribution of earnings and profits. The purchaser will face the same tax burden, and that reality may discourage raiding AAA distributions notwithstanding the benefit from causing a distribution of earnings and profits to the unsuspecting seller. The point is that the statute is flawed in permitting such manipulations to occur.

A potentially more serious trap exists on the issuance of stock in an S corporation. The original issuance of stock in a corporation having an AAA causes a dilution of the account relative to the existing shareholders. If the number of shares outstanding is doubled, for example, the amount that can be distributed pro rata to each shareholder as a tax-free first tier distribution is halved. As a result, S corporations may be discouraged from raising needed additional capital through stock sales. Such a disincentive is a regrettable interference with market activity.

⁶⁶ Compare the rule for partnerships in § 708(b)(1) (sale of 50% interest in partnership terminates the partnership).

⁶⁷ Other faults in this adherence to the separate entity concept are noted in Coven, *Making Subchapter S Work*, 32 TAX NOTES 271 (1986).

⁶⁸ I.R.C. § 1368(c).

The ability to shift the benefits of the corporation level account, however, has created more than just traps for the ill-advised. The ability to benefit from that feature is even more dramatic. The very nature of a corporate level account allows the account to be attributed to the first shareholder in time to receive distributions from the corporation. Ordinarily, corporate distributions are pro rata and thus do not permit the shifting of the benefits of a corporate level account. When distributions are not pro rata, they normally are stock redemptions taxable as a sale under section 302(a).⁶⁹ A distribution in redemption of stock carries with it a fraction of the AAA equal to the proportion of the stock retired.⁷⁰ Again, the ability to shift the benefits of the AAA is curtailed. But, nonredeeming distributions do not have to be pro rata, and redemptions do not always qualify under section 302(a). In those situations, a substantial shift in benefits may occur.

To illustrate how the corporate level AAA may be used to insulate redemptions from dividend treatment, consider a family owned C corporation with ample earnings and profits. An older, high bracket shareholder, who owns 20% of the stock, wishes to retire, but it is unclear whether the redemption of his stock would qualify for sale treatment under section 302(a). If the corporation elects under subchapter S, its income will be taxed to the various family members, some of whom are in lower tax brackets. That income need not be distributed to them but can instead be paid to the retiring shareholder over a period of years in redemption of a portion of his stock. In the unlikely event that the transaction does qualify under section 302,⁷¹ the retiring shareholder will be entitled to capital gains taxation and the AAA will be little affected. If the redemption does not qualify, the shareholder will still be

⁶⁹ Under § 302, stock redemptions are taxed as sales of the stock if the transaction meets one of four tests designed to insure that the redemption is not the equivalent of a dividend. In closely held corporations, the most important of these tests is the complete termination of interest rule of § 302(b)(3). If none of the tests of § 302(b) is met, the redemption is treated as a dividend. I.R.C. § 302(d).

⁷⁰ I.R.C. § 1368(e)(1)(B). In what appears to be an oversight, this section does not limit the reduction in AAA to the basis of the stock redeemed. Thus, on the redemption of low basis stock, the AAA will be reduced by an amount that exceeds the tax-free distribution to the shareholder, a seemingly improper result.

⁷¹ Periodic redemptions rarely survive the tests of § 302, particularly in family owned corporations, because they do not result in sufficient changes in proportionate interest after the application of the stock attribution rules. *See* I.R.C. § 302(b)(2), (c). A further advantage of electing subchapter S status in anticipation of a redemption is that periodic redemptions will not produce dividend treatment.

entitled to capital gains treatment as long as the distribution to him in any year does not exceed the entire balance in the AAA.

Assume that the shareholder's basis for his stock is \$1,000 and that in each year the corporation adds \$800 to its AAA. Under section 1368, an \$800 distribution to the shareholder in the first year is an entirely tax-free first tier distribution, and eliminates the AAA. If, in the second year, a distribution is again made equal to the \$800 AAA accumulated in that year, \$200 (the remaining basis) will be free of tax, and \$600 will be a capital gain.⁷² The AAA will only be reduced by \$200, however, and thus will remain at \$600. By the end of the third year, the AAA will increase to \$1,400, and that amount may be distributed to the shareholder as a first tier distribution.⁷³ By transferring the entire benefit of the AAA to the retiring shareholder, all of his stock can be retired at capital gains rates in a relatively brief period of time—contrary to the structure of the corporate tax.

It is not even necessary for the other shareholders to entirely forgo current distributions from the corporation in order to maximize the benefits to the retiring family member. An S corporation can elect in any year to bypass the first tier of the distribution scheme.⁷⁴ Thus, in any year, the redemption could be withheld and dividends distributed to all shareholders which, if the corporation so elected, would be treated as taxable second tier distributions. That result, however, is no worse than if subchapter S had not been elected, and it preserves the entire AAA for the retiring shareholder.

Quite likely other more sophisticated or more subtle risks or benefits lurk in the ability to shift the corporate level AAA, but further exploration seems unnecessary. Accumulated S income, having been taxed to specific shareholders, belongs in shareholder level accounts attached to specific shares of stock and does not belong in a corporate level account. The creation of that account was misguided and has impaired, rather than promoted, the rationality of subchapter S.

⁷² In fact, a greater amount of the distribution would be free of tax because the basis increase for current income would attach, in part, to the shareholder's remaining stock. For purposes of this illustration, that effect is ignored.

⁷³ The example in the text is conservative in its assumption that the first tier distribution is limited to the amount of the AAA. If the first interpretation of the first tier set forth in the text controls, any amount could be distributed in the second year without becoming a second tier distribution. Since the AAA could not be reduced by more than the \$200 remaining basis for the stock, no amount of distributions would exhaust the account.

⁷⁴ I.R.C. § 1368(e)(3). The election to treat distributions as coming first from earnings and profits was intended to facilitate elimination of that account. It is not clear why an actual distribution is required rather than a consent dividend.

D. The Real Culprits: Earnings and Profits

What is most intriguing about transfers of the benefits of the AAA is not that they can occur but that Congress intended that they should occur.⁷⁵ It is instructive to examine why that is.

As in any sale of property, the seller of stock in an S corporation offsets his basis against the proceeds of sale in determining his gain or loss. Since that basis will have been increased by the amount of income of the S corporation taxed to him, the seller receives tax free the same amount that he could have received as a first tier distribution from the corporation. The seller is made whole by the basis offset and, as far as we have explored, does not need to be able to transfer his interest in the AAA. Nor, at first glance, does it appear that the purchaser needs the benefits of the seller's interest in the AAA. The purchaser will have a basis equal to the amount paid for the stock, presumably the entire value of his interest, and is not entitled to any greater tax-free receipt.

Unfortunately, having a basis in an S corporation that has earnings and profits is not enough to protect the shareholder from tax on distributions. Under the distribution priorities, unless the distribution is of S income, it is of earnings and profits. Thus, unless the purchaser obtained a right to a distribution of AAA, the distribution to him will be fully taxable. That result would be unjust to both parties. If the seller is not able to transfer his right to receive first tier distributions, the value of his stock will be impaired. In addition, taxing a new purchaser on a distribution of earnings and profits while the old shareholders are receiving tax-free distributions is illogical because the earnings and profits are less attributable to him than to the old shareholders. Congress' solution to that potential irrationality was to permit new shareholders to participate in first tier distributions on the same basis as could the old shareholders.

New shareholders could have been protected against untimely second tier distributions without the adoption of a corporate level account. Transferable shareholder level accounts would have had the same effect. Under that approach, however, the level of the purchaser's entitlement to a tax-free distribution would depend on the fortuity of the size of the seller's account. One reason for the adoption of the corporate level AAA was to eliminate that inappropriate result.

Brief reflection on this analysis suggests that the fundamental problem concerns not the transferability of an interest in the AAA but rather the treatment of earnings and profits. It does not make any sense to tax the purchaser on earnings and profits while the other shareholders are receiving tax-free distributions; it makes no sense to tax a post-1982 purchaser

⁷⁵ S. REP. NO. 640, 97th Cong., 2d Sess. 20 (1982), *reprinted in* 1982-2 C.B. 718, 727.

of stock in an S corporation on earnings and profits at all. That account is carried over from prior years to prevent tax avoidance by the persons who were shareholders during nonelecting years, and has no proper relationship to persons becoming shareholders after subchapter S dispensed with that concept.⁷⁶ Nevertheless, consistent with the separate entity concepts that control the regular corporate tax, the earnings and profits account of an S corporation is a corporate level account that may be attributed to, and taxed to, shareholders investing in the corporation in years after the account was generated. Because of that treatment of the earnings and profits account, it became desirable to make the subchapter S income account a corporate level account. Thus, a flaw was introduced into subchapter S to negate the effect of a more fundamental flaw.

It has not yet been demonstrated that it is possible to design a satisfactory system for the taxation of business organizations that combines substantial elements of both conduit and entity taxation. Concern over the potential for manipulation has led to unreasonably rigid definitional and procedural requirements for S corporations.⁷⁷ The second attempt at developing a system for taxing distributions is fundamentally inferior to its predecessor. Those operational defects suggest that corporations having earnings and profits should not be permitted to elect under subchapter S without first purging themselves of that account, either through distributions or the payment of an appropriate tax.

That practical conclusion is strongly supported by principle. The failure to impose any tax with respect to the earnings and profits of an electing corporation is an unjustifiable concession. While the election does not produce an increase in a shareholder's basis,⁷⁸ following the election the shareholders obtain the benefit of the corporation's tax basis for its assets in the computation of their individual tax liabilities. Contrary to the virtually universal application of the taxing system,⁷⁹ that step-up in basis is not accompanied by the imposition of tax. Accord-

⁷⁶ Before the 1982 revision, S corporations could accumulate earnings and profits. The rules of § 312 governing earnings and profits computations differ from the rules governing the computation of taxable income; only the latter was constructively distributed to shareholders. That flaw in the taxation of S corporations was removed in 1982, but the pre-1983 account was preserved. Since the distribution provisions do not distinguish between S period and C period earnings and profits, a corporation that has never been a nonelecting corporation can be subject to the more complex distribution rules. That result is questionable.

⁷⁷ See Coven, *supra* note 67, at 271.

⁷⁸ Because of the basis limitation, the shareholders may not obtain net losses attributable to the higher corporate basis. The income of the S corporation, however, is sheltered by deductions or other allowances generated by the higher basis.

⁷⁹ The glaring exception is the tax-free step-up in basis obtained on death under § 1014.

ingly, the shareholders of a newly electing corporation obtain a tax subsidy that is not warranted by any apparent principle of tax policy. This perception has led some commentators to suggest that a compensating tax should be imposed upon any corporation having earnings and profits that elects subchapter S. During the 1982 revision, Professor Ginsburg, for example, argued that a tax at capital gains rates should be imposed upon the amount of the net increase in basis.⁸⁰

Principles of tax neutrality might suggest an even greater tax. For an existing C corporation to transform itself into the other form of conduit business entity, a partnership, the corporation must liquidate, subjecting both itself and its shareholders to tax. The traditional pattern of taxing liquidations extends to the parties a choice between capital gains taxation on the entire appreciation in value of the corporation, whether or not realized at the corporate level, or ordinary income taxation upon the entire earnings and profits of the corporation.⁸¹ If that tax cost must be incurred in moving to the partnership form, considerations of neutrality suggest that a similar tax be imposed upon the election of subchapter S. Thus, the election might be treated as a constructive liquidation at the shareholder level.⁸²

While the case for the imposition of a tax along one or another of these lines is strong, Congress to date has preferred to permit free entry to the benefits of subchapter S. Assuming that this policy will persist, and thus that subchapter S will not extend true conduit taxation, it is nevertheless possible to improve considerably the operation of its provisions.

E. Shareholder Level Accounting

The use of the corporate level AAA to distinguish between earnings and profits and S income is not satisfactory. Accumulated subchapter S income is not like earnings and profits; it is in fact attributable to individual shareholders and rationally belongs in shareholder level accounts. In this respect, the approach of the prior version of subchapter S was much to be preferred. The 1982 experiment has failed and subchapter S should be returned to the shareholder level accounts used

⁸⁰ Ginsburg, *Subchapter S and Accumulated E & P: A Different View*, 17 TAX NOTES 571 (1982).

⁸¹ Compare § 331 with former § 333.

⁸² On an actual pre-1987 liquidation, some tax is incurred at the corporate level under various statutory and case law principles. See I.R.C. § 1245; *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370 (1983). There would be no reason to impose any such tax liability upon a constructive liquidation because the corporation would in fact continue and the basis of its assets would be unchanged.

under prior law. However, because of other changes in subchapter S, including the elimination of current earnings and profits⁸³ and the imposition of tax on the distribution of appreciated property,⁸⁴ a shareholder level account need no longer be subject to the unfortunate restrictions of prior law.

It is not just the corporate level AAA that is inconsistent with the conduit taxation of S corporations; a corporate level earnings and profits account is equally inappropriate and, in fact, was a contributing factor in the development of the corporate level AAA. The rationality of subchapter S would be greatly enhanced if the accounting for earnings and profits were consistent with the principles of conduit taxation rather than those of entity taxation. Upon an S election, the earnings and profits account should be converted into individual shareholder level accounts by allocating the balance in the account among the shareholders in proportion to their stock ownership.

While individual, shareholder level earnings and profits accounts would constitute a striking deviation from the principles of entity taxation, they would be entirely consistent with the conduit system of taxation that subchapter S was intended to implement. Moreover, the conversion of earnings and profits to shareholder level accounts would permit taxing the undistributed pre-election-period earnings of the corporation to the shareholders who benefited from the tax deferral that entity taxation extends, rather than to shareholders who invested in a conduit entity. Since in principle it would be entirely appropriate to impose a tax with respect to those earnings and profits upon the shareholders of the corporation on the date of its election, it is equally appropriate to limit the future taxation of those earnings and profits to that same body of shareholders.

Shareholder level S income and earnings and profits accounts would operate simply and efficiently. The net increases in a shareholder's basis after the effective date of the amendment would be reflected in an account much like the previously taxed income account used under prior law. Ordinary distributions not in excess of the balance in that account would not be subject to tax, as under current law. Distributions in excess of the account would be taxed as ordinary dividends to the extent of the shareholder level earnings and profits—again, very much as under present law, although using a different measuring rod. Further distributions would be taxed precisely as under present law. Upon a termination of the S election, the process would be reversed. The aggregate of the

⁸³ The only problem of prior law that the corporate level account addresses is transferability. Thus, a return to shareholder level accounts would not reopen any other prior law problem that was resolved in 1982.

⁸⁴ I.R.C. § 1363(d).

remaining shareholder level earnings and profits accounts would become the corporate level account of the nonelecting corporation.

The rationality of the distinction that must be drawn between earnings and profits and S income would be greatly improved by such a system. Shareholder level accounts would prevent the shifting of the benefits or burdens of either accumulated S income or earnings and profits among existing or new shareholders. And, the illogical gap that existing law inserts between first and second tier distributions would be eliminated.

Admittedly, the adoption of shareholder level earnings and profits accounts would require addressing one of the more complex issues in corporation taxation. Since one of the primary purposes for the shareholder level account would be to prevent taxing earnings and profits to new shareholders, the account could not be transferable. Thus, the tax liability inherent in the account must be settled at the time of any stock transfer. Configuring that settlement would require determining the extent to which an ordinary income tax should be imposed upon a gain realized upon the sale or redemption of stock in an S corporation and what exceptions to that tax should be made. Unless an amount equal to the remaining balance in the earnings and profits account were taxed at ordinary rates upon a disposition, the deferred tax could be avoided. On the other hand, precisely that result has traditionally been tolerated on stock redemptions from nonelecting corporations and perhaps the rule of subchapter S should not be harsher.⁸⁵ And, if at least certain redemptions are not to trigger the ordinary tax, perhaps certain stock sales should not either. In 1982, doubt over the proper resolution of these questions would have hampered the adoption of shareholder level accounts.

The acceptability of shareholder level accounts, however, has been greatly facilitated by the elimination of the highly preferential rate of tax on capital gains.⁸⁶ As long as essentially the same rate of tax is imposed upon ordinary income and capital gains, there is little practical significance of the resolution of those theoretically complex questions. Since recharacterizing a portion of the gain on a sale as ordinary income would not significantly alter the income tax consequences of the transaction, doubt concerning the propriety of the recharacterization cannot

⁸⁵ At the corporate level, a redemption is treated as a distribution of earnings and profits even though, at the shareholder level, the transaction is taxed as a sale. See I.R.C. § 312(n)(7).

⁸⁶ The Tax Reform Act of 1986, Pub. L. No. 99-514, § 301(a), 100 Stat. 2085, repealed the exclusion from tax of 60% of a capital gain previously extended by § 1202. However, § 302(a) of the Act added a new § 1(j) which limits the maximum rate of tax on a capital gain to 28%. Thus, capital gains will continue to be taxed at a lower rate of tax than other income during the transition phase-in of the new rate schedules.

be an obstacle to the adoption of shareholder level earnings and profits accounts. As it has throughout the Code, that 1986 reform greatly facilitates improving the rationality of subchapter S.

Regardless of the extent of the preference to which capital gains income is presently, or may in the future, be entitled, the outlines of the appropriate pattern for taxing dispositions of S corporation stock encumbered by a shareholder level earnings and profits account may readily be perceived. A similar problem is addressed by section 306 which contains a mechanism for preventing the avoidance of a deferred ordinary tax attributable to earnings and profits on the disposition of stock.⁸⁷ The stock in an S corporation having earnings and profits might be tainted in a manner similar to the operation of section 306 and, presumably, with similar exceptions. Thus, in general, on a sale or redemption of S corporation stock, ordinary income would be realized to the full extent of the remaining balance in the earnings and profits account unless the disposition amounted to a complete termination of interest in the corporation.

The result of such a taint, of course, would be that the shareholders in a corporation that elected under subchapter S could be subject to a higher rate of tax on the disposition of their stock than if S corporation status had not been elected. That tax, however, merely compensates for the deferral of the tax that could have been imposed at the time of making the election and thus would be entirely proper. Moreover, if the shareholders had an opportunity to purge the earnings and profits of the corporation at the time of election through the payment of a tax imposed at capital gains rates, it would seem entirely appropriate for the deferred tax to be imposed at the higher ordinary rate.⁸⁸

III. PURGING EARNINGS AND PROFITS: CARROTS AND STICKS

While the adoption of shareholder level S income and earnings and profits accounts would greatly improve subchapter S, as would permitting

⁸⁷ In general, § 306 taxes the gain on the disposition of preferred stock received as a dividend at ordinary income rates. The provision contains exceptions to this treatment that roughly correspond to the § 302(b) tests for sales treatment.

⁸⁸ The consequences of stock transfers by gift or in other carryover basis transfers could be resolved in either of two ways. Properly, the amount of the earnings and profits account should be taxed to the donor, who had benefited from the deferral of tax, at the time of transfer. Nevertheless, the policy of not recognizing gain on a gift is strong. As under § 306(c)(1)(C), the ordinary income taint could carry over with the stock basis.

Partial sales, of course, present further problems but, as in the case of gifts, the problems are of a practical, not a substantive, nature. Under § 306, the taint attaches on a per share basis; the sale of a fraction of the stock involved results in ordinary income taxation on a similar fraction of the earnings and profits on the relevant date.

a basis adjustment for corporate level borrowings, conduit level taxation would work best if all continuing elements of the taxation of C corporations were eliminated. That would require the complete purging of the earnings and profits account which Congress has been unwilling to do on a mandatory basis. There is no reason, however, to penalize S corporations without earnings and profits because other S corporations have earnings and profits.

In the 1982 revision of the distribution rules, Congress undertook to create a simplified set of rules governing corporations having no earnings and profits.⁸⁹ Nevertheless, in this and other areas of subchapter S, corporations that lack earnings and profits are penalized by rules designed to govern corporations that possess such an account. While the AAA, for example, is only relevant to S corporations with earnings and profits, the instructions to the S corporation information return require all S corporations to maintain such an account, perhaps because the account may become relevant upon the termination of the S election.⁹⁰ In addition, it has been argued elsewhere⁹¹ that Congress should be more willing to relax the excessively rigid definitional and procedural requirements for S corporations that do not have and could not obtain earnings and profits. For such a corporation, there is no justification for imposing more restrictive procedural or substantive rules than are applicable to partnerships.

On the other hand, the availability of a liberalized version of subchapter S for corporations lacking earnings and profits could allow more stringent treatment of corporations that have earnings and profits. For example, the odd compromise that led to the safe harbor debt provisions is most difficult to apply to corporations having earnings and profits.⁹² A dual subchapter S would permit the repeal of that dispensation for corporations having earnings and profits, and might also permit eliminating the one class of stock requirement for corporations without earnings and profits.

⁸⁹ I.R.C. § 1368(b); *see also* I.R.C. § 1375(a)(1) (tax on passive income only applies if corporation has C period earnings and profits).

⁹⁰ Under § 1371(e), certain distributions of cash following the termination of an S election are treated as tax-free returns of capital rather than ordinary dividends. However, that relief is only available for distributions that do not exceed the AAA. It is ironic that the AAA is relevant to an S corporation lacking earnings and profits only when it is no longer an S corporation.

⁹¹ Coven, *supra* note 67, at 271.

⁹² Under § 1361(c)(5), so-called safe harbor debt that would be treated as stock under general recharacterization principles cannot be treated as a second class of stock that would terminate the S election. The extent to which such debt may be treated as stock for other purposes is unresolved. However, the Treasury Department is unlikely to permit safe harbor debt to be used to avoid dividend treatment of corporate distributions.

If such a dual system were coupled with a reasonable mechanism for purging earnings and profits, many S corporations might choose to voluntarily subject themselves to tax in order to take advantage of the liberalized version. The problem of S corporations with earnings and profits might thus correct itself. In this context, the imposition of a tax along the lines of Professor Ginsburg's suggestion becomes appealing. A tax at capital gains rates on an amount equal to the earnings and profits of the corporation, accompanied by an equal increase in the bases of the shareholders' stock, might be viewed as an accelerated realization of a portion of the gain that would be realized upon liquidation. While a greater levy might well be justified in principle, the more limited tax would result in a deferral of tax on the unrealized gain in the corporate assets—not an unreasonable result.

Two categories of S corporations, then, could be created in order to accomplish the desired compromise of permitting tax-free entry into subchapter S while having a viable system of conduit taxation. Corporations with no earnings and profits that could not obtain earnings and profits because they could not engage in carryover basis transactions with C corporations would be subject to a substantively rationalized and procedurally simplified form of conduit taxation. Ideally, such a corporation could be taxed almost exactly as is a partnership and, after a quarter of a century, subchapter S might live up to its press releases. On the other hand, corporations that had earnings and profits and did not choose to eliminate that account through the payment of whatever toll charge might be deemed appropriate, would remain subject to a version of subchapter S, much like present law, that was designed to prevent manipulative abuses. The added complexity of two versions of subchapter S would be more than offset by the simplification that could be extended to both versions.

IV. AND THEN THERE WAS 1986

After repeatedly narrowing its scope, Congress determined in 1986 to repeal completely the so-called *General Utilities* doctrine.⁹³ Subject to the usual pesky transitional rules,⁹⁴ after 1986, appreciation in the value of corporate assets is subject to the corporate income tax when the assets are distributed from corporate solution or obtain a step-up in basis while remaining in corporate solution. To execute that reversal of policy, Congress repealed section 337 (which had exempted gains on

⁹³ *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935). Under the doctrine that has become associated with this case, corporations recognize no gain or loss on a distribution of property with respect to stock.

⁹⁴ See Pub. L. No. 99-514, § 633(d), 100 Stat. 2085.

sales of corporate assets incident to a taxable liquidation), reversed the rule of section 336 to impose a tax on the appreciation inherent in property distributed in a liquidation, and eliminated the portions of section 311 that had previously barred the imposition of a similar tax on some nonliquidating distributions of appreciated property.

The rigor with which the *General Utilities* doctrine was eradicated resulted in an unnecessarily harsh treatment of taxable asset acquisitions. When assets remain in corporate solution, the policy underlying the repeal only requires a corporate level tax if the assets are given a fair market value basis.⁹⁵ When a business is transferred by one corporation to another and the tax basis of the assets carries over to the acquiring corporation, it is unnecessary, indeed improper, to impose a corporate level tax on the asset transfer because the corporate level tax will be imposed upon a subsequent disposition of the acquired assets by the acquiring corporation. It might have been preferable for Congress to have permitted the transferor in an asset acquisition to continue to escape the corporate level tax if the acquiring corporation elects to carry over the basis of the acquired assets.⁹⁶ Precisely that flexibility is deliberately extended to taxable stock acquisitions. Pursuant to section 338, a corporation acquiring the stock of another has an election to either retain the tax attributes, including basis, of the assets of the acquired corporation or to obtain a step-up in the basis of those assets at the cost of a corporate level tax on the gain inherent in the assets of the acquired corporation.⁹⁷

A. Subchapter S and the Repeal of General Utilities

The repeal of the *General Utilities* doctrine required some modification of subchapter S. Previously, the corporate level tax was usually excused on income and gain realized after the making of the election. Absent extended to taxable stock acquisitions. Pursuant to section 338, a cor-some amendment, a subchapter S election would have become an avenue for avoiding corporate level tax on the gain inherent in the electing corporation's assets at the time of election—avoiding, that is, the burden of the *General Utilities* repeal. The logic of the repeal, coupled with the lack of a carryover basis election in asset acquisitions, might suggest that at the time of the making of a subchapter S election, a corporate level

⁹⁵ See ALI, FEDERAL INCOME TAX PROJECT, SUBCHAPTER C (1982).

⁹⁶ Elective treatment was proposed by the ALI and by the 1985 proposals of the Staff of the Senate Finance Committee. See STAFF OF SENATE COMM. ON FINANCE, 99TH CONG., 1ST SESS., THE SUBCHAPTER C REVISION ACT OF 1985 (Comm. Print 1985).

⁹⁷ I.R.C. § 338(a); see also Temp. Reg. § 1.338-4T(f)(6).

tax should be imposed upon the entire gain inherent in the assets of the electing corporation. Because the election effectively removes the assets from the reach of the corporate income tax, the making of the election could have been treated at the corporate level as a constructive distribution of all the assets of the corporation, even though it is not a taxable transaction at the shareholder level.

Such a tax, however, would offend the longstanding congressional policy of facilitating S elections by not imposing any significant tax burden upon the making of an election.⁹⁸ As a result, the entirely logical, but harsh, extension of the repeal of *General Utilities* was apparently not seriously considered.

Rather, Congress adopted a carryover basis solution for former C corporations;⁹⁹ no corporate tax is imposed at the time of election, and the basis of corporate assets carries over to the S corporation successor. A corporate tax is imposed, however, when the S corporation disposes of the assets it inherited from its C corporation predecessor.

Deferral of the corporate level tax, while not entirely consistent with the amendments to sections 336 and 337, is nonetheless entirely sound. The repeal of the *General Utilities* doctrine does not require imposition of a corporate tax when assets do not obtain a step-up in basis and remain subject to the corporate level income tax. A deferred corporate tax is consistent with section 338, and results in an adequate burden of taxation.

The implementation of the carryover basis concept adopted by Congress, however, is flawed. The deferral of the corporate tax on built-in gain required a blending of C corporation and S corporation concepts, which, as has uniformly been the case, was not successfully accomplished.

B. The Ideal Consequence of the Repeal

While Congress did not treat the making of a subchapter S election as a liquidation at the corporate level, the carryover basis alternative used instead merely defers the imposition of the corporate level tax, and thus should produce consequences that are compatible with the imposition of tax at the time of the making of the election. Since the gain inherent in the assets of a corporation contemplating an S election is a C corporation attribute, an immediate tax on the appreciation in those assets would be regarded as imposed an instant before the S election becomes effective.¹⁰⁰ As under a section 338 election, a step up of the basis of corporate assets to fair market value would be a necessary

⁹⁸ See *supra* text accompanying note 9.

⁹⁹ I.R.C. § 1374.

¹⁰⁰ Compare I.R.C. § 338(a).

corollary of the tax. The tax would have no effect on the shareholders of the electing corporation; the basis for their stock would not be altered. The income recognized at the corporate level, however, would result in an increase in the C corporation's earnings and profits, which, under the existing pattern of taxing S corporations, would carry over to the S corporation.

There would be two salutary consequences of this treatment. First, C corporation and S corporation tax concepts would be integrated as under the existing statutory pattern. As described above,¹⁰¹ the C corporation history carries over to the S corporation through the continuation of the earnings and profits account. The potential double taxation that the earnings and profits account represents is realized only when the S corporation makes distributions traceable to that account. Had Congress implemented the *General Utilities* repeal by treating a C corporation's S election as a constructive liquidation, the double tax burden imposed on gain built in at the time of election would have been treated like any other income or gain realized before the election.

Second, under such a pattern of taxation, the shareholder level tax would be imposed upon the increase in the value of corporate assets in the same manner as that tax is imposed upon nonelecting C corporations. Thus, if the S corporation made distributions in excess of the income accumulated after the making of the election (that is, distributions in excess of the accumulated adjustments account), the excess would be taxable as an ordinary dividend. If the shareholders realized the appreciation through a disposition of their stock, in contrast, they would be taxed on the disposition because the corporate level tax would not have been reflected in the basis of their stock. Similarly, C corporation shareholders are not taxed until appreciation in the value of the corporation is realized by either a distribution or a sale.

C. Actual Consequences of Repeal

The 1986 amendments to subchapter S that were designed to curb avoidance of the *General Utilities* repeal instead produced very different results. Under amended section 1374, when an S corporation disposes of any asset held on the date of its S election, gain is taxed to the corporation to the extent of the gain inherent in the asset when the election took effect. That much is entirely consistent with the carryover basis approach to the repeal of the *General Utilities* doctrine.

The deferred gain and the corporate tax on it, however, were not made part of the C corporation history of the S corporation. Instead, in applying the regular regime for taxing current income of an S corporation, the

¹⁰¹ See *supra* text accompanying notes 10-13, 49-50.

gain is also included in shareholder gross income.¹⁰² Since the shareholders of S corporations are taxed on income recognized at the corporate level without regard to actual distributions, the pattern of taxation adopted under section 1374 imposes immediate double taxation on the built-in gain even though no recognition event occurs at the shareholder level.

This imposition of double taxation without regard to actual distributions is inconsistent with the pattern of taxing either S corporations or C corporations, and is substantially harsher than either pattern. Shareholders of an S corporation are taxed on corporate income whether or not distributed—but only once. Income of C corporations is subject to two levels of taxation—but the second is imposed only when distributions are received or stock is sold. Only shareholders of S corporations that have built-in gains are subject to two levels of taxation without regard to distributions or stock sales. As a result, section 1374 creates a new and inexplicably harsh pattern of taxation.

This novel pattern of taxation has created a highly undesirable discontinuity between the taxation of C corporation gain recognized before and after the making of an S election. The sale of an asset immediately prior to the election results in the usual corporate level tax, and an increase in earnings and profits, which, in turn, will be taxed to shareholders when distributed from that account. A sale of the asset immediately after the election, however, results in instantaneous double taxation. Such a discontinuity is inconsistent with the policy underlying the *General Utilities* repeal of eliminating radically different burdens of taxation upon continuing and liquidating corporations.

Moreover, the approach of section 1374 is undesirable because it creates a second method for integrating C period and S period tax attributes. Prior to 1987, C period accumulated income was taxed to the S corporation shareholders through the distribution priorities of section 1368. The 1986 changes continue that pattern for income and gain recognized before the election, but income and gain that is recognized after the S election but is attributable to C period activities is taxed very differently under section 1374. Since section 1368 is itself defective, the addition of a second—and more defective—integration technique has materially impaired the integrity and usefulness of subchapter S.

D. Proposed Revision of Section 1374

The mechanism for preventing avoidance of the *General Utilities* repeal through S elections is inappropriate, particularly because an appro-

¹⁰² Under § 1366(f)(2), the gain taxable to shareholders is reduced by the amount of the tax paid by the corporation.

priate mechanism is not difficult to conceive. Gain inherent in property inherited by an S corporation from a C corporation should be taxed at the corporate level when recognized, as it now is under section 1374. There is no justification, however, for immediately subjecting the gain to a second tax in the normal operation of subchapter S. Rather, (1) the gain, reduced by the corporate tax on it, should be added to earnings and profits, and (2) neither the AAA nor the shareholders' basis for their stock should be adjusted for the gain or the tax. This procedure would delay the shareholder level tax until the gain is distributed or stock is sold.

Such a pattern of taxation would eliminate the existing defects of section 1374. Pre- and post-election gain would be taxed alike, and in a manner consistent with both the pattern of taxing C corporations and the integration of C corporation and S corporation tax concepts previously accomplished under subchapter S. The excessive harshness of section 1374 would be eliminated.

Section 1374 was hurriedly drafted by the conference committee on the 1986 Act,¹⁰³ and is inconsistent with all preceding legislative proposals. The House bill, which proposed the repeal of the *General Utilities* doctrine, would have imposed double taxation upon S corporations that had converted from C corporation status only if the corporation were liquidated within three years after the S election took effect.¹⁰⁴ Even that measure of double taxation, however, was accomplished through a retroactive termination of the S election, thereby imposing a shareholder tax, if at all, only under the rules for C corporations. The Senate contribution to the 1986 legislation did not contain the House's repeal of *General Utilities*. In the preceding year, however, the Staff of the Senate Finance Committee had proposed a revision of subchapter C which included repeal of the *General Utilities* doctrine. Under the Staff's proposal, double taxation of gain inherent in the assets of a C corporation predecessor was accomplished through the computation of the shareholder's basis for his stock.¹⁰⁵ In general, the proposed bill would have denied an increase in the basis of S stock for the after-tax income or gain recognized by an S corporation attributable to pre-election appreciation. Accordingly, a second level tax would only have been imposed with respect to such a gain when the S corporation made distributions to shareholders in excess of the basis for their stock.

¹⁰³ H.R. REP. NO. 841, 99TH CONG., 2D SESS. II-203 (Conf. Rep. 1986).

¹⁰⁴ H.R. 3838, 99TH CONG., 1ST SESS. § 334 (1985).

¹⁰⁵ STAFF OF SENATE COMM. ON FINANCE, 99TH CONG., 1ST SESS., THE SUBCHAPTER C REVISION ACT OF 1985, at 181-86 (Comm. Print 1985) (proposed amendment to § 1367).

Neither of these proposals may have been sufficiently rigorous. Nevertheless, the general concept underlying each proposal—that a second tax should not be imposed absent a distribution or stock disposition—was sound and inconsistent with the solution adopted by the conference committee.

If subchapter S were not otherwise amended, as it has been argued above that it should be, the revision of section 1374 suggested here could be implemented with no technical difficulties. Gain attributable to pre-election appreciation in corporate property as currently measured under section 1374, less the tax attributable thereto, would increase the corporation's earnings and profits as that gain was recognized. To that extent, the gain would not be included in the income otherwise allocable to the shareholders, and thus would not affect the basis of the stock.

These changes, however, would greatly aggravate the problem of discriminating between distributions of earnings and profits, on the one hand, and income recognized under the S election, on the other. If recognized built-in gains increased earnings and profits rather than the AAA, it would become far more likely that distributions would exceed the first tier allowance and be characterized as second tier distributions of earnings and profits. Accordingly, if section 1374 were rationalized, it would become more important than at present to rationalize the section 1368 treatment of subchapter S distributions.

Amending section 1374 would not complicate the conversion of the present corporate level AAA to individual shareholder level accounts. The carryover basis approach of section 1374, however, does complicate the conversion of earnings and profits to shareholder level accounts. The additions to earnings and profits presently in question would be recognized subsequent to the making of the S election. Had a corporate level tax been imposed when the S election took effect, the increase in earnings and profits would have been allocated among shareholders on that date. That result would be proper because the increase is attributable to gain inherent in the corporate assets at the time the election was made. Arguably, the deferral of the corporate tax through the carryover basis should not alter the earnings and profits allocation. Further, allocating earnings and profits to post-election shareholders would appear inconsistent with the purposes for shareholder level earnings and profits accounts. One of the principal reasons for shareholder level accounts is to prevent the allocation of pre-election earnings and profits to individuals who became shareholders after the S election is made.

Nevertheless, since the carryover basis that survives the election can defer the corporate level tax for several years, it becomes a practical impossibility to allocate the earnings and profits generated by the imposi-

tion of that tax to shareholders on the date of the making of the election. Rather, the earnings and profits must be added to, or perhaps create, shareholder level accounts of shareholders on the date that the earnings and profits are recognized. That allocation would not achieve theoretical perfection. The present corporate level earnings and profits account, however, supports dividend treatment of distributions to shareholders investing in the corporation after an S election becomes effective, and an allocation of earnings and profits from built-in gains to individual accounts of those same shareholders is, at least, no worse.

As suggested above with respect to the elimination of earnings and profits accounts in general,¹⁰⁶ at a very minimum, an election should be provided permitting an S corporation to purge its C corporation tax attributes and thereby become subject to an improved pattern of taxing S corporations. In the present context, that approach requires permitting a corporation making an S election to further elect to pay a corporate level tax on the appreciation in its properties,¹⁰⁷ and step-up the assets' bases to fair market value. Corporations so electing would be freed from section 1374, whatever form it might assume. Shareholders of corporations that do not utilize this election, but instead retain a carry-over basis for the S corporation assets, would remain subject to a deferred corporate level tax and the complexities and theoretical imperfections that such a tax entails. It is to be hoped, however, that the imperfections do not include the punitive double tax contained in the present version of section 1374.

V. CONCLUSION

Because the 1986 Act makes the highest marginal tax rate for C corporations materially higher than the maximum rate applicable to individual taxpayers (including S shareholders), the usage of subchapter S by corporations having earnings and profits will inevitably increase substantially. It thus becomes correspondingly more important to develop a rational approach to the taxation of such corporations and their shareholders. It has been demonstrated here that the continuing use of entity based concepts within subchapter S impairs the rationality of its pro-

¹⁰⁶ See *supra* text accompanying notes 89-93.

¹⁰⁷ Since the shareholders of an S corporation obtain no tax benefit from a step-up in the basis of goodwill and similar intangibles, it seems unnecessary to require that a corporate level tax be paid on the appreciation in value of such nondepreciable intangibles. In fact, unless that element of gain were exempt from an immediate tax, the election to accelerate that tax would rarely be feasible. Compare ALI, FEDERAL INCOME TAX PROJECT, SUBCHAPTER C, PROPOSAL C2, at 120-26 (1982).

visions and increases their complexity. At the very least, those provisions should be replaced with concepts that are compatible with a conduit system of taxation. Ultimately, however, the development of a true conduit corporate tax will require the complete insulation of the S corporation from its C corporation history on either a mandatory or voluntary basis.