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The Subchapter S Revision Act: An Analysis and Appraisal

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THE SUBCHAPTER S REVISION ACT: AN ANALYSIS AND APPRAISAL

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I. INTRODUCTION	571
II. A QUESTION OF SEMANTICS	573
III. QUALIFICATION, ELECTION, AND TERMINATION	574
A. <i>Eligibility</i>	575
1. Maximum Number of Shareholders	575
2. Permissible Shareholders	578
3. One Class of Stock	584
a. Voting Rights	584
b. Consequences of Reclassifying Purported Indebtedness	585
c. Other Issues	592
4. Ineligible Corporations	592
B. <i>Election</i>	593
C. <i>Termination</i>	596
1. Revocation	596
2. Passive Investment Income	599
3. Other Terminations	604
4. Effective Date of Termination	605
5. Inadvertent Terminations	609
D. <i>New Planning Possibilities</i>	613
IV. COMPUTATION OF INCOME	616
A. <i>Prior Law</i>	616
B. <i>Under the Revision Act</i>	622
1. Overview: Subchapter S's Place in the Sun	622

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2.	Computing S Corporation Income	624
a.	In General	624
b.	Separate Statement	628
c.	Characterization of Income	630
d.	Elections	632
e.	Ceilings	635
f.	Foreign Income	636
3.	Timing and Shifting of Income	638
a.	In General	638
b.	Special Allocations	647
c.	Allocations of Income Among Family Members	651
d.	Related Taxpayer Transactions	657
V.	LOSSES	660
A.	<i>Prior Law</i>	660
B.	<i>Under the Revision Act</i>	662
1.	In General	662
2.	Effect of Corporate Debt	665
3.	Shareholder Guarantors	669
4.	Section 465	670
VI.	CAPITAL GAINS AND "ONE-SHOT" ELECTIONS	673
VII.	CORPORATE DISTRIBUTIONS	676
A.	<i>Prior Law</i>	676
B.	<i>Under the Revision Act</i>	679
1.	In General	679
2.	Non Pro Rata Distributions	686
3.	Distributions of Pre-1983 Subchapter S Income	689
4.	Tax-Exempt Income	692
5.	Planning for Shareholder Retirements	694
6.	Critique	698
C.	<i>Eliminating Accumulated Earnings and Profits</i> ..	699
D.	<i>Distributions of Appreciated Property</i>	702
E.	<i>The "Post-Termination Transition Period"</i>	706
VIII.	RELATIONSHIP OF SUBCHAPTER S TO SUBCHAPTER C ..	711
A.	<i>Dividend Equivalence and Stock Attribution</i>	712
B.	<i>Redemptions Subject to Section 311(d)</i>	714
C.	<i>Liquidation of S Corporations</i>	715
1.	Section 337	716
2.	Section 333	719
D.	<i>S Corporations as Stockholders in Liquidating Corporations</i>	720
IX.	OIL AND GAS AND OTHER NATURAL RESOURCE ACTIVITIES	722
X.	OTHER CHANGES AFFECTING S CORPORATION STATUS ..	726
A.	<i>Qualified Deferred Compensation Plans</i>	727

1983]	SUBCHAPTER S REVISION ACT	571
	B. <i>Other Employee Benefits</i>	728
	C. <i>Tax Rates</i>	731
XI.	ENTITY AUDITS	733
	A. <i>Prior Law</i>	733
	B. <i>The New Entity Audit Provisions</i>	734
XII.	CONCLUSION	740

I. INTRODUCTION

In 1958 Congress enacted a wide range of legislative changes designed to encourage the growth of small businesses.¹ That legislative package included a variety of amendments to the Internal Revenue Code (the "Code") designed to reduce the burden of taxation on new or relatively small business units.² Perhaps the most widely known of these provisions was Subchapter S.³ Congress' primary objective in passing Subchapter S was to eliminate the double tax burden on closely held corporations on an elective basis.⁴ Secondarily, some of the attributes of partnership taxation were to be applied to a Subchapter S corporation, including the ability of its shareholders to claim corporate losses directly on their individual returns and the ability to make distributions to shareholders without the imposition of tax.

Although a substantial number of corporations elected to be taxed under these new provisions,⁵ Subchapter S could not be regarded as an unmitigated success. The pattern of taxing Subchapter S corporations fell somewhere between the taxation of corporations and the taxation of partnerships, creating a third system for the taxation of business enterprises that in many respects was more confusing than either. Furthermore, both Congress and the Treasury Department remained somewhat suspicious of their new creation. In order to prevent an undue extension of the relief pro-

1. For non-tax legislation, see, *e.g.*, Small Business Investment Act of 1958, Pub. L. No. 85-699, 72 Stat. 689; Act of July 18, 1958, Pub. L. No. 85-536, 72 Stat. 384 (amending the Small Business Act of 1953, Pub. L. No. 83-163, tit. II 67 Stat. 232); and Act of Aug. 28, 1958, Pub. L. No. 85-800, 72 Stat. 966.

2. The Small Business Tax Revision Act of 1958, Pub. L. No. 85-866, tit. II, 72 Stat. 1676, added to the Code the following sections, among others: § 1244 (losses on small business stock), § 179 (first year depreciation) and § 6166 (extension of estate tax). The Technical Amendments Act of 1958, Pub. L. No. 85-866, tit. I, 72 Stat. 1606, added I.R.C. §§ 1242-43 and 341(e) as well as Subchapter S.

3. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1606, 1650.

4. See text accompanying notes 153-67 *infra*.

5. In 1980, 545,389 corporations filed tax returns as Subchapter S corporations. U.S. TREAS. DEPT., STATISTICS OF INCOME, CORPORATION INCOME TAX RETURNS 63 (1980).

vided by Subchapter S, Congress and the Treasury Department enacted a series of statutory and regulatory provisions which tightly restricted the definition of a Subchapter S corporation and its operation. In practice, however, these provisions made it enormously complex, and thus expensive, to operate a business under Subchapter S. Indeed, Subchapter S became a virtual minefield, and an unacceptably large number of taxpayers encountered disaster in attempting to negotiate its boundaries. It was not at all uncommon for businesses, even acting with the advice of tax professionals, to emerge from an encounter with Subchapter S having paid more tax than would have been imposed had the election not been made.

Over the last decade, the definitional sections of Subchapter S have been repeatedly amended in order to expand the availability of its provisions and to eliminate several of the more pointless "traps for the unwary."⁶ At the same time, Congress began to study the operational provisions of Subchapter S with a view towards simplifying their application.⁷ All of this activity has now culminated in the Subchapter S Revision Act of 1982 (the "Revision Act").⁸ All aspects of Subchapter S corporations have been completely changed under the Revision Act. It has expanded and liberalized the definitional requirements of a Subchapter S corporation, thus making it far more desirable for a large number of small businesses. In addition, the Revision Act has brought the taxing of Subchapter S corporations far closer to the pattern of taxing partnerships and has eliminated many of the needless traps and restrictions. Without question, the normal operation of a Subchapter S corporation will be far simpler than under prior law. On the other hand, the Revision Act retained some of the most significant differences that existed under prior law between partnerships and Subchapter S corporations, thus perpetuating, albeit in diminished form, its hybrid character. Moreover, the substantive simplification achieved was only at the price of a substantial increase in both the length and complexity of the statutory provisions themselves.

This article will explore the changes effected in the taxation of Subchapter S corporations by the Revision Act. In many cases, however, the new provisions are ambiguous and, occasionally, ap-

6. See notes 19-21, 33-46, and 58 *infra* and accompanying text.

7. See JOINT COMMITTEE ON TAXATION, 96TH CONG., 2ND SESS., STAFF RECOMMENDATIONS FOR SIMPLIFICATION OF TAX RULES ON SUBCHAPTER S CORPORATIONS (Comm. Print 1980) (hereinafter cited as STAFF REPORT). The STAFF REPORT contains in an appendix the comments of the Treasury Department on the recommendations. See also Chang, *Recommendations for Restructuring of Tax Rules Relating to Subchapter S Corporations: A Comparative Summary*, 34 TAX LAW. 403 (1981).

8. Pub. L. No. 97-354, 96 Stat. 1669.

parently misdrafted. The legislative history is surprisingly sparse and, at some points, inconsistent with the enacted legislation. Moreover, no significant regulations have been issued yet under the new provisions. As a result, many of the interpretations that we will offer must be regarded as tentative at best.

As this Article was being completed, the Chairman of the House Ways and Means Committee introduced the Technical Corrections Bill of 1983 ("TCB").⁹ Such legislation is normally enacted with few modifications. The TCB retroactively would amend the Revision Act, and other recent legislation affecting Subchapter S, in several minor respects. Unfortunately, the TCB leaves untouched the substantive inadequacies created by the Revision Act. The more significant provisions of the TCB are briefly described in the following pages.

II. A QUESTION OF SEMANTICS

Under prior law, the Code referred to a corporation that met certain of the requirements for electing to be taxed pursuant to Subchapter S as a "small business corporation"¹⁰ and referred to a corporation that actually elected to be taxed pursuant to those provisions as an "electing small business corporation."¹¹ This terminology was confusing in part because the simultaneously enacted section 1244 was entitled "Losses in Small Business Stock." Unfortunately, the definition of the small business referred to in section 1244 bore no resemblance whatsoever to the definition of the small business corporation referred to in Subchapter S. Perhaps for that reason, practitioners insisted on referring to an electing small business corporation as a "Subchapter S corporation." In some circles, however, such a corporation was referred to as a "tax option corporation." Under the Revision Act, Congress has made a partial bow to commercial usage but not without adding some modifications of its own. Henceforth, corporations electing under Subchapter S are "S corporations"¹² and all other corporations are "C corporations."¹³ This article will refer to electing corporations as "S corporations" but will not use the designation "C corporation." Non-electing corporations will simply be so described.

9. H.R. 3805, 98th Cong., 1st Sess. (Aug. 4, 1983).

10. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64(a), 72 Stat. 1606, 1650 (enacting I.R.C. § 1371(a) (repealed)). Hereinafter, all provisions of the Internal Revenue Code, as they appeared prior to amendment by the Revision Act, are referred to as "Former I.R.C. §."

11. Former I.R.C. § 1371(b).

12. I.R.C. § 1361(a)(1).

13. I.R.C. § 1361(a)(2).

III. QUALIFICATION, ELECTION, AND TERMINATION

When Congress somewhat tentatively introduced Subchapter S in 1958, it imposed excessively restrictive limitations upon the character of the corporations that were eligible to elect this new pattern of taxation. Those restrictions remained for almost two decades until the Tax Reform Act of 1976 initiated a landslide of liberalizing amendments.¹⁴ Since 1976, the definition of an eligible corporation has been expanded repeatedly in incremental steps, some of which, while expanding the definition of a Subchapter S corporation, also introduced substantial additional complexity to that definition. In the Revision Act, Congress has indicated its contentment with the present configuration of the definition of an S corporation for, in sharp contrast to the complete revision of the provisions governing the taxation of such corporations, little fundamental change has been made in the eligibility requirements. Notwithstanding this legislative inactivity, the definition of an S corporation cannot be regarded as fully matured. The requirements for the making of a Subchapter S election remain more restrictive than is necessary to accomplish the statutory objectives. It seems probable, therefore, that Congress will continue to expand the class of corporations eligible to make the election, and to simplify the eligibility requirements.

A second reason exists for anticipating a continuing liberalization of the definitional requirements of Subchapter S. In recent years, a growing consensus has emerged among tax specialists that the double taxation of corporations is both improper in principle and excessively distorting of economic behavior in practice.¹⁵ While political support for some measure of integration of the individual and corporate income taxes fluctuates,¹⁶ the respectability of eliminating the second level of tax at the election of the taxpayer has grown enormously since 1958. That Congress did not dramatically expand the availability of Subchapter S in 1982 is somewhat surprising. It seems probable that Congress will continue to support ad hoc expansions of the availability of Subchapter S.

While the basic structure of the definitional requirements of an S corporation has been continued largely intact from prior law, those definitions have been amended in a number of important

14. Pub. L. No. 94-455, 90 Stat. 1520 (1976).

15. See, e.g., C. MCCLURE, *MUST CORPORATE INCOME BE TAXED TWICE* (Brookings Institute 1979), and Comm. on Corporations, *Report on the Integration of Corporate and Individual Income Taxes*, 31 TAX LAW. 37 (1977).

16. Interest in integration has diminished since the adoption of the Accelerated Cost Recovery System of I.R.C. § 168. See Auerbach, *Whither the Corporate Tax?: Reform After ACRS*, 35 NAT'L. TAX J. 275 (1982).

respects. Among the most significant are the declaration of an interim cease fire in the war over the treatment of debt as a second class of stock and the elimination of the passive income restriction for newly formed corporations that elect to be treated as S corporations from the date of their organization. At the same time, unfortunately, new distinctions have been drawn between newly formed and preexisting S corporations.¹⁷

A. Eligibility

Following the somewhat confusing pattern of prior law, the Revision Act continues to distinguish between requirements for eligibility to elect Subchapter S status and circumstances that can cause a Subchapter S election to terminate¹⁸ and that distinction is followed here. Thus, under section 1361(b) five types of requirements are imposed upon a corporation's eligibility: a maximum number of shareholders, the type of permissible shareholders, a single class of stock, not belonging to an affiliated group, and not constituting a corporation entitled to certain special tax provisions.

1. Maximum Number of Shareholders

The most frequently amended provision of Subchapter S is that imposing a maximum limitation on the number of shareholders that an electing corporation may have. Beginning with a strictly defined limit of ten in 1958,¹⁹ the permissible size of an S corporation had expanded to a relatively liberally defined twenty-five under prior law.²⁰ The Revision Act increased the permissible number of shareholders to thirty-five.²¹

The Committee Reports²² suggest that Congress selected the number thirty-five because it conformed to the maximum number of public offerees that may be included in an unregistered sale

17. For another description of the Revision Act, see Meale, *Eligibility, Election and Termination under the Subchapter S Revision Act of 1982*, 11 FLA. ST. U. L. REV. 93 (1983).

18. Governed by I.R.C. § 1362(d).

19. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64(a), 74 Stat. 1606, 1650 (enacting I.R.C. § 1371 (a)(1)). The provision was first expanded in 1959. Act of Sept. 23, 1959, Pub. L. No. 86-376, § 2(a), 73 Stat. 699. See also Tax Reform Act of 1976, Pub. L. No. 94-455, § 902(a)(1), 90 Stat. 1520, 1608, and Revenue Act of 1978, Pub. L. No. 95-600, § 341(a), 92 Stat. 2763, 2843.

20. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 233(a), 95 Stat. 172, 250.

21. I.R.C. § 1361(b)(1)(A).

22. H.R. REP. NO. 826, 97th Cong., 2nd Sess. 7 (1982)(hereinafter cited as HOUSE REPORT), and S. REP. NO. 640, 97th Cong., 2nd Sess. 7 (1982)(hereinafter cited as SENATE REPORT), reprinted in 1983 U.S. CODE CONG. & AD. NEWS 3253.

of a security under Regulation D.²³ Obviously, however, a determination by the Securities and Exchange Commission as to when the public interest requires that a securities offering be registered has no relevance whatsoever to the proper size of an S corporation. Since the present ceiling, like its predecessors, is an arbitrary one, and appears needlessly restrictive, it is not unlikely that the thirty-five shareholder limitation, along with other eligibility requirements, will be liberalized further. Furthermore, as currently enacted, the definitional requirements do not, in fact, have the effect of limiting to thirty-five the number of shareholders an S corporation may have. As under prior law, husbands and wives are treated as a single shareholder for this purpose (regardless of whether they have a joint interest in the stock or file a joint income tax return) as are the estates of deceased spouses (regardless of the identity of their beneficiaries).²⁴ Moreover, section 1361(c)(2) permits a variety of trusts to be shareholders of an S corporation, either permanently or for limited periods of time. The trust itself, however, is not treated as the shareholder of the S corporation; either the creator or beneficiary of the trust is so treated.²⁵ Thus, if that individual is an S corporation shareholder in his individual capacity, the presence of one or more such trusts as shareholders does not increase the number of shareholders of the corporation for the purpose of the computation of the thirty-five shareholder maximum. As a result, while under the Revision Act an S corporation may not be owned by a great deal more than thirty-five separate economic interests, the actual maximum number of shareholders to whom income and loss must be allocated is in theory unlimited and may easily be double or even triple that number.

All of this elaborate computational detail in order to impose a not very onerous restriction, which itself has been repeatedly expanded, may be sharply contrasted with the definition of a partnership for income tax purposes which, of course, contains no limitation on the number of partners. The rationality of retaining any ceiling on the number of shareholders of an S corporation is doubtful. The original reason for limiting eligibility to elect under Subchapter S to corporations having a small number of shareholders is not entirely clear. In the same legislative package, Congress extended ordinary loss treatment to stock in another classification of small businesses which, in this case, was defined with reference to the corporate net worth and contained no limitation

23. 17 C.F.R. §§ 230.501-.506 (1982). Significantly, the number of offerees permissible under the various Rules in Regulation D is considerably larger than 35 and, under certain circumstances, is unlimited. *See* Rule .504.

24. I.R.C. § 1361(c)(1).

25. I.R.C. § 1361(c)(2)(B).

upon the number of shareholders.²⁶ Presumably Congress concluded in 1958 that the pattern of taxation provided by Subchapter S was uniquely appropriate for "incorporated partnerships" in which substantially all of the owners of the business also participated in management.²⁷ In addition, it appears that Congress regarded Subchapter S as an erosion of the tax base that was justified only insofar as it implemented a national policy of encouraging small business enterprise. Finally, Congress undoubtedly feared that the process of auditing Subchapter S shareholders would be substantially more complicated than was the auditing of a single corporate entity subject to the regular income tax at the entity level.²⁸

It is unclear whether any of these policy justifications for limiting S corporations are valid today. The expansion of the maximum number of shareholders to over thirty-five economic interests and perhaps over 100 individual shareholders has far surpassed any conception of an "incorporated partnership." This restrictiveness appears particularly inappropriate since publicly offered limited partnerships, which not uncommonly have more than 100 limited partners, are not only permissible but also can offer substantially greater tax reduction advantages to their limited partners than can an S corporation. Furthermore, the Commissioner's administrative difficulty in auditing Subchapter S corporations has been eliminated, as it has been in widely owned partnerships, by the adoption of an entity level audit procedure the results of which are binding on all shareholders unless they specifically notify the Commissioner of their intention to adopt an inconsistent position.²⁹ Finally, many would argue that the second level income tax imposed upon regular corporations constitutes an improper distortion of the allocation of taxation and that the pattern of taxation imposed under Subchapter S would be more appropriate for all corporations.

Furthermore, eliminating any ceiling on the permissible number of shareholders of an S corporation would not have the effect of making the option available to widely held corporations. The specter of an automobile manufacturing corporation making a "one shot" election in order to pass through a gigantic loss to thousands of shareholders could not occur. Other restrictions upon the making of a Subchapter S election, such as the requirement of unanimous shareholder consent and the inability to have corporations and most trusts as shareholders, together with the difficulty in most states of effectively restricting transfers of S corporation stock for the

26. I.R.C. § 1244(c)(3).

27. S. REP. NO. 1983, 85th Cong., 2nd Sess. 68 (1958), *reprinted in* 1958 U.S. CODE CONG. & AD. NEWS 4791, 4876.

28. STAFF REPORT, *supra* note 7, at 9.

29. See text accompanying notes 479-503 *infra*.

purpose of preventing disqualification,³⁰ effectively preclude the use of Subchapter S by widely owned corporations. Indeed, it is unlikely that the managers of many corporations in the intermediate range of 100 to 200 shareholders would choose to proceed under Subchapter S. No reason appears, however, why those relatively few corporations should not be entitled to avail themselves of the advantages offered by Subchapter S.

2. Permissible Shareholders

As under prior law, an S corporation may have among its shareholders only individuals, estates, and certain specified trusts and may not have a non-resident alien stockholder.³¹ To prevent avoidance of the rule excluding nonresident alien stockholders, the Revision Act expressly excludes foreign trusts from the category of permissible shareholders of an S corporation.³²

The provisions of present law governing the types of trusts that constitute permissible shareholders of an S corporation have undergone a virtual explosion of statutory detail since 1976, when trusts were first permitted to become shareholders of Subchapter S corporations.³³ The Revision Act continues the description of the types of trusts that are eligible shareholders of an S corporation from prior law without modification, except for several minor changes in the definition of the "Qualified Subchapter S Trust" set forth in section 1361(d).³⁴ Since the trust provisions appear excessively restrictive, and are of relatively recent origin, it is probable that this aspect of the definition of an S corporation will also undergo further amendment. The types of trusts that are permitted to be shareholders consist of: (a) a grantor trust,³⁵ including, for a limited period of time, a trust which was a grantor trust on the date of the death of the grantor;³⁶ (b) any trust that receives stock

30. Some states permit such restrictions by statute. *See, e.g.*, DEL. CODE ANN. tit. 7, § 202(d)(1974).

31. I.R.C. § 1361(b)(1).

32. I.R.C. § 1361(c)(2)(A)(flush language).

33. Tax Reform Act of 1976, Pub. L. No. 94-455, § 902(c)(2), 90 Stat. 1520, 1609 (1976).

34. *See* text accompanying notes 38-46 *infra*.

35. I.R.C. § 1361(c)(2)(a)(i). To qualify, the entire trust must be treated as owned by an individual. The provision includes trusts, the income of which is taxable under I.R.C. § 678 to an individual other than the settlor.

36. I.R.C. § 1361(c)(2)(a)(ii). The period is 60 days unless the entire corpus of the trust is includible in the estate of the grantor in which event the period is two years. The special two-year period was added by the Revenue Act of 1978, Pub. L. No. 95-600, § 701(y), 92 Stat. 2763, 2921, and apparently was intended to conform the grace period to the average length of time necessary to administer an estate for those trusts that the grantor likely intended to be testamentary

of an S corporation pursuant to a will, but only for a sixty-day period;³⁷ (c) a voting trust; and (d) a "Qualified Subchapter S Trust" as defined in section 1361(d).

Only the last described trust constitutes a significant expansion of the limitation on permissible shareholders to individuals. Originally enacted as part of the Economic Recovery Tax Act of 1981,³⁸ the provision creating the "Qualified Subchapter S Trust" allows certain trusts to qualify as shareholders of S corporations at the election of the income beneficiary. For the trust to qualify, the income beneficiary must elect to be treated as the owner pursuant to section 678(a) of that portion of the trust consisting of the S corporation stock.³⁹ The effect of such an election, of course, is to substitute the beneficiary for the trust as the shareholder of the S corporation. The beneficiary, thus, must report an allocable share of the income and deductions of the S corporation on his tax return. Since the failure to elect⁴⁰ renders the trust ineligible to be an S corporation shareholder, and thus prevents or terminates the corporation's selection, the mechanics of this election are criticized below in connection with the S election itself.⁴¹

Section 1361(d) is excessively restrictive. While the Revision Act contains several minor liberalizing amendments to the definition of Qualified Subchapter S Trust, the class of trusts that can qualify remains quite small. Only a trust that distributes, or is required to distribute,⁴² all of its trust accounting income⁴³ currently

substitutes. H.R. REP. NO. 700, 95th Cong., 1st Sess. 52 (1977).

Of course, the estate of a deceased shareholder may remain a shareholder for an unlimited period of time. However, the Commissioner does have the power to treat the estate as terminated for federal income tax purposes if its administration is unreasonably prolonged. Treas. Reg. § 1.641(b)-3(a) (1960).

37. I.R.C. § 1361(c)(2)(A)(iii).

38. Pub. L. No. 97-34, § 234(b), 95 Stat. 172, 251 (1981) (enacting former I.R.C. § 1371(g)).

39. I.R.C. § 1361(d)(1).

40. I.R.C. § 1361(d)(2)(D) renders any election made pursuant to I.R.C. § 1361(d)(1) effective up to 60 days before the date of the election, in effect, giving the income beneficiary a 60-day grace period during which to elect. The TCB § 201(f)(1) would increase this grace period to seventy-five days.

41. See notes 109-11 *infra* and accompanying text.

42. The Revision Act added a clause to I.R.C. § 1361(d)(3)(B) to make it clear that a trust can qualify as a Qualified Subchapter S Trust so long as the trust instrument requires that all of its trust accounting income be distributed currently, even though all of the income is not, in fact, distributed. Thus, the S election of the corporation will not be jeopardized by the failure of the trustee to make the appropriate distribution. TCB § 201(f)(2) would limit qualification to those trusts that are required to distribute income currently, thus eliminating the possibility that, as long as all income was distributed currently, a trust would qualify even if the trust instrument granted the trustee authority to accumulate income. See text accompanying notes 49-50 *infra*.

43. The Revision Act added a clause to I.R.C. § 1361(d)(3)(B) to make clear

and has a single current income beneficiary may qualify. Moreover, the trust instrument must not permit trust assets to be distributable to any individual other than the income beneficiary during the beneficiary's life.⁴⁴ The provision, as originally enacted, precluded election by a trust that had more than one beneficiary following the death of the income beneficiary.⁴⁵ The Revision Act amended section 1361(d)(3)(C) to require a single beneficiary only during the lifetime of the current income beneficiary. Thus, the possibility of multiple beneficiaries after the death of the current income beneficiary no longer will disqualify the trust during the income beneficiary's lifetime.⁴⁶

that the word "income" for purposes of that subparagraph was to be defined by I.R.C. § 643(b).

44. I.R.C. § 1361(d)(3).

45. Former I.R.C. § 1371(g)(3).

46. SENATE REPORT, *supra* note 22, at 9. Such a trust would cease to be a Qualified Subchapter S Trust, and therefore, cease to be an eligible S corporation shareholder upon the death of the income beneficiary. Thus, the question arises whether any of the grace periods granted to other eligible trusts when their deemed owners die apply to allow the former Qualified Subchapter S Trust time to distribute or otherwise dispose of the S corporation stock before its ownership of the stock causes a termination of the corporation's Subchapter S election. Congress apparently intended that at least the 60-day grace period allowed to such trusts by I.R.C. § 1361(c)(2)(A)(ii) apply to a Qualified Subchapter S Trust. Indeed, the Senate Report states that it does apply. Unfortunately, while such a grace period is clearly desirable it is not entirely clear that the statute, as enacted, grants it.

Under the Revision Act, the trust will become disqualified following the death of the income beneficiary if it no longer meets the definitional requirements of I.R.C. § 1361(d)(3). That would result, for example, if it had more than one current beneficiary. Further, I.R.C. § 1361(d)(4) unequivocally states that the trust ceases to qualify immediately when it no longer meets the requirements of I.R.C. § 1361(d)(3). This provision seems excessively harsh, since it will cause the trust immediately to become an ineligible shareholder, which, in turn, will cause an immediate termination of the corporation's Subchapter S election. The comment in the Senate Report seems to be a reference to I.R.C. § 1361(d)(1)(A), which provides that a Qualified Subchapter S trust, as to which a valid election has been made, is to be treated as a trust described in I.R.C. § 1361(c)(2)(a)(i), the provision dealing with grantor trusts. The grace periods of I.R.C. § 1361(c)(2)(A)(ii) expressly apply to such trusts on the death of the grantor or other deemed owner. However, the statute does not expressly provide that the grace period provision supercedes I.R.C. § 1361(d)(4) when the two conflict. Nor is it clear that this ambiguity can be resolved without further legislation.

Similar language appeared in the legislative history of the Economic Recovery Tax Act of 1981, which first added the Qualified Subchapter S Trust to the law. S. REP. NO., 144, 97th Cong., 1st Sess. 91 (1981), *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 105, 195. However, under the 1981 provisions the election terminated at the death of each income beneficiary and had to be made again by the successor beneficiary. Thus, the statement could have been intended only to grant a 60-day grace period to the new beneficiary to make a new election as to a trust that continued to meet the requirements of I.R.C. § 1361(d)(3). Such an interpretation would cause no conflict between the grace period provision and

It is regrettable that Congress did not go further in eliminating the restrictions on the Qualified Subchapter S Trust. The legislative history of the Economic Recovery Tax Act of 1981 indicates only that the predecessor to section 1361(d) was added to facilitate the use of Subchapter S corporations by more businesses.⁴⁷ The provision does, in fact, permit the making of gifts of S corporation stock to individuals to whom the transferor-shareholder would not want to give the stock outright, either because the shareholder wishes to place voting power and legal title in the hands of a trustee (for example, if the beneficiaries were minor children or grandchildren)⁴⁸ or because the shareholder wishes to give one donee an income interest in the S corporation stock, but wishes the stock itself ultimately to pass to others.⁴⁹ In order to preserve the corporation's Subchapter S election, however, the shareholder must create a separate trust for each current income beneficiary. Furthermore, while the trust instrument apparently may give the trustee discretion to accumulate income without precluding an election under section 1361(d), the exercise of such discretion while the trust owns S corporation stock will terminate the corporation's election under Subchapter S. Since the trust no longer will be one that either distributes, or is required to distribute, all of its fiduciary

I.R.C. § 1361(d)(4). Under the new law, however, such a grace period is unnecessary since the initial election remains in effect unless the successor beneficiary affirmatively refuses to consent. I.R.C. § 1361(d)(B)(ii).

The statement in the Senate Report to the Revision Act raises another question. I.R.C. § 1361(c)(2)(A)(ii) provides for two grace periods, the 60-day period referred to in the Report and a two-year period for trusts the entire corpus of which is includible in the estate of the deemed owner. The statute clearly mandates application of the two-year grace period when the entire corpus of the Qualified Subchapter S Trust is includible in the estate of the income beneficiary, as would be the case, for example, if the income beneficiary had a general power of appointment over the corpus. The reference in the Senate Report to the 60-day grace period leaves unclear whether Congress intended the two-year period to apply.

47. S. REP. NO. 144, 97th Cong., 1st Sess. 91 (1981), *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 105, 195.

48. It appears that a trust created pursuant to I.R.C. § 2503(c) is eligible to be a Qualified Subchapter S Trust, provided, of course, that a legal representative is appointed for the minor beneficiary and the representative makes the election required by I.R.C. § 1361(d)(2). However, under the Revision Act there is some risk in granting the trustee discretion to accumulate income during the minority of the beneficiary, a standard aspect of such trusts. But, under the TCB, granting the trustee such discretion would preclude qualification of the trust as a Qualified Subchapter S Trust. *See* note 42 *supra*.

49. One of the laudable results of the change permitting multiple beneficiaries following the death of the current income beneficiary is that the new qualified terminable interest trust permitted under the federal estate tax marital deduction provisions (I.R.C. § 2056(b)(7)) is eligible to be a Qualified Subchapter S Trust. Of course, the surviving spouse must make the appropriate election pursuant to I.R.C. § 1361(d).

accounting income currently, it no longer will be a Qualified Subchapter S Trust. Section 201(f)(1) of the TCB would eliminate even this flexibility by limiting qualification to those trusts that are required to distribute their income currently. The drafters of the TCB undoubtedly introduced this provision to eliminate the power of the trustee of an accumulation trust to terminate unilaterally the corporation's S election. Such a device permits termination of the Subchapter S election without compliance with the revocation procedures of section 1362(d)(1) and therefore should not be permitted. While section 201(f)(1) of the TCB thus renders the qualification and termination provisions internally consistent, it does so at the cost of an additional undesirable restriction on the class of trusts that may be S corporation shareholders. The beneficiary must elect to be treated as the owner for purposes of section 678(a) of the S corporation stock held by the trust before the trust can be a Qualified Subchapter S Trust;⁵⁰ therefore, the income therefrom will be taxed to him whether or not it is distributed to him. It is unclear why the power to accumulate should preclude qualification. Lastly, the limitations on accumulation and discretionary distributions to other beneficiaries apparently are not confined to the portion of the trust composed of S corporation stock. In this respect, paragraphs (1) and (3) of section 1361(d) appear inconsistent. The income beneficiary clearly is to be treated as the owner of only that portion of the trust that consists of S corporation stock. The paragraph defining a Qualified Subchapter S Trust, however, speaks in terms of the whole trust.

The difficulty with the Qualified Subchapter S Trust as thus restricted is that it does not comport with the normal estate planning desires of most individuals who would wish to place their S corporation stock in trust.⁵¹ A trust that permits discretionary distributions among beneficiaries according to their needs rather than according to a preconceived formula provides the greatest flexibility in family estate planning. The restriction applicable to Qualified Subchapter S Trusts prohibits placing the stock of an S corporation in such a trust and, thus, creates an unnecessary inflexibility in family estate planning. Since Congress could have achieved its legitimate objectives without imposing such severe

50. I.R.C. § 1361(d)(1)(B).

51. The estate planning opportunities available to S corporation shareholders through the use of trusts under current law are discussed in Huffaker and Doering, *Opportunities and Problems with Sub S Holdings of Estates and Trusts*, J. TAX 130 (1983); Kanter, *To Elect or Not To Elect Subchapter S—That Is a Question*, 60 TAXES 882, 885-906 (1982); and Report of the Committee on Pre-Death Estate Planning, *Estate Planning After 1982 For the Subchapter S Shareholder*, 17 REAL PROP. PROB. AND TR. J. 724, 731-36 (1982).

restrictions, it is hoped that the definition of Qualified Subchapter S Trust will be expanded in time.

Apparently, there are two purposes for this series of restrictions. Requiring a single beneficiary effectively prevents using the trust device to expand the beneficial ownership of an S corporation beyond the thirty-five shareholder limitation. Of course, Congress could have prevented that result in a more flexible manner by counting each beneficiary of the trust as a shareholder as is done with respect to voting trusts.⁵² Secondly, requiring a single beneficiary of the trust prohibits the use of a trust to accomplish a special allocation of items of income and expense incurred by the corporation. One of the restrictive features of prior law that is continued under the Revision Act is the prohibition against an S corporation specially allocating items of income and expense among its shareholders although either a partnership or a trust⁵³ may do so. That aspect of the Revision Act is criticized below;⁵⁴ nevertheless, it remains a feature of the pattern of taxing S corporations. S corporations could easily circumvent the prohibition against their allocating expenses by causing the stock of the corporation to be held by a trust having multiple beneficiaries.

The justification for prohibiting special allocations in S corporations and, *a fortiori*, through Qualifying Subchapter S Trusts is tenuous. Special allocations generally are criticized on two grounds: they introduce needless complexity into the computation of the taxable income of the S corporation and they are abusive and, therefore, should be eliminated as a matter of tax policy. A special allocation permitted in a trust instrument, however, affects only the computation of trust income and, thus, would not increase the complexity of the computation of income and expense by the S corporation itself. Secondly, because it prohibits special allocations, the S corporation is unique among conduit taxation entities. Given appropriate restrictions on such abusive allocations as the retroactive allocation popularized by the tax shelter industry,⁵⁵ special allocations are not improper as a matter of income tax policy. Permitting the flexibility normally incident to trust taxation would introduce desirable flexibility in the taxation of S corporations.

If Congress remains adamantly opposed to the avoidance of the prohibition against special allocations, it could prohibit trusts which have multiple beneficiaries and also require, or grant the trustee discretion to make, special allocations, from being

52. I.R.C. §§ 1361(c)(2)(A)(iv) and (B)(iv).

53. I.R.C. § 704(a); Treas. Reg. §§ 1.652(b)-2, -3(1960), and 1.662(b)-1(1960).

54. See text accompanying notes 267-73 *infra*.

55. I.R.C. § 706(a) has established such restrictions for partnerships.

shareholders in S corporations. It was not necessary to bar trusts having multiple beneficiaries from being shareholders at all.

3. One Class of Stock

The seemingly straightforward requirement for electing Subchapter S status that the corporation have outstanding only a single class of stock⁵⁶ in order to elect Subchapter S status has precipitated the most extended and heated battle between taxpayers and the Commissioner under Subchapter S.⁵⁷ For no apparent reason, the Commissioner always has displayed an extraordinary inflexibility in the construction of the one class of stock requirement notwithstanding that the consequences of an unintentional violation of the requirement were extraordinarily harsh. The presence of a second class of stock not only would preclude a Subchapter S election but also would cause its termination.

Under the Revision Act, Congress liberalized the one class of stock requirement in two significant respects: disparities in voting rights are to be ignored, and some restrictions have been imposed upon the treatment of purported indebtedness as a second class of stock.

a. Voting Rights

Under prior law, a series of statutory⁵⁸ and regulatory⁵⁹ changes in the Commissioner's original position ultimately established that disparities in voting rights produced by the voluntary action of the shareholders did not create a second class of stock. Disparities mandated by the certificate of incorporation, however, did create a second class. Therefore, shareholder agreements, voting trusts and irrevocable proxies all became permissible and effectively emasculated the general prohibition. Since the apparent purpose of the one class of stock limitation was to prevent undue complexity in the allocation of corporate income among shareholders with differing economic interests,⁶⁰ there was no justification for the retention of the prohibition against disparities produced by the certificate of incorporation. This limitation has now been abandoned under section 1361(c)(4) and differences in voting rights among otherwise identical shares of common stock are to be ignored for the

56. I.R.C. § 1361(b)(1)(D).

57. See, e.g., Bravenec, *The One Class of Stock Requirement of Subchapter S—A Round Peg in a Pentagonal Hole*, 6 HOUS. L. REV. 215 (1968).

58. Former I.R.C. § 1371(e)(1)(D)(voting trusts).

59. Rev. Rul. 73-611, 1973-2 C.B. 312. *But see* Rev. Rul. 71-522, 1971-2 C.B. 316.

60. S. REP. NO. 1622, 83rd Cong., 2d Sess. 453-54 (1954).

purposes of the one class of stock requirement. The legislative history does not elaborate upon this new provision but there is no reason for the Treasury Department to construe it narrowly. Thus, it should be permissible either for specified classes of otherwise identical stock to bear a differing number of votes per share or for the corporation to establish different classes of stock with each class having the right to elect a specified number of the directors of the corporation. Indeed, it appears permissible to issue non-voting common stock and to vary the voting strength of the S corporation stock over time either by a recapitalization or by providing for the shift upon a contractually specified contingency.

b. Consequences of Reclassifying Purported Indebtedness

As described in greater detail below,⁶¹ under prior law, Subchapter S corporations, even more commonly than corporations subject to the regular income tax, issued debt instruments to their stockholders. Not uncommonly, the indebtedness arose as a result of a reinvestment of earnings only recently distributed to the shareholders and thus the holdings of the S corporation indebtedness often were roughly proportionate to stockholdings. Not too surprisingly, this configuration of investment in a closely held corporation precipitated frequent attacks by the Commissioner upon the purported indebtedness. The Commissioner alleged, under the usual debt-equity analysis,⁶² that, for tax purposes, the debt instrument should be reclassified as stock. If that reclassification prevailed, the Commissioner would argue further that because the reclassified indebtedness bore characteristics that differed from the corporation's common stock, the indebtedness constituted a second class of stock producing a termination of the Subchapter S election as of the beginning of the year in which the indebtedness was issued. The judicial attitude towards the Commissioner's argument was markedly unsympathetic, presumably because of the severity of the consequences of finding a second class of stock. Thus, some courts held that even though the purported indebtedness should properly be regarded for income tax purposes as a form of equity investment, it nevertheless would not be regarded as a second class of stock.⁶³ Even the Commissioner began to question the propriety of his position and announced that he no longer would litigate the issue of whether indebtedness constituted a second class of stock for the purpose of the definition of a Subchapter

61. See text accompanying note 348 *infra*.

62. Now embodied in I.R.C. § 385.

63. See, e.g., *Gamman v. Comm'r*, 46 T.C. 1 (1966), and *Portage Plastics Co. v. United States*, 486 F.2d 632 (7th Cir. 1973).

S corporation.⁶⁴ As a result of that concession, a peculiar de facto recognition was extended to investments in S corporations that quite closely resembled preferred stock.

The extended debate over the proposed regulations under section 385 has complicated the controversy over the proper treatment of reclassified indebtedness in an S corporation.⁶⁵ Section 385 expressly grants the Treasury Department the authority to issue regulations governing the circumstances under which purported indebtedness might be reclassified as stock. After repeatedly revising the regulations under that section, the Treasury Department recently proposed withdrawing them. Presumably, when regulations under section 385 are issued, they will be applicable to all corporations, including S corporations. Unfortunately, however, the Revision Act was fashioned while the proposed regulations were being hotly contested between taxpayers and the Treasury Department and their final form remained very much in doubt. As a result, the steps taken by Congress towards resolving the treatment of debt in an S corporation are both tentative and incomplete, and the full consequences of the issuance of debt by an S corporation will remain uncertain until regulations under both sections 385 and 1361 and, quite likely, further legislation, are adopted.

Notwithstanding the lingering uncertainties, Congress has taken a significant step towards preventing the loss of Subchapter S status by virtue of the issuance of debt by an S corporation. Under section 1361(c)(5), a debt instrument meeting the safe harbor requirements is not to be treated as a second class of stock even though under normal rules it would be reclassified as an equity investment. Fortunately for taxpayers, the safe harbor definition is both relatively simple and relatively liberal. Congress, in defining safe harbor debt in section 1361, borrowed the concept from the regulations to section 385 that straight debt should be relatively free from reclassification.⁶⁶ The definition of safe harbor debt contained in section 1361(c)(5)(D) appears similar to the definition of straight debt under section 385. For the purposes of the Subchapter

64. T.I.R. 1248 (July 27, 1973).

65. After over a decade of delay, final regulations to I.R.C. § 385 were issued on December 31, 1980 (T.D. 7747, 1981-1 C.B. 141). However, through a series of amendments to Treas. Reg. § 1.385-1(a)(1)(1980), the effective date of the regulations was postponed repeatedly. See T.D. 7744, 1981-1 C.B. 360; T.D. 7801, 1982-1 C.B. 60; and T.D. 7822, 31 I.R.B. 6. In the meantime, an entirely revised set of regulations was proposed on January 5, 1982. Finally, on July 6, 1983, the Treasury Department issued a proposed withdrawal, effective August 5, 1983, of both sets of proposed regulations.

66. See Treas. Reg. §§ 1.385-3(f) and 5(d)(1980).

67. See text accompanying notes 274-82 *infra*.

S rule, therefore, safe harbor debt includes any written unconditional indebtedness requiring repayment of a fixed sum of money, whether on demand or upon a specified maturity date. The interest rate and payment dates, however, must not be contingent on the profitability of the S corporation nor subject to change in the discretion of the S corporation, and the debt must not be convertible into S corporation stock.

Because no other factors pertaining to the indebtedness are to be taken into account in determining compliance with the safe harbor test, relative certainty that a second class of stock has not been created can be achieved. The safe harbor test contains no reference to the debt-to-equity ratio of the corporation, to the proportionality of the holdings of the debt to stock ownership in the corporation, to the degree of subordination, to the consideration for which the indebtedness was issued or to whether the interest rate payable is reasonable. The last enumerated omission is, of course, of substantial importance. While the interest rate specified presumably must be paid (absent, perhaps, insolvency) in order to comply with the requirement that the rate not be subject to the borrower's discretion or geared to profitability, an S corporation apparently remains free to establish an unreasonably low rate of interest without jeopardizing the availability of the safe harbor rule. The establishment of an unreasonably high or low interest rate, however, is not insulated by the safe harbor rule from attack under other provisions of the Code. For example, under section 1366(e), described below,⁶⁷ the Commissioner is empowered to make reallocations of income in the event a member of a shareholder's family furnishes capital to the corporation "without receiving reasonable compensation therefor."

If debt issued by an S corporation meets the safe harbor test, the Subchapter S election cannot be terminated for the reason that the indebtedness constitutes a second class of stock. That much, at least, is clear. On the other hand, because of the liberality of the safe harbor test, in some instances, debt meeting that test will nevertheless be regarded as equity under the more general rules of section 385.⁶⁸ The status of safe harbor indebtedness for other purposes under the Code remains highly uncertain. Both committee reports recognized this potential inconsistency and suggested that the Treasury Department issue regulations that would treat safe harbor indebtedness as indebtedness for other purposes of Sub-

68. The extent of this discrepancy depends upon the final form of the section 385 regulations. Under the proposed revision of those regulations, straight debt may be treated as stock because of the combined effect of an inadequate interest rate, an excessive debt to equity ratio, having been issued for property, being payable on demand, and being proportionately held. *See* Prop. Reg. § 1.385-6 [1983] STAND. FED. TAX REP. (CCH) ¶ 8904.

chapter S in addition to the second class of stock requirement even though the indebtedness would be treated as equity under section 385. Both reports contain the statement that "it is anticipated that the safe-harbor instruments will be treated as debt under Subchapter S, so that no corporate income or loss will be allocated to the instruments."⁶⁹ That statement in effect instructs the Treasury to create an exception to the general application of the regulations to section 385 for debt instruments meeting the safe harbor test of section 1361 for the purposes of the rules governing the allocation of income and expense to shareholders. Quite likely, the exception will be even broader. For example, because the Subchapter S rules governing distributions are related to the income allocation rules, it seems probable that the retirement of safe harbor debt will not be recharacterized as a dividend. In addition, it seems likely that interest paid on safe harbor debt will be deductible by the S corporation and thus by its shareholders. On the other hand, there is no basis whatsoever for any prediction of the position the Treasury Department will take on the treatment of such safe harbor debt instruments under provisions of the Code of general application.

If the debt instrument does not comply with the safe harbor rule, its characterization is to be determined under the general rules of section 385.⁷⁰ If under those rules the instrument would be reclassified as stock, the question would be renewed under present law of whether that reclassified indebtedness should be treated as a second class of stock. Although nothing in the Revision Act expressly overrules prior case law holding that a debt instrument that would be treated as stock under general reclassification rules nevertheless was not to be treated as a second class of stock, the Committee Reports imply that Congress intended its new safe harbor rule to be the exclusive avenue for avoiding that result.⁷¹ While a court might not regard itself as bound by such a statement in the Committee Report, Congress has provided a relatively liberal safe harbor rule for avoiding the consequences of a second class of stock and it is reasonable to anticipate that the courts will be inclined far more favorably towards treating reclassified indebtedness as a second class of stock under the present statutory scheme than they were under prior law. Accordingly, a substantial premium has been placed upon compliance with the safe harbor rules that Congress has provided.

At one stage in the one class of stock battle, the regulations

69. HOUSE REPORT, *supra* note 22, at 8, SENATE REPORT, *supra* note 22, at 8.

70. *Id.*

71. *Id.*

provided that if a purported debt instrument was held in substantially the same proportion as stockholdings, even if the debt instrument was reclassified, it would not be regarded as a second class of stock.⁷² The safe harbor rule of section 1361(c)(5) has not incorporated this approach. If a class of indebtedness does not meet the safe harbor rule but, nevertheless, is held proportionately to shareholdings, the debt instrument apparently will be treated as stock and as a second class of stock if it is so classified under section 385.

The exclusion of convertible debt from the safe harbor rule apparently was copied from section 385. However, the exclusion also impedes evasion of the general inability of an S corporation to specially allocate items of income and expense. In the case of partnerships, it has long been common for the interest of various classes of partners to shift upon the occurrence of a specified event, such as obtaining a pre-specified level of profitability.⁷³ This so called "flip-flop" permits allocation of all the losses of partnership to a specified class of investors until they have received a recovery of their investment whereupon the interests of other classes of partners, typically the promoters of the venture, automatically increase. Such a shifting of participation percentages is not permissible in an S corporation; however, the result of such a flip-flop can be approximated through the use of convertible securities. The promoters could obtain convertible indebtedness which they would be obligated not to convert until a specified level of losses had passed through from the S corporation to the public investors. At that time, the promoters could convert their securities and obtain their desired degree of participation in further S corporation profits and losses. Under present law, that device can be used only if the indebtedness passes the general requirements of section 385. In enacting its safe harbor debt rule, Congress evidently concluded that it did not wish to expand the circumstances in which convertibility could be used to achieve this objective.

It is unclear to what extent the prohibition upon convertibility may be avoided through the use of warrants. Section 1361(c)(5)(b)(ii) specifies that there may be "no convertibility (directly or indirectly) into stock." The legislative history does not explain the significance of the reference to indirect convertibility. Under prior law, the Commissioner ruled that a Subchapter S corporation could issue warrants to acquire its stock without jeopardizing its Subchapter

72. Treas. Reg. § 1.1371-1(g)(1960)(before amendment by T.D. 7747, 1981-1 C.B. 141).

73. See Treas. Reg. § 1.704-1(b)(2) (Example (5)) (1964) and W. MCKEE, W. NELSON AND R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* (1977) [hereinafter cited as MCKEE], ¶ 10.02[1].

S election.⁷⁴ Presumably, that rule will continue to be valid under present law.⁷⁵ Accordingly, if a corporation wishes to avoid the restriction on convertibility, it might issue straight debt accompanied by a warrant and provide that the debt instrument will be accepted in payment of the exercise price under the warrant. It is not clear why such a device would be regarded as inconsistent with Subchapter S status but the Commissioner might well attempt to bar the use of such an investment unit under the "indirect" language.

Viewed as a safe harbor rule of the classification of indebtedness, the restrictions that are imposed by section 1361(c)(5) are not unreasonable. However, in commenting upon the proposals developed by the Joint Committee on Taxation that ultimately formed the basis for much of the Revision Act, the Treasury Department opposed resolving the second class of stock dispute by overriding the general rules to be issued under section 385.⁷⁶ The Treasury acknowledged the impropriety of producing a termination of a Subchapter S election because of a recharacterization of a purported debt instrument; however, it suggested that the difficulty stemmed, not from the impropriety of the reclassification, but rather from the limitation upon the issuance of a second class of stock. Furthermore, the Treasury recognized that the effect of case law decisions refusing to treat reclassified debt as a second class of stock had already created a *de facto* Subchapter S preferred stock. As a result, the Treasury Department suggested that Subchapter S corporations be permitted to issue a class of preferred stock that would have characteristics essentially identical to the definition of safe harbor straight debt that was ultimately enacted.

The Treasury alternative, while not altering greatly the character of the securities that could be issued by an S corporation, had the distinct advantage of greater rationality because the alternative would not have required treating a purported debt instrument differently depending upon the identity of the issuer. That greater rationality would have translated into a greater coherence in the application of certain Code provisions. For example, under the approach ultimately adopted by Congress, prior to making a Subchapter S election a corporation may have outstanding a debt instrument that would be treated as stock under sec-

74. Rev. Rul. 67-269, 1967-2 C.B. 298.

75. Both Committee Reports mention this Revenue Ruling in their statement of prior law (SENATE REPORT, *supra* note 22 at 7; HOUSE REPORT, *supra* note 22 at 7), but make no reference to it in their discussion of I.R.C. §§ 1361(c)(4) and (5).

76. STAFF REPORT, *supra* note 7, at 23.

tion 385. If that instrument complies with the safe harbor rules of section 1361, the election to be taxed under Subchapter S will cause the instrument to be treated as indebtedness for some, and perhaps all, purposes of the Code. The Subchapter S election, therefore, might be treated as an exchange of stock for debt and thus a taxable transaction. Congress appeared to recognize this possibility and in a somewhat confused statement in the Committee Reports⁷⁷ appears to indicate that the making of a Subchapter S election should not produce a tax in this situation. On the other hand, the Report also suggests that distributions with respect to the instrument (which by hypothesis is treated as a debt instrument for Subchapter S purposes) might be treated as dividend distributions to the extent of accumulated earnings and profits. If these suggestions from the Committee Reports are accepted, the result will fall just slightly short of chaos; the Treasury will determine on a section by section basis whether the instrument is stock or debt. All of that complexity would have been avoided if S corporations had remained subject to the general rules of section 385 and had been permitted to issue preferred stock rather than safe harbor "debt."

Furthermore, the flexibility of an S corporation would have been substantially increased if such corporations had been granted the ability to issue a class of preferred stock. The primary financial difference between the safe harbor debt instrument that Congress approved and the class of preferred stock suggested by the Treasury Department lies in the requirement that an annual return be paid on the security regardless of the profitability of the corporation. A debt instrument imposes a fixed charge on corporate earnings that in some years may seriously impair the corporation's cash flow. Preferred stock, by contrast, is more flexible; dividends are payable only as declared by the board of directors and in general may not be declared if their payment would impair the corporation's solvency. In many closely held corporations, the flexibility provided by preferred stock is highly desirable. Secondly, the ability to issue preferred stock greatly expands the ability of the present owners of an S corporation to transfer control of the corporation to succeeding generations of managers without incurring undue tax consequences. Preferred stock has a distinct advantage over indebtedness because it may be exchanged for outstanding common stock without immediate tax consequences.⁷⁸ As a result, the stockholder-managers of a corporation, by exchanging their common stock for preferred stock, can transfer both the residual equity in the corporation and control over the corporate affairs

77. HOUSE REPORT, *supra* note 22 at 8; SENATE REPORT, *supra* note 22 at 8.

78. For example, in a recapitalization pursuant to I.R.C. § 368(a)(1)(E).

to the next generation of corporate managers without incurring a prohibitive income tax liability.⁷⁹

Apparently, the only justification for limiting the availability of Subchapter S to corporations having one class of stock is the desire to avoid the complexities of allocating corporate income to different classes of stock.⁸⁰ As the Treasury recognized,⁸¹ however, those difficulties could have been overcome if Congress had desired to enhance the flexibility of S corporations by permitting the issuance of preferred stock. In this respect, therefore, the Revision Act is unduly restrictive. Congress would do well to reconsider the propriety of permitting an S corporation to issue a class of preferred stock.

c. Other Issues

Other than permitting a disparity in voting rights, the Revision Act does not change the prohibitions of prior law against the issuance of more than one class of stock in an S corporation. One of the more difficult problems posed under prior law was the effect of restrictions imposed administratively, pursuant to a state securities law, upon making distributions upon stock held by promoters or other inside groups. Although in one case the Ninth Circuit Court of Appeals held that such a restriction effectively created a second class of stock,⁸² substantial doubts exist with respect to the correctness of that decision. Under prior law, the regulations contemplated a possible dividend waiver by a shareholder and provided that the Commissioner could, in appropriate circumstances, reallocate the S corporation income to prevent the avoidance of tax through such a device.⁸³ The regulation contains no suggestion that such a temporary waiver would constitute the creation of a second class of stock. By remaining silent, Congress has neither accepted nor rejected the decision of the Ninth Circuit and, thus, has left the development of a proper rule to further litigation.

4. Ineligible Corporations

The Revision Act introduces a new concept into the requirements for eligibility to elect under Subchapter S. New section 1362(b)(2) lists five categories of corporations that are generically

79. This technique is explained in greater detail in text accompanying notes 149-52 *infra*.

80. STAFF REPORT, *supra* note 7, at 10.

81. STAFF REPORT, *supra* note 7, at 23-24.

82. *Paige v. United States*, 580 F.2d 960 (9th Cir. 1978). *See also* Rev. Rul. 71-522, 1971-2 C.B. 316.

83. Treas. Reg. § 1.1375-3(d) (1960).

ineligible to make the election. Under prior law, an S corporation could not be a member of an affiliated group within the meaning of section 1504.⁸⁴ Section 1361(b)(2)(A) continues this prohibition in a slightly expanded form. Under this section, membership in an affiliated group is to be determined without reference to the exceptions contained in section 1504(b). Accordingly, if a corporation directly or indirectly owns 80% or more of the stock of another corporation, the parent corporation will be barred from electing under Subchapter S regardless of whether the corporations actually are entitled to file consolidated returns. The remaining four categories of ineligible corporations described in section 1361(b)(2) consist of corporations that compute their income pursuant to unique rules and thus could not comply easily with the requirement that an S corporation compute its income as an individual. The four enumerated ineligible corporations are: banks and other financial institutions that use the reserve methods of accounting for loan losses provided by sections 585 or 593; insurance companies; possessions corporations that elect the section 936 credit; and DISCs or former DISCs.

B. Election

The Revision Act continues the requirements of prior law that a corporation affirmatively elect S corporation status,⁸⁵ and that all persons who are shareholders on the date of the election consent to the election for it to be valid.⁸⁶ In general, the rules of prior law will continue to apply to these procedural requirements.⁸⁷ Additionally, shareholders holding nonvoting stock under the new provision authorizing issuance of such a security also must consent to the election. On the other hand, persons holding safe harbor debt instruments presumably are not required to consent to the election even if the purported indebtedness would be reclassified as stock under the general rules of section 385 and, in fact, may have been so reclassified prior to the Subchapter S election. The Temporary Regulations to section 1362(a) have failed to deal with either of these questions, but the Temporary Regulations dealing with revocation of the election provide that holders of nonvoting stock must consent to a revocation.⁸⁸ The election is valid for the year in which it is made and all subsequent years until it is terminated.⁸⁹

84. Former I.R.C. § 1371(a).

85. I.R.C. § 1362(a).

86. I.R.C. § 1362(a)(2).

87. See Temp. Reg. §§ 18.1362-1, -2, 48 Fed. Reg. 3591 (1983) (to be codified at 26 C.F.R. pt. 18).

88. Temp. Reg. § 18.1362-3, 48 Fed. Reg. 3592 (1983) (to be codified at 26 C.F.R. pt. 18).

The new law slightly alters the time in which the election must be made. Under prior law, the election had to be made during the taxable year preceding the year for which it was to be effective or within the first seventy-five days of the taxable year for which it was to be effective.⁹⁰ The Revision Act replaces the seventy-five-day rule with the requirement that the election be made on or before the fifteenth day of the third month of the year for which it is to be effective,⁹¹ the date upon which corporate income tax returns are due.

Under prior law, there was some ambiguity concerning the extent to which a corporation and its shareholders must meet the eligibility requirements for making a Subchapter S election during that portion of the year for which the election was first effective, but prior to the time upon which the election was filed.⁹² Section 1362(b)(2)(B) eliminates these ambiguities by imposing the more stringent interpretation. The corporation must meet all of the eligibility requirements of section 1361(b) on each day of the taxable year for which the election is effective, including days prior to the filing of the election. In addition, the new provision specifically requires that all persons who own stock in the corporation during the taxable year for which the election is to be effective consent to the election even though they had completely disposed of their interest in the corporation prior to the filing of the election.

The requirement that shareholders who have disposed of their stock prior to the making of the Subchapter S election must consent to that election is somewhat harsh. Contrary to prior law, Subchapter S income is now allocated to all shareholders on a daily basis. Under present law, making the Subchapter S election will allocate some portion of the S corporation income to the withdrawing shareholder who must include that income in his individual return. Making the election, therefore, subjects the shareholder to a tax that would not have been imposed upon him in the absence of the election. Since that shareholder will be affected directly by the making of the Subchapter S election, it is not unreasonable to require him to consent to that election. The difficulty with the provision is that it permits an individual who no longer has an economic stake in the corporation to control for an entire year the ability of individuals who continue as shareholders of the cor-

90. Former I.R.C. § 1372(c)(1).

91. I.R.C. § 1362(b)(1).

92. Treas. Reg. § 1.1372-1(a) (1960) indicated that the eligibility requirements did not have to be met until the election was filed although there was no statutory basis for that position.

poration to obtain the benefits of a Subchapter S election. The Congressional solicitude for the withdrawing shareholder, thus, may have a substantially adverse impact upon the far larger number of continuing shareholders. Furthermore, the Congressional insistence upon unanimous consent for the making of a Subchapter S election is inconsistent with the present ability of a mere majority of the shareholders of an S corporation to revoke the election.⁹³ The revocation of an election has an immediate financial impact upon the shareholders of the corporation that may be as significant as the making of the election. If it is reasonable to subject the minority shareholders in a corporation to an undesired revocation of the election, it would seem equally reasonable to subject a shareholder who withdraws during the first two and a half months of the corporation's taxable year to the consequences of the making of an election.⁹⁴ Indeed, it seems odd to treat a single withdrawing shareholder more favorably than the holders of 49% of the corporation's stock.

As under prior law,⁹⁵ if a corporation attempts to elect under Subchapter S for a taxable year but the election is not effective for that year, the election nevertheless will be effective for the following and all succeeding taxable years.⁹⁶ Thus, if the election is filed following the two and a half month grace period or is filed during the grace period but the corporation fails to meet the requirements of section 1362(b)(2) for the pre-election period, the election will be treated as effective for the following year. The Regulations, under prior law, qualified this provision with the requirement that the corporation must have been eligible to make an effective election both on the date the election was filed and on the first day of the taxable year for which it was to be effective.⁹⁷ Thus, temporary ineligibility during the year of election but subsequent to the election date did not render the election ineffective as long as the corporation resumed eligibility by the first day of the year for which the election was to be effective. The Temporary Regulations under section 1362 continue this rule.⁹⁸

93. I.R.C. § 1362(d)(1), discussed in text accompanying notes 103-07 *infra*.

94. The allocation of income to such a shareholder would result in an increase in the basis for his stock, thus reducing any gain on the disposition of the stock. The allocation of income, therefore, would result only in the possible conversion of some capital gain to ordinary income. In the alternative, Congress could bar the allocation of any income to a shareholder who withdrew prior to the filing of an election.

95. Former I.R.C. § 1372(c)(2).

96. I.R.C. § 1362(b)(2).

97. Treas. Reg. § 1.1372-1(a) (1960).

98. Temp. Reg. § 18.1362-1(b), 48 Fed. Reg. 3591 (1983) (to be codified at 26 C.F.R. pt. 18).

An election made under prior law remains in effect and is treated as an election made under section 1362(a);⁹⁹ it is not necessary for the corporation to file a new election. Under prior law, the invalidity of an election attributable to the failure to file timely consents could be avoided if the corporation obtained an extension of time for the filing of a shareholder's consent.¹⁰⁰ The Temporary Regulations have continued that practice.¹⁰¹ In appealing cases, courts occasionally granted extensions years following the date upon which the consent should have been filed.¹⁰²

C. Termination

With the Revision Act, Congress has improved greatly the provisions of Subchapter S governing both deliberate and inadvertent terminations of the election, and the consequences of those terminations.

1. Revocation

Under prior law, a Subchapter S election could be revoked voluntarily only with the unanimous consent of the corporate shareholders.¹⁰³ On the contrary, and somewhat inconsistently, a new shareholder of the corporation could affirmatively refuse within a sixty-day period of time to consent to the Subchapter S election.¹⁰⁴ Thus, a single continuing shareholder could force the corporation to continue as a Subchapter S corporation while a single new shareholder could cause the election to terminate. Under the Revision Act both of these features of prior law now have been eliminated. Section 1362(d)(1) now provides that a Subchapter S election may be revoked only if shareholders owning more than one-half of the number of shares of stock in the corporation consent to the revocation. With respect to the making of an election, the statute apparently contemplates that the vote be computed with reference to the number of shares outstanding, not to the voting power of those shares, and the Temporary Regulations so provide.¹⁰⁵ Thus it appears possible that a valid consent to a revocation can be made by shareholders who possess less than a majority

99. I.R.C. § 1379(a).

100. Treas. Reg. § 1.1372-3(c) (1964).

101. Temp. Reg. § 18.1362-2(c), 48 Fed. Reg. 3591 (1983) (to be codified at 26 C.F.R. pt. 18).

102. *Hicks Nurseries, Inc. v. Comm'r*, 62 T.C. 138 (1974), *rev'd*, 517 F.2d 437 (2d Cir. 1975)(consent of new shareholder).

103. Former I.R.C. § 1372(e)(2).

104. Former I.R.C. § 1372(e)(1).

105. Temp. Reg. § 18.1362-3, 48 Fed. Reg. 3592 (1983) (to be codified at 26 C.F.R. pt. 18).

of the voting power of all outstanding stock, a questionable result. Revocation itself, however, is a corporate act that generally requires shareholder approval and the approval, of course, must be obtained from shareholders possessing a majority of the voting power of the corporation's stock. In practice, therefore, revocation will require the effective consent of both the holders of a majority of the voting power in the corporation and the holders of a majority of the number of shares of stock in the corporation.

These new "corporate democracy" features of Subchapter S represent substantial improvements; the elimination of the ability of the new shareholder to cause a termination of the election is particularly worthy of note. When Subchapter S was first enacted in 1958, the prevalent belief was that a new shareholder should not be forced to accept the unusual method of income taxation provided by Subchapter S as part of the price of an interest in the business venture. The original statute provided that the election terminated unless the shareholder timely filed a consent to the election.¹⁰⁶ By 1976, Congress recognized that the original provision resulted in many inadvertent terminations and changed the law to provide that the election would continue in effect unless the new shareholder filed a refusal to consent.¹⁰⁷ The 1976 provision, however, has been criticized because it allows a new shareholder to extort additional consideration from the continuing shareholders as the price for not filing a refusal. Under the Revision Act, new shareholders must take the corporation "as they find it" with respect to its tax status.

Unfortunately, Congress was not consistent in its attempt to prevent a single shareholder from preventing and causing the termination of a Subchapter S election. As noted above, the requirement of unanimous consent for the making of an election has not only been continued but has been expanded by the requirement that a shareholder who withdraws from the corporation prior to the filing of the election must also consent.¹⁰⁸ In addition, the initial income beneficiary of a trust that is eligible to become a Qualified Subchapter S Trust is required to elect that treatment,¹⁰⁹ and each successive income beneficiary may affirmatively refuse to consent to continuation of Qualified Subchapter S Trust treatment.¹¹⁰

106. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1606, 1650 (enacting former I.R.C. § 1372(e)(1)).

107. Tax Reform Act of 1976, Pub. L. No. 94-455, § 902(c), 90 Stat. 1520, 1608-09 (1976) (amending former I.R.C. § 1372(e)(1)).

108. See text accompanying notes 85-94 *supra*.

109. I.R.C. § 1361(d)(2).

110. I.R.C. § 1361(d)(2)(B)(ii). An interesting question arises as to when the successor beneficiary's refusal to consent will be considered timely. The statute can be read as allowing the successor beneficiary to refuse to consent at any

Withdrawing an election, of course, renders the trust an ineligible shareholder of the S corporation, thereby terminating the Subchapter S election. The provision dealing with the initial election to qualify as a Qualified Subchapter S Trust was originally enacted¹¹¹ when each new shareholder had the power to terminate the corporation's Subchapter S election by filing a refusal to consent, and has been reenacted, unchanged, in the Revision Act. The requirement that a successor beneficiary make an affirmative election merely has been transformed from a requirement that the successor beneficiary elect anew to have the trust treated as a Qualified Subchapter S Trust¹¹² into an automatic continuation of the election unless the new income beneficiary affirmatively refuses to consent to the election. Thus, the new rule governing initial income beneficiaries corresponds to the rule dealing with new shareholders prior to 1976, while the rule governing successor beneficiaries is identical to the rule governing new shareholders immediately prior to the Revision Act.

It is not clear whether the retention of this more favorable treatment of an income beneficiary was inadvertent. Perhaps Congress deliberately concluded that income beneficiaries of a trust should not be forced to accept the consequences of an election to treat the trust as a Qualified Subchapter S Trust, namely, the direct inclusion of an allocable portion of the S corporation income and expense in the beneficiary's income tax return.¹¹³ There is, of course, a basis for distinguishing such a beneficiary from a new shareholder who purchased the stock in the S corporation; a new shareholder presumably could have declined to purchase the stock while an income beneficiary is not provided that choice. In almost every instance, such concern for the plight of an income beneficiary is

time; however, that would seem to be inconsistent with the provision that the election, once made, is irrevocable. I.R.C. § 1361(d)(2)(C). Presumably, the Regulations will provide a grace period following the initial income beneficiary's death before the election will become irrevocable with respect to the successor beneficiary.

Congress may have intended to supply some guidance on this matter by noting that the 60-day grace period applicable to grantor trusts following the death of the grantor would be applicable to a Qualified Subchapter S Trust that becomes disqualified by reason of the death of the income beneficiary. SENATE REPORT, *supra* note 22 at 9. While, as was stated above in note 46, the exact scope of this comment is unclear, a 60-day grace period in this context would correspond to that granted to new shareholders under former I.R.C. § 1372(e)(1) and to that which apparently was intended to apply to a successor beneficiary's election under former I.R.C. § 1371(g)(2). See S. REP. NO. 144, 97th Cong., 1st Sess. at 91.

111. Economic Recovery Tax Act of 1981. Pub. L. No. 97-34, § 234(b), 95 Stat. 172, 251 (enacting former I.R.C. § 1371(g)(2)).

112. Former I.R.C. § 1371(g)(2)(B)(ii).

113. See text accompanying note 39 *supra*.

misplaced. Such trusts are family planning devices which serve as an alternative to a direct gift of the S corporation stock between family members. In the case of an outright gift, the donee is required to include Subchapter S income and loss in his individual return. The same fate should befall an income beneficiary. The general effect of this provision simply is to give an unwarranted leverage to a disgruntled family member. Furthermore, as to the initial income beneficiary, the transferor-shareholder who is advised properly will make his transfer conditional upon the timely filing of the appropriate election by the income beneficiary. Thus, the requirement that the initial beneficiary make an election will become another "trap for the unwary" of just the type that the Revision Act was designed to eliminate. Clearly, it would be preferable to require successor beneficiaries to take the trust and the corporation as they find them as must other transferees. In addition, the grantor of a trust, as well as the initial income beneficiary, should be entitled to make the initial election. Indeed, if the trust meets the definition of a Qualified Subchapter S Trust, the election should be deemed made unless the income beneficiary affirmatively objects.

In a further liberalization of prior law, section 1362(d)(1)(C) provides that a revocation for a taxable year will be effective if filed within the first two and a half months of that taxable year.

2. Passive Investment Income

Under prior law, a Subchapter S election was terminated for any year in which more than 20% of the corporation's gross receipts consisted of passive investment income.¹¹⁴ For S corporations that do not have any accumulated earnings and profits attributable to years in which a Subchapter S election was not in effect under either present or prior law, this restriction on S corporations has been eliminated entirely.¹¹⁵ As a result, corporations that have been S corporations under either present or prior law since their incorporation are free to derive any proportion of their income from passive sources without penalty. On the other hand, the Revision Act has liberalized only slightly the passive income rule for those S corporations that do have earnings and profits accumulated during nonelection years.

Although in the early stages of the drafting of the Revision Act Congress contemplated that the elimination of the restriction on passive investment income would be applicable to all corporations, it became concerned that such a degree of liberalization would

114. Former I.R.C. § 1372(e)(5).

115. See I.R.C. § 1362(d)(3).

open substantial avenues of tax avoidance.¹¹⁶ One of the concerns that surfaced was the potential for deferring, and quite possibly avoiding, gain on the complete disposition of the business activities of a corporation subject to the regular income tax.¹¹⁷ Under prior law, a corporation planning to dispose of its entire business was faced with two basic choices. It could sell those assets and liquidate in which event the sale at the corporate level would be sheltered from tax under section 337, but the shareholders would be subject to tax on the entire amount of the appreciation in their stock. Alternatively, the corporation, by disposing of the assets and retaining the proceeds at the corporate level, could become a private investment company. Under the second alternative, a tax would be incurred at the corporate level but no tax would be imposed upon the shareholders. If the corporation had been owned by the same shareholders for a substantial period of time and had reinvested a substantial amount of its earnings, a not unlikely scenario, the gain at the corporate level would be substantially less than the gain that would be subject to tax at the shareholder level upon a liquidation. However, if the corporation chose to remain in existence and it was relatively closely held, the corporation would become a personal holding company. In order to avoid the punitive tax on undistributed personal holding company income,¹¹⁸ the corporation would be required to distribute the entire amount of its ordinary income. Since the overall rate of tax imposed upon personal holding companies and their shareholders typically exceeds the tax that would be imposed upon the same amount of income derived by the shareholders in their individual capacity, the tax advantage of keeping the corporation in existence often would be eliminated quickly. Consequently, most corporations, when disposing of their businesses, chose to eliminate tax at the corporate level by liquidating. If those corporations were given a third option, of remaining in existence and electing to be taxed pursuant to Subchapter S, the balance would shift radically. The overall rate of tax that would be imposed upon the continuing incorporated venture would be the same as the tax that would be imposed on the shareholders had the corporation distributed the proceeds of sale and liquidated. By remaining in existence, the corporation could defer indefinitely the tax on the appreciation in the shareholder's stock. If the shareholder died without disposing of the stock, tax on the appreciation would be forgiven permanently.¹¹⁹ Obviously,

116. STAFF REPORT, *supra* note 7, at 11.

117. Lang, *Subchapter S Revision Act of 1982: Dealing with Transition Rules*, 60 TAXES 928, 930 (1982).

118. See I.R.C. §§ 541-47.

119. I.R.C. § 1014.

this tax avoidance should not be permitted. This problem is just one aspect of a fundamental question of our system of taxation, namely, what should constitute the taxable event with respect to appreciation in corporate stock. Under an ideal income tax the shareholders' gain would be subject to tax, preferably upon the sale of the business assets regardless of a liquidation or, at least, upon the death of the shareholder. In the context of the Revision Act, however, Congress sought to address the more limited goal of preventing this tax avoidance through the use of Subchapter S.

One obvious remedy would be to bar a corporation that was subject to the regular corporate income tax from electing under Subchapter S if that corporation had both a substantial amount of investment assets and earnings and profits. That prohibition would be tailored relatively well to the tax avoidance potential of the transaction. A corporation subject to the regular income tax that has a substantial investment portfolio would either have avoided the accumulated earnings tax¹²⁰ for a substantial period of time or acquired that investment portfolio immediately before the Subchapter S election, presumably through a disposition of a substantial amount of its business assets. The Revision Act effectively adopts that prohibition but adds a grace period for eliminating the accumulated earnings and profits. Under section 1362(d)(3), an S corporation election will be terminated if, in each of three consecutive years, a corporation has both earnings and profits accumulated during nonelection years and passive investment income in excess of 25% of the corporation's gross receipts. In effect, a corporation deriving the prescribed level of passive investment income has three full years of S corporation existence in which to distribute the entire amount of its earnings and profits accumulated prior to the making of the Subchapter S election. If those earnings and profits have not been distributed by the conclusion of the three-year period, the S election terminates and the corporation becomes subject to the regular corporate income tax as of the first day of the following year.¹²¹

120. See I.R.C. §§ 531-37.

121. I.R.C. § 1362(d)(3)(ii). TCB § 201(h) would permit an S corporation to elect to have prior law governing termination for exceeding the passive investment income limitations apply for taxable years beginning in 1982. Under § 6(b)(3) of the Revision Act, the new passive investment income provisions are effective for such taxable years. The effect of § 201(h) will be to permit the corporation to elect to lose its status as an S corporation under the stricter passive investment income termination provisions of former I.R.C. § 1372(e)(5), but to avoid the new tax under I.R.C. § 1375. However, TCB § 201(h) also provides that the "fresh start" rule of § 6(e) of the Revision Act would not apply to the resulting termination. See note 147 *infra*. Thus, the corporation could not reelect to be taxed under Subchapter S for five years unless it obtained permission of the Commissioner pursuant to I.R.C. § 1362(g).

Unfortunately, few corporations will be able to take full advantage of this three-year grace period because of the imposition of a new tax on passive investment income added by the Revision Act. Under section 1375, an S corporation that fails this passive income test for a single year is subject to tax on the amount by which its net passive investment income exceeds 25% of its gross receipts.¹²² The tax is imposed at the highest corporate rate, currently 46%, and is imposed upon the entire amount of the net passive investment income in excess of 25% of gross receipts. Thus, the amount subject to tax may not be reduced by the dividends received deduction normally available to corporations. The shareholders of the S corporation also will be subject to tax with respect to this income, although the amount taxable to them is reduced by the amount of the section 1375 tax imposed at the corporate level.¹²³ Thus, the section 1375 tax effectively imposes double taxation on the entire amount of passive income in excess of the 25% floor. Accordingly, if the corporation has disposed of substantially all of its active business assets and, thus, substantially all of its income is derived from passive investment sources, the combined taxes imposed upon this income will be prohibitive. As a practical matter, therefore, corporations disposing of substantially all of their business assets will be forced to liquidate as under prior law and will be unable to defer tax on their shareholders by electing Subchapter S status.

As a technique for preventing the deferral and possible elimination of tax on a disposition of a business activity, terminating the Subchapter S election following a reasonable grace period appears to be an appropriate remedy. On the other hand, the imposition of a second level tax during this grace period at an effective rate substantially higher than would be paid by either a regular business corporation or a corporation subject to the personal holding company tax constitutes legislative overkill. Terminating the Subchapter S election will force the managers of corporations proposing to dispose of their business assets to face the same choice presented under prior law of either subjecting their shareholders to an immediate tax or operating as a personal holding company. The tax imposed by section 1375, however, bears no relationship to either the tax avoided by the shareholders or the tax avoided by failing to come within the provisions of the personal holding company tax.

122. The amount subject to tax is defined by I.R.C. § 1375(b)(1)(A) as the amount that bears the same ratio to net passive income as passive income in excess of 25% of gross receipts bears to passive income.

123. I.R.C. § 1366(f)(3). In addition, if passive income includes capital gains "taken into account" under the I.R.C. § 1374 tax on capital gains, the amount of the gain subject to the § 1374 tax is reduced by the amount of the gain taxable under I.R.C. § 1375. I.R.C. § 1375(c)(2).

One possible, but not terribly persuasive, justification for the section 1375 tax is the relatively liberal definition of the section 1362 grace period. Before a termination occurs, an S corporation having earnings and profits accumulated during nonelection years must derive passive investment income in excess of the 25% floor in each of three consecutive taxable years. Accordingly, corporations able to pass that test in one out of every three years will be able to prevent indefinitely the termination of the Subchapter S election.

On the other hand, passing the test by reducing the percentage of gross receipts that consist of passive investment income will be far more difficult under present law. As under prior law, the test is applied to gross receipts and not to gross income. Under prior law, taxpayers could prevent terminations of a Subchapter S election by churning temporary investments in capital assets. Under new section 1362(d)(3)(C), gross receipts from the disposition of capital assets other than stock and securities are taken into account only to the extent that the gains from such sales exceed the losses. Thus, the mere buying and selling of property will not enlarge the amount of gross receipts attributable to sources other than passive investment income. The Revision Act has not altered the rule of prior law that, for the purpose of computing passive investment income attributable to the sale or exchange of stock and securities, gross receipts from such sales include the gain from such sales (gross receipts less basis) and are not reduced by losses from the sale of securities.¹²⁴

Both the taxing and termination provisions appear overbroad. Each of them is applicable without regard to the amount of accumulated earnings and profits or the period of time that has passed since those earnings and profits were accumulated. Presumably, Congress expected corporations having relatively small amounts of accumulated earnings and profits to elect to avoid the tax and termination penalties by distributing those earnings and profits to their shareholders even though that distribution would precipitate immediate ordinary income tax. Practitioners, however, are painfully aware of the difficulty of computing accurately an earnings and profits account, particularly when that account has been accumulated over many changes in the provisions of the Code. As discussed below in greater detail,¹²⁵ it is highly regrettable that Congress did not provide some relief for an inadvertent failure to distribute the entire amount of an earnings and profits account.

These penalty provisions would be applicable even if the earnings and profits of the corporation were accumulated gradually

124. I.R.C. § 1362(d)(3)(D)(i).

125. See text accompanying note 401 *infra*.

through normal business operations, rather than through the disposition of a business activity, and even though a Subchapter S election had been in effect for many years before the corporation accumulated sufficient investment assets to exceed the 25% ceiling. Such a corporation would bear no resemblance to the evil that the tax and termination provisions were designed to address. For a corporation that has been actively engaged in business under a Subchapter S election for 15 years and has accumulated an investment portfolio only since the enactment of the Revision Act to become subject to the tax and termination provisions simply is wrong. Indeed, the overbreadth of sections 1362(d)(3) and 1375 appears particularly irrational in light of the fact that an entity incorporating and electing to be taxed under Subchapter S after December 31, 1982 may derive 100% of its income from passive investment sources from its inception and neither jeopardize its election nor become subject to the tax.

It is regrettable that a more tailored solution to the evil addressed by sections 1362(d)(3) and 1375 was not devised. In order to prevent the inappropriate application of the tax and termination provisions, Congress should, at a minimum, amend those provisions to permit an S corporation to outlive their potential application. Thus, neither the tax nor termination provision should be applicable if the corporation has been subject to a Subchapter S election for over 5 years and has not had passive investment income in excess of 25% of its gross receipts in any of the 5 preceding years.¹²⁶

One felicitous aspect of the Revision Act is that the definition of passive investment income has been modified favorably in minor respects. Section 1362(d)(3)(D) exempts interest on obligations attributable to the sale by the corporation of inventory or other property held for sale to customers in the ordinary course of business from the definition of passive investment income. It also exempts gross receipts of an active lending or finance business within the meaning of sections 542(c)(6) and 542(d)(1) from the definition.

3. Other Terminations

As under prior law,¹²⁷ the Subchapter S election automatically terminates if the corporation ceases to meet the eligibility re-

126. The power of the Commissioner to waive inadvertent terminations provides some, but inadequate, relief from the termination provisions but no relief at all from the tax. *See* I.R.C. § 1362(f).

127. Former I.R.C. § 1372(e)(3).

quirements for electing to be taxed pursuant to Subchapter S as set forth in section 1361(b).¹²⁸ On the other hand, the Revision Act has eliminated the prior law provision¹²⁹ requiring a termination of the election if the corporation derived more than 80% of its income from foreign sources.

4. Effective Date of Termination

Under prior law, terminations of a Subchapter S election were applicable to entire taxable years. A revocation, unless made during the first month of the taxable year, was effective only for the succeeding taxable year.¹³⁰ Terminations attributable to such events as ceasing to meet the eligibility criteria for making a Subchapter S election¹³¹ or the affirmative refusal by a new shareholder to consent to the election¹³² produced a retroactive termination of the election beginning on the first day of the year in which the event occurred. This effective date pattern was entirely unsatisfactory in many respects. Notwithstanding the restrictions on voluntary revocations, a corporation always could secure retroactive termination by engineering an event that would produce a retroactive termination. Moreover, when the termination was inadvertent, the retroactive termination barred the shareholders from harvesting the benefits of a Subchapter S election and produced an enormously harsh result compared to the generally insignificant event that produced the technical loss of Subchapter S status.

The Revision Act changed these rules radically and quite favorably. Section 1362(d)(1)(D) permits S corporations to revoke their election as of any day specified in the revocation, even if that day does not constitute the end of the corporation's taxable year. Similarly, if the termination is attributable to the corporation's failure to comply with the requirements for eligibility to make a Subchapter S election, the termination is effective on the day upon which the corporation ceases to constitute a "small business corporation" as defined in section 1361(d).¹³³ Finally, if the termination is attributable to the presence of passive investment income, the termination no longer is retroactive but rather commences on the first day of the taxable year after the third consecutive taxable year taken into account in determining that the passive investment income tolerances have been exceeded.¹³⁴

128. I.R.C. § 1362(d)(2).

129. Former I.R.C. § 1372(e)(4).

130. Former I.R.C. § 1372(e)(2).

131. Former I.R.C. § 1372(e)(3).

132. Former I.R.C. § 1372(e)(1)(C).

133. I.R.C. § 1362(d)(2)(B).

134. I.R.C. § 1362(d)(3)(A)(ii).

Specifying that the effective date of a termination of a Subchapter S election shall be the date upon which the terminating event occurs is obviously a substantial improvement over prior law. As a result, the consequences of the termination under the Revision Act are tailored far better to the underlying financial reality than either the prospective or retroactive rules applied under prior law. This advance, however, is necessarily achieved at the cost of materially increasing the complexity of accounting for a mid-year termination. Under section 1362(e)(1), a mid-year termination produces two short taxable years: the "S year," subject to the Subchapter S election, and the "C year," not subject to the election. For the purpose of allocating the income and loss of the corporation for its year of termination between these two short taxable years, section 1362(e) provides two alternative procedures, a general rule and an elective alternative.

Under the general rule, each item of income and expense of the corporation incurred during the year of termination is prorated between the two short taxable years on a daily basis. The amounts allocated to the earlier short year then will be allocated to the S corporation shareholders under the usual rule applicable to the allocation of the income of an S corporation. The amounts allocated to the post-termination short year will be subject to tax in accordance with the rules applicable to the taxation of corporations subject to the regular corporate income tax. As a result, at least in theory, the corporation is not required to close its books by virtue of a mid-year termination of a Subchapter S election.

The operation of this pro rata allocation can be illustrated by an example in which it is assumed that an S corporation, which reported its income on a calendar year cash basis, revoked its election effective September 15th. The corporation would continue to record receipts and disbursements without closing its books until the end of the S corporation's taxable year on December 31st. Items of income, deduction, loss and credit that are required to be separately stated, and nonseparately stated income, then would be computed under section 1366 for the entire year as though the corporation had been an S corporation for the full year. Of each such item, 257/365 would be allocated to the short Subchapter S year and taxed to the shareholders as in prior years. The remaining 108/365 of each item would be allocated to the second short year and taxed to the corporation under the rules generally applicable to corporations.

If all persons who owned stock in a corporation at any time during the year in which the termination occurs consent, income for the two short taxable years may be computed on the basis of the actual income for the respective periods according to the

corporation's books.¹³⁵ That is, the corporation may elect to close its books on the date that a termination occurs and compute its income for the two short years in accordance with the normal accounting rules under the Code.

It is not entirely clear why Congress selected the pro rata allocation as the general rule applicable when shareholders cannot agree upon the alternative rule. Perhaps Congress anticipated that the pro rata rule would be selected most often because it is simpler. Indeed, because it eliminates the administrative burden of computing taxable income twice in a single year, the pro rata allocation provided by the general rule will be the cheaper and simpler procedure in nearly every instance.

On the other hand, in these days of high tax consciousness, most corporations can be expected to make trial computations of the relative tax consequences of proceeding under both the general rule and the elective alternative. Indeed, corporate managers probably have a fiduciary responsibility to their shareholders to explain the varying consequences before asking them to elect or fail to elect the alternative procedure. Thus, the simplicity of the pro rata rule is largely illusory. Moreover, in most cases, rather than choose the general rule, corporations will choose the elective method of reporting income on the basis of separate accounting periods for the two short taxable years.

Many terminations of Subchapter S elections are not inadvertent but rather are precipitated because the shareholders have determined that the income tax consequences of operating under the Subchapter S election no longer are desirable. When the decision is reached, the shareholders will normally wish to become subject to the regular income tax as quickly as possible. For example, one of the reasons for making a Subchapter S election for a new business venture is to allow the shareholders the direct benefit of the tax losses anticipated during the early years of the business while operating the business in corporate form for non-tax reasons. When the business begins to produce taxable income that will not be distributed, the shareholders may wish to terminate the election in order to benefit from the lower rate of progressivity of the corporate income tax. If this turn-around in the business's taxable income can be identified as it occurs, the corporation can file a prospective revocation of the election under section 1363(d)(1) as of a date just prior to the anticipated receipt of income. In order to maximize the tax benefit of the termination, the shareholders will wish to compute the income separately for each of the two short taxable years thereby produced, claim the losses incurred

135. I.R.C. § 1362(e)(3).

in the early portion of the year under the usual Subchapter S rule and cause the income received later in the year to be taxed to the corporation. Therefore, they will choose the elective computation rather than the general rule.

That more corporations likely will choose the method that requires an affirmative election rather than the one that is automatically applicable ordinarily would not be cause for severe criticism. The terminations in which the elective computation is likely to be chosen are themselves elective and relate directly to the income tax consequences of the Subchapter S election, therefore, shareholders should be able to take action simultaneously to terminate the election and elect to have ordinary accounting principles govern the tax consequences of the termination. However, there is a distinct incongruity between the two election procedures. Unanimous agreement is required to elect the alternative separate accounting rule while the Subchapter S election itself may be terminated by majority vote. In almost every situation the decision to revoke the election will be the more important and will have the more significant financial impact upon the shareholders. If a majority rule is regarded as the most equitable to all concerned in that context, it is extremely difficult to understand why Congress did not adopt the same rule for determining how the corporation should compute its income for the year of termination. Indeed, this disparity in consent procedures may create a serious trap for the majority shareholders and reintroduce the very problem that permitting revocation by majority vote was designed to eliminate. While the majority indeed may be able to revoke the Subchapter S election, they will not be able to maximize the tax benefits of the termination without the consent of all other shareholders. Potentially, therefore, a single shareholder having little economic stake in the corporation may, for whatever reason, obstruct the most favorable method of reporting income by the remaining shareholders. The requirement of unanimity is particularly oppressive in view of the requirement that all shareholders who have disposed of their stock during the year or have acquired stock during the year of termination must also concur in the decision to adopt the alternative method of accounting for income.¹³⁶ If either of the two accounting rules is to be applied in the absence of unanimity among the shareholders, it would seem most appropriate to apply the rule requiring the actual computation of income for the two separate periods rather than a rule that somewhat arbitrarily prorates income over the period.

Since section 1362(d)(1)(D) permits the filing of a voluntary revocation specifying any future date upon which the revocation

136. I.R.C. § 1362(e)(3)(B).

is to be effective, the question necessarily arises whether such a revocation itself might be rescinded. There is no apparent reason why such a prospective revocation cannot be rescinded prior to its effective date; yet, because the revocation need be accompanied only by the consents of a majority of the shareholders, it is unclear which shareholders must consent to such a rescission, if it is permitted. Would it be sufficient for only a majority of the stockholders to consent to the rescission, and, if so, must they be the same stockholders who originally consented to the revocation? In order to avoid these questions, and because a rescission of a revocation more nearly resembles an election to be taxed under Subchapter S than a revocation of the election, the Treasury Department would be justified in requiring that any such rescission be accompanied by the consents of all of those who are stockholders on the date on which the rescission is filed.¹³⁷

5. Inadvertent Terminations

One of the most interesting additions to Subchapter S introduced by the Revision Act is the express grant of authority to the Commissioner by section 1362(f) to disregard an inadvertent termination of a Subchapter S election. Under prior law, inadvertent terminations occurred with horrifying regularity and because the terminating event frequently was not discovered, or at least not conceded, until years following its occurrence, the consequences of such terminations were extraordinarily harsh to the relatively unsophisticated shareholders who had sought the advantages of taxation pursuant to Subchapter S. Many of the provisions of the Revision Act are designed to prevent either an inadvertent termination or the excessively harsh consequences that flowed from such a termination under prior law. The requirements for electing to be taxed pursuant to Subchapter S remain relatively strict, however, and the possibility of an inadvertent termination continues. Thus, this new provision constitutes a form of catch-all relief for the shareholders of S corporations.

Under section 1362(f), relief may be granted if the termination occurs either because the corporation ceases to qualify as a "small business corporation" or because the corporation fails the three year passive investment income test. The subsection contains three prerequisites to the granting of relief:

- (1) the Commissioner must determine that the termination was inadvertent;
- (2) steps must be taken within a "reasonable period" after

137. *Contra*, Shaw & August, *An Analysis of the Subchapter S Revision Act: Eligibility, Election, Termination*, 58 J. TAX. 2, 7 (1983).

discovery of the event resulting in termination to make the corporation a small business corporation once again; and

(3) the corporation and each person who was a shareholder during a period of time to be specified by regulation must agree to make such adjustments as the Commissioner prescribes.

Each of these three requisites to the exercise of the Commissioner's discretion will, of course, require substantial regulatory elaboration. One of the most difficult problems that the regulations need to address is the definition of "inadvertent." Under prior law, taxpayers seeking a retroactive termination of a Subchapter S election would cause a corporation to violate deliberately one of the conditions for eligibility to elect Subchapter S status. It is clear that section 1362(f) precludes the granting of relief in such circumstances. Under present law, however, such artifices are unnecessary; voluntary revocations may specify the date of termination and there is no action that the corporation can take to make the termination retroactive. Accordingly, it seems unlikely that any corporation will cause a termination of a Subchapter S election under either the small business corporation definition or the passive investment income restriction in the sense of willfully permitting the violation to occur in order to terminate the election.

Short of such clear, and presumably unlikely, cases, the nebulous and unavoidably unsatisfying question arises: what state of mind on the part of what individuals will constitute inadvertence within the meaning of this relief provision? The range of possibilities seems infinite. It is probable that the regulations will take the position that a termination is inadvertent if it occurs because of an event that the managers of the S corporation could not have anticipated¹³⁸ or one that they could not have prevented even if they had known about it.¹³⁹ It is also probable that a termination will be considered inadvertent if the managers of the S corporation were aware that the terminating event was about to occur but were unaware that its occurrence would cause a termination of the S election because

138. For example, the passive investment income earned by the corporation may unexpectedly exceed the limitations of I.R.C. § 1362(d)(3). The Commissioner permitted reelection under former I.R.C. § 1372(f) before the expiration of the five year waiting period (*see* text accompanying notes 146-47 *infra*) when, because of a change in market conditions, a corporation's passive investment income exceeded the limitations under prior law. Rev. Rul. 78-275, 1978-2 C.B. 221.

139. *Cf.* Rev. Rul. 78-275, *supra* note 138. *See also*, Rev. Rul. 78-333, 1978-2 C.B. 224, in which the Commissioner granted permission under former I.R.C. § 1372(f) to make a new election within the five year period when termination of the prior election occurred because passive investment income exceeded applicable limitations during a year when the corporation's business assets had been leased to another while the corporation's manager was disabled and could not be replaced.

they were ignorant of the law governing terminations.¹⁴⁰ On the other hand, it is likely that a termination will not be considered inadvertent if it is reasonable to expect the managers of the S corporation to have anticipated the event and to have taken steps to prevent its occurrence.¹⁴¹ These relatively optimistic speculations are based largely upon Congress's admonition to the Commissioner to be reasonable in waiving the consequences of an inadvertent termination.¹⁴²

The second prerequisite, that small business corporation status be restored with reasonable promptness, seems relatively unambiguous. The provision, of course, is not applicable if the termination is the result of a violation of the passive investment income test.

The elaboration of the third requirement is likely to be highly controversial. Section 1362(f)(4) limits the discretion of the Commissioner to require adjustments only by a parenthetical expression which requires that the adjustments be "consistent with the treatment of the corporation as an S corporation." However, the legislative history indicates that the Commissioner's authority would extend beyond merely requiring the shareholders to report their income in the same manner as it would have been reported had the S election remained in effect. For example, the Committee Reports suggest that if the termination is caused by a violation of the passive investment income test for the reason that the corporation reasonably believed that it did not have accumulated earnings and profits, the Commissioner might require the shareholders to treat the earnings and profits as were determined on audit to have been retained by the corporation as ordinary dividend distributions.¹⁴³ If, on the other hand, the termination occurred because of an unanticipated receipt of an excessive amount of passive investment income, it is not at all clear what adjustments might be required. Since that excess passive income already would have been subject to the relatively severe section 1375 tax at the

140. Cf. Rev. Rul. 78-274, 1978-2 C.B. 220, in which the Commissioner permitted a corporation to reelect under former I.R.C. § 1372(f) after sale of stock to a nonresident alien caused its election to terminate. The selling shareholder was unaware that a nonresident alien could not be a shareholder of a Subchapter S corporation. He repurchased the stock promptly when his attorney informed him of the law.

The regulations under new I.R.C. § 1362(f) will probably contain an exception for the relatively rare instances when the taxpayers can be shown to have deliberately attempted to remain ignorant of the law.

141. For example, if the managers of the S corporation attempt to avoid the passive investment income limitations by generating active business income but have reason to know that their attempt will fail for the third consecutive year.

142. HOUSE REPORT, *supra* note 22, at 12-13.

143. *Id.*

corporate level and included in the corporation's taxable income allocated to the shareholders, any further adverse tax consequences of the receipt of that income would be punitive.

An inadvertent termination also may occur because a class of purported indebtedness that did not comply with the safe harbor rules of section 1361(c) (5) was reclassified as a second class of stock. The legislative history specifically suggests that, in that circumstance, the Commissioner should waive the inadvertent termination if no tax avoidance has occurred.¹⁴⁴ Of course, it is not clear what might be regarded as tax avoidance in this context. If the debt instrument has been retired by the corporation and the proceeds treated by the owner of the instrument as a tax-free return of capital in circumstances in which a distribution by the corporation with respect to its stock would also have been tax free but would have reduced the accumulated adjustments account required by section 1368(e), the potential for a substantial tax reduction surely would have been obtained. Absent tax avoidance, it would not be unreasonable for the regulations to require that the offending security be eliminated, and, perhaps, to provide for the restoration to income of any deductions claimed by the S corporation, and therefore its shareholders, for interest paid on the purported debt instrument.¹⁴⁵

Section 1362(g) continues the provision of prior law¹⁴⁶ that bars a corporation from electing to be taxed under Subchapter S for a five year period following the termination of a previous Subchapter S election unless the Commissioner consents to the second election.¹⁴⁷ The relatively modest restriction that this revision imposes upon the free movement between the regular and the Subchapter S patterns of taxation is considered below in connection with the related tax upon capital gains.¹⁴⁸ In view of the scope of the Commissioner's discretion to waive inadvertent terminations,

144. *Id.*

145. Where the termination occurs because the corporation acquires an ineligible shareholder, an adjustment of the income tax liabilities of the S corporation shareholders would be inappropriate beyond a reversal of any allocation of income or expense to the ineligible shareholder. Presumably, the amount of any allocation to an ineligible shareholder that the Commissioner orders reversed should be reallocated to that shareholder's transferor rather than to the other shareholders of the S corporation (unless, of course, the stock was originally issued by the corporation to the ineligible shareholder).

146. Former I.R.C. § 1372(f).

147. Section 6(e) of the Revision Act enacts a "fresh start" rule that eliminates the five-year waiting period for reelection if the termination occurred under former I.R.C. § 1372. Pub. L. No. 97-354, 96 Stat. 1669, 1700 (1982). TCB § 201(j) would treat revocations under prior law in the same way as terminations for purposes of § 6(e).

148. See text accompanying notes 335-43 *infra*.

reelecting with the consent of the Commissioner will become far less common. If the corporation cannot obtain a waiver of an inadvertent termination, either because the termination was determined not to be inadvertent or because the corporation failed to take corrective action or to make the adjustments required by the Commissioner, the Commissioner is unlikely to consent to the reelection within the five year period. Accordingly, the section 1362(g) reelection will be useful only in those relatively rare situations when a corporation experiences a bona fide change in circumstances that will make a new Subchapter S election advisable.

D. New Planning Possibilities

The elimination of the restriction upon the receipt of passive investment income, at least for some S corporations, together with the ability to issue stock possessing different degrees of voting power and the safe harbor debt rules open up significant new planning possibilities for the use of S corporations. Some taxpayers prefer to manage the investment portfolios of various members of their family through a single business entity. In the past, taxpayers have employed trusts and partnerships, as well as corporations, for this purpose. The entity investment vehicle permits centralized management of the investment portfolio and the ability to spread the risk of speculative investments over a large number of investors. In addition, the concentration of economic power that the entity creates permits the investors to participate in investments as a group that would not be available to them individually. Moreover, the use of an entity permits the older generation members of the family to follow the advice of their estate planning consultants and make lifetime gifts to younger members of the family without sacrificing their investment objectives. The gifts are made of ownership interests in the investment vehicle and not in its underlying portfolio of investments. It has become increasingly popular to take the planning for this investment vehicle a step further. With certain of the entities that are used for this purpose, it is possible to have the older generation acquire securities in the investment vehicle that lack a growth potential, and by issuing the younger generation a different class of security, have them receive the appreciation in the investment portfolio. Such a technique effectively passes the appreciation potential in the investment portfolio to the second generation free of any transfer taxes and freezes the size of the estate of the older generation.

When the family's assets consist primarily of an active business enterprise, the preferred investment vehicle traditionally has been a corporation because of the well-established tax and corporate law rules governing the division of ownership into different classes

of stock. More recently it has been suggested that similar results can be achieved through the use of a partnership.¹⁴⁹ Where the assets consist of portfolio investments, the corporation would constitute a personal holding company unless the ownership of its stock is distributed far beyond a few family groups. If the investments held by the personal holding company consist of debt securities or dividend paying stock, the company must distribute its ordinary income annually in order to avoid the high tax upon personal holding company income. As a result, the growth potential of the investment company is blunted and the income from the investments is subject to a higher current rate of tax than would be incurred if the investments were owned by the shareholders individually. To avoid these consequences, many taxpayers employ a partnership as the investment vehicle for portfolio investments. That format, however, somewhat complicates both annual giving programs and the ability to freeze the estates of the older generation.

Under the Revision Act, such taxpayers may use an S corporation instead of a personal holding company as their investment vehicle. Formation of a new corporation and an immediate election under Subchapter S will avoid completely the increased tax that is created by the use of a personal holding company and will permit an unlimited accumulation of earnings without the imposition of the accumulated earnings tax. In order to permit the freezing of the estates of the older generation while not passing control over the investment portfolio to the second generation at the time such a corporation is formed, S corporations normally will issue three types of securities: voting common stock, nonvoting common stock, and indebtedness meeting the new safe harbor rules. The older generation may hold the indebtedness and either all of the voting stock or a sufficient amount to establish control over corporate affairs. The nonvoting stock, or a mix of voting and nonvoting stock, which will possess the right to substantially all the appreciation in the corporate assets, may be given immediately or over time to younger generation members of the family. A typical estate plan would call for a gradual transfer of the voting stock in the corporation to the second generation through a lifetime giving program.

In most instances, this estate planning technique will be useful only if the corporation can be formed free of tax. That objective can be obtained if the incorporation qualifies under section 351. If the diversification rules of that section are avoided,¹⁵⁰ qualification under section 351 is normally routine.

149. Nelson, *The Partnership Capital Freeze: Income, Estate, and Gift Tax Considerations*, 1 VA. TAX R. 11 (1981).

150. I.R.C. § 351(e)(1).

The extent to which appreciation in the value of the S corporation can be shifted to the second generation free of transfer taxes is largely a function of the rate of interest that must be paid on the indebtedness issued to the older generation. To the extent that a low rate of interest may be used on safe harbor debt instruments, more appreciation may be shifted to the second generation through an S corporation than through a corporation subject to the regular tax. Of course, in establishing the interest rate on any indebtedness, the family and its tax advisors must take care not to violate the family group reallocation rules of section 1366(e)¹⁵¹ or the Code provisions of general application such as sections 385 and 482.

A Subchapter S investment company may not have any earnings and profits accumulated during years in which a Subchapter S election was not in effect. The presence of those earnings and profits would precipitate both the tax on passive investment income and the ultimate termination of the Subchapter S election. As a result, in most instances it will not be possible merely to convert a corporation presently subject to the regular income tax to a Subchapter S investment company. Possible techniques for eliminating earnings and profits from an S corporation are discussed below.¹⁵² If the use of the S corporation device seems to produce sufficient savings of income and transfer taxes, it might be desirable to suffer the capital gains tax attributable to the complete liquidation of the old corporation and to reincorporate the investment portfolio in a new S corporation free of all earnings and profits.

If an existing corporation subject to a Subchapter S election does not have earnings and profits accumulated during nonelection years but does have earnings and profits accumulated during Subchapter S years, there still may be difficulties in implementing an estate freeze. The first step in accomplishing an estate freeze using a corporation subject to the regular tax is to convert outstanding common stock owned by the older generation into a class of preferred stock. Subject to section 305 and the future application of section 306, such a conversion is free of tax. Unfortunately, however, an S corporation cannot issue preferred stock: the freezing security must be a debt instrument. Exchanging outstanding common stock for such a debt instrument is a taxable transaction and in many instances the cost of an accelerated capital gains tax will outweigh the prospective benefits of estate tax reduction. The alternative is to distribute the debt instrument as a dividend and make gifts of the common stock; however, if the corporation has any earnings and profits, such a distribution could be subject to a prohibitive ordinary income tax.

151. See text accompanying notes 274-82 *infra*.

152. See text accompanying notes 399-405 *infra*.

IV. COMPUTATION OF INCOME

A. *Prior Law*

The choice of the form in which to conduct business, with few limited exceptions,¹⁵³ traditionally has determined the pattern of taxation to which the business was subject. Subchapter S was added to the Code in 1958 as an exception to a tax structure which recognizes, now as then, two major classifications of business enterprise, the corporation and the partnership, and subjects them to radically different forms of taxation.

If the business entity is incorporated, it is treated as a taxable entity separate from its shareholders and is subjected to the corporate income tax,¹⁵⁴ thus producing a two-level taxing system. With the exception of a few provisions that govern the taxation of the transmission of property among corporations,¹⁵⁵ a corporation is required to compute its income in a manner not terribly dissimilar from the manner in which individuals compute their income.¹⁵⁶ That corporate taxable income is then subject to tax in the hands of the corporation on an annual basis under a rate schedule that, compared to the rate schedule applicable to individuals, is relatively nonprogressive and does not reach rates quite as high as does the individual schedule.¹⁵⁷

In order for the owners of such an incorporated business to obtain a direct benefit from the corporate earnings, they would, in most cases, be required to subject those earnings to a second level of tax. For example, if those earnings were distributed currently, the resulting dividend would be subject to tax at ordinary income rates.¹⁵⁸ If the profits were realized through the sale of corporate stock, the sale would be subject to the second tax, albeit

153. Between 1954 and 1966, certain partnerships were permitted to elect under Subchapter R of the Code to be taxed as corporations. In addition, a business trust or limited partnership may be treated as an association taxable as a corporation by Treas. Reg. § 301.7701-2 (1973).

154. I.R.C. § 11. Cf. I.R.C. §§ 56 and 1201.

155. See e.g., I.R.C. §§ 243 (85% or 100% exclusion for dividends received by corporations) and 332 (non-recognition of gain on liquidation of subsidiary).

156. See generally B. BITTKER and J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND THEIR SHAREHOLDERS*, ch. 1, (4th ed. 1979)[hereinafter cited as BITTKER AND EUSTICE].

157. Under relatively recent legislation, the corporate and individual rate schedules have become increasingly similar. Corporate taxable income below \$100,000 is now subject to five bracket rates ranging from 15% to 46%. In addition, the maximum individual rate has been reduced to 50%. For a further comparison of the corporate and individual rate structures, see text accompanying notes 477-78 *infra*.

158. I.R.C. § 301(c)(1).

at capital gains rates.¹⁵⁹ In order to distinguish between a corporate distribution of profits and a return of the stockholder's capital, the corporate tax provisions employ the concept of earnings and profits.¹⁶⁰ A distribution from a corporation will be treated as a dividend and subject to tax at ordinary income rates only to the extent that the distribution does not exceed the corporate accumulation of undistributed earnings and profits.¹⁶¹

If the owners of the business venture choose not to incorporate and to become subject to partnership taxation, the picture changes radically.¹⁶² Although the existence of a partnership substantially affects income tax liability, the partnership itself is not subject to tax.¹⁶³ Rather, specific items of partnership income are allocated among the partners pursuant to the terms of the partnership agreement.¹⁶⁴ The partners then are required to include these items of income and expense on their individual returns and are subject to tax on those amounts pursuant to the same rate schedule that is applicable to their other income.¹⁶⁵ In general, the allocated items retain the same character on the individual partner's return as they had in the hands of the partnership.¹⁶⁶

This two-pronged system was modified, although not as greatly as might appear, by the introduction of the Subchapter S corporation in 1958. While later interpreters of Subchapters S often referred to the new provisions somewhat casually as subjecting a corporation to tax "like a partnership," Congress' limited objective for the 1958 legislation was to permit incorporated business ventures to avoid having their income subject to tax on two levels, the corporate and the shareholder.¹⁶⁷ Indeed, the underlying philosophy of the 1958 legislation was to change the method of taxing corporations only to the minimum extent necessary to eliminate the corporate tax. As a result of this highly limited objective, Congress created a third form of business taxation that in many respects was more complicated than either of the other two.

The limited nature of Congress' objective in enacting Sub-

159. I.R.C. §§ 1221 and 1202.

160. See I.R.C. §§ 312 and 316.

161. Under I.R.C. § 316, a distribution may be taxed as a dividend to the extent of either current or accumulated earnings and profits.

162. See generally MCKEE, *supra* note 73, and A. WILLIS, J. PENNELL, and P. POSTLEWAITE, *PARTNERSHIP TAXATION* (1981).

163. I.R.C. § 701.

164. I.R.C. § 704.

165. I.R.C. § 702(a).

166. I.R.C. § 702(b).

167. S. REP. NO. 1983, 85 Cong., 2nd Sess. 68 (1958), *reprinted in* 1958 U.S. CODE CONG. & AD. NEWS 4791, 4876.

chapter S is evidenced most clearly in the provisions governing the computation of income under prior law. With few exceptions, the income of an electing corporation was computed in exactly the same manner as taxable income was computed for a nonelecting corporation,¹⁶⁸ however, the corporation itself was not subject to the corporate income tax.¹⁶⁹ Instead, its taxable income, as so computed, was taxed directly to its shareholders.¹⁷⁰ As the mechanism for achieving that tax, Congress created the fiction of a constructive year-end dividend to the shareholders of an amount equal to the corporate taxable income.¹⁷¹ That amount, with certain modifications, was referred to under prior law as undistributed taxable income and by practitioners as "UTI." Consistently with the established corporate pattern, this constructive distribution was subject to tax in the hands of the shareholders in precisely the same manner as an actual dividend distribution would have been. To the extent of the corporate earnings and profits, the constructive dividend was subject to tax at ordinary income tax rates. As a result, the earnings and profits account of a Subchapter S corporation had to be computed accurately in order to determine the ceiling on the amount of the constructive distribution that was to be taxable to shareholders. Thus, under prior law, Subchapter S corporations were required to compute annually not only the amount of their taxable income, as modified under Subchapter S, but also the amount of their current earnings and profits.

In principle, every corporation must compute its earnings and profits currently. Unfortunately, that computation has always been troublesome; the concept is not defined comprehensively anywhere.¹⁷² Section 312 sets forth a series of circumstances in which the computation of earnings and profits is to vary from the computation of taxable income but otherwise provides no assistance. As a result, earnings and profits computations are notoriously

168. Former I.R.C. § 1373(d). See generally Lourie, *Subchapter S After Six Years of Operations: An Analysis of Its Advantages and Defects*, 22 J. TAX. 166 (1965); L. BRAVENEC, *TAXATION OF SUBCHAPTER S CORPORATIONS AND SHAREHOLDERS* (PLI, 1978); and BITTKER AND EUSTICE, *supra* note 156 at ch. 6.

169. Former I.R.C. § 1372(b). As under current law, Subchapter S corporations were subject to tax on certain capital gains. Former I.R.C. § 1378. While under I.R.C. § 58(d) items of tax preference incurred by the corporation were allocated to its shareholders, if the corporation became subject to the tax on capital gains, it also became subject to the add-on preference tax imposed by former I.R.C. § 56 with respect to those capital gains.

170. Former I.R.C. § 1373(a).

171. Former I.R.C. § 1373(b).

172. BITTKER AND EUSTICE, *supra* note 156, at ¶ 7.03. See also Blum, *The Earnings and Profits Limitation on Dividend Income: A Reappraisal*, 53 TAXES 68 (1975) (suggesting the elimination of the concept for all corporations).

inaccurate.¹⁷³ For corporations subject to the corporate tax, this relatively casual approach towards the computation of earnings and profits is normally entirely adequate. Unless the corporation argues that a current distribution to its shareholders is not subject to tax in whole or in part because the distribution exceeds earnings and profits, the precise level of the earnings and profits accounts is largely academic. For Subchapter S corporations, however, the accuracy of the computation was of immediate importance.

Actual distributions of cash by a Subchapter S corporation, at least to the extent of the current earnings and profits of the corporation, were treated in precisely the same manner as dividends from regular corporations. To the extent of the current earnings and profits, such dividends were fully taxable as ordinary income to the recipients.¹⁷⁴ At the corporate level, the amount of cash dividends were charged against and reduced both the corporation's earnings and profits account and the amount of its undistributed taxable income. Consequently, the amount of the constructive year-end dividend to the Subchapter S shareholders was reduced by the full amount of the cash distribution.¹⁷⁵ This two stage computation did not alter the amount of corporate income that was subject to tax to the shareholders but it did affect the identity of the shareholders who would be subject to tax. While the constructive dividend was taxable to shareholders with respect to their holdings on the last day of the corporation's taxable year,¹⁷⁶ actual distributions were taxable to those who received them.¹⁷⁷

These computations became considerably more complex, however, if the Subchapter S corporation made an actual distribution of any property other than cash. Regrettably, the shareholders of Subchapter S corporations, for reasons discussed below,¹⁷⁸ had a far greater incentive to cause their corporation to make distributions of property, particularly debt obligations of the Subchapter S corporation itself, than did shareholders of regular business corporations. Prior law dealt with all such property distributions quite harshly. Actual distributions in any form other than cash did not reduce undistributed taxable income¹⁷⁹ nor, at least as an initial matter, were the corporate earnings and profits

173. See *Estate of Meyer v. Comm'r*, 200 F.2d 592 (5th Cir. 1953)(computation of earnings and profits by CPA determined to be in error by nearly \$1 million).

174. Former I.R.C. § 1375(d)(by implication); and Treas. Reg. § 1.1373-1(d) (1968).

175. Former I.R.C. § 1373(c).

176. Former I.R.C. § 1373(b).

177. Treas. Reg. § 1.1373-1(f) (1960).

178. See text accompanying note 353 *infra*.

179. Former I.R.C. § 1373(c).

allocated to such property distributions.¹⁸⁰ Rather, notwithstanding the property distribution, the constructive year-end distribution still comprised the entire corporate taxable income. In determining the amount of each of these two distributions that actually was to be subject to tax in the hands of the shareholders, the corporate earnings and profits were allocated ratably between the fair market value of the property and the entire amount of the constructive distribution.¹⁸¹

The earnings and profits that were available to support taxation of these distributions included not only the corporation's current earnings and profits but also all accumulated earnings and profits;¹⁸² therefore, the net effect of a property distribution often was to subject the shareholders to a far greater tax than would have been the case if they were subject merely to tax on the corporate taxable income. For example, assume that a Subchapter S corporation had only a single shareholder and that it derived \$100 of taxable income for the current year. If the corporation made an actual cash distribution of \$40 during the year, that \$40 was subject to tax as was any dividend distribution from a corporation. In addition, the corporation's undistributed taxable income, \$100 less the \$40 actual distribution, also would have been subject to tax to the shareholder. As a result, the shareholder would be subject to tax on the \$100 of corporate taxable income. Even if the corporation had accumulated earnings and profits, no greater amount would be subject to tax. On the other hand, if the \$40 distribution were in the form of property, the constructive year-end distribution would be the full \$100. If the corporation's earnings and profits for the year were also \$100 and it did not have any accumulated earnings and profits, the \$100 of earnings and profits would be allocated ratably between the \$40 actual distribution and the \$100 constructive distribution. The shareholder, then, would have taxable income in the amount of \$29 attributable to the distribution of the property and of \$71 attributable to the constructive year-end distribution. The computation seems unduly complex but the result, subjecting the shareholder to tax on \$100, seems essentially fair. If, however, the corporation had accumulated earnings and profits in excess of \$40, the full amount of both the \$40 property distribution and the \$100 constructive distribution would be subject to tax as if the shareholder had received a dividend distribution of \$140.

The existence of accumulated earnings and profits in a Subchapter S corporation was not a mere hypothetical possibility.

180. Treas. Reg. § 1.1373-1(d) and (e) (1960).

181. Treas. Reg. § 1.1373-1(e)(2) (1960).

182. Treas. Reg. § 1.1373-1(g)(Example (4)) (1960).

Unless the corporation had been a Subchapter S corporation since its formation, it probably would have an earnings and profits account attributable to its preelection years. However, even a corporation that elected Subchapter S upon its formation could have a substantial accumulated earnings and profits account. In order that all taxable income was taxed to shareholders, prior law provided that earnings and profits could never be less than taxable income.¹⁸³ Taxable income, however, frequently is less than earnings and profits. Tax-exempt interest, derived from the holding of municipal bonds, for example, would not produce taxable income but does create earnings and profits.¹⁸⁴ Moreover, while accelerated methods of depreciation reduce taxable income, earnings and profits are reduced only by straight-line depreciation.¹⁸⁵ Thus, the constructive year-end dividend does not necessarily eliminate current earnings and profits every year.

The use of the corporate tax dividend concept to govern the income tax consequences of actual and constructive distributions was far less favorable to the shareholders of a Subchapter S corporation than was the pattern of taxing partners. Since both actual and constructive distributions were regarded as dividends under prior law, they were subject to tax without regard to the underlying character of the corporate income that produced the amount subject to tax. With the notable exception of capital gains, the character of the income earned by the corporation was not retained when that income was distributed, actually or constructively, to shareholders. As a result, Subchapter S corporations proved to be substantially less flexible than partnerships and subjected their shareholders to a higher overall rate of tax than would have been applicable if the business had been operated as a partnership.

In retrospect, it seems evident that in 1958 Congress erred in setting such limited objectives for its new form of business taxation. Corporate conceptions that were suitable for a system that contemplated the double taxation of the separate legal entity of a corporation were unnecessary to the taxation of the shareholders of a Subchapter S corporation and added the pointless complexity and inflexibility described above. In the Revision Act, Congress has pursued the twin objectives of eliminating from the taxation of S corporations unnecessary corporate concepts while bringing the taxation of those corporations into greater conformity with the taxation of partnerships.

183. Former I.R.C. § 1377(b).

184. Treas. Reg. § 1.312-6(b) (1960).

185. See I.R.C. § 312(k)(1), dealing with traditional accelerated depreciation under I.R.C. § 167, and I.R.C. § 312(k)(3), prescribing a similar rule for property subject to the cost recovery system provided by I.R.C. § 168.

B. Under the Revision Act

1. Overview: Subchapter S's Place in the Sun

The Revision Act has changed completely the entire system of taxing S corporations.¹⁸⁶ Indeed, the only important resemblance that an S corporation bears to its predecessor, the Subchapter S corporation, is that the entity generally is not subject to tax.¹⁸⁷ The Act even affects that generalization, however, by expanding the circumstances in which the S corporation may in fact be subject to taxation at the corporate level.¹⁸⁸ Congress has attempted to correct the defects in prior law by disconnecting the taxation of S corporations from the corporate concepts that needlessly plagued its predecessor. That attempt was largely successful with respect to relatively routine matters, such as the computation of income, but was only partially successful with respect to more conceptual questions. Under present law, an S corporation computes its income in the same manner as does an individual and specific items of corporate income and expense are allocated to the shareholders for inclusion in their returns in a manner virtually identical to the pattern of taxing partnerships. On the other hand, many of the old corporate entity concepts persist. Corporate debt is not added to the tax basis of the shareholder's investment in the corporation and property distributions are reflected at market value rather than under the partnership basis rule. As a result, although the disconnection from corporate law that the Revision Act did accomplish has materially improved Subchapter S, the provisions remain complex and often surprising. An S corporation is still subject to a unique pattern of taxation, neither entirely borrowed from corporate entity concepts nor entirely embracing the partnership conduit approach.

In many respects, the disconnection of the taxation of S corporations from general corporate concepts has worsened the problem of relating an S corporation to the pattern of taxing other entities. While an S corporation computes its income in the same manner as an individual, it remains a corporation. Thus, absent

186. For other descriptions of the Revision Act, see the series of articles by Shaw and August appearing at 58 J. TAX 2, 84, and 300 (1983).

187. I.R.C. § 1363(a).

188. As under prior law, an S corporation may be subject to tax on certain capital gains. See text accompanying notes 335-43 *infra*. In addition, the corporation may be subject to tax on certain passive investment income. See text accompanying notes 122-24 *supra*. Finally, if the corporation disposes of property upon which an investment tax credit under I.R.C. § 38 was claimed for a non-election year in a manner that produces a recapture tax under I.R.C. § 47, the S corporation, rather than its shareholders, is liable for the tax so incurred. I.R.C. § 1371(d)(2).

further elaboration under the Code, an S corporation would be treated as a corporation by those sections that accord different tax consequences to transactions entered into by corporations than to those entered into by individuals even though the corporate income is taxable to individuals. To some extent, Congress specifically addressed this entity characterization question in the Revision Act. For some purposes under the Code, an S corporation is treated as an individual while for other purposes it is treated as a corporation. Moreover, under other sections of the Act, an S corporation is treated as a partnership and in some instances its shareholders, and sometimes just some of them, are treated as partners. Unfortunately, it is not always entirely clear how an S corporation is to be characterized. While in some instances Congress stated explicitly how an S corporation is to be treated for the purposes of a specific Code provision, in many other situations the question is left either ambiguous or entirely open. While the regulations, when issued, may assist in resolving many of these ambiguities, the status of an S corporation under the Code is likely to remain confused for many years in the future.

This uncertain, multi-faceted character of an S corporation may have been unavoidable. The cost in terms of accelerated income taxation of changing from corporate to partnership form is generally prohibitive.¹⁸⁹ Thus, casual changes in the form in which business is conducted in order to secure momentary tax advantages is rarely feasible. Properly, Congress did not wish to impose such tax costs upon the making of a Subchapter S election.¹⁹⁰ Quite the contrary, few corporations are subject to any accelerated tax liability by virtue of either electing or terminating a Subchapter S election.¹⁹¹ Moreover, while special provisions of the Code are designed to restrict the desirability of making temporary Subchapter S

189. The liquidation of a corporation is a taxable event which normally subjects the shareholders to tax on the full value of the corporation less their tax basis for their stock. I.R.C. § 331. The alternative provided by I.R.C. § 333 subjects the shareholders to ordinary income taxation on the entire amount of the corporate earnings and profits and thus is less desirable generally.

190. HOUSE REPORT, *supra* note 22, at 6; SENATE REPORT, *supra* note 22, at 6.

191. The numerous questions that a mid-stream Subchapter S election raises, under either prior or existing law, are beyond the scope of this Article. However, under prior law and apparently under the Revision Act, a Subchapter S election does not trigger depreciation recapture under I.R.C. §§ 1245 or 1250, nor, apparently, does the election constitute the disposition of an installment obligation under I.R.C. § 453B. Under I.R.C. § 1371(d)(1), the election does not require recapture of the investment tax credit provided by I.R.C. § 38. On the other hand, operating losses from pre-election years may not be carried over and claimed while the election is in effect although the years during which the election is in effect count in determining the number of years to which a loss or credit may be carried. I.R.C. § 1371(b).

elections, those provisions are not punitive and, except in limited circumstances, are not particularly effective.¹⁹² As a result, the possibility of tax manipulation beyond the remedial purposes of Subchapter S remains relatively high. In order to reduce the incentive for such tax motivated transactions, Congress concluded that it was necessary to retain many of the entity based rules of corporate taxation under the Revision Act.¹⁹³ Had the full pattern of taxing partnerships been made available to S corporations while permitting a Subchapter S election without significant tax costs, corporate managers would have had available too wide a variety of tax consequences of transactions between the corporation and its shareholders. Preventing the anticipated abuses of Subchapter S would have required a lengthy series of complex restrictions that would have been inconsistent with the general desire of simplifying the operation of Subchapter S corporations.

Whether Congress could have more closely conformed the taxation of S corporations to the partnership conduit model will undoubtedly be explored during the coming years. Perhaps experience under the existing Act will demonstrate that more of the entity-based features of Subchapter S can be discarded without undermining the integrity of those provisions. For the time being, however, the general effect of the compromise reached under the Revision Act is evident. While in many respects the operation of a Subchapter S corporation has been simplified, the task of its tax advisors remains as complex as ever. The intricate and partially undefined position of the S corporation as part corporation, part individual and part partnership is enormously confusing.

2. Computing S Corporation Income

a. In General

Reversing prior law, section 1363(b) provides that, with minor exceptions,¹⁹⁴ the taxable income of an S corporation shall be

192. See text accompanying notes 335-43 *infra*.

193. STAFF REPORT, *supra* note 7, at 8.

194. In addition to the separate statement described below, I.R.C. § 1363(b) permits S corporations to amortize organization expenses under I.R.C. § 248 and bars the deductions that are not allowed to partnerships under I.R.C. § 703(a)(2). That section disallows certain deductions because they are allowed at the partner (or shareholder) level, including personal exemptions, depletion of oil or gas wells, and the net operating loss deduction. The provision also disallows a partnership deduction for foreign taxes, charitable contributions, and the itemized deductions for individuals. For both partnership and S corporations, the disallowance of these deductions is largely superfluous because those items must be separately stated and passed through to the partner or shareholder. For partnerships, Treas. Reg. § 1.703-1(a)(2)(vii) (1960) expands this list to include the I.R.C. § 1202 capital

computed in the same manner as that of an individual. As a result, S corporations are denied deductions and exempted from inclusions in income that are applicable only to corporations. For example, S corporations may not take the dividends received deduction provided by section 243 nor claim the "deemed paid" credit for foreign taxes paid by foreign subsidiaries under section 902.¹⁹⁵

Many Code provisions governing the computation of taxable income contain different rules for corporate and individual taxpayers. Absent additional guidance, in many cases it would be unclear whether the application of those sections was controlled by the general principle of section 1363(b) that an S corporation computes its income in the same manner as an individual or by the fact that an S corporation remains a corporation. For example, in providing for the taxation of corporate distributions, section 301 distinguishes sharply between corporate and noncorporate recipients of the distribution. Regardless of how an S corporation is required to compute its taxable income under section 1363(b), under section 301(d), the amount of a property distribution to be taken into account by a corporate shareholder is not the fair market value of the property distributed, rather it is the lesser of that value or the adjusted basis of the property in the hands of the distributing corporation.

Congress has attempted to address such ambiguities in two ways. Under section 1371(a)(2), an S corporation "in its capacity as a shareholder of another corporation" is to be treated as an individual for the purposes of Subchapter C of the Code, which includes the three hundred series of sections governing the consequences of corporate transactions, such as distributions and reorganizations. The significance of this provision in determining how an S corporation is to be treated for purposes of Subchapter

gains deductions and the I.R.C. § 1212 capital loss carryover. Since these items are computed at the S corporation shareholder level as well, a similar rule most likely will be applied to I.R.C. § 1363.

One possible consequence of the exclusion of these items from the computation of the income of a partnership is that the limitation of I.R.C. § 704(d) may not apply to such items. *See* Treas. Reg. § 1.704-1(d)(2) (1960) and MCKEE, *supra* note 73, at ¶ 10.10[1](b). Apparently, partners may deduct their share of charitable contributions even though the amount of that expense exceeds the basis for their partnership interest. Under the Revision Act, the limitation on the allowability of losses to a shareholder's basis imposed by I.R.C. § 1366(d)(1) is expressly applicable to both charitable contributions and foreign taxes by I.R.C. § 1366(a)(1) (last sentence). No explanation for this deviation from partnership taxation appears in the legislative history.

195. Because the S corporation is a corporation in spite of this provision, it may incur expenses of a type that true individuals cannot; for example, expenses incident to the issuance and redemption of stock, liquidations, and taxable or tax-free acquisitions. Presumably, the treatment of these expenses will be governed by the rules applicable to other corporations.

C is considered below.¹⁹⁶ With respect to the computation of taxable income, however, sections 1371 and 1363 make clear that an S corporation is to include the fair market value of a property distribution from a corporation in which it is a shareholder and is not entitled to use the corporation basis rule.

In addition, in the Revision Act Congress has amended several sections of the Code to provide specifically for the treatment of an S corporation. While it is quite clear that Congress intended to provide a needed measure of assistance through this series of specific amendments, that effort may prove to be more a source of confusion than a source of assistance. The difficulty is that the pattern of amendments made by Congress seems almost random. In many cases, specific provision is made for an S corporation that would appear completely unnecessary in light of the general statement that an S corporation is to compute its taxable income in the same manner as an individual. For example, section 447 requires certain corporations engaged in farming (and partnerships of which a corporation is a partner) to use the accrual method of accounting and to capitalize certain expenses. Since the provision directly addresses the computation of income, it would seem to follow from the general rule of section 1363 that the provision was not applicable to S corporations. Nevertheless, subsection (c) of the provision specifically so states. On the other hand, section 291, added by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"),¹⁹⁷ requires that the amount of certain preferential items included in a corporate return be reduced by 15%. For example, a corporation is entitled to deduct only 85% of the amount of intangible drilling expenses that it would have been entitled to deduct in the absence of section 291.¹⁹⁸ As originally enacted, this new provision specifically excluded from its application Subchapter S corporations.¹⁹⁹ In the Revision Act, that specific exclusion was deleted and, on its face, the provision is now applicable to all corporations. That pattern of amendment might indicate a Congressional intent that section 291 be applicable to S corporations; however, legislative history to the Revision Act makes clear that S corporations are not subject to the cut down rules of section 291.²⁰⁰ Presumably Congress concluded that the general rule of section 1363 made this point with sufficient clarity that the specific exclusion in section 291 was unnecessary.

196. See text accompanying notes 429-35 & 448-51 *infra*.

197. Pub. L. No. 97-248, § 204, 96 Stat. 324, 423 (1982).

198. I.R.C. § 291(b).

199. Former I.R.C. § 291(e)(2).

200. HOUSE REPORT, *supra* note 22, at 14; SENATE REPORT, *supra* note 22, at 15.

Section 170, permitting a deduction for charitable contributions, provides different rules for corporations and individuals at several points. In subsection (e)(3) and (4), for example, the section provides a special rule for determining the amount deductible with respect to contributions of certain inventory and of scientific property to be used for research. Both of these special provisions are applicable only to charitable contributions by corporations. Because both provisions relate to the computation of income, an S corporation might be regarded as excluded from their application under the general rule. Nevertheless, Congress specifically provided that the special ceilings are not applicable to contributions by S corporations.²⁰¹ On the other hand, no other reference to a corporation in section 170 was modified similarly. In general, corporations are subject to a 10% ceiling on the overall amount deductible with respect to their charitable contributions and they are subject to ceilings that are different from those applicable to individuals with respect to contributions of certain appreciated property.²⁰² It is clear that neither of these limitations is applicable to S corporations, but, rather, the full amount of their charitable contributions is to be stated separately and allocated to their shareholders.²⁰³ The ceilings on the amount deductible are to be applied at the shareholder level. However, it is not at all clear why Congress thought it necessary to provide specially for corporations for the purposes of some provisions in section 170 but not for others. The resulting pattern creates needless confusion.

In large part, the resulting statutory pattern merely has been carried over from prior law. For example, sections 170(e)(3) and (4) previously excluded Subchapter S corporations from their scope and that exclusion has been continued under current law. In this respect, the amendment of section 291 is exceptional. The difficulty, of course, is that under prior law, a Subchapter S corporation was regarded as a corporation and computed its income as a corporation; thus, the specific exclusions of Subchapter S corporations were necessary to the result Congress sought. Under present law, in many instances the exclusions do not appear to be necessary and, thus, create uncertainty concerning how other sections of the Code, lacking such specific references, are to be construed. It is unfortunate that Congress was not able to integrate the new S corporation more completely into the statutory pattern.

An S corporation is required to compute its taxable income as if it were an individual, yet it remains a corporation for all other

201. I.R.C. § 170(e)(3)(A) and (4)(D)(i).

202. I.R.C. § 170(b)(2) and (e)(1).

203. HOUSE REPORT, *supra* note 22, at 14; SENATE REPORT, *supra* note 22, at 16.

purposes under the Code except to the extent that the Code specifically provides to the contrary. As noted above, for certain purposes under Subchapter C, an S corporation is regarded as an individual and not as a corporation. Similar provisions are contained in a series of specific Code sections. These provisions are also carried over from prior law but in general are necessary to the proper construction of the Code. For example, an S corporation is subject to the hobby loss provisions of section 183 and to the related limitation on the deduction of expenses with respect to a residence imposed by section 280A.²⁰⁴

In other situations, Congress has continued the treatment of an S corporation as a corporation when it should have treated it as an individual. For example, under section 1244, a loss sustained on certain stock is entitled to ordinary, rather than capital, loss treatment. That favored treatment, however, is available only when the stock is issued to, and held by, an individual or partnership.²⁰⁵ With the elimination of the passive investment income restriction, S corporations are free to invest in other businesses and, indeed, may be used as investment companies. The unavailability of ordinary loss treatment under section 1244, however, seriously reduces the attractiveness of investing in new or small business ventures. There is no reason why the shareholders of S corporations should not be entitled to the same benefits under section 1244 that are available to partners.²⁰⁶ The failure to amend section 1244 to extend its benefits to S corporations perpetuates a further unfavorable, and unnecessary, distinction between partnerships and S corporations that is inconsistent with the general approach of the Revision Act.²⁰⁷

b. Separate Statement

The mechanics of translating the income derived by an S corporation into the tax liability of its shareholders has been copied virtually intact from partnership law. The S corporation is required to separately state items of income and expense²⁰⁸ and each

204. See also I.R.C. §§ 1251(b)(2), 1256(e)(3)(B), and 6661(b)(1)(B).

205. I.R.C. § 1244(a).

206. It would be reasonable to condition such an extension upon the corporation's continuous qualifications as an S corporation during the period beginning with the issuance of the section 1244 stock and ending on the date the loss is incurred.

207. As under prior law, stock issued by an S corporation may be section 1244 stock and normally it is desirable to qualify under that provision. However, in contrast to the revision of Subchapter S, the passive investment income limitation on corporations issuing section 1244 stock has been retained. I.R.C. § 1244(c)(1)(C).

208. I.R.C. § 1363(b)(1).

shareholder is required to take into account on his individual return his pro rata share of each such item.²⁰⁹ Under partnership tax accounting the number of such items that must be separately stated is indeed impressive.²¹⁰ The Code in section 702(a) enumerates only six such items while the regulations,²¹¹ issued under express statutory authority,²¹² add many more. The partnership information return adds still others. Moreover, the partnership regulations provide that additional items must be separately stated and taken into account by all partners if the separate statement would result in an income tax liability for any partner that would vary from the liability resulting from a failure to state the item separately.²¹³ The items specifically enumerated in the Code, in the regulations, or on the return, must be separately stated in all events but other items are to be stated separately only if that statement would affect the tax liability of a partner. Thus, literal compliance with the partnership regulations requires that the partnership specifically determine in each year, based upon the individual characteristics of the partner's return, whether separate statement would affect the tax liability of a partner.

Unlike the partnership approach, new section 1366(a)(1) merely provides that the items that must be separately stated are those "the separate treatment of which could affect the liability for tax of any shareholder." The significance of the different statutory approach to the S corporation is not clear since no reference is made in the legislative history to the deviation from the partnership provisions. Specifically, it is not clear what frame of reference should be used in interpreting the meaning of the word "could" in section 1366. Virtually any item of income could affect the tax liability of a shareholder of a Subchapter S corporation under some conceivable configuration of his individual income. If that is the construction that the Treasury places on the new statutory language, the number of items that must be separately stated for S corporation purposes will be even greater than the number of items that must presently be separately stated for partnerships. On the other hand, the proper frame of reference for interpreting the word "could" might be the individual characteristics of the shareholder's returns. That is, a separate statement may be required if such statement "could" be material to a shareholder in view of his other sources of income and expense. In that event, the number of items that must be separately stated for an S corporation might be materially less than the number that must be separately stated

209. I.R.C. § 1366(a)(1).

210. See MCKEE, *supra* note 73, at ¶ 9.03.

211. Treas. Reg. § 1.702-1(a)(8)(i) (1972).

212. I.R.C. § 702(a)(7).

213. Treas. Reg. § 1.702-1(a)(8)(ii) (1960).

by a partnership, although the same problem of individual determinations of shareholders' income and expense situations would remain. This uncertainty with respect to the scope of section 1366, engendered by the use of the word "could" rather than the word "would," should not substantively affect the tax liability of S corporation shareholders. It is clear that if the separate statement would make a difference in fact, a separate statement must occur. Rather, the doubt pertains to the procedural question of how complex it will be to prepare S corporation information returns. Notwithstanding the ambiguity of the statutory language, it is probable that in issuing regulations pursuant to this provision the Treasury will follow the partnership format. Thus, it can be expected that through a combination of these regulations and the Subchapter S information return, S corporations will be required to separately state a specified list of items of income and expense, which probably will correspond to the items that must be separately stated on a partnership return. In addition, the Treasury undoubtedly will require the separate statement of any additional item if that separate statement would affect the tax liability of any shareholder.

c. Characterization of Income

While Congress was unquestionably correct in conforming the taxation of S corporations to the existing pattern of taxing partnerships, that approach is not an entirely unmixed blessing. The conformity thereby achieved necessarily will include the uncertainties that persist in partnership taxation. For example, new section 1366(b), governing the characterization of items of income and expense allocated to a shareholder, states that the character of any item is to be determined "as if such item were realized directly from the source from which realized by the corporation." This language is quoted directly from the similar provision applicable to partnerships.²¹⁴ Where the characterization of an item of income and expense is inherent in the item itself and is unaffected by the nature of the recipient, this provision has caused little difficulty under partnership taxation. However, it has long been recognized that this provision is ambiguous where the character of an item is affected by the nature of its recipient.²¹⁵ For example, gain from the sale of property that would be entitled to capital gains taxation if the property had been owned by some sellers, will be subject to ordinary income taxation if the seller is a dealer in such property. In that event, the character of an item received by the

214. I.R.C. § 702(b).

215. MCKEE, *supra* note 73, at ¶ 9.05.

corporation might be very different from the character of the same item received by one of the shareholders. The literal language of new section 1366(b), as well as the language of the partnership taxation predecessor, suggests that the characterization is to be made at the shareholder or partner level. If that were the case, different shareholders could be subject to different characterizations of the same item of income passed through the S corporation and that diversity of result would make it impossible for the S corporation to allocate separately items of income and expense. The corporation would not know whether the item constituted ordinary income or capital gains; therefore, it would be unable to state separately the total amount of its capital gains and inventory sales income and thus would be required to state separately each item of income and expense from each separate transaction in which the corporation engages—a totally impossible burden.

When this question has arisen in the taxation of partnerships, the more sensible construction generally has been achieved. The Commissioner usually has taken the position that characterization is to be determined at the partnership level and the courts usually have agreed.²¹⁶ The legislative history of the Revision Act reflects not only this confusion under partnership law but also Congress' intention to incorporate that confusion into the new S corporation rules. Thus, the House Report states that the characterization rule for S corporations will be the same as the partnership rule and that "under the partnership rules, this has generally resulted in an entity level characterization."²¹⁷

In relatively rare circumstances, entity characterization might result in improper tax avoidance. For example, a dealer in a certain type of property might transfer that property in a non-recognition exchange to an entity that he dominated and largely owned in an attempt to secure capital gains on the disposition of the property. In such a circumstance, the character of the proceeds of the disposition should be determined, arguably, by reference to the dealer himself and not the entity.²¹⁸ Absent such transparent tax avoidance, however, entity characterization yields the proper result and is likely to prevail in the taxation of S corporations.

216. See, e.g., *Barnham v. United States*, 301 F. Supp. 43 (M.D. Ga. 1969), *aff'd per curiam*, 429 F.2d 40 (5th Cir. 1970); Rev. Rul. 67-188, 1967-1 C.B. 216. But see *Riddell v. Scales*, 406 F.2d 210 (9th Cir. 1969). See generally MCKEE, *supra* note 73, at ¶ 9.05.

217. HOUSE REPORT, *supra* note 22, at 16; SENATE REPORT, *supra* note 22, at 17.

218. To the limited extent of distinguishing ordinary from capital gain, this level of characterization problem also existed under the old Subchapter S rules. In an attempt to avoid the results described in the text, Treas. Reg. § 1.1375-1(d) (1960) provided that while the character of gain was determined ordinarily at the corporate level, if a Subchapter S corporation was used to convert ordinary

d. Elections

One feature of partnership taxation that many taxpayers find unduly restrictive is the requirement that most elections be made at the partnership level. The entity level election requirement has been justified on the ground that a partnership must be able to compute its items of income and expense in order to allocate those items to its partners. On the other hand, the very nature of an election contained in the income tax laws implies an understanding that different taxpayers may be affected quite differently by a taxing provision and, within the tolerance allowed by the election, should be able to arrange their tax position to their best advantage. Most elections are contained in provisions in which Congress intended to provide a benefit while recognizing that in certain circumstances the "benefit" offered might prove to be a disadvantage. A taxpayer already sustaining operating losses, for example, derives relatively little benefit from increasingly accelerated methods of depreciation. Thus, the new cost recovery system, granted by section 168 in lieu of depreciation, permits taxpayers a wide latitude in selecting the degree of acceleration they wish to claim. To the extent that taxpayers are bound by an election made at the corporate or partnership level, they are denied this flexibility.

The conflict between aggregate and entity characterization of a partnership often reduces to a conflict between flexibility and administrative ease. The preference for partnership level elections may represent an excessive concern for simplifying the audit of partnerships. In some circumstances the added complexity of permitting elections at the partner level may be intolerably great, not only to the Commissioner, but also to the partnership itself. In many other cases, however, this conclusion is far from clear.

In any event, Congress has followed the partnership format in section 1363(c).²¹⁹ Subject to the same exceptions as are applicable to partnerships,²²⁰ all elections are to be made by the S corporation. Unfortunately, the list of exceptions to this general rule contained in section 1363 is not exclusive. Specific sections of the Code occasionally provide that elections provided under those sections

income into capital gain in connection with the contemplated disposition of property, the character of the gain might be determined at the shareholder level. This "collapsible" provision was not tested and its validity remains in doubt. A similar provision probably will be included in the regulations governing S corporations.

219. See I.R.C. § 703(b).

220. The shareholder level elections provided by I.R.C. § 1363(c)(2) are those provided by: (1) I.R.C. §§ 108(d)(4) (discharge of indebtedness) and (d)(5); (2) I.R.C. § 163(d) (investment interest); (3) I.R.C. § 617 (mining exploration expenses); and (4) I.R.C. § 901 (foreign tax credit). I.R.C. § 703(b)(1) also includes the election under I.R.C. § 57(c) (defining net leases) but that provision is now obsolete.

are to be made at the partner or S corporation shareholder level. For example, TEFRA added new section 58(i) which permits taxpayers to amortize the tax benefits attributable to certain enumerated preference items over a 10-year period. If that election is made, the amortized items are not treated as items of tax preference either for the purpose of the alternative minimum tax imposed by section 55 on noncorporate taxpayers or the add-on minimum tax imposed by section 56 on corporations. Section 58(i)(5)(D) provides that an election to claim the benefits of this new provision is to be made separately by each partner or shareholder of an S corporation. If Congress wished to provide an enumeration in section 1363 of exceptions to the entity level election provision, it is regrettable that the enumeration could not be complete.

Clearly, it is desirable for the taxation of S corporations to parallel the taxation of partnerships to the greatest extent possible. However, it is not at all clear that elections that can be made at the partner level without causing excessive complexity or unfairness can also be made with similar ease at the S corporation shareholder level. There are important differences between the taxation of S corporations under the Revision Act and the taxation of partnerships, and those differences, in some circumstances, make certain shareholder level elections impractical. For example, the election under section 617 to deduct the cost of exploring for hard minerals is excessively complex. Section 617 is considered below in connection with other Revision Act changes governing the treatment of natural resources.²²¹ A second election that does not seem to operate properly at the shareholder level is the election to defer cancellation of indebtedness income.

In general, the cancellation of an indebtedness produces a gain to the debtor that is taxable as ordinary income.²²² Under the recently revised sections 108 and 1017, the recognition of that cancellation income, in certain circumstances, may be deferred. To the extent that the taxpayer is insolvent or the discharge occurs in the course of a federal bankruptcy proceeding under Title 11, the amount of the income is automatically applied in reduction of the taxpayer's carryovers of operating losses, credits and capital losses in a statutorily prescribed order.²²³ Any remaining income then is applied in reduction of the basis of the taxpayer's depreciable property in the manner prescribed in section 1017.²²⁴ In addition, if the indebtedness was incurred in a trade or business, the taxpayer

221. See text accompanying note 462 *infra*.

222. Treas. Reg. § 1.61-12 (1960).

223. I.R.C. § 108(b).

224. I.R.C. § 108(b)(2)(D).

may elect to reduce the basis of his depreciable property by the amount that would otherwise be taxed currently as cancellation income, thus deferring tax on that amount.²²⁵ Following the rule applicable to partnerships, section 108(d)(6) provides that the provisions of section 108 are to be applied at the shareholder level in the case of an S corporation and section 1363(c)(2)(A) provides that the elections that may be made under section 108 are to be made separately by each shareholder. The key to understanding this pattern of section 108 lies in the insolvency exception to cancellation of indebtedness income under prior law.²²⁶ Since as a matter of state law, general partners have unlimited personal liability for partnership obligations, it makes little sense to apply the insolvency test at the partnership level. If the partners themselves were solvent and all of the creditors of the partnership would be repaid fully, there is no justification for failing to tax income derived through the cancellation of an indebtedness merely because the assets of the partnership itself were insufficient to discharge the partnership obligations. Applying the insolvency test at the partner level, however, produces different results to different partners as some may be insolvent while others are not. In addition, the elective application of section 108 is applicable only to the extent that a cancellation causes the taxpayer to become solvent.²²⁷ Thus, the amount subject to the election may well vary for each partner. As a result, it is entirely appropriate for section 108, and the elections thereunder, to apply at the partner level. On the other hand, there could have been the potential for a substantial unfairness in so applying the basis reduction rules of section 108. In many instances, the only depreciable property in which a partner may have an interest would be the property belonging to the partnership itself. If section 108 relief could be elected only by a solvent partner to the extent that the partner individually owned depreciable property, the benefits of that provision would commonly be unavailable to partners. Since the partnership, which had originally incurred the indebtedness now cancelled, might nevertheless own substantial amounts of depreciable property, barring a partner from the benefits of section 108 would be both irrational and excessively harsh. To prevent this result, section 1017(b)(3)(C) provides that the interest of a partner in a partnership shall be treated as depreciable property to the extent that the property owned by the partnership consists of depreciable property. In order for a partner to be entitled to reduce the basis of his partnership interest under this provision, the partnership

225. I.R.C. § 108(c).

226. Treas. Reg. § 1.61-12(b) (1960); *Lakeland Grocery Co.*, 36 B.T.A. 289 (1937).

227. I.R.C. § 108(a)(2).

also must reduce its basis in depreciable property as to that partner. The net effect of these provisions is to extend to the partner the benefits of section 108 by permitting him to recognize the cancellation income through greater distributions of income from the partnership to him in future years.

While section 108 is also applicable at the shareholder level in an S corporation, the rationality of that application is not entirely clear. The shareholders of S corporations do not have unlimited personal liability with respect to the obligations of the corporation; therefore, insolvency at the corporate level is meaningless. On the other hand, the tax carryovers to be reduced through the operation of section 108 do not exist at the corporate level but rather are aspects of the computation of the tax liability of the respective shareholders. Unfortunately, section 1017 does not permit shareholders in S corporations to reduce the basis of their S corporation stock in a manner analogous to the reduction of the basis of a partnership interest. Accordingly, the unfairness described above exists with respect to S corporation shareholders and, in many instances, those shareholders will not be able to take advantage of the elective deferral of tax on cancellation income extended by section 108 to partnerships and other taxpayers. This harsher treatment of shareholders of S corporations is wrong and should be corrected by permitting a corporate level election to reduce the basis of property in order to obtain the deferral benefits of section 108.

Congress appears to have recognized this defect under section 108 and the TCB has adopted the approach suggested above.²²⁸ Under the proposed amendment, section 108 is to be applied at the corporate, rather than the shareholder, level and the elections available under that section are to be made at the corporate level. In addition, for the purpose of reducing the tax attributes of the S corporation, losses not currently available to the shareholders under section 1366(d)(1), because they exceed the basis of their investment, are to be treated as a net operating loss of the S corporation. That provision may require further development. As presently drafted, the TCB amendment could cause the burden of section 108 to fall unevenly among the shareholders since different shareholders will have different amounts of non-deductible losses.

e. Ceilings

Under many provisions of the Code, a ceiling is imposed upon a benefit or allowance that is extended to a taxpayer. Neither the new statutory provisions for S corporations nor the legislative

228. TCB § 201(b).

history to the provisions address the question of whether those limitations are to apply at the corporate or shareholder level. The general statements in the committee reports, however, suggesting that the computation of S corporation income is to follow the computation of partnership income, probably will control the resolution of this issue.²²⁹ Unfortunately, the treatment of ceilings for partnership purposes has never been entirely clear.²³⁰ The regulations indicate that the ceilings are to be imposed at the partner level without addressing the question of whether they are also applicable at the partnership level.²³¹ In addition, many specific sections of the Code granting allowances contain their own rule. For example, the limitation contained in section 48(c)(2) on the investment tax credit applicable to used property is to be determined at both the partner and partnership level. Accompanying the new S corporation rules are a series of amendments to other sections of the Code that attempt to integrate the new S corporation into the complicated scheme of the law. Where the specific section in the past addressed whether ceilings were to be imposed at the partner or partnership level, the issue has been resolved similarly with respect to S corporations. For example, the limitations on the investment tax credit for used property applicable to partners and partnerships has been extended to S corporations and their shareholders.²³² Similarly, the Act copied the enormously complex partner level ceiling on the depletion allowance for oil or gas production.²³³

f. Foreign Income

Section 1363(c)(2)(D) provides that each shareholder make the

229. See, e.g., HOUSE REPORT, *supra* note 22, at 6.

230. MCKEE, *supra* note 73, at ¶ 9.08[1].

231. Treas. Reg. § 1.702-1(a)(8)(iii) (1972).

232. I.R.C. § 48(c)(2)(D). Similar rules are contained in I.R.C. §§ 179(d)(8) and 194(b)(2)(B). I.R.C. § 48(q)(1) requires a corporate level reduction, equal to fifty percent of the investment tax credit, in the basis of the asset as to which the investment tax credit was taken. Neither I.R.C. § 48(q) nor the Revision Act requires any offsetting adjustment at the shareholder level, although it is clear that the credit itself will be allocated to the shareholders under I.R.C. § 1366(a)(1)(A). TCB § 102(b) would add new I.R.C. § 48(q)(6), that would require an "appropriate" adjustment in the basis of the S corporation stock in the hands of the shareholders to "take into account" the corporate level reduction in the basis of the asset; the provision requires the same adjustment in the basis of a partner's interest in a partnership. The appropriate adjustment in a partner's basis for his or her partnership interest may have to be determined individually, to take into account the effect of any special allocations. Since special allocations are not permitted under Subchapter S, the "appropriate adjustment" will always be a reduction in the shareholder's basis in the S corporation stock equal to his or her pro rata share of the corporate level reduction in basis.

233. I.R.C. § 613A(c)(13). See text accompanying notes 456-62 *infra*.

election under section 901 to treat his or her share of any foreign taxes paid as a deduction or a tax credit; section 1366(a)(1) provides that the amount subject to the election shall be separately stated.²³⁴ These rules parallel the treatment of the foreign tax credit in partnership taxation.²³⁵ In addition, new section 1373(a) provides that, for purposes of the provisions dealing with the foreign tax credit (sections 901 through 908) and controlled foreign corporations (sections 951 through 964), the S corporation will be treated as a partnership and its shareholders as partners. Section 1373(a) was apparently added to make clear that source rules, including the capital gains source rule of section 904(b), and the limitations of sections 904 and 907 will also apply at the shareholder level.²³⁶ These source rules and limitations apply at the partner level by virtue of section 901(b). To implement this rule, the legislative history contemplates that items of foreign source income and loss will also be among the items required to be separately stated under section 1366(a)(1)(A).²³⁷ In addition, section 1373(a) makes it clear that neither the S corporation nor its shareholders are entitled to the credit for foreign taxes paid by foreign subsidiaries under section 902.

The election to be taxed under Subchapter S and the termination of the election are treated under section 1373(b) as dispositions of the business for purposes of the recapture of foreign losses under section 904(f). Thus, when a corporation elects to be taxed under Subchapter S, it will have to recapture any foreign losses previously taken and not previously recaptured. Similarly, upon the termination of the corporation's Subchapter S election, the shareholders will have to recapture any foreign losses passed out to them and not previously recaptured. This rule seems correct

234. The flush language following I.R.C. § 1366(a)(1) requires a separate statement of amounts described in I.R.C. § 702(a)(6). That is the section requiring a separate statement of a partner's distributive share of foreign taxes paid by the partnership.

235. I.R.C. §§ 703(b)(5) and 702(b)(6).

236. SENATE REPORT, *supra* note 22, at 16; HOUSE REPORT, *supra* note 22, at 15. One author has suggested that this provision will permit special allocation of foreign taxes to particular shareholders in charge of the S corporation's foreign operations, pursuant to Treas. Reg. § 1.704-1(b)(2). That regulation deals with the extent to which special allocation of foreign source income to particular partners will be considered to have substantial economic effect. Fellows, *Allocation of Foreign Taxes To S Corporation Shareholders Under the Subchapter S Revision Act of 1982*, 61 TAXES 402 (1983). While a literal reading of the phrase "treated as a partnership" might lead to that conclusion, it seems reasonably clear that Congress's intent in drafting this provision was only to permit tax treatment of foreign taxes to be determined at the shareholder level instead of at the corporation level, rather than to deviate from the general rules of section 1366 with respect to allocation among shareholders.

237. SENATE REPORT, *supra* note 22, at 16; HOUSE REPORT, *supra* note 22, at 15.

inasmuch as a different taxpayer will be eligible for the foreign tax credit before and after an election or termination. However, it injects an additional consideration that was not present under prior law into the decision to elect or terminate Subchapter S treatment.

3. Timing and Shifting of Income

a. In General

In marked contrast to the inflexibility of the computation of the income of a Subchapter S corporation, prior law permitted a substantial degree of latitude in the timing of the taxation of the income of a Subchapter S corporation to its shareholders and in the ability to shift that income from one shareholder to another. While shareholders were subject to tax on actual distributions from the Subchapter S corporation in the taxable year of the shareholder in which the distribution was received,²³⁸ constructive distributions of undistributed taxable income were subject to tax in the taxable year of the shareholder in which the taxable year of the corporation ended.²³⁹ Moreover, in contrast to the rules governing the selection of the taxable year for partnerships, which in general requires that partners and partnerships be on the same taxable year,²⁴⁰ there were no special restrictions upon the adoption of the taxable year for a Subchapter S corporation.²⁴¹

The flexibility that these provisions created was not lost on practitioners and it was not uncommon for Subchapter S corporations to adopt taxable years ending on January 31. Under such election, income derived by a Subchapter S corporation during the period extending from February 1, 1970 to January 31, 1971 would be included in the shareholders' taxable income for the year 1971 for which a return was not due until April 15, 1972. As a result, taxpayers were able to defer the payment of tax for substantial periods of time. Perhaps even more favorably, the shareholders of the Subchapter S corporation could elect whether they wished to take advantage of that deferral possibility or whether they wished to accelerate tax on the corporate income. For example, in a year in which a major Subchapter S shareholder had unusually

238. Treas. Reg. § 1.1373-1(f) (1960).

239. Former I.R.C. § 1373(b).

240. I.R.C. § 706(b)(1).

241. Like other corporations, a new Subchapter S corporation could adopt any taxable year under I.R.C. § 441. However, the regulations imposed greater restrictions upon the change of a Subchapter S corporation's taxable year than upon the change of a regular corporation's taxable year. Treas. Reg. § 1.442-1(c)(4) (1960).

low income outside of the corporation, the shareholders could cause the corporation to make an actual cash distribution prior to the expiration of the calendar year. Thus, given the availability of cash, which of course could always be borrowed, Subchapter S shareholders had substantial flexibility in selecting the year in which they wished to be taxed on income earned by the corporation.

Even more inconsistent with the normal application of the Code, shareholders of a Subchapter S corporation had the opportunity to shift the liability for taxes on Subchapter S income even after that income had been earned. The rule applicable under prior law, that the constructive distribution of undistributed taxable income must be included in the return of a stockholder on the last day of the taxable year of the Subchapter S corporation, was not altered by shifts in the ownership of the corporate stock during the year. Thus, as long as the Subchapter S stockholder was willing to make a complete and unconditional transfer of his ownership of the stock, he could transfer his potential liability for tax with respect to the portion of the corporation's undistributed taxable income allocable to his stock by making a gift of that stock just prior to the close of the corporation's taxable year. By making such gifts in years in which the corporation had unusually large amounts of income and by transferring the stock to members of his family in materially lower income tax brackets, a Subchapter S shareholder could obtain quite substantial savings in income taxes.

Under the Revision Act, Congress has restricted severely the ability of taxpayers to manipulate the timing of taxation of S corporation income and has eliminated the ability of taxpayers to shift the incidence of tax on that income to transferees. Under new section 1378, an S corporation must use, as its period for accounting for taxable income, a "permitted" year, which is defined as the calendar year, unless it is able to establish to the satisfaction of the Commissioner that there is a business purpose for the adoption of a different accounting period.²⁴² This provision follows the substance, although not the form, of the partnership rules which require a partnership to use the same accounting period as that used by all of its principal partners, defined as partners having a five percent or greater interest in partnership profits or capital,²⁴³ unless a business purpose is established for the use of a different year.²⁴⁴

In Revenue Procedure 83-25,²⁴⁵ the Commissioner has issued relatively liberal rules governing the adoption or retention of a

242. I.R.C. § 1378(b).

243. Treas. Reg. § 1.706-1(b)(3) (1973).

244. I.R.C. § 706(b)(1).

245. 1983-15 I.R.B. 13.

fiscal year other than the calendar year by corporations in connection with the making of an S election.²⁴⁶ The Procedure states three situations in which a fiscal year other than the calendar year will constitute a permitted year under section 1378. First, a permitted year includes any fiscal year if shareholders owning a majority of the outstanding stock in the S corporation have or adopt the same year.²⁴⁷ In addition, the Procedure indicates that the permitted year requirement is satisfied if the requested year will result in a deferral of income for a period of three months or less to shareholders owning a majority of the outstanding stock in the corporation.²⁴⁸ Thus, in a corporation the majority of whose shareholders are calendar year taxpayers, fiscal years ending on the last day of September, October or November will be permitted years. Thirdly, the Procedure indicates that a permitted year includes the natural business year of the corporation, and contains a mechanical test for determining whether a proposed fiscal year constitutes the natural business year for this purpose.²⁴⁹

The general effective date of the Revision Act is January 1, 1983 and, as originally adopted, that general provision also was applicable to the new taxable year provisions.²⁵⁰ However, the Treasury Department evidently became concerned that too many S corporations would attempt to adopt fiscal years prior to the first day of 1983 in order to take advantage of the grandfathering provision described below. Accordingly, in the Technical Correc-

246. Unfortunately, the Commissioner has not yet indicated whether similar rules will apply to corporations that have elected previously to be taxed under Subchapter S and now wish to change their fiscal year. However, Congress has expressly indicated an intention that the rules governing whether an S corporation may have an accounting period other than the calendar year be similar to those governing partnerships. H.R. REP. NO. 986 (Conf. Rep.), 97th Cong., 2nd Sess. 22 (1982), *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 4203, 4210. For the procedures governing adoption and change of partnership fiscal years, see Treas. Reg. § 1.706-1(b)(4) (1973) and the Revenue Procedures cited in notes 248 and 249 *infra*.

247. Rev. Proc. 83-25, § 4.02, 1983-15 I.R.B. 13, 15. However, in order for the S corporation to qualify for this permitted year, any principal shareholders who change their accounting year to the one chosen for the corporation first must secure the approval of the Commissioner for their change of year under Treas. Reg. § 1.442-1(b)(1) (1960). A principal shareholder is one who owns more than five percent of the outstanding stock in the corporation. Temp. Reg. § 18.1378-1(b)(1), 48 Fed. Reg. 3593 (1983) (to be codified at 26 C.F.R. pt. 18).

248. Rev. Proc. 83-25, § 4.03, 1983-15 I.R.B. 13, 15. Rev. Proc. 72-51, 1972-2 C.B. 832, provides a similar de minimus rule for partnerships as long as the deferral is no longer than three months for any principal partner.

249. Rev. Proc. 83-25, § 4.04, 1983-15 I.R.B. 13, 15-16. *Compare* Rev. Proc. 74-33, 1974-2 C.B. 489, which defines the natural business year of a partnership and the extent to which it may be used as the partnership's accounting period.

250. Revision Act, § 6(a). Pub. L. No. 97-354, § 6(a), 96 Stat. 1669, 1697 (1982).

tions Act of 1982,²⁵¹ Congress provided that section 1378, governing the taxable years of S corporations, should take effect on the day following October 19, 1982, the date when the Revision Act was approved.²⁵² Therefore, unless the corporation had elected to be taxed under Subchapter S prior to October 20, 1982 and had adopted a fiscal year other than the calendar year prior to that date, it will be required to adopt a permitted year in accordance with the new rules of section 1378 before it will be eligible to elect Subchapter S treatment.²⁵³ The Temporary Regulations mitigate the retroactive application of this effective date provision through the adoption of a generally available *de minimus* rule consistent with Revenue Procedure 83-25. Thus, a corporation that was formed prior to January 1, 1982, filed a Subchapter S election after October 19, 1982, and adopted a taxable year ending on the last day of September, October or November, will be permitted to retain that taxable year.²⁵⁴

A potential trap exists under section 1378 for taxpayers attempting to elect under Subchapter S when, whether through ignorance or otherwise, the corporation has not adopted a permitted year. In that event, the election will not be effective unless the corporation seeks and obtains a determination from the Commissioner that a business purpose exists for the use of the adopted fiscal year. The Temporary Regulations²⁵⁵ attempt to prevent such ineffective elections first by providing that in most circumstances²⁵⁶ a corporation may adopt automatically a calendar year if it otherwise does not have a permitted year and, then, by providing that the making of a Subchapter S election by a corporation eligible for that automatic change will be treated as an automatic change of the taxable year to the calendar year. That relatively imaginative regulation will save many elections that otherwise would not have become effective. Some taxpayers, however, may be surprised to learn that the filing of a Subchapter S election automatically changed their accounting period. If such a corporation wishes to retain its fiscal year, or to adopt a new fiscal year other than the calendar year, the Temporary Regulations provide that such

251. Pub. L. No. 97-448, 96 Stat. 2365 (1982).

252. Pub. L. No. 97-448, § 305(d)(1)(A), 96 Stat. 2365, 2399 adding § 6(f) to Revision Act.

253. I.R.C. § 1378(a)(2).

254. Temp. Reg. § 18.1378-1(c), 48 Fed. Reg. 3593 (1983) (to be codified at 26 C.F.R. pt. 18); Rev. Proc. 83-25, § 4.03, 1983-15 I.R.B. 13, 15.

255. Temp. Reg. § 18.1378-1(b), 48 Fed. Reg. 3593 (1983) (to be codified at 26 C.F.R. pt. 18).

256. The regulation requires that all shareholders owning 5% or more of the outstanding stock of the corporation have or adopt the calendar year as their taxable period.

a request may accompany the making of a Subchapter S election.²⁵⁷ If the request is denied, however, the Subchapter S election will not become effective unless the election is accompanied by a further request to adopt the calendar year in the event that the request to adopt a different year is denied. These Temporary Regulations apply to all Subchapter S elections made after October 19, 1982.

Some of the more complicated provisions of the new S corporation rules are addressed to transitional problems. The general rule of section 1378 does not require existing Subchapter S corporations that presently use a fiscal year that would not be permissible under the new law to change their accounting period. Thus, corporations for which a valid Subchapter S election was in effect prior to October 20, 1982 may continue to obtain whatever benefits of deferral they obtained previously. The grandfathering of existing corporations obviously created the potential for the development of a market in used Subchapter S corporations that could provide the benefits of an 11-month deferral of tax to their new owners. In order to prevent, or at least retard, that development, section 1378(c) effectively provides for the loss of grandfathered status upon a shift in the ownership of the corporation in excess of fifty percentage points subsequent to December 31, 1982. Since the application of this rule will require a clear demonstration of the percentage of stock in the Subchapter S corporation owned by each shareholder on December 31, 1982, any ambiguities in ownership should be resolved promptly. In order to make the required computation, the increase in the percentage of the stock of the S corporation owned by each shareholder must be aggregated with the similar increases of all other shareholders. When that increase exceeds 50%, grandfathered status will be lost. Having so provided, Congress continued to exclude certain increases in stock ownership from the fatal computation.²⁵⁸ Thus, stock acquired from any person who owned it on December 31, 1982 (or who acquired it in an exempt transfer) either by inheritance from any person, by gift from a family member (within the meaning of section 267(c)(4)), or pursuant to certain buy-sell agreements²⁵⁹ from a family member

257. Temp. Reg. § 18.1378-1(b)(2)(ii), 48 Fed. Reg. 3593 (1983) (to be codified at 26 C.F.R. pt. 18).

258. I.R.C. § 1378(c)(3).

259. This buy-sell agreement exception of I.R.C. § 1378(c)(3)(A)(ii) (III) is defined quite tightly. The agreement must have been continually in force since September 28, 1982, and must provide that on the death of a stockholder, his stock "will be" sold to those surviving parties to the agreement who were parties on September 28, 1982. The provision suggests that both the obligation to sell and the obligation to purchase must be mandatory and unconditional. Oddly, however, the provision does not require that the agreement be written.

Although the definition of a qualified buy-sell agreement refers only to sales on the death of a shareholder, the provision exempting this stock exempts ac-

is not to be treated as acquired after 1982, but rather will be regarded as held on December 31, 1982. It should be underscored that this dispensation does not extend to all acquisitions of stock by one S corporation shareholder from another but only to acquisitions of stock in the manner described above by any person, regardless of whether he was a shareholder on December 31, 1982. For example, if one individual who was a shareholder on December 31, 1982 purchases stock in the corporation from another such shareholder (other than pursuant to a qualified buy-sell agreement) the increase in percentage ownership of the S corporation so purchased counts against grandfathered status.

The greatest danger of accidental loss of grandfathered status will occur when S corporation stock is redeemed, perhaps because of death or retirement of a shareholder-employee. Such a redemption automatically increases the percentage ownership of the S corporation stock by each of the remaining shareholders. If over one-half of the stock that remains outstanding following the redemption is treated under these rules as having been acquired after December 31, 1982, grandfathered status will be lost by virtue of the redemption. Although many buy-sell agreements commonly used by closely held corporations require that a shareholder's stock be redeemed by the corporation rather than purchased by the other shareholders, such agreements are not covered by the statutory exception for newly acquired stock. Presumably, that omission was intentional. If shifts in ownership occasioned by a redemption did not produce a loss of grandfathered status, the 50% change in ownership rule could be circumvented all too easily through a combination of sales and redemptions. Obviously, the application of this transitional rule must be monitored carefully. It is not fully clear whether buy-sell agreements in effect on September 28, 1982 may be modified at the present time to replace mandatory redemption provisions with shareholder purchase requirements and thereby obtain the benefit of the grandfathering rule. The definition of a "qualified buy-sell agreement" contained in section 1378(c)(3)(D) requires only that the agreement be in existence since September 28, 1982 and that the agreement provide that upon death stock will be sold to persons who were parties to the agreement on that date. The provision does not specifically address amendments to agreements or require that the parties to such agreements were bound on September 28, 1982 to purchase the stock. Nevertheless, it would be appropriate for all of the grandfathering provisions to be narrowly construed. On the other hand, buy-sell agreements can always be amended to delete mandatory redemp-

quisitions "from a qualified transferor (or his estate) who was a member of" the transferee's family. Thus, it is unclear whether inter vivos sales pursuant to a buy-sell agreement that also requires transfers at death fall within the exemption.

tion features that might result in the loss of grandfathering status. In many circumstances, it may be appropriate to convert mandatory redemption provisions into options or to provide an exception in the event that the redemption could result in the loss of grandfathered status.²⁶⁰

The entire transitional rule provided under section 1378 should be criticized harshly. The overriding purpose for the adoption of the new S corporation rules was to simplify Subchapter S and to eliminate the countless "traps for the unwary" that littered its provisions. Complicated transitional rules such as this one governing the loss of grandfathered fiscal years are inconsistent with that objective. Of course, whenever Congress enacts a material change in the taxing statute it is appropriate to give due consideration to those who have acted in reliance upon prior law. On the other hand, that quite legitimate objective must in every instance be balanced with the countervailing desire to produce a Code that is manageable and comprehensible. From the perspectives of equity and complexity, the transitional rule in section 1378 is inappropriate. Since every S corporation continues to be eligible to adopt any fiscal year for which a business purpose exists, it is difficult to make a case for preserving the fiscal year of existing Subchapter S corporations on equitable grounds. By definition, such taxpayers had garnered a tax advantage that Congress has now determined to be inappropriate. A continuation of the benefits that those shareholders legitimately received under prior law cannot be justified today. On the other hand, it was obviously a complicated matter for Congress to address the grandfathering of those benefits. On balance, the transitional rule of section 1378 is inappropriate and should be deleted.²⁶¹

While Congress equivocated with respect to the tax deferral potential inherent in the selection of fiscal years, it abruptly terminated the ability of shareholders of S corporations either to affect

260. If grandfathered status is lost and the corporation does not have a permitted year, I.R.C. § 1378 provides that the corporation no longer will be treated as an S corporation as of the beginning of its next taxable year. That provision raises many questions. Presumably, if a permitted year is adopted before the end of the year in which the loss of grandfathered status occurs, the election will not terminate at all although that is not certain from the statutory language.

If Subchapter S status is in fact lost, it is unclear whether the loss constitutes a "termination" within I.R.C. § 1362(d); that provision does not refer to I.R.C. § 1378. If the event is not a "termination," then it obviously cannot be an inadvertent termination eligible for relief under I.R.C. § 1362(f). Presumably, therefore, the regulations will treat the loss of grandfathered status as a termination and as eligible for relief.

261. For a compelling argument against all such grandfathering, see Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47 (1977).

the timing of their liability for tax on corporate income or to shift the incidence of tax on that income to others. As examined more fully below,²⁶² actual distributions by S corporations will no longer in most instances be subject to tax. Rather, as in the taxation of partnerships, S corporation shareholders are subject to tax on their allocable portion of the corporate income without regard to whether it has been distributed. In calculating each shareholder's allocable portion of the corporate income, the Revision Act employs the rule that previously was applicable to the allocation of Subchapter S losses, a topic also addressed below.²⁶³ Under new section 1377(a), each item of S corporation income that must be separately stated, and the residual income, is to be allocated to each shareholder on a ratable basis determined by the number of days during the year in which he was a shareholder and his percentage interest in the corporation. If, under present law, a shareholder were to assign a portion of his stock in an S corporation to a child on December 30, the transferor, not the child, would be subject to tax on all but the last day's worth of corporate income. While the foregoing description clearly is consistent with Congress' intent in enacting the new provisions,²⁶⁴ and undoubtedly reflects the manner in which it will be interpreted, the statutory language itself is not as clear. Section 1366(a)(1) requires that the income of an S corporation be taxable to shareholders in their taxable year in which the taxable year of the S corporation terminates. An individual who disposed of his entire interest in the corporation during the taxable year would not be a shareholder on the date on which the corporation's taxable year terminated. Nevertheless, it is quite clear that the statute is referring to any individual who was a shareholder at any time during the taxable year of the corporation.²⁶⁵

Congress recognized that the general rule described above, allocating corporate income ratably to each day during the corporate taxable year, would work a hardship in some cases. For example, if a shareholder sells his stock in an arm's-length transaction in an early part of the corporation's taxable year, he will be unable to establish a price for the stock that can reflect accurately the income of the corporation to be earned during the balance of the year. Notwithstanding that the price established may reflect a projected low level of earnings, the shareholder will be subject to tax on a ratable share of the earnings derived

262. See text accompanying notes 359-85 *infra*.

263. See text accompanying note 291 *infra*.

264. HOUSE REPORT, *supra* note 22, at 15-16.

265. If a shareholder dies during the corporation's year, the portion of the S corporation income attributable to the period prior to his death is includable in the shareholder's final income tax return even though the corporation's year does not end within that final year. I.R.C. § 1366(a)(1).

throughout the entire year even though that amount is materially greater than the amount taken into account in the sale. In some situations, shareholders may be able to protect themselves from such occurrences by providing for contingent payments in the contract of sale geared to the actual earnings of the corporation throughout the balance of the taxable year. Obviously, however, such agreements are unwieldy, create the potential for abuses between the parties, and are not obtainable in all events. Section 1377(a)(2), therefore, provides an alternative rule for the allocation of items of income and expense in any year in which a shareholder terminates his interest in the corporation. If all persons who are shareholders in the corporation during the taxable year agree, for the sole purpose of the allocation of corporate income, the taxable year of the corporation shall be regarded as closed on the date on which the termination of interest occurs. In that event, income earned before and after the termination of interest is to be allocated separately as if the corporation had two taxable years. The requirement that all shareholders of the S corporation concur in this alternative method for allocating corporate income seems unnecessary. The alternative method of allocating income should have no effect at all upon shareholders who have not altered their interests in a corporation during the taxable year. Since those individuals have no interest in the outcome of this election, it seems unnecessary and perhaps improper to permit them to participate in the election. It should have been sufficient for Congress to require all individuals who either completely terminated their interest in the corporation during the year or acquired stock from such a terminating individual to consent to the election.

As drafted, the alternative method for allocating income apparently applies only in the event of a complete termination of interest, and the Temporary Regulations confirm that construction.²⁶⁶ Evidently, however, there is little reason to bar the application of this more flexible rule to a partial disposition of stock by a shareholder. The difficulties in establishing a proper purchase price on the sale of stock are just as great as they are when the shareholder completely terminates his interest. Perhaps in limiting the application of this provision to complete terminations, Congress was concerned about the limited possibilities of shifting the tax on previously accrued income, or shifting accrued losses created by the elective provision. For example, many businesses have cyclical income patterns with substantial incomes in one portion of the year and reduced income or even losses in

266. Temp. Reg. § 18.1377-1, 48 Fed. Reg. 3592 (1983) (to be codified at 26 C.F.R. pt. 18).

other portions of the year. In that situation, a high bracket shareholder might wish to make a gift of stock following the low point in the business cycle, thus obtaining a loss for the short year for himself while shifting the income to be derived in the latter portion of the year to his lower bracket children. If the alternative method of allocating income is applicable only on a complete termination of interest, such careful timing of intra-family gifts can occur only once for each shareholder in the older generation. If partial dispositions invoked the alternative provision, such manipulations could occur on an annual basis. Nevertheless, a shareholder can dispose of his stock only once. It is difficult to see what greater tax avoidance is created by a series of small, but well timed, gifts of S corporation stock than would be produced by a single disposition by a member of the older generation of his entire interest, thus obtaining the entire benefit of splitting taxable years at one time. On balance, the need to provide greater flexibility in the allocation of income in the case of an arm's-length sale would appear to outweigh whatever concern Congress may have had with respect to the shifting of income on the gift of S corporation stock.

In contrast to Congress' careful attempts to prevent the assignment of income by transfers of stock, the Revision Act apparently has created a major opportunity to shift the incidence of tax on accumulated earnings and profits through non-pro rata distributions, a possibility considered below.

b. Special Allocations

Two aspects of partnership taxation have proven to be critical to the tax shelter industry: the ability to specially allocate items of income and expense, and the addition of partnership indebtedness to the basis of the individual partners. Not too surprisingly, in spite of Congress' general objective to conform the taxation of S corporations to partnership taxation, the Revision Act contains neither provision. The basis question is considered later;²⁶⁷ the inability to specially allocate items of corporate income and expense is analyzed here.

In the taxation of partnerships, each item of income and expense is allocated to the partners pursuant to the terms of the partnership agreement, including any amendments prior to the date of filing the partnership return.²⁶⁸ That single provision gives the partnership form much of its enormous flexibility. On the other hand, the provision has produced, at least in the past, considerable

267. See text accompanying notes 313-19 *infra*.

268. I.R.C. §§ 704(a) and 761(c).

taxpayer abuse.²⁶⁹ Notwithstanding its potential for abuse, the ability to allocate specific items of partnership taxable income and deductible expense to particular partners, in a manner that varies from the general allocation of partnership income and expense or from the relative capital accounts of the partners, can serve an entirely legitimate business purpose. Perhaps the most appealing case for permitting such an allocation occurs upon the contribution of appreciated property to an existing partnership. Assume, for example, an existing partnership, AB, where the partnership assets consist of \$100 in cash and assume that C has become an equal partner upon the contribution of appreciated property having a value of \$50. In reality, the property contributed to the partnership by C does not have a value to the partnership of \$50 because it brings with it the liability to pay federal income tax on the element of appreciation. That liability, however, cannot be valued accurately. The liability can be deferred indefinitely into the future by failing to dispose of the asset and may never be incurred if the asset declines in value subsequent to its contribution to the partnership. Accordingly, there is no accurate way that the parties can value the property contributed by C and appropriately reduce his interest in the partnership. Moreover, it is entirely appropriate that C should bear the burden of taxation with respect to the pre-contribution appreciation in the property. If he, in fact, is given a one-third interest in the partnership because the liability for income taxes cannot be valued, he will have benefited from the appreciation in the value of the property. The ideal solution is to permit the partnership to allocate to C the liability for any tax attributable to the pre-contribution appreciation in the value of the property. Under the rules applicable to partnership taxation, such an allocation is permissible.²⁷⁰ Admittedly, the need to specially allocate gain or loss attributable to pre-contribution appreciation or depreciation is far greater in a partnership than it is in a corporation. The need arises only if gain is not realized on the contribution. Under partnership law, a contribution of appreciated property to a partnership does not constitute a taxable event.²⁷¹ In the corporate context, the contribution of appreciated property constitutes a nontaxable event only if the transaction falls within the scope of section 351. In general terms, that nonrecognition provision is applicable only on the formation of corporations or when the property is contributed by a shareholder who, follow-

269. For example, in the past, year-end tax shelter offerings sought to allocate retroactively losses for the entire year to partners joining the venture at the end of the taxable year. That abuse is now barred by the combined effect of I.R.C. §§ 704(a) and 706(c)(2)(B).

270. I.R.C. § 704(c).

271. I.R.C. § 721(a).

ing the contribution, owns eighty-percent of the outstanding stock of the corporation. Nevertheless, just because the need to specially allocate gain attributable to pre-contribution appreciation or depreciation will not occur as commonly in the context of an S corporation as it will in connection with a partnership, this does not alter the importance of such flexibility on the occasions in which the need does arise.

Moreover, it is not uncommon in the conduct of a small business that the owners of the business retain a special interest in certain of the business assets. A partner may be willing to contribute a particular asset such as a building to the partnership for its use during the duration of the partnership, but may demand that the building be returned to him upon termination of the partnership. In addition, the partner may be willing to bear the economic cost of the deterioration of that particular asset in return for an entitlement to any gain upon its disposition. Although, in law, the asset has become partnership property, in reality, the partner has merely loaned the property to the partnership. There is nothing devious about such a business arrangement and there is no reason why the tax laws should not accommodate it. Under partnership taxation, the depreciation in that building may be specially allocated to the contributing partner as long as he is willing to bear the economic deterioration of the asset through a reduction of his capital account by the amount of the depreciation claimed.²⁷² Similarly, any gain on the disposition of the asset may be specially allocated to that partner as long as the actual proceeds of sale are also allocated to him, thereby increasing his capital account. In this respect, partnership taxation recognizes the flexibility of small business arrangements and conforms to their quite legitimate and non-tax related expectations.

Under the rules applicable to S corporations, neither these nor any other special allocations of corporate income or expense are permissible. Under the rule described above requiring the ratable allocation of all items of corporate income and expense to each shareholder, special allocations are precluded. As a result, in this very material respect, the taxation of S corporations varies substantially from the taxation of partnerships and is far less attractive to taxpayers than the pattern of taxation applicable to partnerships.

The making of special allocations of items of income and expense by an S corporation would be made somewhat more complex by the inherent differences between partnerships and corporations under state law. Most special allocations, other than those

272. I.R.C. § 704(b); *Orrisch v. Comm'r*, 55 T.C. 395 (1970), *aff'd*, 476 F.2d 502 (9th Cir. 1973); and see Krane and Sheffield, *Beyond Orrisch: An Alternative View of Substantial Economic Effect Under Section 704(b) (2) Where Nonrecourse Debt Is Involved*, 60 TAXES 937 (1982).

with respect to pre-contribution appreciation or depreciation, must be accompanied by an underlying economic effect upon the partners in order to achieve recognition for tax purposes. For example, for partnership accounting purposes, the loss attributable to depreciation must reduce the capital account of the partner to whom the tax loss is allocated and that reduction in capital account, in turn, must result in a reduction of the amount of partnership assets to which the partner would be entitled upon a liquidation of the partnership. Those economic adjustments are accommodated easily under partnership law. The allocation of partnership assets upon liquidation and adjustments to capital accounts is governed by the partnership agreement which may be drafted in whatever manner the partners choose.

This flexibility is lacking under state corporate law. Corporate law contemplates that upon liquidation the assets of the corporation will be distributed ratably among shares of the same class of stock and between classes of stock as provided by the certificate of incorporation. While in theory, even assuming that the Revision Act had permitted different classes of stock in an S corporation, priorities in the application of the proceeds of a liquidating corporation could be altered by annual amendments to its certificate of incorporation, in practice such a procedure would be too unwieldy. Annual amendments to the certificate of incorporation could be avoided if the liquidation preference, as stated in the certificate with respect to each share of stock, were such amount as specified by the board of directors from time to time. It is doubtful, however, that such a provision would be enforceable today in any state.²⁷³ The problem described, however, is a problem of flexibility of state corporation laws and not a problem of federal income taxation. If through either interpretation or legislative revision, state corporation laws proved sufficiently flexible to accommodate a substantial economic effect in connection with the special allocation of tax liabilities, there is no apparent reason why the federal taxing statute should bar such an allocation.

Responsible students of income taxation uniformly would agree that the ability to make special allocations has been abused widely in the past and remains a matter of concern. However, to the extent that businesses organized in partnership form are permitted special allocations, the same flexibility should be extended to businesses organized in the corporate form and electing to be taxed pursuant to Subchapter S. If Congress becomes persuaded that special alloca-

273. Typical state corporation statutes specify that the liquidation preference of any class of stock must be stated in the certificate of incorporation. *See, e.g.*, TENN. CODE ANN. § 48-201 (1979).

tions in the partnership context should be curtailed further, it obviously would be appropriate to extend that curtailment to S corporations. In the interim, however, it is disappointing that Congress produced such a substantial disparity in treatment between partnerships and the new S corporation.

c. Allocations of Income Among Family Members

When more than one member of a family owns an interest in any business entity, a high potential exists for shifting income among members of that family. While in form a transaction might appear to be a failure to act at arm's-length with a non-controlled entity, and thus not subject to challenge, in substance it would be a failure to act at arm's-length with a family member and would constitute a disguised gift and an impermissible assignment of income. For example, in a partnership or Subchapter S corporation, a high bracket partner or shareholder who is also a key employee may fail to obtain adequate compensation for his services. The amount of the shortage remains the income of the entity to be allocated among all of the owners, including lower bracket members of the employee's family, and thus, the overall tax on the family unit is reduced. In order to blunt this potential for tax avoidance, the statutory provisions governing both the taxation of partnerships and Subchapter S corporations have contained specific provisions dealing with the allocation of income in such circumstances.

Under the prior law applicable to Subchapter S corporations, the Commissioner was specifically authorized to reallocate dividends, whether actual or constructive, among shareholders who are members of the same family group if he determined that such reallocation was necessary in order to reflect the value of services rendered to a corporation by those family member shareholders.²⁷⁴ Thus, if one shareholder-employee received either excessive or inadequate compensation, the liability for tax on the Subchapter S income could be allocated either to or from that shareholder. Any amount reallocated continued to be treated as a dividend, and not as compensation for services, to the affected shareholder.

The statute did not address directly the possibility that dividends themselves might be allocated in a manner not properly reflective of stock interests of the shareholders in Subchapter S corporations. Presumably, any such disproportionate distribution of income could have been regarded as a gift under general principles of taxation. The regulations, however, specifically provided that should a shareholder receive less than his pro rata share of

274. Former I.R.C. § 1375(c).

a corporate distribution, a proper portion of the amount distributed to members of his family could be reallocated to him for income tax purposes.²⁷⁵

The rule applicable to family partnerships is considerably narrower. While reallocation among Subchapter S shareholders was authorized regardless of how the stock was obtained, reallocation among family partnerships is authorized under section 704(e)(2) only when a partnership interest has been transferred from one partner to another. When such a transfer has occurred, the Commissioner is authorized to reallocate income only when the transferor of the partnership interest has received inadequate compensation for services or an inadequate return on invested capital. Finally, the allocation may be made only between the transferor and the transferee of a partnership interest. Thus, under a literal application of the statute, the Commissioner is not authorized to reallocate income should a low bracket donee-family member receive excessive compensation, nor is he authorized to reallocate income in the event a high bracket taxpayer receives inadequate compensation but no partnership interests have been transferred by that partner to another. Of course, the Commissioner's authority to reallocate income in the family partnership context may be broader than the specific authority granted by section 704(e)(2). While in a clear or abusive case, the Commissioner could be expected to prevail in an attack upon the allocation of income among family members in a partnership, in practice arrangements falling outside the scope of section 704 have obtained substantial insulation from reallocation.²⁷⁶ On the other hand, the statutory family partnership provision is broader than prior law applicable to Subchapter S corporations because it specifically authorizes a reallocation of income in the event the proportion of partnership income in excess of reasonable compensation for services (the return on partnership capital), is allocated disproportionately to the donee. Again, the statute does not authorize an allocation in the event partnership income is allocated disproportionately to the transferor relative to his capital interest.

New section 1366(e) continues the Commissioner's authority to reallocate income among family members owning stock in S corporations in a somewhat strange synthesis of prior law provisions governing partnerships and Subchapter S corporations. Under section 1366(e), if an individual who is a member of an S corporation shareholder's family receives inadequate compensation from the corporation for either performing services or furnishing capital, the Commissioner may adjust the items taken into account by the

275. Treas. Reg. § 1.1375-3(d) (1960).

276. McKEE, *supra* note 73 at ¶ 14.05.

family members in order to reflect the value of the services or capital. In contrast to the partnership provisions, but following prior law applicable to Subchapter S corporations, section 1366(e) applies whether or not there has been a transfer of a stock interest between family members. However, in an extension of prior law governing Subchapter S corporations, the provision is expressly applicable even if the family member employee is not himself a stockholder in the S corporation. Thus, if inadequate compensation is paid to a nonshareholder employee, S corporation income may be reallocated by the Commissioner to him and away from shareholder members of his family.

Reallocations of S corporation income are permitted under section 1366(e) when there is a failure to pay either adequate compensation for services or an adequate return on "furnished capital." In one important and highly questionable respect, this provision appears to go further than either its Subchapter S or partnership predecessors. Apparently, section 1366(e) is intended to apply not only to inadequate return on an equity investment of capital in the corporation, but also to inadequate return on capital lent to the corporation. Thus, if a nonshareholder member of a shareholder's family loans money to the corporation but does not obtain an adequate rate of interest, the statute apparently grants the Commissioner authority to make an allocation of income from the shareholder members of his family to the family member creditor. In isolation, this provision is as reasonable as is granting the Commissioner authority to make a reallocation in the event of an inadequate return on labor. However, the authority of the Commissioner to, in effect, increase the rate of interest payable on a debt obligation must be viewed in context of the extended battle over the form of the regulations to section 385.²⁷⁷ At this writing, the final form that those regulations will take remains in doubt. As originally issued, the regulations gave the Commissioner extensive power to adjust the rate of interest payable on corporate debt obligations through the creation of original issue discount.²⁷⁸ If that aspect of the regulations survives, it should be the exclusive remedy available to the Commissioner in the event of an inadequate rate of interest and it would be improper to grant a further, and slightly different, authority under the provisions applicable to Subchapter S. On the other hand, if the final regulations under section 385 do not grant the Commissioner this authority, it would seem highly questionable to grant the Commissioner similar authority, but only with respect to S corporations under the very general language of section 1366(e). At present, therefore,

277. See note 65 *supra*.

278. Treas. Reg. § 1.385-3(a) (1980).

the scope of this new provision as applicable to loans from either stockholders or members of their families remains in doubt.

Somewhat surprisingly, but in common with partnership taxation, the new S corporation provision is not applicable in the event the family member employee receives excessive compensation for services or an excessive return on capital. It does not necessarily follow, of course, that if one shareholder receives excessive compensation, other shareholders must have received either an inadequate compensation or an inadequate return on capital. It is entirely conceivable that the Commissioner would be able to demonstrate that one shareholder employee had obtained excessive compensation for services but that the corporation could demonstrate that no other shareholder employee received inadequate compensation and that the residual return on capital was entirely adequate.

The absence of a specific reference in the statute to the possibility that an employee of the corporation may receive excessive compensation creates troublesome problems of interpretation. The Commissioner has general authority under section 162 to disallow any deduction for excessive compensation for services and there is no reason to suppose that this general authority does not extend to S corporations. Should the Commissioner disallow such a deduction to an S corporation, the effect would be to increase the income immediately subject to tax of all of the shareholders of the corporation, not merely members of the family of the employee who received the excessive compensation. Such a result would be strangely at variance with the specific authority granted the Commissioner under section 1366(e) in the event of an inadequate compensation. Moreover, in a corporation subject to the regular tax, such a disallowance has no effect upon a shareholder employee who receives excessive compensation. He remains subject to the same amount of income tax, albeit with respect to dividend rather than salary income. In an S corporation, however, the reclassification of a portion of the salary as a distribution of cash with respect to stock normally will have no immediate income tax consequences other than a reduction of the shareholder's tax basis for his stock. Thus, the effect of such a disallowance would be to convert the cash distribution to the excessively compensated shareholder from immediate ordinary income into a deferred capital gain while penalizing the other shareholders of the corporation in a manner more harsh than Congress apparently sanctioned under section 1366(e). One solution to this anomaly would be to construe new section 1366(e) broadly to grant the Commissioner authority to make a reallocation of S corporation income in the event of excessive compensation as well as in the event of inadequate compensation. The validity of a regulation so construing the new provision, however, would be dubious in light of the express statutory

language and its origin in prior law, which clearly limited reallocations to the payment of inadequate compensation. It would seem, therefore, that section 1366(e) should be amended to extend the scope of the Commissioner's authority to the payment of excessive compensation with respect to labor or capital, as well as inadequate compensation.

If a reallocation is required under section 1366(e), it is not entirely clear how the adjustment is to be made. The statute provides only that the Commissioner is authorized to "make such adjustments in the items taken into account by [the family members] as may be necessary in order to reflect the value of such services or capital." Logic would suggest that inadequate compensation for services or inadequate interest on borrowed capital should be corrected by imputing income to the individual and a correlative deduction to the members of his family. Indeed, when the individual who is compensated inadequately is not a shareholder, it is difficult to see what other solution would be rational. Section 1366(e), however, does not appear to sanction such an approach. Rather, the provision contemplates a reallocation of specific items of corporate income and, perhaps, expense among the family members. This plainly less rational approach appears borrowed from the partnership rule that authorizes a reallocation of distributive shares in the event of inadequate compensation.²⁷⁹ That partnership approach, however, is entirely unsuited to an S corporation in which special allocations are not permitted and all items of income and expense are allocated ratably to shareholders in proportion to their stockholdings. As a result, section 1366(e) will require either creative regulatory interpretation or, preferably, legislative correction.

Both Committee Reports contain the statement that the Commissioner has authority under this section to adjust the timing of compensation.²⁸⁰ Section 1366(e), as enacted, does not reflect Congress' intent to give the Commissioner such authority inasmuch as it grants him power to make adjustments to reflect more accurately the "value" of services or capital. Furthermore, such authority has no precedent under either the partnership tax provisions or the prior law governing S corporations. However, the Treasury might, based upon this comment in the legislative history, adopt regulations interpreting the Commissioner's authority under section 1366(e) to include adjustments to the taxable year in which compensation must be taken into income by a member of a shareholder's family and deducted by the shareholders.

279. I.R.C. § 704(e) (2).

280. HOUSE REPORT, *supra* note 22, at 16; SENATE REPORT, *supra* note 22, at 17.

The Commissioner has explicit authority to deal with matters of timing under a number of other sections of the Code. Even if the reference to timing in the legislative history were held to justify, as a general matter, regulations concerning timing under section 1366(e), it seems highly unlikely, absent express statutory authorization, that the reference could justify granting the Commissioner broader authority under section 1366(e) than he has under the other provisions. Moreover, in most cases the Commissioner does not need additional authority. Obviously, the only power a regulation concerning timing could give the Commissioner is the power to require that a particular item be included in income or deducted in a different taxable year from that in which it is actually received or paid. If the payment of compensation were accelerated so that the family member received compensation prior to actually rendering services or furnishing capital to the corporation, the Commissioner could require an adjustment to "clearly reflect income" pursuant to his general authority under section 446. Similarly, if payment were deferred, the employee or investor would have received inadequate compensation in the earlier year thus invoking the rules of section 1366(e). Furthermore, new section 267(f), considered below,²⁸¹ specifically deals with the deductibility of expenses paid to related persons by an S corporation. Clearly, Congress did not intend to give the Commissioner authority to make an adjustment under section 1366(e) that would conflict with the express statutory rules of section 267(f).

The reference to timing in the Committee Reports might be construed by the Treasury as authorizing the Commissioner to adjust the time of the deductibility of payment of compensation to family members if such adjustment would change the shareholder entitled to the deduction. For example, a high-bracket shareholder might arrange for the payment for services performed by a low-bracket family member to be made early in the corporation's taxable year, and subsequently make a gift of his stock to a low-bracket taxpayer (either the family member employee or someone else). Under section 1377(a),²⁸² the transferor may, with the consent of all other shareholders, elect to treat the transfer as closing the corporation's current taxable year as to himself and the transferee so that he will get full benefit of the prepaid deduction. Without this election, the deduction would be prorated daily over the corporation's actual taxable year, and the transferee would benefit from that part of the deduction corresponding to the fraction of the year during which he owned the stock. Such tax manipulation should not be permissible. However, because this device would not

281. See text accompanying notes 283-87 *infra*.

282. See text immediately following note 265 *supra*.

alter the S corporation's actual taxable year in which the deduction was claimed, the Commissioner arguably may lack the authority to challenge the accelerated deduction under general accounting principles such as section 446(b). Thus, the Treasury may claim the authority under the language in the Committee Reports to alter the timing of income or deductions in the event of a transfer of S corporation stock.

d. Related Taxpayer Transactions

Section 267, one of the oldest tax avoidance provisions in the Code, generally denies the normal tax benefit of two specified transactions when the parties to the transaction fall within the strictly defined categories of related persons described in section 267(b). The two transactions affected by the section are losses from the disposition of property and deductions for interest or other business expenses unless the expenditure is actually paid, or otherwise includable in the income of the recipient, within two and a half months following the close of the year in which a deduction for the expenditure is claimed. There is no question whatsoever that section 267 is badly in need of revision.²⁸³ It was drafted in a far simpler era in which the attack against tax avoidance had not become nearly as finely tuned as it is today. Thus, the list of relationships contained in section 267(b) is incomplete, particularly with the absence of any reference to partnerships, and the definitions of the transactions subject to section 267 are relatively liberal. The two-and-one-half month tolerance permits a one-year deferral of income; a deduction for an accrued expenditure is not disturbed if the recipient is subject to tax on the amount in the following year.

Unfortunately, Congress has made section 267 worse. New section 267(f) contains a special rule governing the deduction of interest and other expenses by an S corporation when paid to a defined category of related persons. Under this new provision, an S corporation will not be permitted a deduction for interest or expenses deductible under sections 162 or 212 prior to the day upon which the amount of the expenditure is included in the gross income of the related person. The only difference between this special rule and the general rule of section 267 is the elimination of the two-and-a-half month leeway and, thus, the deferral of income for one year. There should be no objection to the elimination of this deferral possibility; it is entirely consistent with the new S corporation provisions governing the adoption of fiscal years. On the other hand, it represents the very worst in legislative draft-

283. See Coven, *Affinity Provisions of the Internal Revenue Code: A Case Study in Nonsimplification*, 45 TENN. L. REV. 557 (1978).

ing to adopt this new rule only for S corporations. Whatever substantive merit such a new provision might have is outweighed enormously by the increased complexity of having two similar, but slightly different, provisions attacking the same tax avoidance technique when undertaken by different taxpayers. Quite obviously, if Congress is dissatisfied with section 267, the entire provision should be overhauled in its application to all taxpayers.

The new provision contains a second change from the general format of section 267. New subsection (f) contains its own definition of related taxpayers and that definition is vastly broader than any of the definitions contained under the general rule of section 267(b).²⁸⁴ Thus, the S corporation is regarded as related to any person who owns two percent of its stock or to any person related to such a shareholder within the meaning of section 267(b) or section 707(b)(1)(A).²⁸⁵ Evidently, the two percent stock ownership is to be computed without the application of any stock attribution rules. While section 267 contains such rules in subsection (c), those rules are applicable only for the purposes of subsection (b), not subsection (f). On the other hand, in determining whether an entity is related to such a two percent shareholder within the meaning of subsection (b), presumably, the attribution rules of subsection (c) are applicable. If so, new subsection (f) creates a provision of enormous scope. For example, if the brother of a two percent shareholder in an S corporation owns fifty-one percent of the stock of a second corporation, that corporation is regarded as related to the S corporation.

In addition, the S corporation is regarded as related to all of the individuals or entities to whom it would be regarded as related under the general rule of section 267(b).²⁸⁶ In general, however, all of the subsection (b) relationships will also fall within the special rule of subsection (f). It should be noted that section 267 is rendered unnecessarily confusing by this use of two overlapping sets of relationship definitions, but that would merely seem the natural consequence of the highly undesirable creation of a special rule governing S corporations.

It would seem excessively harsh to define a two percent shareholder of an S corporation as a related person for the purposes of this new provision, particularly if the definition of related person is to be expanded to include all persons related to such

284. Under I.R.C. § 267(b), corporations are regarded only as related to shareholders owning 50% or more of their stock. Under the similar rule applicable to partnerships, a partnership is regarded only as related to a 50% partner. I.R.C. § 707(b)(1).

285. I.R.C. § 267(f)(2).

286. I.R.C. § 267(f)(2)(c).

a stockholder. In general, the holder of only two percent of the stock of a corporation will be a mere employee who has received compensatory stock and whose interests are quite unrelated to those of the majority stockholders. The tax avoidance potential in accruing unpaid salary due to such individuals would seem to be far outweighed by the enormous complexity of tracing the section 267(b) relationships of such a minor stockholder. While the tax avoidance potential of S corporations may be greater with respect to accrued items than is presented by most of the relationships described in section 267, the two percent requirement is too far out of line with preexisting law. Such extreme fine tuning of tax avoidance provisions rarely is justified in light of the complexity they create. It would have been preferable for Congress to have been content to disallow deductions for accrued expenses between S corporations and shareholders having a substantial economic interest in the corporation. Section 1563(e), for example, employs a relatively extreme five percent de minimus rule in attributing the ownership of stock. If Congress were to insist upon the use of a two percent test for the purpose of defining a shareholder who is related to the S corporation, it should at least eliminate the provision that expands that relationship by including other entities or individuals related to a shareholder as minor as a two percent shareholder. Such an extension of the scope of the defined relationships should be limited to substantial shareholders.

By way of contrast, the other substantive transaction governed by section 267, the disallowance of losses on the sale of property among related persons, is extended to S corporations without the special modifications contained in new section 267(f). The category of relationships under subsection (b) has been expanded by the inclusion of S corporations and other entities but only in the presence of fifty percent overlapping ownership.²⁸⁷

There is one desired change in prior law that the Revision Act did not make. Under section 1311, in a variety of tightly defined circumstances, the general statute of limitations on both refunds and deficiencies is waived. In general, the provision is designed to prevent a double inclusion in income, or a double deduction, when an adjustment to tax liability is made but the usual statute of limitations bars making a correlative adjustment. For no apparent reason, S corporations and their shareholders have never been brought within the scope of this provision.²⁸⁸ As a result, the inequity that section 1311 is designed to prevent can, and occa-

287. I.R.C. § 267(b)(10) (partnerships), (11) (other S corporations) and (12) (other corporations).

288. I.R.C. § 1313(c). By contrast, trusts and their beneficiaries, and partners, are included.

sionally does, occur in the context of S corporations. For example, should the Commissioner successfully contend that a corporation was not an S corporation for a year in which it had not made any actual distribution to its shareholders but they had nonetheless included all of the corporate income in their individual returns, the shareholders plainly should be entitled to a refund of tax in order to prevent the double inclusion of an item in income. Nevertheless, if the statute of limitations for claiming refunds of tax has expired, that refund cannot be obtained and the mitigation provision of section 1311 will not be of any assistance. While the new relief provisions, described below,²⁸⁹ permitting limited tax free distributions following the termination of a Subchapter S election at least permit shareholders to withdraw from the corporation the amount upon which they have been subject to tax, in many instances that relief will not be available because the corporation will neither have sufficient cash reserves to make the distribution nor wish to incur that amount of indebtedness. Moreover, such a distribution will not compensate for what would in effect amount to the prepayment of a tax liability by several years.

V. LOSSES

For many taxpayers the most favorable aspect of a Subchapter S corporation was that a net loss incurred at the corporate level, like a net profit, would pass through to the shareholders and could be used by them to offset unrelated income in their individual tax returns.²⁹⁰ Unfortunately, this feature of Subchapter S corporations under prior law was subject to a series of technical and highly restrictive provisions that, in far too many cases, caused the loss of the pass-through benefit that Congress intended. Indeed, the case law under this provision was a virtual chamber of horrors. The new S corporation rules eliminate many, but by no means all, of the unsatisfactory features of prior law.

A. *Prior Law*

Under prior law, a net operating loss incurred by a Subchapter S corporation was prorated over each day in the taxable year and allocated to all shareholders during the corporation's year.²⁹¹ Thus, in sharp contrast to prior law provisions governing the allocation of Subchapter S income, the benefit of operating losses could not be shifted by a transfer of stock.

289. See text accompanying notes 423-27 *infra*.

290. Former I.R.C. § 1374.

291. Former I.R.C. § 1374(c)(1).

As in the case of the taxation of partnerships,²⁹² the losses that could be claimed by shareholders in a Subchapter S corporation could not exceed the amount of their investment in the corporation.²⁹³ Thus, losses could not be claimed in excess of the sum of a shareholder's tax basis in his Subchapter S corporation stock and in any indebtedness of the corporation held by the stockholder. Losses allocated to a shareholder were applied first in reduction of the basis of his stock and thereafter in reduction of the basis of any indebtedness. Quite unlike partnership taxation, however, losses in excess of that amount were forfeited permanently. Although the basis limitation also applies to partnership losses on an annual basis, excess losses incurred in any year could be claimed by a partner in future years when his basis was restored either by partnership profits or by further investments.²⁹⁴ No such loss carryover, however, was available to a shareholder in a Subchapter S corporation.²⁹⁵ Moreover, the likelihood of operating losses exceeding shareholders' bases in Subchapter S corporations was far greater than in partnerships. In a major difference from the pattern of taxing partnerships, debt incurred at the entity level by a Subchapter S corporation did not cause an increase in the shareholder's basis. Thus, a corporation that leveraged its operations with outside indebtedness could easily incur operating losses in excess of the shareholders' investment, but those losses could never be claimed by its shareholders. Moreover, a Subchapter S corporation was denied the ability to carry operating losses over to other years of the corporation.²⁹⁶ Thus, profits earned in future years, in effect a recovery of nondeductible losses, would be fully taxable to shareholders. In the taxation of partnerships, this inequity is eliminated substantially by increasing the basis of a partner's interest in the partnership by an allocable portion of any indebtedness incurred at the entity level.²⁹⁷ As a result, nearly all losses incurred by a partnership may be deducted currently by its partners.

Furthermore, a shareholder could lose basis in a Subchapter S corporation in ways other than by claiming operating losses. For example, if the Subchapter S corporation was formed in a transaction subject to the provisions of section 351 and in the exchange the corporation assumed liabilities of the business in an amount that exceeded the aggregate basis of properties contributed to the corporation, the shareholder would obtain a zero basis for his stock

292. I.R.C. § 704(d).

293. Former I.R.C. § 1374(c)(2).

294. Treas. Reg. § 1.704-1(d)(1) (1960).

295. Treas. Reg. § 1.1374-1(b)(2) (1963).

296. Former I.R.C. § 1373(d)(1).

297. I.R.C. §§ 722 and 752(a).

in the corporation even though the value of the assets transferred vastly exceeded the amount of the liabilities assumed.²⁹⁸ As a result, the shareholder would not be able to claim operating losses incurred by the corporation until such future time as his basis in the corporate stock increased. In addition, if the Subchapter S stock became worthless during a taxable year, presumably because of operating losses, the Subchapter S shareholders could be denied the benefit of losses attributable to the portion of the corporation's taxable year subsequent to the date on which the stock became worthless. In a questionable decision,²⁹⁹ the Tax Court held that because worthlessness is treated as a sale or exchange of the stock under section 165(g), it must be treated as a disposition of stock for purposes of Subchapter S as well, thus terminating the shareholder's entitlement to further losses. As a result, a portion of the ordinary loss sustained during the year was converted into a capital loss on the constructive disposition of the Subchapter S stock.

While income of a Subchapter S corporation increased the basis of a shareholder's stock, thus restoring his eligibility to claim future losses, no provision of prior law allowed for recovery of the basis of indebtedness eroded by losses.³⁰⁰ Thus, a subsequent retirement of indebtedness produced a gain to the stockholder. That result appeared particularly harsh when the funds used to retire the indebtedness were attributable to current earnings that were fully subject to tax to the shareholder as a constructive dividend attributable to undistributed taxable income.³⁰¹

The loss pass-through was limited to operating losses. Capital losses incurred by the corporation did not pass through to shareholders; nor did they reduce the amount of the corporate taxable income that was taxed to the shareholders. On the other hand, Subchapter S corporations were entitled to carry capital losses forward to be applied against capital gains incurred in future years.³⁰²

B. Under the Revision Act

1. In General

Under new sections 1366(a) and 1377(a), losses are allocated to

298. I.R.C. §§ 358(a)(1)(A)(ii) and (d)(1). *See* Wiebusch v. Comm'r, 59 T.C. 777, *aff'd*, 487 F.2d 515 (8th Cir. 1973).

299. Abdalla v. Comm'r, 69 T.C. 697 (1978).

300. Former I.R.C. § 1376.

301. *See* Cornelius v. Comm'r, 494 F.2d 465 (5th Cir. 1974).

302. In these respects, a Subchapter S corporation was treated like any other corporation. I.R.C. §§ 1211 and 1212.

S corporation shareholders pursuant to the same daily proration formula that is applicable to the allocation of S corporation income (and which under prior law was applicable to the allocation of operating losses). As noted above in connection with the allocation of S corporation income, the new law does not provide clearly that losses may be allocated to an S corporation shareholder who disposes of all his stock during the taxable year although prior law was explicit on the point.³⁰³ Nevertheless, the legislative history to the Revision Act apparently contemplates such an allocation³⁰⁴ and there is no indication that Congress intended any change in this respect. Because new section 1366(a) requires the allocation of specific items of income and expense, all such items incurred by an S corporation, including capital losses, are now allocated to S corporation shareholders. As under prior law, losses allocated to a shareholder are applied first in reduction of the basis for his stock in the corporation³⁰⁵ and thereafter in reduction of the adjusted basis of any indebtedness of the S corporation held by the shareholder.³⁰⁶ Although any loss in excess of that amount incurred during the taxable year may not be claimed by the taxpayer in that year,³⁰⁷ in contrast to prior law, that excess loss is not forfeited permanently. New section 1366(d)(2) adopts the rule applicable to partnership taxation and provides that any loss disallowed to a shareholder because it exceeds his aggregate basis in the S corporation stock and debt may be carried forward and claimed as a loss by him in a future year in which his basis has been increased either by corporate income allocable to him or by a contribution to capital.

In addition, Congress anticipated that the new ability to carry forward losses could result in the carry-over of unused losses to a taxable year of the corporation in which the S corporation election had terminated. A forfeiture of losses in that manner would seem particularly inequitable when the termination of Subchapter S status was not desired by the affected shareholder and perhaps occurred without his knowledge. That possibility quite commonly occurs when the termination results from the corporation ceasing to qualify as a small business corporation, in which event (under present law) the S election terminates upon that date. To minimize the possibility of such a forfeiture of losses, section 1366(d)(3) provides that the unused loss can be claimed by the shareholder as a loss incurred on the last day of the so-called "post-termination

303. Former I.R.C. § 1374(c)(2)(A).

304. HOUSE REPORT, *supra* note 22, at 16; SENATE REPORT, *supra* note 22, at 17.

305. I.R.C. § 1367(a)(2)(B).

306. I.R.C. § 1367(b)(2)(A).

307. I.R.C. § 1366(d)(1).

transition period" ("PTTP") to the extent of the shareholder's basis in the corporation's stock on that day even though the Subchapter S election has been terminated. This grace period for the claiming of carried over losses, which is used for other purposes under the new law as well, should eliminate much of the harshness incurred under prior law upon involuntary terminations of Subchapter S elections. Unfortunately, the definition of the "post-termination transition period" contained in section 1377(b) is ambiguous and does not appear to conform to the description of the provision contained in the legislative history. As a result, it is not entirely clear how the grace period is intended to operate. Since these ambiguities are more significant with respect to post-termination corporate distributions, the PTTP is analyzed in that context below.³⁰⁸

The seeming unfairness under prior law of prohibiting the restoration of the basis of indebtedness in a Subchapter S corporation that had been eroded by losses has been reversed. Under section 1367(b)(2)(B), if the basis of any such indebtedness has been reduced through the claiming of losses, any increase in basis to which the shareholder is entitled must first be allocated to a restoration of the basis of the indebtedness. Only after the basis of the indebtedness has been restored to its initial level will the basis in the shareholder's stock be increased. While this provision is properly designed to mitigate the harshness of prior law, it will require regulatory elaboration. For example, further advances by the shareholder to the corporation presumably will be ignored in determining when the basis of the indebtedness has been returned to its initial level. Similarly, it may be presumed that if the shareholder no longer owns the indebtedness at the end of a year in which he is entitled to an increase in basis, the increase in basis will be allocable to the shareholder's stock and neither lost nor allocated to the transferee of the indebtedness.

In most instances, a shareholder either will be indifferent to whether the basis of his stock or of his indebtedness is increased because the basis in either security will support the claiming of losses, or he will prefer the rule specified in section 1367 requiring a restoration first of the basis of the indebtedness. Notwithstanding the liberalization of the rules governing the consequences of distributions from S corporations,³⁰⁹ in many situations a greater amount can be withdrawn from the corporation free of tax upon the retirement of indebtedness than by a distribution with respect to stock.³¹⁰ On the other hand, there may be situations in which

308. See text accompanying notes 423-27 *infra*.

309. See text accompanying notes 359-91 *infra*.

310. That would be the case, for example, if an S corporation had accumulated earnings and profits and sought to make a distribution in excess of accumulated Subchapter S income.

a taxpayer would prefer a restoration of the basis of his stock to a restoration of the basis of his debt. For example, a loss on the worthlessness or disposition of stock in an S corporation is eligible for the ordinary loss treatment provided by section 1244 but a loss on a disposition of indebtedness is not. Section 1244 treatment is barred for losses attributable to increases in the basis of stock, including increases in the basis of S corporation stock attributable to the allocation of corporate profit to the shareholder.³¹¹ Section 1244 treatment, however, may be available to the extent of the initial basis of S corporation stock, even though that initial basis has been reduced by losses but subsequently restored to its initial level. In such a situation, a shareholder may wish to dispose of indebtedness before a restoration in basis occurs.

A further problem of construction is presented by the making of a donative transfer of both S corporation stock and indebtedness. Post-transfer income of the S corporation will produce an increase in basis to the donee, but it is not clear whether that increase in basis is to be allocated to the donated stock or the donated debt. The basis of the indebtedness would have been reduced by prior S corporation losses, but, at the time of the reduction, it was not the donee's indebtedness. The unfairness that this new provision addresses is not altered by whether the reduction in the basis of the indebtedness occurred while the debt was held by its present owner or by a predecessor in interest. Accordingly, the relief that new section 1367(b)(2)(B) extends should be available when the taxpayer holds indebtedness, the basis of which is determined by the basis it had in the hands of his transferor, if that basis was reduced by losses allocated to that transferor. It is not entirely clear, however, whether the Treasury would consider such a regulation consistent with the statutory language which refers to a reduction in "the shareholder's basis."³¹²

The Revision Act also has coordinated the loss pass-through with the worthless stock loss provision contained in section 165(g). Under section 1367(b)(3), losses allocated to an S corporation shareholder for any taxable year in which the stock of the corporation becomes worthless may be claimed by the shareholder without regard to the worthlessness loss. Any basis in the stock remaining after reduction attributable to those losses may then be claimed as a worthless stock loss.

2. Effect of Corporate Debt

The Revision Act has eliminated many of the unsatisfactory

311. Treas. Reg. § 1.1244(d)-2(a) (1960).

312. I.R.C. § 1367(b)(2)(B).

features of prior law and in many material respects conformed the new S corporation provisions to partnership law, but in one highly significant respect, the Act perpetuates a distinction between the taxation of S corporations and partnerships. As under prior law, the shareholders of S corporations are not permitted to increase the basis for their stock in the corporation by virtue of borrowing at the corporate level. As a result, losses incurred at the corporate level cannot be claimed by S corporation shareholders in an amount in excess of their basis in corporate stock and indebtedness, an amount approximating their investment in the corporation enlarged by the net amount of any income allocated to the shareholders but not distributed to them.

This limitation upon the total loss that an S corporation shareholder may claim to the amount of his investment in the corporation may have made eminently good sense under prior law because the entity characteristics of the Subchapter S corporation predominated. Since the deductibility of a loss sustained by a shareholder on an investment in a regular business corporation is limited to the amount of his investment in the corporation,³¹³ it may have seemed logical to impose a similar limit upon losses incurred by a shareholder in a corporation electing under Subchapter S. In fact, it might seem logical in any context to limit the tax benefit of any loss attributable to an activity to the amount currently invested in that activity. Because by definition the taxpayer cannot sustain a greater economic loss, there might seem little reason to extend a tax benefit with respect to a greater amount. Permitting taxpayers to claim a tax benefit attributable to the loss or expenditure of borrowed funds, however, does not create an artificial tax loss in excess of the taxpayer's actual economic loss. Rather, the question is one of the timing of claiming tax deductions or losses. Under long established rules of income tax accounting, the point in time at which an individual is entitled, indeed compelled, to claim the tax benefit of an expenditure is wholly unaffected by whether the funds used to make the expenditure were borrowed.³¹⁴ Similarly, a taxpayer's basis in property is unaffected by the source of the funds used for the purchase, even if those funds were borrowed under an arrangement that did not involve the personal liability of the taxpayer, for example, a nonrecourse loan.³¹⁵ Under normal circumstances, that is,

313. I.R.C. § 165(b).

314. The methods of accounting permitted by I.R.C. § 446(c) do not make that fact relevant. The Supreme Court applied this principle expressly in *Crane v. United States*, 331 U.S. 1 (1947), even though the borrowing was connected directly to the deductions in question by a mortgage on the property being depreciated.

315. *Crane* so held. *Id.*

absent deliberate tax manipulation, these general principles produce a correct tax result. The economic detriment is suffered by the taxpayer at the time the expenditure is made or the purchased property depreciates and it is proper that this economic detriment should be reflected in a contemporaneous reduction in income tax liability. If the taxpayer were denied a tax benefit at the time the expenditure was made and required to defer claiming the deduction until the indebtedness was repaid, the computation of taxable income would become disassociated from the taxpayer's economic change in position. Moreover, the taxpayer would obtain a substantial measure of control over the timing of his tax deductions by choosing to repay the indebtedness in a year in which its tax consequences would be most advantageous.

In a highly technical sense, the normal application of these general timing and basis rules is not affected by limiting the losses that may be claimed by a partner or S corporation shareholder to the basis of his investment. In reality, however, if the basis of that investment is not enlarged by borrowings at the entity level, the normal consequence of these rules will be altered. Deductions that could be claimed currently if the business were conducted as a sole proprietorship will be deferred because of the basis limitation.

In the taxation of partnerships, this disruption of the normal timing and basis rules is avoided. The amount of any borrowing at the partnership level increases the basis of the partners' interest in the partnership, thereby permitting a current tax benefit from losses and expenditures. Consequently, conducting a leveraged business operation in partnership form is not penalized. The possibility of a windfall tax loss might be created if the partnership did not in fact repay the indebtedness. In that event, the ultimate economic loss would fall upon the creditor rather than the partners who claimed the tax benefit. That possibility is eliminated, however, by a proper application of the rules governing cancellation of indebtedness income. To the extent that the indebtedness is not repaid, the partnership, and thereby the partners, become subject to tax on the amount not repaid. In effect, the tax benefit from the prior deductions is recaptured.³¹⁶

Admittedly, other systems for accounting for indebtedness could be devised; whether they would be superior is debatable. Until such a different system is generally adopted, however, the treatment of indebtedness under the taxing system should be neutral with respect to the form of business enterprise. It is highly

316. In the partnership context, the proper computation of this tax was confused by the decision in *Stackhouse v. United States*, 441 F.2d 465 (5th Cir. 1971). Nevertheless, it is clear that such a cancellation of indebtedness should produce income under I.R.C. § 61(a)(12). See MCKEE, *supra* note 73, at ¶ 9.06[2].

undesirable for the taxing system to treat indebtedness differently depending upon whether the business is incorporated, if the tax is not computed at the entity level. Yet, that is the result reached by continuing the prohibition against adding the amount of borrowings at the entity level to the basis of S corporation stock. As a result of this disparity in treatment, a major difference remains between the taxation of partnerships and S corporations which is inconsistent with the general objectives of the Revision Act. The primary consequence of this restriction on the addition of corporate borrowings to the basis of stock in S corporations is that the shareholders will not be entitled to obtain the benefits of the Accelerated Cost Recovery System provided by section 168 if their investment is materially leveraged at the corporate level. It is difficult to understand why Congress would wish to withhold that investment stimulation from S corporations while granting it to all others.

The above described treatment of indebtedness under our taxing system has not been subject to extensive criticism when the borrower incurred personal liability for the repayment of the loan. When the loan is without recourse to the personal assets of the borrower, however, the propriety of the normal timing and basis rules has been questioned. It is not entirely clear whether this reevaluation of the role of nonrecourse indebtedness is in response to a perceived difference in principle between loans for which the debtor is personally liable and those for which he is not, or is in response to the greater opportunities for abuse and tax manipulation when personal liability does not exist.³¹⁷ Regardless of the rationale, Congress and the Treasury view nonrecourse indebtedness with growing suspicion. Corporate shareholders, as a matter of state law, do not incur personal liability for corporate borrowings; from the perspective of the shareholder all such borrowings resemble nonrecourse indebtedness. That view of corporate borrowings, however, does not justify treating the shareholders of S corporations differently from partners in partnerships that incur nonrecourse indebtedness. The ability of all taxpayers to obtain tax benefits attributable to the expenditure of funds obtained in a nonrecourse borrowing is restricted by the "at risk" rules of section 465, which was adopted in response to growing abuses of

317. See, e.g., *Estate of Franklin v. Comm'r*, 544 F.2d 1045 (9th Cir. 1976). The Supreme Court's recent decision in *Tufts v. Comm'r*, ____ U.S. ____, 103 S. Ct. 1826 (1983) eliminated one such tax abuse by holding that, for purposes of I.R.C. §§ 1001(b) and 752, the amount realized upon disposition of property subject to a nonrecourse mortgage is the full amount of the outstanding indebtedness, even though the fair market value of the property on the date of disposition was less than the indebtedness.

nonrecourse indebtedness by the tax shelter industry. While the "at risk" rules should be applicable to the shareholders of S corporations to the same extent that they are applicable to partners, there is no justification for subjecting S corporation shareholders to an additional and far stricter rule.

Moreover, it is not consistent with the financial realities of the closely held corporation automatically to regard corporate borrowings as being in the nature of nonrecourse indebtedness. A substantial amount of such borrowing is secured through the personal guarantees of one or more of the corporate shareholders. By virtue of those guarantees, the shareholders incur personal liability that is not meaningfully distinguishable from the liability of a general partner. When such a guarantee exists, it is as appropriate to increase the basis of the shareholder for a proper proportion of the guaranteed corporate indebtedness as it is to increase the basis of a partner. While, of course, in most instances such a shareholder will not be called upon to perform this guarantee, general partners rarely are called upon to discharge partnership obligations from their personal assets. Even if Congress were unwilling to conform the taxation of S corporations to the taxation of partnerships completely in this respect, it is unfortunate that Congress did not permit a basis adjustment when the personal liability of a shareholder in the form of a guarantee is present.

3. Shareholder Guarantors

To some extent, the harshness of failing to increase the basis of stock by corporate borrowings has been mitigated by other changes in the Revision Act that will operate to benefit shareholder guarantors. It is not uncommon for a corporation to sustain losses in years prior to defaulting on its indebtedness. Under prior law, as under the Revision Act, a shareholder guarantor was not entitled to claim his allocable portion of those losses by virtue of the guarantee. While his subsequent payments under the guarantee would be treated as increasing the basis of his stock, thus entitling him to claim future losses incurred by the corporation, he could not obtain thereby the benefits of the losses previously incurred. Under prior law, such losses had to be claimed in the year incurred and could not be carried forward. As a result, many Subchapter S guarantors lost entirely the benefits of losses sustained by the corporation, notwithstanding their substantial investment under the guarantee on behalf of the corporation. Under present law, those losses can be carried forward and claimed by the guarantor for the year in which he discharges his obligations under the guarantee. The net effect of this relatively roundabout route to the claiming of S corporation losses is that, to the extent that an S shareholder in fact becomes personally liable for corporate obliga-

tions, he will be entitled to claim losses originally attributable to a corporate borrowing.

While the position of a shareholder guarantor thus is much improved under present law, the result remains far different from that under partnership taxation. The guarantor still is not entitled to claim losses in the year in which the loss or expenditure producing the tax deduction was incurred.³¹⁸ Rather, the tax benefit is deferred until the indebtedness is in fact repaid. In this respect, the treatment of a guarantor resembles the treatment of a partner subject to the "at risk" provisions; yet the guarantor does not benefit from the exceptions and refinements contained in section 465.

Under prior law, a guarantor could improve his position by substituting himself as the direct creditor of the corporation. The Commissioner has ruled that if a guarantor, by issuing his personal note to the S corporation's lender, caused the corporation to become directly indebted to the guarantor rather than to the original lender, the guarantor's basis for his investment in the S corporation would be increased by the face amount of the note.³¹⁹ Through this device, the guarantor would be entitled to claim the S corporation losses currently rather than at the time he is required to discharge his obligations under the guarantee. While the necessity of the guarantor's assumption of primary liability in order to obtain S corporation losses has been eliminated by carrying forward the corporate losses, the device still may be useful if a shareholder wishes to accelerate the deduction of such losses.

4. Section 465

Under section 465 certain taxpayers are barred from claiming any losses attributable to an activity to the extent that the aggregate amount of those losses exceeds the amount of the taxpayer's investment in the activity that is "at risk." The "at risk" amount includes the investment of the taxpayer's own funds as well as the investment of borrowed funds upon which the taxpayer has personal liability.³²⁰ Thus, in general effect, section 465 bars taxpayers from claiming deductions attributable to the expenditure of nonrecourse borrowings. The disallowed losses may be carried forward by the taxpayer and used at such future time as the taxpayer's amount "at risk" increases.³²¹ The section contains elaborate rules defining the separate activities to which the "at risk" rules

318. Rev. Rul. 71-288, 1971-2 C.B. 319.

319. Rev. Rul. 75-144, 1975-1 C.B. 277.

320. I.R.C. § 465(b).

321. I.R.C. § 465(a)(2).

are applicable³²² and that exclude certain transactions from the provision, particularly investments in real property.³²³

Under prior law, section 465 was expressly applicable to all Subchapter S corporations.³²⁴ The provision was not applicable, however, to partnerships; the limitations of the section were applied only at the partner level.³²⁵ As a result, a loss sustained by a partnership from engaging in tax sheltering activities or other activities financed by a nonrecourse borrowing passes through to its partners without limitation. Each partner is required to compute separately the amount of deductions so allocated that exceeds the partner's individual amount "at risk" in the partnership activity. For this purpose, nonrecourse borrowing, whether by the partner or by the partnership, does not constitute an amount "at risk."³²⁶ Thus, the limitation imposed by section 465 on a partner's deduction of such losses is significantly stricter than that imposed by the limitation upon claiming losses in excess of a partner's basis for his partnership interest.

Prior law imposed upon Subchapter S corporations a third limitation on the claiming of losses. Section 465 not only was applicable at the shareholder level, but also was applicable at the corporate level.³²⁷ Thus, losses at the entity level that exceeded the S corporation's "at risk" investment were disallowed at the corporate level and did not pass through to the shareholders. Such losses could be carried forward by the S corporation and would be allowable to shareholders in future years as the corporate amount "at risk" increased.³²⁸ Somewhat oddly, taxpayers often benefited by having the limitation of section 465 apply rather than the basis limitation, because losses currently disallowed under section 465 could be carried forward while losses exceeding the shareholder's basis would be forfeited forever.³²⁹

Under the Revision Act S corporations no longer are subject to section 465 as such,³³⁰ but Congress has continued the application of that provision to corporations that meet the stock ownership

322. *E.g.*, I.R.C. §§ 465(c)(2) and (3)(B).

323. I.R.C. § 465(c)(3)(D).

324. Former I.R.C. § 465(a)(1)(B).

325. I.R.C. § 465(a)(1)(A). *See* MCKEE, *supra* note 73, at ¶ 10.11[2].

326. I.R.C. § 465(b)(2).

327. Former I.R.C. § 465(a)(1)(B).

328. I.R.C. § 465(a)(2).

329. *See* the extensive analysis of the application of I.R.C. § 465 to S Corporations in Bravenec, *Subchapter S Corporations and Shareholders Under the At Risk Rules of Section 465*, 36 TAX LAW. 93 (1982) and Bravenec, *Subchapter S Corporations and Shareholders Under the At Risk Rules—Revisited*, 36 TAX LAW. 765 (1983).

330. I.R.C. § 465(a)(1).

requirements of a personal holding company.³³¹ It is not at all clear from the Revision Act modifications to section 465 whether closely held S corporations continue to be subject to the provisions of section 465 at the entity level. For the purposes of that provision, an S corporation is regarded as a corporation. Moreover, section 465 clearly affects the computation of income; an S corporation must compute its income in the same manner as an individual.³³² Individuals, of course, are subject to section 465.³³³ However, if S corporations were regarded as subject to section 465 because they compute their income as individuals, then all S corporations would be subject to the provision regardless of whether their stock is so closely held that they meet the requirements of the personal holding company definition. It seems unlikely that Congress intended that result in view of its deletion of S corporations from the enumeration of taxpayers subject to section 465. Section 201(l)(1) of the TCB attempts to resolve this question by limiting the provision dealing with closely held corporations to non-electing corporations. Although this proposed amendment to section 465(a)(1)(B) does not deal directly with the deemed individual rule, it seems to indicate clearly that section 465 was not intended to apply any longer to any S corporation at the entity level.

Although the amended section 465 is ambiguous it probably no longer will be applied at the entity level to any S corporation. Whether section 465 should ever be applied at the entity level to either corporations or partnerships is debatable. The resulting triple restriction on the allowance of losses is unacceptably complex and can produce irrational results.³³⁴ On the other hand, sheltering income at the entity level through deductions attributable to nonrecourse indebtedness is difficult to justify because those deductions are not allowed to individuals. Regardless of the propriety of applying section 465 at the entity level, S corporations and partnerships should be treated similarly. Because the overriding objective of the Revision Act was to conform the taxation of S corporations to the taxation of partnerships to the extent possible, the Treasury Department most likely will resolve statutory ambiguities in favor of conformity. Accordingly, it seems probable that the regulations will construe the amendment to section 465 as exempting S corporations from the application of that section at the entity level.

331. I.R.C. § 465(a)(1)(c).

332. I.R.C. § 1363(b).

333. I.R.C. § 465(a)(1)(A).

334. For a contrary opinion of the continuing applicability of I.R.C. § 465 to closely held S corporations at the entity level, and a thorough discussion of the irrational results this application can cause, see Bravenec, *supra* note 329.

VI. CAPITAL GAINS AND "ONE-SHOT" ELECTIONS

With the adoption of Subchapter S, Congress acknowledged that it was acceptable for a corporation and its shareholders to be subject to only a single level of tax. On the other hand, Congress has remained wary of the ability of taxpayers to switch back and forth between the normal system for taxing corporations and Subchapter S. Presumably Congress is concerned that if taxpayers were able to elect their desired method of taxation annually, the judicious use of Subchapter S could result in a lower burden of taxation over a period of time than would be imposed upon the business under either system of taxation alone. As a result, Subchapter S contains a variety of provisions designed to restrict such freedom of choice. If that is indeed Congress' concern, the striking feature of each of these provisions is its relative ineffectiveness. A corporation is free to elect Subchapter S for a single year only and, unless the corporation has an extraordinary amount of capital gains in that year, the only penalty incurred is the inability to again elect Subchapter S for a period of years.³³⁵ In essence, a corporation can move freely in and out of Subchapter S — but only once in every five years. Somewhat inconsistently, perhaps, the reverse is not true; an S corporation may not terminate its election for a one-year period. Under the same five-year wait provision, unless the consent of the Commissioner is obtained, the corporation cannot reelect under Subchapter S for five years. In addition, if a corporation attempts to pass through to its shareholders a substantial amount of capital gains income in the course of a "one-shot" election, the capital gain becomes subject to tax at the corporate level.

In the one provision of the Revision Act that is carried over unchanged from prior law, a corporation previously subject to the regular tax that elects Subchapter S treatment and, within three years, incurs a capital gain in an amount exceeding fifty percent of the corporation's taxable income for that year is subject to tax at the corporate level on the gain at the same rate that would have applied had Subchapter S treatment not been elected.³³⁶ This provision has no effect upon the taxation of the capital gain at the shareholder level except that, in computing the amount of gain taxable to the shareholder, a deduction is permitted for the tax paid by the corporation.³³⁷ Thus, the section addresses only the

335. See text accompanying notes 146-47 *supra*.

336. I.R.C. § 1374.

337. I.R.C. § 1366(f)(2) reduces the amount of long-term capital gains passed through to the shareholders by the amount of any tax paid by the corporation under I.R.C. §§ 56 and 1574.

incurring of massive capital gains, such as might be incurred on a transaction falling just short of a partial liquidation. Moreover, even though the transaction does not amount to a partial liquidation, the section imposes an overall burden of taxation similar to the tax imposed upon such a transaction.³³⁸ In many instances, the total capital gains taxes at the corporate and shareholder levels will be less than the taxes that would have been imposed had the corporation not made a Subchapter S election but had distributed the proceeds of the disposition as an ordinary dividend to its shareholders.

If the ability to switch back and forth between the regular and Subchapter S system of taxation posed a serious threat of tax avoidance, Congress might have been more rigorous in foreclosing this device. For example, the entire benefit of a Subchapter S election could be denied retroactively if that election were terminated within two years. Such a provision could contain appropriate exceptions governing the death of a major shareholder, for example, or a disposition to unrelated persons of a majority of the corporation's stock.

Clearly, the "one-shot" pass through of capital gain should not be permitted. The transaction that section 1374 is designed to impede amounts to the extension of the exclusion from tax provided by section 337 to transactions that may not even qualify as partial liquidations. In addition, the ability to secure one level of tax on a capital gain might in some situations seriously undermine the collapsible corporation provisions of section 341³³⁹ (although in most instances in which the corporation would be eligible for capital gains treatment, the collapsible provisions may deserve to be undermined). It is not at all clear, however, that this tax avoidance use of a Subchapter S corporation is any more serious than other temporary uses of the option. It seems, for example, highly inappropriate to permit a substantial extraordinary loss to pass through to shareholders pursuant to a one-year Subchapter S election although no provision of either prior or present law prevents such a use of Subchapter S. Additionally, it seems somewhat peculiar to permit a corporation to elect Subchapter S

338. See I.R.C. § 302(b)(4).

339. I.R.C. § 341 is designed to prevent the conversion of ordinary income into capital gain through the device of causing a corporation to create value in property which then is realized by the shareholders through a transaction in the stock of the corporation rather than the exploitation of the value created. The capital gains pass through of an S corporation, however, is not a stock transaction that triggers the collapsible provisions. However, the I.R.C. § 1374 tax only retards the avoidance of I.R.C. § 341 when the collapsible assets produce a capital gain upon a disposition. The application of I.R.C. § 341 in most such circumstances is questionable and often can be avoided under I.R.C. § 341(e).

only for its final year of existence in order to extend the benefits of section 337 to items of income not insulated from tax under that provision.³⁴⁰ In any event, the pattern of prior law has been continued: Except where substantial capital gains are incurred, the only sanction for making a "one-shot" election is the prohibition against reelection for five years.

In light of the other changes made to Subchapter S, it appears unfortunate, if not erroneous, for the prior law version of the section 1374 tax to have been continued without modification. The tax is imposed when the taxable income of the corporation exceeds \$25,000 and the capital gain exceeds \$25,000 and exceeds fifty percent of taxable income. Section 1374(d), as amended by the Technical Corrections Act of 1982, provides that the taxable income of the corporation, for purposes of applying these tests, shall be determined under section 63(a) with certain modifications.³⁴¹ The cross-referenced provision defines taxable income of a corporation as gross income minus all deductions. Thus, for the purpose of determining whether the S corporation is liable for the special tax, the income of the S corporation must be computed in the same manner, with certain minor modifications, that it would be computed if the corporation had not elected under Subchapter S. The decision to require all calculations under section 1374 to be made by reference to taxable income computed as though the corporation were subject to the regular corporate income tax is unfortunate. Since an S corporation has no other occasion to compute its income in this manner, its normal computations of income and expense will not disclose whether it is approaching liability for the special tax on capital gains. In order to make that determination, the corporation's accountants will be required to make this special and highly complex computation, at the corporation's expense. No useful purpose is served by determining the liability for the special capital gains tax by referring to the income as it would be computed for a corporation. Both the \$25,000 and the fifty percent tolerances are entirely arbitrary. It is needlessly complex and expensive for taxpayers to be required to make complicated and precise computations in order to determine whether the amount of their capital gains exceeds a totally arbitrary floor. It would be preferable if the section were amended so that the taxable income concept used in the triggering definition was the same as the taxable income normally computed by the S corporation.

As under prior law, an S corporation generally is not subject

340. See text accompanying notes 439-41 *infra*.

341. The corporation may not claim the net operating loss deduction or the special deductions allowed to corporations by I.R.C. §§ 241 to 250 (except the § 248 organization expense amortization). I.R.C. § 1374(d)(2).

to the additional taxes imposed upon items of tax preference. Under section 58(d), however, as under prior law,³⁴² if a corporation becomes subject to the tax imposed on capital gains by section 1374, the S corporation also becomes subject to the add-on corporate minimum tax imposed by section 56—but only with respect to capital gains subject to that tax. Under prior law, incidentally, the express exemption of the S corporation was contained in the preference tax provisions.³⁴³ In the Revision Act, the exemption is accomplished by the general rule of section 1363 that, unless otherwise provided, an S corporation is not subject to the taxes imposed by Chapter One of the Internal Revenue Code.

VII. CORPORATE DISTRIBUTIONS

A. *Prior Law*

Without question, the greatest failure under prior law in the scheme of Subchapter S was the manner of taxing actual distributions from the corporation to its shareholders. Under the scheme of taxing partnerships, the distribution of cash or property from a continuing partnership rarely produces a tax to the distributee partner.³⁴⁴ Rather, taxation of gain on any appreciation in partnership properties is deferred by reducing the basis of the partner's interest in the partnership by the amount of any cash distributed plus the adjusted basis to the partnership of any property distributed.³⁴⁵ The partner acquires a basis in the distributed property equal to its basis in the hands of the partnership.³⁴⁶ This rule is highly favorable to the conduct of business in partnership form. Partners can substantially reduce their level of investment in the partnership by exchanging a highly appreciated partnership interest for partnership property and the transaction will not produce a tax until the partner receiving the distribution converts that property into cash or other property. While in some cases this liberal non-recognition rule permits an arguably improper deferral of gain, the rule obtains ample justification in the flexibility it permits partnership operations. Because of this rule, partners and partnerships are able to contribute and distribute cash and other property with relatively little fear of adverse or unanticipated tax consequences. As a result, relatively unsophisticated taxpayers engaged in business in partnership form have been able

342. Former I.R.C. § 1372(b)(1).

343. Former I.R.C. § 58(d).

344. I.R.C. § 731(a)(1).

345. I.R.C. § 733.

346. I.R.C. § 732(a).

to avoid the unfortunate predicaments in which shareholders in Subchapter S corporations found themselves. The drafters of the original Subchapter S provisions seemed to believe they were adopting a similar rule for Subchapter S corporation shareholders. The legislative history stated that "where a shareholder has been taxed on corporate earnings which were not at that time distributed, and then the corporation in a subsequent year distributes these earnings to such shareholders no further tax is required from the shareholder at that time, since these earnings have already been taxed to him in a prior year."³⁴⁷ That happy result, however, was not to be.

Under prior law, as it was ultimately enacted (and interpreted by relatively unfriendly regulations), actual distributions from a Subchapter S corporation (with a minor subsequently enacted exception) were treated exactly like distributions from corporations subject to the regular income tax to the extent of the corporation's current earnings and profits.³⁴⁸ Only actual distributions in excess of current earnings, therefore, could be regarded as distributions of the taxable income of the corporation that had been taxed previously to the shareholders but not distributed. This amount was referred to as previously taxed income or PTI.³⁴⁹ Moreover, the regulations, with some support in the legislative history, took the position that only cash distributions from the corporation could be regarded as distributions of PTI.³⁵⁰ Of course, the distribution of cash in an amount equal to the current earnings and profits of the corporation did not increase the tax payable by shareholders; had that amount not been distributed, it would have been taxable as a constructive year-end dividend.³⁵¹ Before a shareholder was able to withdraw the previously taxed income, however, an actual cash distribution equal to the amount of current earnings and profits was required. Moreover, the regulations took the position that any distribution of PTI must be pro rata to all shareholders; distributions in redemption of the Subchapter S stock did not qualify.³⁵² As a result, the cash burden of making distributions of PTI was more than most businesses could bear. Furthermore, if the corporation attempted to generate cash in order to make a distribution of previously taxed income, the conversion of the asset to cash would be a taxable event to the S corporation shareholders. In

347. S. REP. NO. 1983, 85th Cong., 2nd Sess. 68 (1958), *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4791, 4876-77.

348. Treas. Reg. § 1.1373-1(d) (1968).

349. Treas. Reg. § 1.1375-4(b) (1968).

350. *Id.*

351. Former I.R.C. §§ 1373(b) and (c); *see* text accompanying notes 171 & 177-80 *supra*.

352. Treas. Reg. § 1.1375-4(b) (1968).

practice, therefore, many Subchapter S corporation shareholders were unable to obtain distributions of previously taxed income.

This failure of expectations under Subchapter S led to a lengthy series of battles between taxpayers and the Commissioner as taxpayers sought to secure the anticipated advantage of the Subchapter S format through other means. Shareholders commonly caused their corporation to make annual cash distributions, either to prevent the build-up of PTI or to obtain a distribution of PTI, whereupon the distributed cash would be lent back to the corporation.³⁵³ It is indeed a sad commentary upon the structure of prior law that cash could be removed from a corporation free of tax far more easily through the traditional mechanism of the repayment of indebtedness than it could be removed as a distribution of PTI. Unfortunately, the Commissioner attacked this device with surprising vigor. Where possible, he argued that the distribution and reinvestment constituted a step transaction that amounted to the distribution of a corporate obligation.³⁵⁴ Since such an obligation constituted property, not cash, it did not constitute a distribution of PTI nor did it eliminate completely a taxable year-end constructive dividend. When this attack was not available, the Commissioner argued that the indebtedness obtained by the stockholder should be recharacterized under the usual debt-equity analysis as stock, rather than debt.³⁵⁵ Furthermore, the Commissioner took the position that the recharacterized indebtedness constituted a second class of stock and that, consequently, the Subchapter S election had been terminated retroactively.³⁵⁶

The need to distribute PTI in order to secure the supposed advantages of operation as a Subchapter S corporation became particularly acute when stock in the corporation was to be sold or donated to another or the Subchapter S election was to be terminated. The regulations took the position that the PTI attributable to a shareholder's stock constituted an account that was personal to the shareholder to whom the income had been taxed and was not transferable by him.³⁵⁷ Thus, distributions from the Subchapter S corporation to the transferee could not be regarded as tax free distributions of PTI accumulated prior to the transfer. As a result, the little ability that existed under prior law to distribute PTI was lost permanently if the stock became the subject of a gift. In addition, the regulations stated that a distribution of PTI had to occur while the Subchapter S election

353. See Bittker and Eustice, *supra* note 156, at ¶ 6.08.

354. *Roesel v. Comm'r*, 56 T.C. 14 (1971).

355. *Stinnett v. Comm'r*, 54 T.C. 221 (1970).

356. See text accompanying notes 61-62 *supra*.

357. *Treas. Reg.* § 1.1375-4(e) (1968).

was in effect.³⁵⁸ Distributions following the termination of the election would be treated as regular dividends and would thus be subject to ordinary income tax under section 301(c) to the extent of the corporation's accumulated earnings and profits for the year following the termination. When the termination was inadvertent and thus, under prior law, retroactive, the effect of this rule was extraordinarily harsh.

B. Under the Revision Act

1. In General

Under the Revision Act, how S corporation distributions are treated depends upon whether or not that corporation has accumulated earnings and profits. For corporations lacking earnings and profits, the new rules have been simplified considerably and brought substantially into line with the taxation of partnerships—although with a most significant catch.³⁵⁹ For other corporations, the rules have been changed but not much improved. Unfortunately, most S corporations will have earnings and profits and, thus, will not be eligible for these simplified rules. Nearly every corporation that elected Subchapter S treatment after having been subject to tax as a regular corporation will have an accumulated earnings and profits account. In addition, most corporations accumulated some amount of earnings and profits even when operating under the provisions of prior law because of the discrepancies between the computation of taxable income and the computation of earnings and profits.³⁶⁰ Thus, the simplified rules governing distributions will be applicable, in general, only to corporations formed after January 1, 1983, that elect to be taxed under Subchapter S from the time of their initial organization.

For such fortunate corporations, the old concept of previously taxed income has been discarded along with the concept of earnings and profits. Any distribution from an S corporation that, absent new section 1368, would be taxable as a dividend to the extent of corporate earnings and profits, is treated instead as a return of capital.³⁶¹ Thus, unless the amount of cash or the fair market value of property distributed exceeds the shareholder's basis in his S corporation stock, as increased under section 1367(a) (1) by any net profits allocable to him but remaining undistributed, the entire amount of the distribution will be free of tax. Any excess

358. Treas. Reg. § 1.1375-4(a) (1968).

359. See text accompanying notes 406-19 *infra*, for an analysis of the tax that may be accelerated by a property distribution.

360. See text accompanying notes 183-85 *supra*.

361. I.R.C. § 1368(b)(1).

is to be treated as gain from the sale or exchange of property, thus generally producing a capital gain.³⁶² To the extent of the distribution, the shareholder's basis for his S corporation stock is reduced.³⁶³ For example, on a distribution of property, the basis of the S corporation stock will be reduced by the fair market value of the property distributed and the shareholder will have a basis for the property equal to its fair market value.

If the S corporation does have accumulated earnings and profits, the taxation of corporate distributions can become substantially more complex. Moreover, in some instances, the pattern of taxation prescribed by the Revision Act seems improper. This added complexity stems from the legitimate desire of Congress to prevent the use of Subchapter S to avoid a tax at the shareholder level on distributions of earnings and profits accumulated prior to the Subchapter S election. If the simplified rules described above were applicable to such corporations, a corporation could elect S corporation status and commence tax free capital distributions even though the corporation had substantial accumulated earnings and profits that were the actual source of the distributions. To prevent that result, the Revision Act, like prior law, creates a somewhat awkward synthesis of the Subchapter C rules and the Subchapter S rules governing corporate distributions. These two very different patterns of taxation are coordinated by rules that establish a priority of distributions. The priority that Congress apparently intended to establish under the Revision Act is identical to the priority of distributions under prior law.³⁶⁴ However, under the Revision Act, that objective will not always be achieved.

In general, section 1368 apparently contemplates that distributions from an S corporation are first governed by the concepts of Subchapter S and are free of tax to the recipient. Only if the amount of the distribution exceeds the accumulated net income earned by the corporation subsequent to the effective date of the Revision Act are distributions taxed as dividends to the extent of accumulated earnings and profits under the normal rules of Subchapter C. Distributions in excess of both accumulated Subchapter S income and earnings and profits are treated as returns of capital and thereafter as gain from the sale or exchange of the S corporation stock.

Under prior law, the distinction between tax free distributions and distributions taxed as ordinary dividends was drawn by the computation of a shareholder's personal PTI account which

362. I.R.C. § 1368(b)(2).

363. I.R.C. § 1367(a)(2)(A).

364. HOUSE REPORT, *supra* note 22, at 19; SENATE REPORT, *supra* note 22, at 20.

measured the net income that had been taxed to that shareholder while a Subchapter S election was in effect. The Revision Act discards the concept of a personal account and creates instead an "accumulated adjustments account," defined in section 1368(e) (1) (A) as the aggregate net post-1982 increase in the tax bases of all shareholders' stock prescribed by section 1367. The accumulated adjustments account roughly corresponds to the sum of the PTI accounts of all shareholders under prior law except that the account is a single corporate account, not personal to any shareholder. The account is similar to the earnings and profits account that must be maintained by corporations subject to the corporate income tax. Thus, the accumulated adjustments account is increased by the total amount of income allocated to all shareholders (with one exception, noted below)³⁶⁵ and reduced by all losses and tax free distributions to shareholders (that is, distributions from the accumulated adjustments account).

To the extent distributions from a corporation that has earnings and profits do not exceed the amount of the accumulated adjustments account (and do not exceed the shareholder's basis), the distributions are free of tax just as are distributions from a corporation that does not have earnings and profits.³⁶⁶ Distributions in excess of that amount are treated in the same manner as dividend distributions from corporations subject to the regular corporate tax.³⁶⁷ Thus, to the extent of the corporation's accumulated earnings and profits, such distributions are taxable as ordinary income to the S corporation shareholders. Once the earnings and profits account has been exhausted, distributions are regarded as returns of capital; and, once the shareholder's basis is exhausted, the distributions are regarded as capital gains.³⁶⁸

This new method for distinguishing between tax free distributions and distributions of accumulated earnings and profits appears to operate properly only in the very simplest of circumstances. For example, assume that an S corporation has an accumulated adjustments account of \$500 and accumulated earnings and profits of \$600. The stock of the corporation is owned equally by two shareholders, A and B, each of whom has a basis of \$350 for his stock. Assume further that the corporation makes a pro rata distribution, not in exchange for its stock, in the amount of \$700 each to A and B. To the extent of the \$500, the amount of the accumulated adjustments account, the distribution is free of tax and reduces the shareholder's basis in his S corporation stock. Although the statute does not specifically address the question,

365. See text accompanying notes 386-89 *infra*.

366. I.R.C. § 1368(c)(1).

367. I.R.C. § 1368(c)(2).

368. I.R.C. § 1368(c)(3).

presumably this tax free portion of the distribution is to be allocated ratably between A and B—at least in the case of a simultaneous distribution. Thus, the basis of the stock held by each of them is reduced to \$100. In addition, A and B are treated as if they had each received a dividend distribution in the amount of \$300, their allocable share of the earnings and profits account, which would be subject to tax at ordinary income rates. To the extent that the distribution is so treated, it does not reduce the basis of stock in the S corporation.³⁶⁹ Further, A and B would receive a \$100 tax free return of capital which would exhaust the basis of their stock, and \$50 of capital gain.

By converting the personal PTI account to a corporate accumulated adjustments account, Congress has simplified somewhat Subchapter S and has provided the mechanism for avoiding certain of the harsh results that prevailed under prior law, such as the nontransferability of the PTI account. In several common situations, however, the use of the corporate level account causes a reversal of the normal priority of distributions from S corporations. As a result, S corporation shareholders may become subject to unanticipated tax liabilities. It is not clear that all of these results were anticipated or desired by Congress and, at least in certain circumstances, those results are highly questionable.

The accumulated adjustments account approach does not take into account the differences in the amount of the corporation's taxable income that has been previously taxed to a particular shareholder. That amount could be substantially less or greater than the shareholder's current pro rata share of the accumulated adjustments accounts. Thus, on the facts of the foregoing example, the tax consequences would not be altered if B had become a shareholder in the S corporation subsequent to the time that the accumulated adjustments account had been created.

At least with respect to pro rata distributions, Congress intended this result. The Committee Reports explicitly state that the rules governing distributions will apply to the transferee of stock in an S corporation regardless of how he acquired his stock.³⁷⁰ When S corporation stock is transferred by an existing shareholder, either by gift or in a transaction that produces a tax basis to the transferee in excess of the amount of the accumulated adjustments account, the result reached under section 1368 seems to be proper. The remaining shareholders are not prejudiced by the stock transfers because the accumulated adjustments account is

369. I.R.C. § 1367(a)(2)(A) provides that only distributions not includible in income reduce basis.

370. HOUSE REPORT, *supra* note 22, at 19; SENATE REPORT, *supra* note 22, at 20.

unaffected by the stock transfer and the existing shareholders retain an unaltered interest in that account. If, however, by issuing stock to new investors, the corporation increases the number of shares of stock outstanding, each shareholder's proportionate interest in the accumulated adjustments account will be diminished. Accordingly, pro rata distributions to shareholders will exhaust the accumulated adjustments account before an amount has been distributed to the old shareholders equal to the net amount upon which they have been subject to tax. If the aggregate of the distributions made to the shareholders exceeds the accumulated adjustments account, each of the shareholders will become subject to tax on the distribution at ordinary income rates. The distributions will now be regarded as distributions of earnings and profits, even though the old shareholders will not have received distributions equal to the post-1982 increases in their basis for their S corporation stock. At the corporate level, the distribution has not been treated as a distribution out of earnings and profits until the entire amount of the accumulated adjustments account has been exhausted, but from the perspective of the old shareholders, their distributions have become taxable before the full amount of S corporation income upon which they have been taxed has been distributed to them.

This effect of the corporate level accumulated adjustments account can be illustrated by assuming that B was not an old stockholder of the corporation but rather had purchased his stock from the corporation for \$1000 immediately prior to the distribution. Prior to that purchase, A, as the sole shareholder, would have been entitled to receive a tax free distribution of \$500, the entire accumulated adjustments account. Subsequent to the purchase, the corporation still can distribute \$500 free of tax to the distributee shareholders but if the corporation makes a pro rata distribution, A cannot receive more than \$250 tax free.³⁷¹ Any further distributions will be subject to tax to both A and B at ordinary income rates until the earnings and profits account of the corporation has been exhausted. Consequently, A will not be able to obtain a tax free distribution of the amount of S corporation income that has been taxed to him until the corporation has eliminated its earnings and profits account. Because of this "spreading out" of the accumulated adjustments account, S corporations may be inhibited from raising new capital through the issuance of additional stock. Should the Revision Act have that effect,³⁷² it would be an unfor-

371. Non pro rata distributions are discussed in the text accompanying notes 374-80 *infra*.

372. At least insofar as the tax consequences to the new shareholder (B in our example) are concerned, the result may have been intended. One of the reasons given in the early stages of revision for making the accumulated ad-

tunate by-product of legislation that was designed to enhance the flexibility and desirability of S corporations.

While new shareholders in an S corporation can produce a reversal of the normal priority of distributions to the old shareholders by accelerating the point at which a distribution of earnings and profits is deemed to occur, the new shareholders themselves may also be subject to a reversal of priorities. If the basis for a shareholder's stock is lower than his allocable portion of the accumulated adjustments account, distributions can produce a capital gains tax to the shareholder before the shareholder becomes subject to ordinary income treatment on a distribution of earnings and profits—a conceptually dubious result. In the above example, B might have purchased stock in the corporation for \$100 if the properties of the corporation had contained large unrealized losses. Section 1368(b) and (c)(1) literally state that to the extent of the accumulated adjustments account, a distribution is free of tax to the extent of the shareholder's basis for his S corporation stock and, thereafter, is subject to capital gains taxation. Only distributions in excess of the accumulated adjustments account are treated as distributions of earnings and profits. Once the earnings and profits account is exhausted through further distributions, B again would be subject to tax at capital gains rates because his basis would have been exhausted.

There are several problems, both practical and conceptual, with this pattern of taxation. Extending capital gains taxation to B to the extent the accumulated adjustments account exceeds his basis is arbitrary. That account is designed to discriminate between distributions that are to be treated as tax free returns of previously taxed Subchapter S income and distributions attributable to accumulated earnings and profits. Once B has received a return equal to the basis of his stock, he is not receiving a tax free distribution of accumulated S corporation income; he is harvesting the appreciation on his investment and, quite properly, he is being taxed on the amount of that appreciation at capital gains rates. The proper tax consequences to B in this circumstance are wholly unrelated to the level of the accumulated adjustments account.

The irrelevance of the accumulated adjustments account to the taxation of B is underscored by the adjustments that are made to the account attributable to distributions to shareholders. Under section 1368(e)(1)(A), the accumulated adjustments account is to be adjusted in a manner similar to the adjustments to basis provided

justments account a corporate level account was the desire to treat distributions to a new shareholder the same way whether the shareholder purchased the stock from the corporation or from an old shareholder. STAFF REPORT, *supra* note 6 at 18.

by section 1367. Under section 1367(a)(2)(A), the basis of a shareholder's stock is to be reduced by distributions that are not includible in the income of the shareholder by virtue of section 1368. Thus, and quite properly, the basis of S corporation stock is reduced by tax free distributions but is not reduced by distributions in excess of basis. The accumulated adjustments account should be computed similarly. Thus, to the extent that distributions to B exceed his basis, the accumulated adjustments account should not be reduced. Indeed, it plainly would be erroneous to reduce the account by virtue of such distributions. Because B will be taxed on distributions in excess of his basis, the account has not supported tax free distributions of accumulated S corporation income. Furthermore, since B is not regarded as receiving distributions from the accumulated adjustments account, the level of the accumulated adjustments account should be irrelevant to the tax consequences to B of distributions.

In this and other situations, the level of the accumulated adjustments account will rationally identify the point at which distributions are to be regarded as distributions of earnings and profits. Because distributions in excess of basis do not reduce the accumulated adjustments account, the account will never be exhausted so long as distributions in excess of basis are made only to a single shareholder. On the other hand, if distributions were made ratably between a high basis A and a low basis B, the full amount of the distributions to A would reduce the level of the accumulated adjustments account although the distributions to B would not. Thus, the account would not be exhausted until the aggregate of distributions to A and B totalled twice the amount in the account when the distributions commenced. Plainly, the use of the accumulated adjustments account to identify distributions of earnings and profits in this circumstance is totally arbitrary and, indeed, irrational. These irrational tax consequences could be ameliorated somewhat if section 1368 provided that distributions would be free of tax to the extent of the lesser of the accumulated adjustments account or a shareholder's basis for his stock. Further distributions might then be regarded as distributions of accumulated earnings and profits. However, that solution also could be subject to criticism. B would be regarded as receiving a distribution of earnings and profits while A was continuing to receive a tax free distribution from the accumulated adjustments account; therefore, B would be subject to tax at ordinary income rates on a greater proportion of the distribution than would A. Such a result would seem particularly inappropriate if the earnings and profits were accumulated before B became a shareholder in the S corporation.

It may be that there is no ideal solution to the problem of synthesizing the Subchapter S and Subchapter C rules governing

distributions; however, Subchapter S would be much improved if persons becoming shareholders in S corporations after 1982 were never regarded as receiving distributions of earnings and profits. Since by definition an S corporation cannot accumulate earnings and profits after 1982, there is no reason why a shareholder who has purchased his interest in an S corporation after that date should be subject to tax at ordinary income rates upon the distribution of accumulated earnings and profits. Of course, such a rule would require that those individuals who were shareholders on the effective date of the Revision Act must be taxed on their allocable share of corporate earnings and profits upon any disposition of their stock. While that approach would be highly radical from the perspective of the corporate income tax, it would be entirely consistent with the partnership model upon which Subchapter S is presently based.³⁷³

2. Non Pro Rata Distributions

Since the accumulated adjustments account is a corporate rather than a personal account, the amount of that account quite commonly will exceed the basis of any shareholder's stock. Thus, the unsatisfactory pattern of taxing distributions when the amount of the accumulated adjustments account exceeds the basis of the distributee shareholder's stock frequently will arise in the context of a non pro rata distribution, such as a redemption that is treated as an ordinary section 301 dividend. However, through the use of non pro rata distributions, the shareholders of S corporations can use that pattern of taxing distributions to their advantage. Section 1368 is applicable to all distributions that, in the absence of Subchapter S, would be taxable as dividends under section 301(c).³⁷⁴ Section 301(c), however, applies to all distributions by a corporation that are not governed by more specific Code sections, such as sections 302 and 303, which treat certain distributions in exchange for stock as sales or exchanges. Those sections, however, are not applicable to all purported redemptions of stock. Under section 302, for example, a redemption is entitled to sales treatment, and thus is removed from the scope of section 301(c) only if the redemption results in a meaningful reduction in the redeeming shareholder's continuing proportionate interest in the corporation, or it meets one of the alternative tests for sales treatment provided by that provision.³⁷⁵ Accordingly, many redemptions of

373. See text accompanying notes 344-47 *supra*.

374. I.R.C. § 1368(a).

375. These tests often are particularly difficult to meet in the context of a closely held corporation because of the applicability of the I.R.C. § 318 attribu-

stock by closely held corporations fall within the scope of section 301(c) and if the redeeming corporation is an S corporation, the redemptions are governed by section 1368.

Section 1368 provides that if the S corporation has accumulated a sufficient amount of post-1982 income so that the accumulated adjustments account exceeds the entire amount of the non pro rata distribution, then the entire amount of the distribution will be free of tax to the extent of the shareholder's basis and, thereafter, will be subject to tax only as gain from the sale or exchange of the S corporation stock, presumably a capital gain. Although it is not entirely clear whether the tax free recovery will be limited by the basis of the stock redeemed or by the aggregate basis of all the shareholder's stock, it is clear that the shareholder will be subject to a very favorable pattern of taxation. Only if the amount of the distribution exceeds the entire balance in the accumulated adjustments account will the taxpayer be exposed to a tax at ordinary income rates.

While this pattern of taxation produces favorable results to the first shareholder to redeem from an S corporation under section 1368, the procedure can produce quite severe consequences to the remaining shareholders in the corporation. Returning to our illustrative S corporation, the corporation had an accumulated adjustments account of \$500 and accumulated earnings and profits of \$600. The corporation had two equal shareholders, A and B, each of whom had a basis for his stock of \$350. Assume that the corporation redeems one-half of A's stock for \$500 in a transaction that is not treated as a sale or exchange under section 302. Pursuant to section 1368(c)(1) and (b)(1), the distribution is free of tax to the extent that it does not exceed "the adjusted basis of the stock." Since the transaction as to A is treated as a section 301 dividend, presumably the basis referred to in that provision is A's entire basis of \$350 and not merely the basis of the stock purportedly redeemed, \$175. In any event, A will have a tax free distribution to the extent of his basis (let us assume that the proper figure is \$350) and a capital gain in the amount of the rest of the distribution, \$150. Under sections 1368(e)(1)(A) and 1367(a)(2)(A), the accumulated adjustments account will be reduced by this transaction by the amount of the tax free distribution, \$350, and thus will have a remaining balance of \$150.

Assume that in a subsequent year in which there has been no change in the level of the accumulated adjustments account, the corporation redeems the same amount of stock from shareholder B. Again, in a transaction that does not qualify for exchange treat-

tion rules, which treat the shareholder as owning stock actually owned by members of his family or other entities in which he has an interest.

ment under sections 302 or 303, the consequences to B will be very different. B will be entitled to a tax free distribution only to the extent of the remaining accumulated adjustments account, \$150. The balance of the distribution will be treated under section 1368(c)(2) as a distribution of accumulated earnings and profits and be subject to tax at ordinary income rates.

Quite plainly, shareholder A will have benefited enormously at the expense of shareholder B. A will have been able to avoid dividend treatment by using the portion of the accumulated adjustments account that was created by virtue of income allocated and taxed to B. As a result, A will be able to obtain capital gains taxation with respect to the distribution and will be able to shift the burden of ordinary income taxation to B. Even if A does not wish so to benefit at the expense of B, he cannot avoid that consequence. The rules of sections 1367 and 1368 are mandatory. As illustrated below, B can be protected from this result if the redemption can be brought within the scope of section 302. In many family owned corporations, however, qualifying a redemption under that section can be a difficult and uncertain matter.³⁷⁶ Alternatively, the shareholders can attempt to negotiate a price for the redemption that reflects the tax consequences to the remaining shareholders. That process, however, will be difficult and imprecise even where the parties are acting in good faith. Accordingly, this aspect of the corporate level account may seriously impede the redemption of stock by S corporations when the transaction cannot be brought within the scope of sections 302 or 303.

On the other hand, well-advised taxpayers may be able to use this pattern of taxation to their advantage. The planning possibilities of non pro rata distributions are discussed below.³⁷⁷

No provision in the Revision Act addresses the point in time at which additions or subtractions are to be made to or from the accumulated adjustments account. Under prior law governing Subchapter S corporations, the computations of earnings and profits and undistributed taxable income occurred on an annual basis as of the end of the corporation's fiscal year.³⁷⁸ Thus, the extent to which a distribution constituted a distribution of current earnings and profits could not be ascertained accurately until the end of the year. That approach conformed to the rules governing the corporate income tax under which the computation of earnings and profits occurs as of the end of the corporation's year.³⁷⁹ By contrast, a partner's basis in his partnership interest is calculated on

376. See note 375 *supra*.

377. See text accompanying notes 392-98 *infra*.

378. Former I.R.C. §§ 1373(c) and 1377(a); Treas. Reg. §§ 1.1373-1(b)-(e) (1968).

379. Treas. Reg. §§ 1.316-1(a)(1) (1963) and 1.1377-2(b) (1960).

a daily basis. Pursuant to section 731, distributions from the partnership are compared with a partner's basis of his partnership interest "immediately before the distribution."³⁸⁰ While the Treasury Department in all likelihood will seek to conform to the greatest possible extent the taxation of S corporations to the taxation of partnerships, in this circumstance it appears clear that the annual computation of the corporation tax is better suited to the S corporation than is the approach of section 731. The controlling consideration is that, unlike partnership taxation, the accumulated adjustments account is a corporate level account. As illustrated above, to the extent that account is exhausted by distributions to one shareholder, the account cannot support tax free distributions to the remaining shareholders. Accordingly, some mechanism must be established for allocating the amount of the accumulated adjustments account among shareholders receiving distributions from the corporation at different times throughout the taxable year. While it might be technically possible to devise a rule strictly allocating the accumulated adjustments account in accordance with the chronological order of distributions, such a rule would be unavoidably unsatisfactory. Thus, because it would seem necessary in the event of simultaneous redemptions to allocate the account ratably, it would become necessary to create an arbitrary and difficult to administer definition of simultaneity. In addition, because non-simultaneous distributions might be taxed quite differently, contrary to the probable expectations of the parties, a major trap for less well-advised shareholders would be created. Accordingly, it would be vastly preferable if the accumulated adjustments account were adjusted annually at the end of the corporation's taxable year, at least with respect to reductions for distributions. If such a rule were adopted, there would be little reason to make more frequent adjustments to the account for any other purpose.

3. Distributions of Pre-1983 Subchapter S Income

The computation of the accumulated adjustments account is not retroactive; the account only includes income accumulated after 1982.³⁸¹ Accordingly, the general mechanism established by the Revision Act for defining tax free distributions does not permit the tax free distribution of previously taxed income accumulated prior to 1983 by a corporation having earnings and profits. While it seems reasonably clear that Congress did not intend to cause the retroactive forfeiture of the benefits of PTI accounts existing on December

380. I.R.C. § 731(a)(1).

381. I.R.C. §§ 1368(e)(1)(A) and (2).

31, 1982, the Revision Act contains relatively little to indicate how those accounts will be treated under present law. Section 1379(c) provides that the rules of prior law governing the distribution of previously taxed income "shall continue to apply with respect to distributions of undistributed taxable income for any taxable year beginning before January 1, 1983." While that provision could be read as applying only to fiscal year corporations and only for the taxable year including January 1, 1983, the Committee Reports contain the more general statement that pre-1983 previously taxed income "can be distributed" under the provisions of present law.³⁸²

The ability to distribute pre-1983 previously taxed income prior to a distribution of earnings and profits seems to have been preserved in principle, but the Revision Act contains no guidance whatsoever as to how such distributions may be accomplished. Most importantly, no provision in the Revision Act purports to coordinate distributions of PTI with the distribution priorities established under section 1368.³⁸³ Under prior law, the regulations stated that distributions were regarded as distributions of PTI only after the corporation had distributed the entire amount of its current earnings and profits in cash.³⁸⁴ Under present law, however, there is no rational basis for requiring an actual distribution of current year additions to the accumulated adjustments account as a prerequisite to a PTI distribution. Accordingly, the Treasury Department seems to have virtually unfettered discretion in coordinating distributions of PTI with the provisions of existing law. There seem to be three obvious choices for accomplishing this coordination: (a) the earliest distributions could be regarded as distributions of PTI, (b) the earliest distributions could be regarded as distributions from the accumulated adjustments account followed by distributions of PTI, or (c) distributions of PTI could be at the election of the shareholder.

Distributions of PTI will not reduce the balance in the accumulated adjustment account. If under either a mandatory or elective provision PTI is distributed first, all shareholders would be subject to the same tax on distributions from the S corporation regardless of the size of their PTI accounts. That is, the initial distributions to some shareholders would be regarded as tax free distributions of PTI, not the reduction of the accumulated adjustments account, while the distributions to shareholders lacking

382. HOUSE REPORT, *supra* note 22, at 25; SENATE REPORT, *supra* note 22, at 26.

383. Indeed, the legislative history of I.R.C. § 1368 contains no reference to the treatment of pre-1983 PTI in taxable years beginning after 1982. HOUSE REPORT, *supra* note 22, at 18-19; SENATE REPORT, *supra* note 22, at 19-20.

384. Treas. Reg. 1.1375-4(b) (1968); and *see* text accompanying notes 348-50 *supra*.

PTI accounts would be regarded as distributions from the accumulated adjustments account. Once the balance in any PTI account had been exhausted, further distributions would be free of tax to all shareholders to the extent of the remaining balance in the accumulated adjustments account. The difficulty with that approach is that it deprives shareholders having PTI accounts of a portion of the benefit to which they should be entitled from the accumulated adjustments accounts. Because a shareholder having a PTI account would have been previously subject to tax on both pre-1983 income and an allocable portion of post-1982 income, such a shareholder should be entitled to a larger tax free distribution.

On the other hand, if the earlier distributions were regarded as attributable to the accumulated adjustments account, all shareholders would receive tax free distributions until the account was exhausted. Thereafter, shareholders having PTI accounts would receive further tax free distributions and other shareholders would be regarded as receiving distributions of earnings and profits. While such a rule would protect shareholders having PTI accounts, it could also produce an inequity because the shareholder having a PTI account may, in effect, shift the tax on the distribution of earnings and profits to other shareholders. That result would seem particularly inequitable where the old shareholder owned his stock in the corporation at the time the accumulated earnings and profits accounts were generated but the shareholder lacking a PTI account invested in the corporation only after 1982.

Neither priority of distributions will produce an equitable result in all circumstances; therefore, the Treasury Department should permit distributions to be regarded as distributions of PTI at the election of the corporation and, perhaps, upon the consent of all shareholders. The flexibility that such a provision would create would permit the shareholders in the S corporation to minimize the potential inequities produced by the amendments to Subchapter S and, through negotiation, to arrange for the compensation of prejudiced shareholders.

The only statutory basis for permitting distributions of PTI appears in the transitional provisions of section 1379(c), which state that subsections (f) and (d) of prior law section 1375 will continue to apply. Therefore, at least certain of the restrictive and technical constructions of sections 1375(d) and (f) presumably continue to apply. Thus, the PTI account will remain a personal and non-transferable account. On the other hand, the Treasury should not continue to insist that distributions of PTI be made in cash. The reason for that requirement has been eliminated under the Revision Act by the imposition of the section 1363(d) tax on the distribution of appreciated property. Since there is no basis for exempting distributions of PTI from the application of that tax, there is no reason to insist that the distribution of PTI be in cash.

4. Tax-Exempt Income

The computation of the accumulated adjustments account varies in two respects from the computation of the adjustments to basis under section 1367. The reduction in the account produced by a section 302 or 303 redemption is explained below.³⁸⁵ In addition, the account is not to be increased by tax-exempt income or decreased by expenses that are neither deductible nor properly capitalizable.³⁸⁶ Surprisingly, this provision effectively bars tax free distributions to shareholders of amounts attributable to tax-exempt income. Should the amount of any distribution exceed the accumulated adjustments account as so computed, the excess will be treated as a distribution of accumulated earnings and profits rather than a distribution of non-taxable S corporation income. Thus, the character of tax-exempt interest passes through to the shareholder under the new income allocation rules, and shareholders are not subject to tax by virtue of the receipt of such amounts by the S corporation (regardless of whether the corporation had earnings and profits) but upon the distribution of tax-exempt income, the shareholders of a corporation which has earnings and profits become subject to tax. On the other hand, if the S corporation lacks earnings and profits, distributions are not subject to tax regardless of their origin. In such a case, the distribution of tax-exempt income, like any other distribution, will simply reduce the shareholder's basis for the stock.³⁸⁷ This reduction produces a wash because the basis will have been increased previously pursuant to section 1367(a) by the amount of the tax-exempt income.³⁸⁸

The rule directing the exclusion of tax-exempt income and the deductions attributable thereto from the accumulated adjustments account merely accelerates the taxable event rather than creates taxable income. Section 1367(a), governing increases in basis, makes no distinction between corporations that have accumulated earnings and profits and those that do not. While the distribution of tax-exempt income in excess of the accumulated adjustments account will be taxable currently to the shareholders, it will not reduce the shareholders' basis for their stock.³⁸⁹ Thus, on the

385. See text accompanying notes 397-98 *infra*.

386. I.R.C. § 1368(e)(1)(A). Under I.R.C. § 1367(a)(2)(D), expenses that are neither deductible nor capitalizable reduce the basis of S corporation stock in order to prevent shareholders from obtaining a tax benefit from the expense on a disposition of stock. Thus, omitting that adjustment from the computation of the accumulated adjustments account is favorable to shareholders.

387. I.R.C. § 1367(a)(2)(A).

388. I.R.C. § 1367(a)(1)(A) refers to I.R.C. § 1366(a)(1) which in subparagraph (A) specifically includes tax-exempt income.

389. Under I.R.C. § 1367(a)(2)(A), only tax free distributions reduce basis.

ultimate disposition of the stock, the shareholders' basis still will include an amount attributable to the tax exempt income and a portion of the tax free return of capital enjoyed by the shareholder on disposition of the stock will be attributable to the tax-exempt income.

There is no explanation in the Committee Reports for the special treatment of tax-exempt income in the computation of the accumulated adjustments account. Section 1367, however, seems to be part of the general attack upon passive investment income of an S corporation that has earnings and profits attributable to periods when no Subchapter S election was in effect. Congress was concerned that taxpayers would dispose of all of the business assets of a corporation subject to the regular income tax but defer a substantial portion of the tax on the disposition by failing to liquidate the corporation, electing under Subchapter S, and investing the proceeds of the sale. Even in that context, however, this special treatment of tax-exempt income seems unnecessary and undesirable. For the purposes of both the tax on passive investment income and the termination of the S corporation election, tax-exempt interest is treated in the same manner as taxable interest.³⁹⁰ Accordingly, the tax and termination penalties cannot be avoided by investing in tax-exempt securities. Thus, the further penalty on tax-exempt income imposed by this definition of the accumulated adjustments account does not serve a constructive purpose. For the reasons set forth above, the tax and termination provisions adequately, if not excessively, bar tax avoidance attributable to the disposition of business assets followed by a Subchapter S election.³⁹¹ There is no reason to impose a further penalty upon the investment of those assets in tax-exempt securities. Should such an investment be undertaken, and neither the tax nor the termination sections be applicable, there is no reason why the shareholders of the S corporation should not be entitled to an immediate tax free distribution of the tax-exempt interest their corporation earned.

Moreover, this penalty on deriving tax-exempt income is overbroad. Unlike the tax and termination penalties, this provision affects not only corporations that have earnings and profits attributable to years in which a Subchapter S election was not in effect, but also corporations that have accumulated earnings and profits while under a Subchapter S election. In fact, no reason ap-

390. The definition of "passive investment income" in I.R.C. § 1362(d)(3)(D), the termination provision, merely refers to "interest." I.R.C. § 1375, which imposes the special tax on excess passive investment income, incorporates by reference the definition in I.R.C. § 1362(d)(3). I.R.C. § 1375(b)(3).

391. See text accompanying notes 120-26 *supra*.

pears for so penalizing S corporations that have earnings and profits, not attributable to the disposition of a business, derived decades ago but prior to making a Subchapter S election. It is difficult to see why historical accumulation of earnings and profits are relevant to whether distributions of current income should be subject to tax. The provision only inserts another point of distinction between S corporations having and lacking earnings and profits, and between S corporations and partnerships; it does little to promote the integrity of the taxation of S corporations, and therefore, should be deleted.

5. Planning for Shareholder Retirements

A major aspect of the tax planning for closely held corporations has been to insure that shareholders withdrawing from the corporation, whether upon their retirement from active involvement in the business or otherwise, obtain capital gains taxation upon the redemption of their stock under section 302. If other members of the shareholder's family also own stock in the corporation, capital gains treatment usually can be obtained only if the withdrawing shareholder completely terminates his interest in the corporation. However, the favorable rule provided by section 302(b)(3) is subject to a series of qualifications that cannot always be met.³⁹² Furthermore, in a corporation subject to the corporate income tax, the retention of income in contemplation of the redemption of stock can subject the corporation to the accumulated earnings tax.³⁹³ While the redemption of stock in an S corporation

392. Because of the applicability of the attribution rules of I.R.C. § 318, which treat the redeeming shareholder as owning stock owned by members of his family, completely terminating the interest of a shareholder in a family corporation generally is virtually impossible without making use of the special waiver provisions of I.R.C. § 302(c). Under that subsection, the family attribution rules will not apply to a redemption under I.R.C. § 302(b)(3) if immediately after the redemption the redeeming shareholder has no interest in the corporation other than as a creditor and does not acquire such an interest other than by inheritance for 10 years thereafter. The statute specifically lists the capacities of officer, director, and employee as prohibited interests.

Compliance with this provision often will not comport with other family objectives. For example, the retiring shareholder cannot reduce his interest gradually in a series of redemptions. Furthermore, the Treasury Department generally has construed the word "interest" broadly against the taxpayer, and the courts usually have upheld the government's construction. See generally BITTKER AND EUSTICE, *supra* note 156, at ¶ 9.23.

I.R.C. § 318 also requires attribution to the redeeming shareholder of stock owned by entities in which the redeeming shareholder has an interest. These attributions cannot be waived under I.R.C. § 302(c).

393. I.R.C. §§ 531-537. The accumulated earnings tax does not apply to S corporations.

is not entirely free of planning complexities, it will be far simpler to obtain capital gains taxation for a withdrawing shareholder under the Revision Act than it will be under the corporate income tax. Accordingly, when the current income tax consequences of a Subchapter S election are not unfavorable and the qualification of a redemption under section 302 might be difficult, a Subchapter S election may provide an attractive solution.

If the redemption of stock qualifies for capital gains treatment under either section 302 or section 303, the consequences to the withdrawing shareholder in an S corporation are identical to the consequences to a shareholder withdrawing from a corporation subject to the corporate income tax. The shareholder will be subject to tax at capital gains rates on the difference between the amount distributed in exchange for his stock and his tax basis for the stock. If the corporation is an S corporation, however, it may be possible to achieve the same consequence even if the redemption does not qualify under section 302 and thus would be treated as an ordinary section 301 dividend if the corporation were subject to the corporate income tax.

The rules of section 1368 seem to be applicable to all section 301 distributions, even though they are non pro rata or are distributions in exchange for stock. Thus, all such distributions are free of tax to the extent of the shareholder's basis and thereafter subject to capital gains taxation as long as the accumulated adjustments account exceeds the amount distributed to the shareholder in exchange for his stock. Even though the redemption does not qualify under section 302, the shareholder will not be subject to tax at ordinary income rates unless the amount distributed exceeds the accumulated adjustments account. Moreover, as noted above, the amount of the accumulated adjustments account is not reduced by distributions in excess of a shareholder's basis that are subject to tax at capital gains rates.³⁹⁴ While it cannot be entirely clear how the Treasury Department will attempt to integrate the level of the accumulated adjustments account with non pro rata distributions, it may thus be that if the amount of the accumulated adjustments account exceeds by any amount the basis of the stock being redeemed, no amount of the distribution can be treated as a distribution of earnings and profits (provided that no other distributions are made by the corporation during the taxable year). In any event, the literal language of section 1368 provides that even though the redemption does not qualify under section 302, the shareholder can not be subject to tax at ordinary income rates until the amount of the distribution exceeds the amount of the accumulated adjustments account.

394. See text accompanying notes 372-73 *supra*.

The prerequisite for this favorable treatment is that the accumulated adjustments account must exceed the shareholder's basis (and perhaps the entire amount of the distribution). Since the accumulated adjustments account is defined generally as the net accumulated income earned after 1982 while under a Subchapter S election,³⁹⁵ few corporations will be able to redeem stock under section 1368 at capital gains rates until they have operated as an S corporation for a substantial period of time. Accordingly, taking advantage of the S corporation provisions governing distributions will require long range planning.

On the other hand, the amount that must be accumulated in the accumulated adjustments account to avoid ordinary income taxation on any distribution under section 1368 can be minimized by the making of periodic stock redemptions. In a corporation subject to the regular corporate income tax, periodic stock redemptions almost invariably are treated as ordinary section 301 dividends. However, under section 1368, a partial redemption of stock will always be treated as a capital transaction provided the amount distributed does not exceed the accumulated adjustments account. Accordingly, in a Subchapter S corporation there is no need to limit redemptions to complete terminations of interest. Periodic redemptions can obtain the same favorable treatment while imposing a smaller cash drain on the corporation.

It was observed above that under the pattern of taxation created by section 1368, the first shareholders redeemed by an S corporation benefited at the expense of those remaining in the corporation.³⁹⁶ The initial redemption might exhaust the accumulated adjustments account and cause subsequent distributions to be treated as distributions of accumulated earnings and profits that are subject to ordinary income taxation. However, it is not uncommon in closely held corporations for the first redemptions by the corporation to be of stock held by older, and often higher bracket, members of the family. The ability of the second generation of stockholders to permit the withdrawing shareholder to use their portion of the accumulated adjustments account to produce capital gain taxation can produce a quite favorable consequence to the family as a whole. The transaction effectively shifts the incidence of tax on the accumulated earnings and profits of the corporation to the lower bracket members of the family. Moreover, the second generation family members may not intend to cause their stock to be redeemed for a substantial period of time. In the interim, the accumulated adjustments account may be replenished and can support capital gains taxation upon the next round of

395. I.R.C. § 1368(e)(1)(A) and (2).

396. See text accompanying notes 375-76 *supra*.

redemptions. With careful planning, it may not be necessary to subject any shareholder to taxation with respect to the earnings and profits accumulated prior to the Subchapter S election.

To the retiring shareholder, the consequences of a non pro rata distribution that does not exceed the amount of the accumulated adjustments account are precisely the same as the consequences of a redemption that qualifies as a sale or exchange under section 302 or 303; therefore, the shareholder may be indifferent whether the transaction qualifies under those sections. Careful taxpayers, however, generally will prefer to qualify their redemption under section 302. If a miscalculation has occurred in the computation of the accumulated adjustments account and a distribution in fact exceeds the amount of that account, that excess will be taxable at ordinary income rates to the redeeming shareholder to the extent of the accumulated earnings and profits account. Moreover, the effect upon the remaining shareholders in the S corporation of a redemption that qualifies under either section 302 or section 303 is far less severe than the consequences of a non pro rata redemption governed by section 1368.

As noted above, if the distribution does not qualify as a redemption under section 302 the accumulated adjustments account is reduced by an amount equal to the basis of the stock redeemed or, perhaps, by an amount equal to the basis of all of the stock owned by the withdrawing shareholder.³⁹⁷ On the other hand, under section 1368(e)(1)(B), if the redemption does qualify for sale or exchange treatment under either section 302 or 303, the accumulated adjustments account is reduced only by a fraction equal to the proportion of the outstanding shares of stock in the corporation that are redeemed. In most instances, this ratable portion of the accumulated adjustments account will be less than the basis of the stock being redeemed. Indeed, if the redemption is of a substantial proportion of the outstanding stock of the corporation, the basis of the stock redeemed may well equal the entire balance in the accumulated adjustments account. Accordingly, if the redemption qualifies under section 302 or 303, a far larger proportion of the accumulated adjustments account will be preserved for the remaining shareholders without resulting in any prejudice to the withdrawing shareholder. For example, in the illustration used above, the accumulated adjustments account of \$500 would have been reduced at the time of the first redemption of the stock of A by twenty-five percent or \$125 if the redemption had qualified under section 302. If the redemption failed to qualify under that provision, the accumulated adjustments account would have been reduced by \$350 (or \$175). Obviously, the importance of qualifying a redemption

397. See text accompanying notes 372-73 *supra*.

under section 302 or section 303 increases as the basis of the stock increases relative to the value of the stock. Thus, it remains as important as ever to qualify the redemption of stock of a deceased shareholder under section 303 or section 302. Conversely, in the relatively uncommon situation where the basis of a shareholder's stock is less than his allocable portion of the accumulated adjustments account, a smaller reduction in the amount of the account will be produced by a redemption that does not qualify under section 302 or 303. However, as long as the amount of the redemption remains less than the entire amount of the accumulated adjustments account, such a redeeming shareholder will avoid ordinary income taxation.

The net result of the pattern of taxing non pro rata distributions from S corporations is that the normal planning assumptions for small business corporations are not altered if the corporation is an S corporation. In almost every instance, the tax consequences, for both withdrawing and remaining shareholders, of a redemption qualifying under section 302 or 303 will be superior to the consequences of a redemption that does not so qualify. On the other hand, the disparity in tax consequences between qualifying and nonqualifying redemptions is not as great under Subchapter S as in the case of a corporation subject to the corporate income tax. Thus, the consequences of failing to qualify under section 302 are not as severe if the corporation is an S corporation. Moreover, the S corporation is permitted substantially greater flexibility in the timing of redemptions than a regular corporation is permitted. In a Subchapter S corporation, periodic redemptions can produce tax consequences to the withdrawing shareholder that are at least as favorable as complete terminations of interest. In addition, under Subchapter S, income may be accumulated to fund a redemption with no adverse tax consequences unless the limitations on passive investment income imposed upon S corporations that have accumulated earnings and profits are exceeded.³⁹⁸

6. Critique

While the general congressional design in enacting the Revision Act was to bring the taxation of S corporations more closely into line with the taxation of partnerships, the accumulated adjustments account represents a change from prior law towards the corporate model. In shifting from the personal PTI account to the corporate level accumulated adjustments account for the purpose of establishing the priority of distributions from an S corporation, the drafters of the Revision Act moved in a direction directly con-

398. See text accompanying notes 114-26 *supra*.

trary to the primary objective of the Act. That judgment may have been faulty.

Evidently, the adoption of a corporate level account was designed to eliminate some of the difficulties experienced with PTI accounts under prior law. However, the difficulties under prior law did not stem from the personal nature of the PTI account, rather, they were attributable to the various characteristics, such as its nontransferability, that the Treasury Department assigned to the PTI account. Those difficulties could have been solved without shifting to a corporate level account. There is no reason that a personal PTI account could not be transferable even to a purchaser of S corporation stock; upon the transfer of less than all of a shareholder's stock, a personal account could be allocated arbitrarily. Had Congress continued the use of a personal account, many of the problems described above would have been avoided and, in general, the taxation of S corporations would have resembled more closely the taxation of partnerships.

C. Eliminating Accumulated Earnings and Profits

The complexities, and potential tax liabilities, created by the presence of an accumulated earnings and profits account in S corporations undoubtedly will cause the managers of many corporations to seek to eliminate that account. Unless the account is quite small, however, its elimination may prove to be difficult. The most straightforward procedure for eliminating an earnings and profits account is to make a distribution to shareholders in a sufficient amount to exhaust accumulated earnings and profits. That distribution will be subject to tax at ordinary income rates and thus, in many instances, would be prohibitively expensive. Even if the shareholders were willing to bear the burden of an accelerated income tax, many corporations will not have available sufficient assets to fund an adequate distribution. The response to this circumstance will precipitate a replay of the difficulties posed under prior law in attempting to distribute previously taxed income. Under prior law, taxpayers were seriously disadvantaged by the inability to distribute PTI pursuant to a property distribution. However, there is no such limitation under present law upon the ability to distribute accumulated earnings and profits. As a result, there does not appear to be any reason why an S corporation may not distribute its own obligation to its shareholders in an amount sufficient to exhaust its accumulated earnings and profits account. Such a distribution constitutes a dividend under general law³⁹⁹ and

399. I.R.C. § 312(a)(2). Another possibility is the distribution of a taxable stock dividend. A pro rata distribution would not suffice, but if each shareholder

no reason appears for a different rule under Subchapter S. Of course, when making such a distribution the managers of an S corporation must carefully avoid the prohibition contained in section 1361(b)(1)(D) on two classes of stock.

As originally enacted, the Revision Act contained a further obstacle to the voluntary elimination of accumulated earnings and profits. Under the distribution priority rules of section 1368(c), distributions by an S corporation that has accumulated earnings and profits are treated first as distributions of accumulated Subchapter S income and only thereafter as distributions of accumulated earnings and profits. While that provision is favorable to taxpayers wishing to avoid tax on distributions from S corporations, it substantially increases the amount that must be distributed by a corporation wishing to eliminate its earnings and profits account. In order to facilitate the elimination of accumulated earnings and profits accounts, Congress added a new section 1368(e)(3) as part of the Technical Corrections Act of 1982.⁴⁰⁰ This provision stipulates that if all of the shareholders to whom a distribution is made by an S corporation during a taxable year so elect, the distribution will not be treated as a tax-free distribution of Subchapter S income; rather, it will be treated as an ordinary dividend to the extent of the accumulated earnings and profits of the corporation.

Section 1368(e)(3) indicates that Congress recognized the value of an elective elimination of earnings and profits; it is regrettable that Congress did not go further and deal with the two greatest deterrents to this elimination: the need to make an actual distribution and the risks of a subsequent determination on audit that the corporation incorrectly calculated its earnings and profits. There are great hazards in attempting to eliminate an accumulated earnings and profits account through actual distributions. The computation of earnings and profits is far from an exact science and even with professional assistance, taxpayers may remain uncertain that the account has been eliminated completely. During the congressional hearings on the Revision Act, the suggestion was made that shareholders of S corporations be permitted to elect to treat an amount equal to the corporation's entire accumulated earnings and profits account as having been constructively distributed and reinvested.⁴⁰¹ That suggestion, obviously, has great merit. On the

had a bona fide election between cash or stock, the stock dividend should be taxable and, thus, should accomplish a distribution of earnings and profits. I.R.C. § 305(b)(1).

400. Pub. L. No. 97-448, 96 Stat. 2365, 2399.

401. *Hearings on S. 2350 Before the Senate Comm. on Finance*, 97th Cong., 2nd Sess. 109-10 (1982) (statement of David G. Glickman, Deputy Assistant Secretary, Tax Policy, Department of the Treasury). A similar approach was recommended by the Section of Taxation of the American Bar Association; see testimony of M. Bernard Aidinoff, *id.*, at 161.

one hand it would eliminate the need to deplete the liquid assets of the corporation, while on the other, it could be drafted to eliminate computational uncertainties. If, as a result of a subsequent audit, it was determined that the amount taken into income did not equal the entire amount of accumulated earnings and profits, a deficiency inclusion could be made available. Regrettably, this provision was not contained in the Revision Act; it should be added.

For some purposes merely substantially eliminating the accumulated earnings and profits account will be sufficient. For example, the concern that distributions will exceed the amount that may be distributed tax free will be sufficiently eliminated even if some small amount remains in the account. The shareholders' exposure to further tax, by definition, is limited to the amount that they were willing to include in income as an actual dividend distribution. On the other hand, the restrictions and tax on passive investment income in excess of twenty-five percent of gross receipts are applicable if the S corporation has any amount of accumulated earnings and profits. Apparently, the tax is applicable even though it is determined subsequently that the corporation retained as little as one dollar of earnings and profits—a result of doubtful rationality. Accordingly, in eliminating the accumulated earnings and profits account, it may be advisable to select a technique that automatically eliminates the entire account.

The elimination of an accumulated earnings and profits account through any means that will subject the S corporation shareholders to an immediate ordinary income tax on the full amount of the account will be prohibitively expensive for many S corporations. Thus, if a corporation wishes to attempt the elimination of its earnings and profits, it should consider one of the devices employed by corporations subject to the regular tax for accomplishing that objective. One common technique for eliminating earnings and profits is the liquidation of the corporation, followed by the reincorporation of a portion of its assets in a newly formed corporation.⁴⁰² While the liquidation-reincorporation device subjects the shareholders of the corporation to tax on the entire amount of the appreciation in their stock and not merely the amount of the corporate earnings and profits, the tax is imposed at capital gains rates. Moreover, the transferee corporation obtains a step-up in basis for the corporate assets equal to their fair market value and the entire earnings and profits account of the predecessor corporation is eliminated. The advantages sought by such a transaction will fail if the overall transaction can be reconstructed by the Com-

402. For a recent treatment see Robinson, *Tax Interpretation: Lessons From the Reincorporation Cases*, 34 U. FLA. L. REV. 1 (1981). See also BITTKER AND EUSTICE, *supra* note 156, at ¶ 14.54.

missioner as a reorganization within the meaning of section 368 and will largely fail if the transaction can be reconstructed as falling within section 351. However, the Commissioner has not had much success in recharacterizing carefully planned liquidation-reincorporations as reorganizations. In fact, where twenty percent of the stock of the new corporation is owned by individuals who neither owned any stock in the old corporation nor are related to shareholders of the old corporation, no case has held that the transaction constituted a reorganization.⁴⁰³ While there is some indication in the case law that the Commissioner's chances of successfully attacking such a transaction may be improving,⁴⁰⁴ the managers of an S corporation in which accumulated earnings and profits constitute a substantial handicap might seriously consider such a device.

For some S corporations, particularly those that have an uncertain but not substantial amount of accumulated earnings and profits, the tax imposed on a complete liquidation would substantially exceed the tax that would be imposed upon a distribution of accumulated earnings and profits. If that corporation also does not have a substantial investment portfolio, it might be desirable for the shareholders to liquidate the corporation under the provisions of section 333 of the Code. The relationship between section 333 and the Subchapter S provisions is considered below.⁴⁰⁵

D. Distributions of Appreciated Property

The reason that the Treasury Department insisted that previously taxed income could be distributed under prior law only by a cash distribution, and not by a property distribution, was that a property distribution of previously taxed income could result in the avoidance of tax at both the corporate and the shareholder level on any element of appreciation in the property.⁴⁰⁶ Under the rule attributed to the Supreme Court in *General Utilities*,⁴⁰⁷ a distribution of property with respect to stock does not constitute a taxable event to the corporation. While that rule has come under

403. See Coven, *The Relevance of Fresh Investment to Corporate Distributions and Adjustments*, 38 TAX L. REV. 419, 456-72 (1983), in which one of the authors has argued that these results are wrong and that the transaction suggested in the text should be treated as a reorganization.

404. *Id.* at 470-72.

405. See text accompanying notes 446-49 *infra*.

406. See *De Treville v. United States*, 445 F.2d 1306 (4th Cir. 1971). See also Oberst, *Reform of the Subchapter S Distribution Rules: Repudiation of Section 311(a)*, 38 TAX L. REV. 79, 90-94 (1982).

407. *General Utilities & Operating Co. v. Comm'r*, 296 U.S. 200 (1935).

increasing attack⁴⁰⁸ and has been modified widely for redemptions,⁴⁰⁹ it has not been altered for distributions in complete liquidations⁴¹⁰ or dividend distributions. Thus, under prior law, the distribution of property by a Subchapter S corporation did not produce a tax to the corporation. If such a property distribution had been permitted to qualify as a distribution of PTI, the shareholder would not be subject to tax upon the receipt of the property although the property would obtain a tax basis in the shareholders' hands equal to its fair market value.⁴¹¹ Accordingly, in lieu of selling property at the corporate level and incurring an immediate tax that must be borne by the S corporation shareholders, the corporation would be inclined to distribute the property in kind to the shareholders because a sale at that level would avoid any tax on the disposition. The benefit of such a device would be a deferral of taxation, not a permanent exemption. The shareholder's basis in his stock would be reduced by the fair market value of the property distributed.⁴¹² Accordingly, on a subsequent disposition of the stock, the shareholder would be subject to tax with respect to the element of appreciation that had escaped tax at the time the property was distributed to him and sold. However, that deferral could be indefinite, or even permanent, should the shareholder die without previously disposing of his stock.⁴¹³ In general effect, the Subchapter S corporation and its shareholders, as a group, could obtain a step-up in basis to fair market value of any corporate asset at any time merely by distributing the asset.

The obvious solution to this unwarranted result is the one adopted in the taxation of partnerships. A distribution of property from a partnership to a partner is, in effect, a nonrecognition transaction providing for a carryover basis. The partner takes a basis in the distributed asset equal to the basis that the asset had in the hands of the partnership⁴¹⁴ and the basis in his partnership interest is reduced by the same amount.⁴¹⁵ Thus, should the partner dispose of the distributed asset, he would be subject to tax on exactly the same amount as the partnership would have been had it sold the asset. This rule prevents the unnecessary acceleration of tax and prohibits an unwarranted deferral of tax.

In practice, however, the taxation of partnership distributions

408. See, e.g., ALI, FEDERAL INCOME TAX PROJECT, SUBCHAPTER C (Tent. Draft No. 1, 1977), and Oberst, *supra* note 406.

409. See I.R.C. §§ 311(b)-(d).

410. I.R.C. § 336(b) does contain an exception concerning certain inventory.

411. I.R.C. § 301(d)(1).

412. Treas. Reg. § 1.1375-4(a) (1968).

413. I.R.C. § 1014.

414. I.R.C. § 732(a)(1).

415. I.R.C. § 733.

is not as simple as this generalization suggests. In order to prevent the conversion of ordinary income that would otherwise be received at the partnership level into capital gains at the partner level, Congress enacted the "collapsible partnership" provisions of section 751, which override all of the rules of partnership taxation. In the case of distributions to partners, the provisions of section 751(b), which one commentator has described as "awesomely complex,"⁴¹⁶ are brought into play. When the Treasury Department began its study of the revision of Subchapter S, the carryover basis rule of partnership taxation was considered but rejected because of the complexity of adapting the collapsible partnership rules to S corporations.⁴¹⁷ In addition, the Treasury Department was concerned that providing for tax-free distributions and a carryover basis would create too large a contrast between the rules applicable to S corporations and those applicable to corporations subject to the regular tax.⁴¹⁸ It was feared that such a pattern of taxation would create too great an incentive to abuse the purposes of Subchapter S by electing S corporation status for brief periods of time in order to execute tax-free distributions.

The *General Utilities* rule, as applied to corporations subject to the regular tax, also has come under increasing attack. In TEFRA, enacted only weeks before the Revision Act, Congress again reduced the scope of that rule by expanding section 311(d) and imposing a tax at the corporate level on the element of appreciation contained in distributed property in an expanded class of redemptions.⁴¹⁹ In addressing the distribution of appreciated property under the Subchapter S rules, Congress adopted the same approach. Thus, section 1363(d) provides that upon the distribution of appreciated property by an S corporation, gain shall be recognized as if the property had been sold to the distributee at its fair market value "notwithstanding any other provision of this subtitle." While the Subchapter S rule appears far stricter than the rule applicable under section 311(d) to corporations subject to the regular tax, its effect is very different. If a corporation is subject to the corporate income tax, the reversal of the *General Utilities* rule produces two levels of taxation and the desirability of that reversal is a function of the propriety of that double taxation on particular corporate transactions. Under Subchapter S, however, normally no issue of double taxation is presented. Taxing the gain on distributed property merely affects the timing of the realization of that gain and its allocation among the S corporation shareholders.

416. MCKEE, *supra* note 73, at ¶ 20.01.

417. STAFF REPORT, *supra* note 7, at 17.

418. *Id.*

419. TEFRA, Pub. L. No. 97-248, §§ 222, 223, 96 Stat. 324, 478, 483 (1982).

Because of this reversal of the *General Utilities* rule for S corporations, the gain in appreciated property of the S corporation cannot escape tax upon the distribution of the property. Accordingly, in a sharp and favorable contrast to prior law, the Revision Act does not distinguish between the distribution of cash and the distribution of property.

This new aspect of S corporation taxation, however, creates an unfavorable difference between the pattern of taxing partnerships and the pattern of taxing S corporations. While both patterns of taxation produce the same ultimate burden of tax, under the Subchapter S rules a distribution of appreciated property accelerates the tax on the gain in the property to the time of the distribution rather than permitting the deferral of the tax until the distributed property is disposed of by the shareholders. Such lack of conformity between these two forms of business organization generally is undesirable. In this instance, however, Congress seems to have achieved the correct result. Whether properly or not, the Revision Act did not adopt the partnership approach of permitting the special allocation of items of corporate income and expense to particular shareholders. If the partnership basis rule had been adopted for distributions of property by S corporations, such a rule would permit the corporation to shift the burden of tax on the element of appreciation in the distributed property away from the other shareholders in the corporation and to the distributee shareholder. Such special allocations generally are not permitted; therefore, it would have been inappropriate to permit the same result to be achieved through the device of distributing appreciated property. Section 1363(d) provides that the gain attributable to the distributed appreciated property is allocated to all of the S corporation shareholders under the usual rules allocating S corporation income.

This new aspect of S corporation taxation seems appropriate where the property distribution to the shareholder is free of tax because it represents a distribution of S corporation income; however, the application of the new provision is not limited to such distributions. Thus, even though the property distribution is regarded as a distribution of accumulated earnings and profits and, thus, will be fully subject to tax at ordinary income rates to the distributee shareholder, gain on the distributed property remains includible in the income of the S corporation. As a result, the S corporation and its shareholders become subject to a form of double taxation in a circumstance in which a regular corporation is subject to only a single level of taxation. The appreciation in distributed property is taxed twice, once as a capital gain allocated to all of the shareholders and again as ordinary income to the distributee shareholder. That result is plainly erroneous. Since Congress deliberately has perpetuated the *General Utilities* rule with respect to

ordinary dividends from corporations subject to the regular tax, it is inappropriate to subject the shareholders of an S corporation to double taxation on distributions out of accumulated earnings and profits. It is not at all clear that Congress appreciated this interrelationship between new sections 1363(d) and 1368(c). Section 1363(d) was designed to accomplish a different objective entirely: preventing the complete avoidance of tax on the appreciation in distributed property. Accordingly, the provision should be amended to prevent this double taxation.

As originally enacted section 1363(d) was also applicable to distributions in complete liquidation, although that result did not appear to have been intended by Congress. Under the TCB, gain is not to be recognized upon such distributions.⁴²⁰ The proper application of section 1363(d) to complete liquidations, and the relationship of that provision to the Subchapter C rules governing liquidations, is considered below.⁴²¹

E. The "Post-Termination Transition Period"

The harshness of the inability to withdraw amounts of previously taxed income following the voluntary or involuntary termination of a Subchapter S election has been softened greatly by new section 1371(e). Under that provision, any distribution of cash during the post-termination transition period (PTTP) by a corporation that was previously an S corporation, rather than being treated as a taxable dividend, is treated as a return of capital which reduces the basis of the shareholder's stock in the corporation. The adoption of such a grace period is highly desirable and the relief it extends is a welcome addition to the S corporation rules. However, at present the provisions contain serious ambiguities.

The PTTP suffers from the attempt to make one concept accomplish too much. This grace period is used to accomplish two very different functions: to fix the date upon which losses unused upon the termination of a Subchapter S election may be claimed,⁴²² and to provide a period of time within which tax-free distributions may be made from a corporation following the expiration of its election. The definition of the PTTP that may be most rational for one of these purposes may not be rational for the other. Section 1377(b) defines the PTTP as (a) the period beginning the day following the termination of the S corporation election and continuing for the longer of one year or until the due date for the filing of the final S corporation tax return, including any extensions

420. TCB § 201(a). See note 9 *supra*.

421. See text accompanying notes 439-447.

422. I.R.C. § 1366(d)(3).

thereof, and as (b) the 120-day period beginning on the date of a determination that the corporation's election has terminated. For this purpose, a determination means a final court decision, a closing agreement, or an agreement between the corporation and the Commissioner that the corporation has failed to qualify as an S corporation.⁴²³

Thus, the PTTP seems to consist of two discrete periods of time, the one-year period immediately following termination and a 120-day period that may occur years later. Obviously, the two separate periods are addressed to two different types of termination of S elections. The one-year period following termination will be useful to corporations when the termination, whether intentional or inadvertent, is at least known to the managers of the corporation when it occurs. The alternative 120-day period will be beneficial when the termination of the S election is not known to the managers of the corporation at the time it occurred, or at least is not conceded. Because the possible loss of S corporation status often is raised on an audit that occurs more than one year after the alleged termination, the one-year period of time will provide no relief for inadvertent terminations. Nevertheless, the availability of the PTTP is not so limited. The alternative definitions are connected by the word "and;" therefore, regardless of the nature of the termination of the S corporation election, the corporation apparently is entitled to both such periods. In addition, the proper definition of the PTTP is confused further because the description of the PTTP in the legislative history does not correspond to the statutory language. Both the House and Senate Reports state that the PTTP is to extend from the actual termination of the S corporation election until the expiration of the latter of the two described periods.⁴²⁴ That language seems to indicate that the grace period constitutes a single continuous period expiring after one year in the event the termination does not precipitate a "determination" or, if a determination occurs, 120 days after it is rendered.

When the grace period is used to identify the time at which unused losses may be claimed, the preferable construction of the PTTP would be that it consisted of two discrete periods. In that situation, the Code must specify the date upon which the loss is deemed to be sustained. Indeed, section 1366(d)(3)(A) provides that the loss may be claimed on the last day of "any" PTTP, thus suggesting that more than one PTTP may be available. If the termination is inadvertent, the corporation may pass through the first one-year period before the shareholders are aware of the

423. I.R.C. § 1377(b)(2).

424. HOUSE REPORT, *supra* note 22, at 16-17; SENATE REPORT, *supra* note 22, at 18.

termination. Congress, therefore, provided the alternative post-determination PTTP. In the case of an inadvertent termination, however, a corporation may sustain losses that some of its shareholders cannot claim because of an absence of basis at the end of its actual final year as an S corporation, yet the shareholders may obtain an increase in their stock basis during the following year attributable to contributions to capital or the discharge of obligations as the guarantor of corporate indebtedness. In that event, the shareholders will have claimed the carried over losses under the normal Subchapter S rules. If the S corporation status is contested subsequently and a determination rendered that a termination in fact occurred, the shareholders should be entitled, under PTTP rules, to retain that loss in the year following the termination. Requiring the deferral of losses would be far less favorable, not only because of the extended deferral of the tax benefit, but also because of the complexity introduced by potential changes in stock ownership. No useful purpose would be served by requiring the shareholders to suffer the deferral of their loss until, after many years, a final determination is issued. However, that deferral can be avoided only if the PTTP includes two discrete periods, both of which have a last day upon which losses can be claimed pursuant to section 1366(d)(3)(A).

If this more favorable rule is not adopted, the managers of S corporations will be faced with a difficult choice when it is possible that a termination has occurred. If the termination is conceded, the carried over losses may be claimed at once—under the one year PTTP. However, if the termination is contested, the shareholders will face the possibility that the tax benefit of those losses must be deferred until an adverse determination is rendered. That pressure to concede debatable terminations is improper. Rather, as long as a sufficient basis for the stock has been created, the shareholders should be permitted to claim losses at the end of either the one-year or the 120-day period and losses claimed erroneously under the normal Subchapter S rules should be treated as losses claimed on the last day of one-year PTTP.

When the PTTP concept is employed to permit tax-free distributions from corporations that have terminated their Subchapter S status, regardless of how the PTTP is defined the relief seems to be somewhat less than rational. Under section 1371(e), the relief extended is mandatory. Thus, any distribution during the PTTP is treated as a return of capital. There seems to be no purpose whatsoever for this "relief" in the event of a deliberate and known termination of a Subchapter S election. In that event, no relief is warranted and the normal pattern for taxing corporations subject to the regular income tax should have been left undisturbed. In fact, it is doubtful that Congress intended a

one-year moratorium on taxable dividends distributed by corporations subject to the corporate income tax simply because the corporation was subject to Subchapter S during the preceeding year. Nevertheless, there does not appear to be any basis in the statute for excluding distributions by such corporations from the mandatory grace period.

Where the termination of the S election is inadvertent, the corporation may have made actual distributions to its shareholders in several years following the inadvertent termination but before it was aware that the termination had occurred. If the PTTP consists of two discrete periods of time, distributions during the first year following the inadvertent termination will constitute tax-free returns of capital while distributions thereafter will be subject to tax as normal dividends to the extent of the corporation's earnings and profits. Because corporations rarely are subject to audit within one year following the conclusion of their taxable year, the relief extended by the one-year period seems incomplete and relatively arbitrary.

Furthermore, the creation of a 120-day window through which additional tax-free distributions may be made seems excessively restrictive. Before a final determination is made that a Subchapter S election has been terminated inadvertently, a substantial inhibition against making dividend distributions will exist. If the Subchapter S status of the corporation has terminated, the distributions will be taxable as ordinary dividends. However, if the corporation defers making distributions until a final determination is rendered, the distribution will be tax-free. One hopes that the shareholders of such a corporation have other means of support. Regardless of whether the corporation remains subject to a Subchapter S election, a tax-free distribution will be permissible at some point; therefore, it seems unduly restrictive to require that distribution only during a brief period of time many years later. Thus, from both these perspectives, a more rational construction of the PTTP is a single continuous period ending 120 days following a determination that the Subchapter S election has terminated.

In addition to granting relief to known voluntary terminations of S elections, the application of the PTTP concept to corporate distributions seems overbroad in a second respect. The relief extended by section 1371(e) apparently is available without regard to the ownership of the stock of the corporation during the PTTP. Thus, a corporate distribution during the grace period to a shareholder who acquires his stock after the Subchapter S election has in fact terminated will be free of tax even though the shareholder, at the time of purchase, was fully aware that the corporation was subject to the regular income tax. By virtue of the increased basis that he is able to offset against the proceeds

of the sale, the seller of the stock already will have received a tax-free recovery of the amount of S corporation income that previously had been taxed to him; therefore, there is no justification for granting relief to the purchaser of that stock. Indeed, section 1371(e) effectively converts what otherwise is a dividend subject to ordinary income taxation into a deferred capital gain. Providing grace period relief to a transferee of S corporation stock who acquires that stock by gift or in another transaction producing a carryover basis is appropriate, but the statute should be amended to bar such relief to a purchaser of stock.

Two further aspects of distributions during the PTTP should be observed. First, the relief provision of section 1371(e) applies only to distributions of cash. Presumably, Congress so limited the grace period relief to prevent the avoidance of tax on any gain in appreciated property distributed during the grace period. At the time of the distribution, the corporation does not in fact constitute an S corporation; therefore, the new rule of section 1363(d) imposing a tax on the element of appreciation in distributed property will not be applicable. For a corporation subject to the regular corporate income tax, the exemption from tax on the appreciation in distributed property continues to apply to ordinary dividend distributions. As a result of this limitation, property distributions following an unknown termination cannot be regarded as tax free under the grace period relief provision. Moreover, corporations short of cash and unwilling or unable to borrow will have difficulty taking advantage of a PTTP distribution, even if the property that they wish to distribute has not appreciated in value. An alternative would have been to apply the rule of section 1363(d) to all property distributions treated as returns of capital under section 1371(e). That approach would have prevented the avoidance of tax and substantially increased the flexibility of PTTP distributions. It is regrettable that Congress did not pursue that alternative.

Secondly, the amount that may be distributed by a corporation tax free pursuant to this provision may not exceed the amount of its accumulated adjustments account. That account, it will be recalled, generally corresponds to the net accumulated income of the S corporation since January 1, 1983.⁴²⁵ This limitation effectively prevents the tax-free distribution during the PTTP of earnings and profits accumulated after the termination of the Subchapter S election (as well as of pre-election or pre-1983 earnings and profits). The objective is entirely reasonable but it illustrates a minor flaw in the Revision Act. The only reason S corporations that do not have any earnings and profits are required to maintain

425. I.R.C. §§ 1368(e)(1)(A) and (e)(2).

an accumulated adjustments account is that they may obtain earnings and profits. However, such corporations can acquire earnings and profits in only two ways, neither of which is likely to occur: by the acquisition of another corporation in a transaction in which earnings and profits carry over, and during the PTP.⁴²⁶ It is highly unfortunate that all S corporations will be subjected to the burden of currently maintaining such accounts when that expense will have significance for only a very few. Requiring this largely wasted effort is inconsistent with the objective of simplifying Subchapter S. Congress should seek an alternative solution.⁴²⁷

VIII. RELATIONSHIP OF SUBCHAPTER S TO SUBCHAPTER C

The integration of the new S corporation with the rules of general application governing corporate distributions and adjustments, contained in Subchapter C of the Code, was one of the most complicated aspects of revising Subchapter S. Unfortunately, few of the complex issues raised are addressed directly by the Revision Act and the legislative history offers only the slimmest guidance as to how this integration was intended to be accomplished. In addition, while the TCB would remove some doubts, it seems probable that other aspects of the application of Subchapter C to S corporations will require legislative revision. As a result, the relationship between Subchapter S and Subchapter C remains quite uncertain and the following observations must be regarded as highly tentative.

The relationship between Subchapter S and Subchapter C is governed largely by three rules: (a) an S corporation is a corporation and, except to the extent inconsistent with Subchapter S, Subchapter C applies to an S corporation,⁴²⁸ (b) for the purposes of Subchapter C, an S corporation "in its capacity as a shareholder of another corporation" is treated as an individual,⁴²⁹ and (c) the income of an S corporation is computed in the same manner as an individual computes income.⁴³⁰ The problem, then, is determining when the deemed-individual rule and, to a lesser extent, the income computation requirement should be regarded as inconsistent with

426. See HOUSE REPORT, *supra* note 22, at 19.

427. There are many other uncertainties concerning the PTP that the regulations, or Congress, must address. For example, if any PTP is available when a deliberate termination occurs, it is unclear whether the corporation by subsequently agreeing with the Commissioner that the termination in fact occurred may create an additional PTP for claiming losses or making distributions.

428. I.R.C. § 1371(a)(1).

429. I.R.C. § 1371(a)(2).

430. I.R.C. § 1363(b).

the general rules of Subchapter C. The only illustration of the relationship among these three rules contained in the Committee Reports concerns the receipt of dividends of property by S corporations.⁴³¹ However, the breadth of the deemed-individual rule clearly indicates that Congress intended the scope of that provision to encompass far more than merely subjecting S corporation shareholders to tax on the full fair market value of property dividends received by their corporation.

A. Dividend Equivalence and Stock Attribution

It seems relatively clear that whenever an S corporation receives a distribution with respect to stock from another corporation, the deemed-individual rule should prevail. Therefore, the consequences of the distribution to the S corporation and its shareholders should be determined in the same manner as if the distributions were received by an individual. Accordingly, it seems safe to assume that in applying section 302 for the purpose of determining the character of a distribution received by an S corporation, the S corporation should be regarded as an individual. The treatment of an S corporation in this context will be primarily of significance under section 302(b)(4). Pursuant to that provision, redemptions incident to the partial liquidation of a corporation are entitled to capital gains taxation but only when the stock is redeemed from a shareholder other than a corporation. Evidently, S corporations are entitled to the benefits of section 302(b)(4) by virtue of the deemed-individual rule.

In many circumstances, the characterization of a purported redemption under section 302 requires the application of the stock attribution rules of section 318. Section 318 contains rules governing the attribution of stock ownership to and from individuals, corporations, and other entities. Under the Revision Act, it was not entirely clear whether an S corporation was to be regarded as an individual for the purpose of section 318 which would have produced absurd results, or as a corporation. The TCB would resolve this doubt by treating an S corporation as a partnership, and its shareholders as partners, for the purpose of attributing stock ownership in another corporation between the S corporation and its shareholders.⁴³² Under section 318, stock ownership in a second cor-

431. HOUSE REPORT, *supra* note 22, at 14; SENATE REPORT, *supra* note 22, at 15.

432. TCB § 201(i). *See* note 9 *supra*. Technically, the amendment would treat an S corporation as a partnership for all purposes of attributing the stock of another corporation. However, for the purpose of attributing stock between the S corporation and another entity in which it holds an interest, it is irrelevant whether the S corporation is treated as a corporation or as a partnership. New

poration is attributed between a corporation and a shareholder only if the shareholder actually or constructively owns fifty percent or more of the stock in the corporation;⁴³³ attribution between a partnership and its partners is not so limited by a threshold ownership requirement. Thus the effect of the proposed amendment is to expand materially the potential for attributing the ownership of stock in a second corporation between an S corporation and its stockholders for the purposes of those sections of the Code that employ the attribution rules of section 318.⁴³⁴ The TCB amendment would not alter the treatment of an S corporation for the purpose of attributing the ownership of the stock in the S corporation itself.

Similar confusion surrounds the proper construction of section 304. That provision, among other things, requires that certain sales of stock in a corporation to a second corporation controlled by the same persons be reconstructed and treated as if the purchasing corporation had redeemed its own stock from the controlling shareholders. The constructive redemption is tested for dividend equivalence under section 302. A Subchapter S election will be terminated if another corporation acquires stock in the S corporation; therefore, a section 304 transaction involving an S corporation can occur only when the S corporation acquires stock in a sister corporation (or a subsidiary). If the S corporation is regarded as an individual for the purposes of section 304, the provision would not be applicable. While the S corporation, as a result of its purchase of stock, will become a shareholder in another corporation, the purpose of reconstructing the sale as a redemption by section 304 does not concern the S corporation in its capacity as a shareholder. The basic transaction addressed by section 304 is the attempt by the controlling shareholders to extract funds from a controlled corporation at capital gains rates by purporting to enter into a sale of stock. The section does not address the participant corporations in their capacity as shareholders; rather, it addresses them in their corporate capacity. Thus, the Treasury

I.R.C. § 1373(a) also provides that an S corporation will be treated as a partnership for purposes of the attribution rules of I.R.C. § 958 dealing with controlled foreign corporations.

433. I.R.C. §§ 318(a)(2)(C) and (3)(C).

434. The pattern of the attribution rules spread throughout the Code is so chaotic that it is not possible rationally to criticize the TCB amendment. Treating an S corporation in the same manner as a partnership for this purpose makes more sense than treating it as a corporation. However, the 50% threshold requirement for back attribution, i.e., attribution from an owner to an entity, is a desirable limitation that probably should be extended to partnerships, rather than withdrawn from S corporations. See Coven, *Affinity Provisions of the Internal Revenue Code: A Case Study in Nonsimplification*, 45 TENN L. REV. 557, 695-97 (1978).

Department probably will take the position that an S corporation is to be regarded as a corporation for the purposes of section 304.

If section 304 does apply to the purchase of stock in a sister corporation by an S corporation, the consequences of that application of section 304 often will be very different from the consequences of its application to corporations subject to the corporate income tax. In the latter context, the application of section 304 is almost invariably unfavorable to the taxpayer. The section reconstructs a purported sale at capital gains rates into a redemption that may fail the test of section 302 and thus be subject to ordinary income tax to the full extent of the proceeds received by the controlling shareholder. When the purchasing corporation is an S corporation, however, the taxable sale instead may be converted into a tax-free distribution from the accumulated adjustments account. The consequences of such non pro rata distributions from S corporations are treated above.⁴³⁵

B. Redemptions Subject to Section 311(d)

Under section 311(d) the distribution of appreciated property by a corporation in redemption of its stock is treated as a realization of the gain in the distributed property, thus subjecting the distributing corporation to tax on the element of appreciation. That general rule, however, is subject to a series of exceptions including a redemption incident to a partial liquidation of "qualified stock." Under section 311(e)(1), qualified stock is defined as stock held by a person other than a corporation, who for the five year period preceding the redemption (or the lesser period of corporate existence), owned at least ten percent of the value of the stock of the distributing corporation. Under the Revision Act as enacted and the deemed-individual rule of section 1371(a)(2), stock redeemed from an S corporation would be eligible for this exemption from the tax imposed under section 311(d).

Congress evidently became concerned that the scope of this exemption could be unduly broadened through the use of conduit entities. Several stockholders, each of whom owned less than ten percent of the stock of a corporation, could combine their holdings through the formation of an S corporation, a partnership or a trust. If the ten percent test of section 311(e) were applied at the entity level, an exemption from tax beyond that intended by Congress could be achieved. To bar that result, the TCB would amend section 311(e)(1) to provide that the definition of qualified stock shall

435. See text accompanying notes 374-80 *supra*.

be applied at the shareholder, partner or beneficiary level.⁴³⁶ The provision apparently contemplates that the ownership of the stock of the distributing corporation be attributed to the S corporation shareholders (or partners or beneficiaries) for the five year period in accordance with their interests in the S corporation, which, of course, will have varied over time. If that attributed ownership meets both the ten percent and the five year tests, the exemption will be available. Presumably this attribution of ownership should be made even though during a portion of the five year period, the S corporation was not an electing corporation. Similarly, an S corporation shareholder should be entitled to tack onto this period of attributed ownership any prior period of his actual ownership of the stock in the distributing corporation. However, the amendment is silent on all such questions.

In addition, the proposed amendment provides that the distribution is to be treated as made directly to the shareholders, partners or beneficiaries in proportion to their interests in the entity. Presumably this language is not to be read literally. It seems most unlikely that Congress intended that the S shareholders be taxed directly on the gain attributable to the distributed property or treated as if they had received a constructive distribution from the S corporations. Rather, this second provision appears intended to confirm that the distributing corporation will be subject to tax with respect to stock deemed owned by less than ten percent shareholders and will not be subject to tax with respect to stock deemed owned by shareholders that are treated as meeting the test of section 311(e)(1)(A).

C. Liquidation of S Corporations

The provisions of the Code governing the consequences of a liquidation do not address the liquidating corporation in its capacity as a shareholder. Accordingly, the deemed-individual rule should not be applicable. On the other hand, it does not necessarily follow that the general rules of Subchapter C are therefore applicable to the liquidation. The provisions of Subchapter C that govern the consequences to a corporation of its liquidation address the computation of the income of the liquidating corporation. In particular, section 336 provides that, generally, no gain or loss shall be recognized to the liquidating corporation on the distribution of property in complete liquidation, and related section 337 provides that no gain or loss will be recognized by the corporation on a sale of property pursuant to a plan of liquidation if the corporation

436. TCB § 102(f).

is, in fact, liquidated within one year following the adoption of the plan. Under prior law, both of these non-recognition provisions applied to Subchapter S corporations. However, as the Revision Act was originally adopted, it was not fully clear whether either continued to apply. S corporations are required to compute their income in the same manner as an individual and individuals, of course, are not entitled to the benefits of either section 336 or 337. Moreover, although the result appeared contrary to the legislative history,⁴³⁷ section 1363(d) literally required the recognition of gain on any distribution of appreciated property by an S corporation, even in complete liquidation. That specific provision appeared to supplant section 336 and, since section 336 and 337 are related provisions, suggested that section 337 also might not be applicable to the liquidation of an S corporation.

Under the TCB, section 1363(d)⁴³⁸ would not apply to distributions in complete liquidation. While that exemption from the tax imposed on other distributions of appreciated property falls short of a specification that section 336 does apply to S corporations notwithstanding that they are to compute their income as individuals, the congressional intent seems reasonably clear. And, if section 336 is to apply, it might be surmised that Congress also intended that section 337 apply to the liquidation of S corporations. However, that conclusion is far from certain.

1. Section 337

Under prior law, one of the specialized uses for Subchapter S corporations was to minimize the tax consequences of a disposition of the property of a corporation before its complete liquidation. Although section 337 eliminates a tax at the corporate level on most of the gain inherent in business property, the list of exceptions to that rule is lengthy and expanding.⁴³⁹ In addition, the ordinary business income of the corporation remains subject to tax for its final year of operation even though the profits derived will be distributed immediately to the shareholders and again subject to tax. Accordingly, many closely held corporations engaged in a complete liquidation have elected under Subchapter S for their final year.⁴⁴⁰ The Commissioner endorsed this use of Subchapter

437. Both the House and Senate Reports state that I.R.C. § 1363(d) was not applicable to distributions in complete liquidations. HOUSE REPORT, *supra* note 22, at 19; SENATE REPORT, *supra* note 22, at 20.

438. TCB § 201(a). See note 9 *supra*.

439. See *Midland-Ross Corp. v. United States*, 485 F.2d 110 (6th Cir. 1973); and *Tennessee-Carolina Transportation, Inc. v. Comm'r*, 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979).

440. In addition, I.R.C. § 337 is not available to collapsible corporations as

S under prior law and ruled that the tax imposed on capital gains derived by a Subchapter S corporation in certain circumstances is not applicable to gain protected from tax by section 337.⁴⁴¹ A corporation so proceeding could avoid double taxation on items of income not sheltered by section 337 without incurring any unfavorable consequences. Although this technique was well known, there is no indication in the legislative history to the Revision Act that Congress intended to alter the availability of this tax reduction technique and the TCB seems to confirm that conclusion. However, the new Subchapter S rules were not integrated properly with section 337 and as a result, if that section is applicable on the liquidation of an S corporation, the gain in the corporation's properties will be relieved of tax at both the corporate and shareholder levels. Such a result could not possibly have been intended by Congress.

If section 337 does apply to a disposition of properties by an S corporation, the S corporation shareholders would not be subject to tax. However, the basis of their stock in the S corporation would be increased by the amount of gain realized but not recognized on the disposition. Under section 1367(a)(1), the basis of a shareholder's stock in an S corporation is increased by his allocable share of items of income attributed to him under section 1366(a)(1). Under that provision, the allocation includes all items of income "including tax-exempt income." Because section 337 clearly exempts gain from tax, sections 1366 and 1367 apparently require an increase in the shareholder's basis for that amount of gain. As a result, when the proceeds of that corporate sale are distributed to the shareholders in liquidation, the gain in the shareholder's stock that corresponds to the gain exempted from tax under section 337 will again be free of tax. Thus, gain attributable to the disposition of the property of the corporation in preparation for a liquidation will be exempt from tax at both the corporate and the shareholder level. Such a result is plainly wrong because the purpose of section 337, like the purpose of Subchapter S, is to eliminate double taxation and not to eliminate all taxation upon the appreciation in value of corporate property.

There apparently are two possible solutions to this problem. Either by a most aggressive regulation or through further corrective legislation, it could be provided that the basis of a shareholder's stock shall not be increased by the amount of any gain unrecognized under section 337. Alternatively, S corporations could be barred from obtaining nonrecognition under section 337. Somewhat surpris-

defined in I.R.C. § 341(b). I.R.C. § 337(c)(1). Thus, electing under Subchapter S in the year a collapsible corporation is to be liquidated frequently will be desirable.

441. Rev. Rul. 78-89, 1978-1 C.B. 272.

ingly, perhaps, a superior tax result would be achieved if section 337 were not applicable to the liquidation of an S corporation. In contrast to the consequence of failing to apply section 337 to a corporation subject to the corporate income tax, withdrawing the availability of that section from S corporations would not produce double taxation. The income recognized on a disposition of the corporate properties would cause an increase in the basis of the stock in the corporation which would shelter the distribution of the proceeds of the corporate level sale from further tax.⁴⁴² Rather, the application of section 337 to S corporations merely affects the characterization of that gain. If section 337 is not applicable gain on the appreciation in the corporate properties will be characterized at the corporate level and thus will yield ordinary income to the extent that properties are not eligible for capital gains treatment. Conversely, if section 337 is applicable but no adjustment to the basis of the corporate stock results from the income excused from tax, the gain in the corporate properties will be converted into a capital gain under section 331 upon the distribution in complete liquidation.⁴⁴³ There is no obvious reason why the gain on the final disposition of the property of a corporation should be converted into a capital gain. On the contrary, entity level characterization would be more consistent with the pattern of taxing partnerships⁴⁴⁴ and would retard the use of S corporations to avoid the collapsible corporation provisions of section 341.

It would seem, therefore, that the preferable approach would be to resolve the ambiguity concerning the application of section 337 in favor of its unavailability. However, if section 337 were not applicable to S corporations, it would be intolerable for section 336 to apply when the shareholders will be subject to tax under section 331. The application of section 336 to an S corporation produces precisely the same result as would the application of section 337. Thus if section 336 were to apply but section 337 did not, S corporation shareholders would be subject to different tax consequences depending upon whether the corporation assets were sold at the corporate level or distributed and, likely, sold at the shareholder level—the very inconsistency that section 337 was enacted to eliminate. As a result, if Congress wishes to bar S corporations from the benefits of section 337, the TCB must be amended to limit the scope of the exclusion of distributions in complete liquidation from section 1363(d). If the shareholders will

442. I.R.C. § 1367(a)(1)(A).

443. Of course, even if I.R.C. § 337 is applicable, some ordinary income may be generated on a disposition of the properties of the corporation. *See, e.g.*, I.R.C. §§ 337(b)(1) and 1245. *See* note 439 *supra*.

444. *See* I.R.C. §§ 735 and 751.

be subject to tax under section 331, section 336 should not apply and gain should be recognized under section 1363(d).⁴⁴⁵ On the other hand, even if section 337 is not available to S corporations, section 336 must apply if the shareholders are subject to tax under section 333. In any event, prompt further amendment of the Revision Act to coordinate section 337 with the new provisions seems required regardless of the approach taken.

2. Section 333

Under prior law, one of the relatively few circumstances in which it was desirable to liquidate a corporation pursuant to the provisions of section 333 was when the corporation was a Subchapter S corporation. If the shareholders of a liquidating corporation elect to be subject to tax pursuant to section 333, they are not subject to tax with respect to the entire amount of gain inherent in their stock in the corporation. Rather, individual shareholders are subject to tax at ordinary income rates on an amount equal to their allocable portion of the earnings and profits of the liquidating corporation (but not on an amount in excess of the gain realized on the liquidation).⁴⁴⁶ The liquidating distribution is not subject to any further tax except to the extent that the properties distributed consist of cash and certain investment securities. Thus, if a corporation having a relatively small amount of earnings and profits, such as an S corporation, distributes its assets in kind to its shareholders, the liquidation may be virtually free of tax consequences. The shareholders will obtain a basis for the distributed assets equal to the basis that they had in their stock in the corporation.⁴⁴⁷ Thus, section 333 is a form of nonrecognition provision that roughly mirrors a tax free incorporation under section 351. There are strong policy reasons for desiring to retain the application of section 333 to the liquidation of S corporations. The pattern of taxation produced by the provision more nearly resembles the consequences of dissolving a partnership than it resembles the normal consequences of liquidating a corporation. In operation, the provision permits the shareholders of an S corporation to revert to partnership form without immediate tax consequences. Thus, the provision is entirely consistent with the underlying philosophy of the Revision Act.

445. If the gain so recognized was large enough, it might attract the corporate level capital gains tax imposed by I.R.C. § 1374. The resulting double taxation plainly would be erroneous. Accordingly, if I.R.C. § 1363(d) was to be made applicable to distributions in complete liquidation, the gain so recognized should be exempt from tax under I.R.C. § 1374.

446. I.R.C. § 333(e). A slightly different rule, discussed in the text below, is applicable to corporations.

447. I.R.C. § 334(c).

If the liquidating S corporation were subject to tax on the appreciation inherent in properties distributed to its shareholders, the benefits of section 333 would be eliminated substantially. While the shareholders technically would remain free to elect section 333 treatment, in fact they would be subject to tax on the entire amount of the appreciation in the corporate properties distributed to them. While in many instances the appreciation in the shareholder's stock would be greater than the appreciation in the corporation properties, and thus some amount of gain may remain deferred, in most situations little advantage would remain to electing under section 333. Although under the Revision Act it appeared that distributions in complete liquidation might be subject to tax under section 1363(d), the TCB would bar that result. Accordingly, electing under section 333 upon the liquidation of an S corporation remains as desirable as under prior law. Indeed, since S corporations will not accumulate any earnings and profits after 1982, the attractiveness of section 333 has been enhanced.

D. S Corporations as Stockholders in Liquidating Corporations

When the S corporation is a shareholder in the corporation that is being liquidated, the deemed-individual rule clearly controls the tax consequences to the S corporation and its shareholders. While the consequences of such liquidations seem relatively unambiguous, those consequences nevertheless can be somewhat surprising.

Under the relatively complex scheme of Subchapter C, the shareholders of liquidating corporations may be subject to tax under one of three separate provisions. Under the general rule of section 331, shareholders, whether corporate or individual, are subject to tax in the same manner as if they had sold their stock in the liquidating corporation. Thus, the shareholders are subject to tax on the amount by which the value of the cash or property distributed exceeds the basis in the S corporation stock. As a result, the shareholders obtain a basis in any property distributed equal to its fair market value.⁴⁴⁸

The alternative elective treatment under section 333 is available to both corporations and individuals although with slightly differing tax consequences. While the amount subject to tax does not depend upon the nature of the shareholder, corporate shareholders are subject to tax at capital gains rates on the entire amount recognized.⁴⁴⁹ Furthermore, under section 333(b), a corporation that at any time after January 1, 1954 owned fifty percent of the voting stock of the corporation to be liquidated is excluded from section

448. I.R.C. § 334(a).

449. I.R.C. § 333(f).

333 treatment. Since an S corporation is treated as an individual for the purposes of section 333, neither of these rules applicable to corporations should be applicable to S corporations—at least those formed after 1982. On the other hand, it is not entirely clear that an S corporation will be regarded as eligible to elect section 333 treatment if it owned over fifty percent of the stock of the corporation being liquidated either prior to the making of an S election or while it was a Subchapter S corporation prior to 1983. In such instances, the corporation might be treated as one that owned over fifty percent of the stock of the corporation being liquidated even though it is treated as an individual today.

Finally, under section 332, no gain or loss is recognized to a corporation upon the liquidation of another corporation in which it owns eighty percent or more of the stock. Under the deemed-individual rule, section 332 apparently will not be available to S corporations.

One context in which an S corporation will be a stockholder in a liquidating corporation is where the S corporation has purchased all or substantially all of the stock of another corporation with a view to the immediate liquidation of that corporation and the acquisition of all of its assets. Technically, an S corporation is prohibited from acquiring eighty percent or more of the stock of another corporation.⁴⁵⁰ However, under prior law the Treasury Department recognized that an overly literal application of that prohibition would serve no useful purpose but would interfere with the conduct of legitimate business transactions. One common technique for acquiring the assets of another corporation is to purchase the stock of that corporation and to liquidate it immediately. Between the time of purchase and the time of liquidation, the S corporation momentarily would violate the prohibition against the ownership of over eighty percent of the stock in another corporation. If that prohibition had been enforced literally, Subchapter S corporations would have been barred from acquiring assets in this manner. Recognizing that this technique was not inconsistent with Subchapter S, the Commissioner ruled that the momentary ownership of more than eighty percent of the stock of another corporation would not cause a termination of the Subchapter S election.⁴⁵¹ None of the amendments to Subchapter S produced by the Revision Act have any bearing on the desirability of waiving literal compliance with this aspect of the definition of an S corporation. Presumably, therefore, the flexibility shown by the Treasury Department in this respect will be continued under present law.

450. I.R.C. § 1361(b)(2)(A).

451. Rev. Rul. 73-496, 1973-2 C.B. 312. *See also* Rev. Rul. 72-320, 1972-1 C.B. 270.

When a corporation subject to the regular income tax acquires eighty percent or more of the stock of another corporation during a one-year period, it is entitled under section 338 to elect to increase the basis of the assets of its newly acquired subsidiary to their fair market value on the date of the stock acquisition. It is not entirely clear whether an S corporation is entitled to make this section 338 election. Technically, the election does not affect the acquiring corporation, rather, it alters the basis of the assets of the subsidiary. However, because of its position as a stockholder in the newly acquired subsidiary, the acquiring corporation makes the election. Thus, the deemed-individual rule might be regarded as barring S corporations from making this election. That disability, however, apparently is not significant. Since an S corporation can own eighty percent or more of the stock of another corporation only momentarily, at best, any such acquired subsidiary must be liquidated promptly. The liquidation will be subject to section 331; thus, the acquiring S corporation will obtain a basis for any assets distributed in the liquidation equal to the fair market value of the assets on the date of liquidation. This value should not vary materially from the amount paid for the S corporation stock.

IX. OIL AND GAS AND OTHER NATURAL RESOURCE ACTIVITIES

Under prior law, a Subchapter S corporation was not a particularly attractive vehicle for conducting extensive oil and gas exploration or development.⁴⁵² The depletable character of the corporation's income would not pass through to its shareholders and if losses attributable to intangible drilling or percentage depletion exceeded the basis of the shareholders' stock, the tax benefit of those deductions was lost forever.⁴⁵³ More importantly, because earnings and profits are reduced only by cost and not by percentage depletion,⁴⁵⁴ the corporation normally would have current earnings and profits in excess of taxable income and, thus, would tend to accumulate a substantial earnings and profits account. As a result, distributions of previously taxed income could not be made without completely sacrificing the benefits of percentage depletion for that year. In addition, the income from some types of mineral exploitation constituted passive investment income.⁴⁵⁵ For these and other

452. See generally MILLER'S OIL AND GAS FEDERAL INCOME TAXATION ¶ 27-2 (J. Houghton 21st ed. 1983).

453. Former I.R.C. § 1374(c).

454. I.R.C. § 312(k) and Treas. Regs. §§ 1.312-15 (1972). Earnings and profits of a Subchapter S corporation were computed in essentially the same manner as those of a non-electing corporation. Treas. Regs. §§ 1.1377-2(b) (1960).

455. Treas. Reg. § 1.1372-4(b)(5)(v) (1976).

reasons, the use of a Subchapter S corporation was rarely desirable when a substantial portion of the corporation's activities consisted of oil and gas investments.

The Revision Act has eliminated many of these prior law provisions that made oil and gas activity unattractive for Subchapter S corporations. For new corporations, there is no restriction on passive investment income.⁴⁵⁶ The depletable character of the corporate income passes through to its shareholders⁴⁵⁷ and the distinction between income and earnings and profits is no longer relevant. When a corporation without pre-1983 earnings and profits makes distributions in excess of accumulated S corporation income, they are treated as a return of capital.⁴⁵⁸ Such treatment preserves the benefit of the special tax allowances for this industry. While the ability of a shareholder to claim losses remains limited to the basis for his stock and that basis is not increased by any indebtedness incurred at the corporate level, unused losses at least may be carried over and deducted in future years.⁴⁵⁹ However, as noted below, under current law, it is far less likely that losses will exceed the shareholders' bases.

In addition, Congress has made the use of an S corporation more attractive to taxpayers engaged in oil and gas activities in ways that go beyond changes in prior law of general application. The Revision Act has adopted many of the features of partnership taxation that are designed specifically to favor the extractive industries in general and oil and gas operations in particular. In several respects, these special rules are inconsistent with the general structure of the revised Subchapter S and will increase materially the complexity of the taxation of S corporations for taxpayers taking advantage for these special provisions. While those incongruities are regrettable, it was entirely proper for Congress to have conformed the taxation of S corporations to the pattern of taxing partnerships in these respects.

In general, the computation of depletion occurs at the partnership or S corporation level and the amount so computed is allocated to the owners as a separately stated item. For both entities, however, a markedly different rule is applicable to the computation of percentage depletion on oil or gas properties under the independent producers exemption to the general denial of that tax preference. Under section 613A(c)(13), the S corporation is required

456. I.R.C. § 1362(d)(3), the new provision dealing with termination of the election because of excess passive investment income is applicable only to those S corporations that have accumulated earnings and profits remaining from a year in which they were non-electing corporations.

457. I.R.C. § 1366(b).

458. I.R.C. § 1368(b).

459. I.R.C. § 1366(d).

to allocate to each shareholder a pro rata share of the corporation's adjusted basis in each oil or gas property. The shareholders are then required to compute their own depletion allowance with respect to the oil or gas property just as they would for individually owned properties. As a result of this provision, oil and gas depletion does not enter the computation of S corporation income; thus, it is not a separate item allocable to its shareholders. In order to prevent a double deduction for these losses, section 1367(a)(2)(E) provides that the basis of a shareholder's stock in an S corporation is to be reduced by the amount of the depletion deduction claimed with respect to oil and gas wells.

Since the Revision Act continues the limitation on S corporation losses to the shareholders' bases for their S corporation stock, the benefit of percentage depletion still could be lost by S corporation shareholders because the amount of such depletion is not limited to the basis for the depletable property. In order to prevent that result, section 1367(a)(1)(C) provides that the basis for a shareholder's stock is to be increased by the amount by which deductions for depletion exceed the basis of the depletable property. As a result, shareholders in S corporations normally will be able to obtain a current benefit with respect to the entire amount of percentage depletion even though the depletion allowance has exceeded the shareholder's investment in the corporation.

For the purpose of computing eligibility for the independent producer exemption, production is attributed to the shareholders ratably and the limitation is applied at the shareholder and not at the corporate level. Similar treatment is extended to an S corporation for the purposes of the windfall profits tax. Thus, for the purpose of determining whether oil production constitutes independent producer oil for the purposes of the lower rate of tax imposed by section 4987(b)(2) upon such oil, section 4942(f) provides that an S corporation shall be treated as a partnership and its shareholders as partners. As a result, the independent producer amount is calculated for each shareholder separately.

On a disposition of property subject to section 613A(c)(13), each shareholder is required to compute his gain or loss separately. Under section 1254, deducted intangible drilling expenses are subject to recapture and, thus, on a disposition of property with respect to which such deductions have been claimed, the proceeds of sale are subject to tax at ordinary income rates to the extent of the prior deduction. Under partnership taxation, all such recapture provisions are brought within the scope of the collapsible partnership provisions of section 751. Thus, if a partner disposes of his interest in the partnership and the underlying partnership properties include an element of section 1254 recapture, some portion of the gain on the disposition of the partnership interest similarly would be subject to tax at ordinary income rates. In general, S

corporations, like corporations subject to the regular tax, are not subject to the bifurcation approach of section 751; rather, they are subject to the collapsible corporation provisions of section 341. Under the collapsible corporation approach, ordinary income treatment is imposed only, as a general proposition, when the corporate assets viewed as a whole consist, in substantial part, of ordinary income assets and, even then, ordinary income taxation is imposed only if the corporation or its shareholders attempt to dispose of those assets before having realized a substantial part of the income to be derived from those properties.⁴⁶⁰ However, if section 341 is applicable, the entire amount of gain from the disposition of stock in the corporation is subject to tax at ordinary income rates.⁴⁶¹ Presumably because S corporation shareholders are treated as if they individually owned oil and gas properties, in the one instance of section 1254, the Code applies the partnership collapsible provision of section 751 rather than the collapsible provisions of section 341. Thus, under section 1254(b)(2), upon a disposition of S corporation stock where the corporation holds oil and gas properties with respect to which an intangible drilling deduction has been claimed, an allocable portion of the gain on the sale is subject to tax at ordinary income rates.

For the purpose of the anti-transfer rules under the independent production exemption, either the making or the termination of a Subchapter S election is treated as a transfer. Thus, shifting between electing and non-electing status causes a loss of the ability to claim percentage depletion on oil or gas properties owned at the time of the shift. Moreover, under section 613A(c)(13)(C)(i), an S corporation is treated as a partnership, and its shareholders as partners, for the purpose of the anti-transfer provisions. Under section 613A(c)(9)(A), the transfer of an interest in a partnership is treated as a transfer of the oil or gas property and such a transfer bars percentage depletion to the transferee. Apparently a similar rule is intended to be applicable to transfers of stock in an S corporation.

Although the election to deduct intangible drilling expenses must be made at the partnership level, the somewhat similar election to deduct the cost of exploring for hard minerals is made at the partner level.⁴⁶² Under section 1363(c)(2)(C), this pattern has been extended to S corporations. That pattern is relatively complex. Because that election will affect the basis of the property with respect to which the election was made, the proportion of the basis in such property attributable to the S corporation shareholders should vary from their general ownership interest

460. I.R.C. § 341(e).

461. I.R.C. § 341(a).

462. I.R.C. § 703(b)(4).

in the S corporation. In addition, section 617 contains elaborate and complex recapture provisions which, to some extent, are elective and those elections are also made at the shareholder level. Thus, on an event producing recapture, different S corporation shareholders should be subject to different amounts of recapture. It is not entirely clear, however, that this individualized treatment of S corporation shareholders can be achieved under section 617. In contrast to the more elaborate provisions of section 613A, which were designed expressly to achieve such a complete aggregate approach for partnerships and S corporations, section 617 does not treat property subject to the election as if it were owned by the S corporation shareholders individually. If this individualized treatment of S corporation shareholders cannot be achieved under section 617, providing for a shareholder level election under that section is inappropriate. Either all shareholders will make the election or the non-electing shareholders will bear an increased tax burden attributable to the election by others. Congress should either conform section 617 to section 613A or should require the section 617 election to be made at the corporate level.

X. OTHER CHANGES AFFECTING S CORPORATION STATUS

The desirability of electing to be taxed under Subchapter S has been altered both by the Revision Act and by other recent legislation in ways unrelated to the definition or taxation of such corporations. The nature and availability of fringe benefits to the shareholders of an S corporation have been revised and the continuing reductions in the rates of tax applicable to individuals, and thus S corporations, have affected the attractiveness of the S corporation. As under prior law, the extent to which these changes favor the making of an S election remains complex and will vary in individual cases.

Under prior law, qualified plans providing deferred compensation benefits to employees of Subchapter S corporations were subject to special restrictions, the general design of which was to extend the relatively severe limitations imposed on partnership plans to Subchapter S corporations.⁴⁶³ Thus, the limitation on contributions to plans benefiting employees of Subchapter S corporations were far lower than the ceilings applicable to plans adopted by corporations subject to the regular income tax. On the other hand, Subchapter S corporations were treated as corporations under prior law. Accordingly, employee-shareholders of such corporations were entitled to the broad range of fringe benefits that corporations traditionally have been able to provide their employees. The treat-

463. Former I.R.C. § 1379.

ment of many of these ancillary benefits of incorporation has been changed radically by the combined effect of the Revision Act and TEFRA.

A. Qualified Deferred Compensation Plans

TEFRA eliminated the special limitations imposed by former sections 1379(a) and (b) upon qualified deferred compensation arrangements adopted by S corporations for years beginning after December 31, 1983.⁴⁶⁴ Moreover, TEFRA completely revised the treatment of various categories of employers. As a result, partnerships, regular corporations and Subchapter S corporations are all entitled to adopt qualified deferred compensation arrangements that generally are subject to the same ceilings and other restrictions on benefits. However, Congress did not produce this conformity by simply eliminating all restrictions which previously applied only to certain employers. Rather, the amendments added by TEFRA are a mixed bag, some of which entirely eliminate former restrictions while others extend to all employers restrictions which previously applied only to certain entities and still others add entirely new restrictions. A number of these provisions likely will have greater impact on the deferred compensation plans of closely held businesses than on those of more widely owned enterprises.⁴⁶⁵ In general, these new rules will increase the costs and reduce the benefits of qualified plans relative to the effect of the former rules applicable to non-electing closely held corporations. Thus, while the shareholders of S corporations no longer are prejudiced by their S election and generally will benefit from the conformity of treatment among entities, they will have to deal with these new restrictions.

Among the limitations imposed by TEFRA that particularly will affect closely held businesses are the restrictions upon "top-heavy" plans. New section 416(g) defines a top-heavy plan as one in which more than sixty percent of the present value of the accrued benefits, if the plan is a defined benefit plan, or of the account balances, if the plan is a defined contribution plan, have been accumulated for the benefit of key employees. A "key employee" is an officer of the employer,⁴⁶⁶ one of the ten employees with the greatest ownership, an owner of five percent of the employer, or

464. TEFRA, Pub. L. No. 97-248, § 238(c), 96 Stat. 324, 513 (1982).

465. For a more detailed description and analysis of these provisions, see Sirkin and Sirkin, *The Effect of the TEFRA Pension Provisions on Closely Held and Professional Businesses*, 7 REV. TAX'N INDIVIDUALS 99 (1983).

466. However, in no event will more than 50 employees, or if less, the greater of three employees or 10% of all employees, be treated as officers. I.R.C. § 416(i)(1)(A) (flush language).

a one percent owner of the employer whose annual compensation from the employer is in excess of \$150,000.⁴⁶⁷ A five percent owner and a one percent owner of a corporation are defined as one who owns five percent and one percent, respectively, of the corporation's outstanding stock or of the total combined voting power of all of its stock. The attribution rules of section 318 apply for purposes of determining who is a five percent owner and who is a one percent owner.

If the plan is "top-heavy" it must provide certain special benefits to non-key employees and meet additional vesting requirements not generally imposed upon non-top-heavy plans.⁴⁶⁸ These provisions apply to plan years beginning on or after January 1, 1984.⁴⁶⁹

Among the other provisions of TEFRA which will be of particular interest to the owners of closely held businesses are the new general limits upon the maximum annual benefit payable per participant in a defined benefit plan and the maximum annual contribution per participant in a defined contribution plan,⁴⁷⁰ new special limitations for defined benefit plans upon benefits that commence before the participant reaches the age of sixty-two,⁴⁷¹ and the restrictions the new provisions place upon the amounts that can be loaned to plan participants from plan funds.⁴⁷² The loan limitation provisions apply to any loan made after August 13, 1982.⁴⁷³

In addition to these provisions dealing with administration of qualified plans, TEFRA adds new section 2039(g) to the estate tax provisions of the Code, which limits to \$100,000 the amount of plan proceeds payable to a deceased participant's beneficiaries that is excluded from the participant's gross estate for federal estate tax purposes.

B. Other Employee Benefits

Consistent with the general treatment of S corporations under the Revision Act, section 1372 provides that the S corporation shall be treated as a partnership for the purpose of applying the provi-

467. I.R.C. § 416(i).

468. I.R.C. §§ 416(a)-(d).

469. TEFRA, Pub. L. No. 97-248, § 241(a), 96 Stat. 324, 520 (1982). Although the statute uses the word "years" without modification, Prop. Reg. 1.416-1, ¶ G-2 [1983] STAND. FED. TAX REP. (CCH) ¶ 8972 states that amendments necessary to bring existing plans into compliance with the top heavy provisions must be effective on the first day of the first plan year that begins after 1983.

470. I.R.C. §§ 415(b) and (c).

471. I.R.C. § 415(b)(2)(C).

472. I.R.C. § 72(p). For a discussion of the relationship of this new provision to other provisions of the Code dealing with qualified deferred compensation plans, see Sirkin and Sirkin, *supra* note 465, at 113-17.

473. TEFRA, Pub. L. No. 97-248, § 236(c), 96 Stat. 324, 513 (1982). While

sions of the Code which "relate to employee fringe benefits." While the result Congress attempted to achieve with this section appears correct, the imprecise drafting of this provision creates needless ambiguity. The term "fringe benefits" is colloquial; it is not a defined term under the Code. As a result, it is not clear what provisions are intended to be affected by new section 1372. The Committee Reports enumerate five examples of benefits that Congress intended the new provision to curtail:⁴⁷⁴ the \$5,000 death benefit exclusion provided by section 101(b); the exclusions from income of amounts paid for accident and health plans provided by sections 105 and 106; the exclusion of the cost of up to \$50,000 of group term life insurance provided by section 79; and the exclusion of meals and lodging furnished for the convenience of the employer provided by section 119.

Unfortunately, the list does not entirely clarify the intended scope of the provision. On the one hand, it scarcely exhausts all of the items commonly referred to as fringe benefits available under current law to employees. On the other hand, the enumeration extends to items that do not fall within the traditional notion of a fringe benefit. Apparently, the purpose of this provision is to prevent the shareholder-employees of an S corporation from receiving tax-free certain employment-related benefits that are excluded from the income of shareholder-employees when received from a non-electing corporation, but are taxable to partners when received from the partnership. By using the imprecise term "fringe benefit," Congress has left to the Treasury Department the task of implementing the legislative purpose by regulation. Regrettably, section 1372 contains neither a definition of the term fringe benefit nor a list of all of the provisions intended to be affected.

The application of new section 1372 is made somewhat more complex by the further provision that in applying the section, only a shareholder owning two percent of the stock of the corporation, after the application of the stock attribution rules of section 318, is to be regarded as a partner.⁴⁷⁵ Presumably, lesser shareholders are to be regarded as nonpartner employees. Thus, to the extent that partnerships are able to provide fringe benefits to their nonpartner-employees under these and other provisions of the Code, those benefits will continue to be available to minor S corporation shareholder-employees.

this provision does not require repayment of loans outstanding on that date in excess of the limitations, it does apply to any outstanding loan that is renegotiated, extended, renewed, or revised after August 13, 1982; furthermore, it requires aggregation of pre-August 13, 1982 loans with later loans for purposes of applying the limitations to the new loans.

474. SENATE REPORT, *supra* note 22, at 22; HOUSE REPORT, *supra* note 22, at 21.

475. I.R.C. § 1372(b).

Congress, undoubtedly, was justified in treating an S corporation as a partnership for these purposes. The effect of permitting the S corporation a deduction for a section 105(b) medical expense reimbursement plan, for example, would be to permit the shareholders of the corporation to deduct directly the entire costs of their medical care without regard to the ceilings imposed by section 213. On the other hand, it must be recognized that Congress merely has replaced one disparity in treatment for another. While S corporations now are treated similarly to partnerships, they are treated quite differently from corporations not subject to an S election. Moreover, the special treatment of fringe benefits injects a further consideration into the already complicated question of whether Subchapter S should be elected. Shareholders contemplating such an election now will have to calculate the costs of the loss of such forms of nontaxable income that the Treasury may determine are included within the scope of new section 1372.

Section 1372 generally is effective for the years beginning after December 31, 1982, but if the corporation was a Subchapter S corporation on September 28, 1982, then section 1372 is not effective until after December 31, 1987 with respect to "existing fringe benefits."⁴⁷⁶ An "existing fringe benefit" is defined as any employee fringe benefit "of a type" provided by the corporation to its employees on September 28, 1982. The phrase "of a type" will require some regulatory clarification; it may mean that the benefit must merely be similar to one provided on that date. The availability of this grandfather provision ceases on the date that the corporation's S election is terminated; the date the corporation fails to meet the passive investment income percentage test under former section 1372(e)(5); or more than fifty percent of the corporation's stock becomes newly owned within the meaning of section 1378(c)(2), the special provision dealing with noncalendar fiscal years, discussed earlier.

This grandfather provision seems unduly complex. While Congress quite justifiably might have wished to avoid imposing a new income tax liability on previously existing benefits which previously were not subject to tax, it should have accomplished this goal with a simpler provision. Moreover, the five year grace period is excessive. It would have been preferable for Congress to have provided that the fringe benefits enjoyed by shareholder-employees of S corporations in existence when the Revision Act was passed were to continue to be tax free for a relatively short statutory grace period, for example, one year, and that thereafter all such benefits would be subject to tax.

476. Revision Act § 6(d), Pub. L. No. 97-354, § 6(d), 96 Stat. 166a, 169a (1982).

C. Tax Rates

While not a part of the 1982 legislation, the continuing reduction in the rates of tax applicable to upper income individuals has affected materially the desirability of electing to be taxed pursuant to Subchapter S. Indeed, while the reduction of the individual tax rates relative to the corporate tax rate has reduced the desirability of incorporating businesses in the first instance, it has enhanced the desirability of electing Subchapter S treatment for those businesses that are incorporated.

Of course, no simple test exists for determining whether it would be advantageous for a corporation to be taxed under Subchapter S. Whether the business is projected to be profitable or unprofitable, individual comparisons of the consequences under the regular tax and under Subchapter S must be made in every case. Nevertheless, some general principles are apparent. If the corporation has earnings and profits and if, for any reason, the corporation must distribute a substantial part of its earnings currently to its shareholders, the overall burden of taxation on the business enterprise almost always will be less if the corporation elects to be taxed under Subchapter S. Regardless of the relationship between individual and corporate rates, incurring a current double taxation on a material portion of the corporate profits will almost always be more expensive than incurring the single level tax under Subchapter S. The relative unattractiveness of the regular tax can be diminished through a variety of techniques. If the corporate profits subject to tax at the corporate level can be reduced through expensing techniques, the burden of double taxation is correspondingly reduced. Methods for accomplishing such a reduction of the double tax include using shareholder debt, high (but reasonable) compensation packages including qualified plans, and leasing of property from a shareholder to the corporation. If, after the application of these techniques, substantial profits remain to be distributed, Subchapter S must be examined as an alternative.

If the corporation is either unable to distribute profits because of the expanding needs of the business, or is not required to do so because sufficient profits can be expensed, the equation becomes more complex. While the ultimate extraction of those accumulated corporate profits ultimately may be subject to double taxation, the potential for infinite deferral of that tax and the possibility that it may be avoided by death or otherwise, often justified ignoring that feature of the regular corporate tax structure. Accordingly, a comparison may be made between the regular corporate tax payable and the tax payable by shareholders if Subchapter S is elected. That comparison is influenced by two factors; the number of shareholders of the corporation and their average income tax brackets. Obviously, the more shareholders an S corporation has,

the greater the income splitting advantage provided by a Subchapter S election. Assuming that at least some of the shareholders are not in the highest individual tax brackets, the aggregate tax payable will be reduced by distributing the corporate income over the number of such shareholders. By contrast, all income derived by a corporation subject to the regular tax is taxable to a single entity.

It is in connection with the second branch of the comparison that the recent changes in individual rate structure significantly have affected the desirability of a Subchapter S election. Although the maximum corporate tax rate has remained relatively stable, currently at forty-six percent,⁴⁷⁷ the maximum individual rates have dropped from a maximum of seventy percent to a maximum of fifty percent on all sources of income.⁴⁷⁸ At the same time, the level of income at which the maximum bracket becomes effective has been increased materially. As a result, the amount of tax to be saved by causing the business to be subject to the regular corporate income tax rather than the individual tax has been diminished greatly. For this reason, it may be anticipated that many more businesses will find it desirable to elect to be taxed under Subchapter S.

The interrelationship of these taxes can best be understood through an illustration. Although such an illustration has no application beyond the facts assumed, it can establish a framework for evaluating the desirability of a Subchapter S election. Under the rates in effect for 1983, a corporation having taxable income of \$500,000 will be subject to a corporate tax of \$209,750. Assume that the corporation is owned by one married individual who files a joint income tax return with his spouse, and who has taxable income other than corporate profits, in excess of all deductions, in the amount of \$30,000. That income is subject to a tax of \$5,064. If the corporation elected to be taxed under Subchapter S, and that election did not affect the manner in which it computed its income, the individual would become subject to an additional tax payable in the amount of \$243,938, producing a total tax to the shareholder of \$259,002. As a result, the business would be subject to an additional income tax liability of \$34,188 because it made the Subchapter S election. On the other hand, if the corporation were owned by ten equal shareholders, all of whom had the same noncorporate income and the same tax return filing status as the individual in our first example, dividing the corporate income of \$500,000 among them would produce an additional tax liability to each of \$19,750, for an aggregate increase in tax liability of \$197,500.

477. I.R.C. § 11(b).

478. I.R.C. § 1.

As a result of the splitting of income among the shareholders, the overall tax liability to which the business is subject would be reduced by over \$12,000.

Apparently, in a closely held corporation that is retaining all of its income, Subchapter S status frequently will produce an increase in tax liability, but the reverse quickly becomes true if the corporation is required to distribute a material amount of its profits. Thus, if the corporation described above was subject to the corporate tax, was owned by a single shareholder, and distributed a dividend equal to fifteen percent of its earnings, \$75,000, the tax liability of the shareholder would increase to \$36,590. When this liability is added to the amount of corporate tax, \$209,750, the total tax on the business, \$246,340, approximates the tax burden under a Subchapter S election. Thus, if larger dividends are required, the aggregate tax burden can be reduced by electing Subchapter S status.

XI. ENTITY AUDITS

The Revision Act extended the "entity audit" procedure previously applicable to partnerships to S corporations. New sections 6241 through 6245 provide for binding determination in an audit of the S corporation's return of the tax treatment at the shareholder level of all "subchapter S items," defined by section 6245 as any item the tax treatment of which is determined by the Commissioner to be more appropriately determined at the corporate level than at the shareholder level. New section 6244 states that all provisions of subtitle F of the Code (sections 6001 through 7852) dealing with partnership items⁴⁷⁹ shall be applicable to Subchapter S items unless modified or made inapplicable by regulations. Thus, sections 6221 through 6232, the new partnership entity audit procedures added to the Code by TEFRA, generally will apply to S corporations.

A. *Prior Law*

Under prior law, a Subchapter S corporation was exempt from the income tax; nevertheless, it was required to file an information return similar in form to the ordinary corporate income tax return.⁴⁸⁰ The Subchapter S corporation return also included items of income and loss allocated to the shareholders. However, prior law lacked any provision requiring a shareholder to treat any item

479. A "partnership item" is defined by I.R.C. § 6231(a)(3) as any item the tax treatment of which is determined by the Commissioner to be determined more appropriately at the partnership level.

480. I.R.C. § 6037 prior to amendment by the Revision Act.

on his personal income tax return consistently with this schedule. Thus, even though the proper characterization of an item could be determined only at the corporate level, the shareholders were free to disregard the characterization determined by the corporation's tax advisors and to make their own determinations in preparing their individual returns. Furthermore, since the individual shareholders, not the corporation, were the taxpayers, the Internal Revenue Service could not collect any deficiency due to adjustments on the corporation's income tax return without also auditing returns of the individual shareholders and assessing a deficiency against them. Moreover, there was no procedure by which the IRS could make such deficiencies binding upon all shareholders of the corporation without auditing each one individually before the statute of limitations ran for the audit of the individual return. Not surprisingly, as the series of amendments to Subchapter S increased the permissible number of shareholders, the Treasury Department began to consider ways to decrease the administrative burden of these shareholder-by-shareholder audit and assessment procedures.⁴⁸¹

A similar problem arose under the prior law governing partnership income tax returns. Partnerships also were exempt from income tax at the entity level, but were required to file an information return, including a schedule of items of income and loss allocated to each partner.⁴⁸² However, since the partners, rather than the partnership, were the taxpayers, matters affecting the partners' tax liabilities could be determined definitively only by audit of the return of each individual partner. The administrative burden with respect to partnerships was even greater than that of Subchapter S corporations for two reasons: first, there has never been any limit upon the number of partners a partnership may have, and second, partnerships are permitted to make special allocations of certain items of income and loss to particular partners.

B. The New Entity Audit Provisions

The new provisions appear to ameliorate substantially the administrative procedures for audit of S corporation income tax returns. New section 6241 states that the tax treatment of any Subchapter S item shall be determined at the corporate level, and section 6037 has been amended to require that the S corporation's information income tax return must include each shareholder's pro rata share of each item.⁴⁸³ Furthermore, new section 6242 now re-

481. STAFF REPORT, *supra* note 7, at 25.

482. I.R.C. § 6031 prior to amendment by TEFRA.

483. I.R.C. § 6031, dealing with partnership information income tax returns,

quires that each shareholder treat each Subchapter S item on his or her personal income tax return in a manner consistent with the treatment of that item on the corporate return unless the shareholder notifies the Commissioner of an inconsistent treatment.

The provisions dealing with audit of partnership income tax returns, made applicable to S corporations by section 6244, set out in considerable detail the procedures to be followed.⁴⁸⁴ In summary, the partnership is required to furnish on the partnership tax return the names, addresses, and share of taxable income of all persons entitled to a distributable share.⁴⁸⁵ In addition, the partnership may designate a "tax matters partner" (TMP) whose role is to act as representative of the partnership in all audit proceedings should the partnership return be selected for audit. If the partnership fails to designate such a person, the statute provides that the Commissioner will treat the general partner who is entitled to the largest share of partnership profits as the TMP, or if there is more than one such partner, the one whose name appears first alphabetically.⁴⁸⁶

Upon receiving notice from the Service that the partnership's return has been selected for audit, the TMP must then provide the Service with the name, address, profits interest and taxpayer identification number of everyone who was a partner during the year to be audited.⁴⁸⁷ Section 6223 sets out in considerable detail the time, manner and extent to which the Service must notify all other partners, both of the fact of the commencement of the audit and of its final result (called the "final partnership administrative adjustment" or FPAA). Generally, all partners are entitled to notice, except those who own less than one percent of a partnership having more than one hundred partners and those who fail to provide the Commissioner with their name, address and profits interest to enable him to determine that they are entitled to notice. Since a partner of a partnership can be another entity, such as another partnership or a trust, the owners or beneficiaries of any such entity-partner also are entitled to notice, if, because of the conduit nature of the entity, the income tax liability of its owners or beneficiaries may be affected by the determination of a partnership item.⁴⁸⁸ Section 6223(g) also requires the TMP to keep all

as amended by TEFRA, requires that every person who was a partner at any time during the tax year be provided with a copy of the return. Curiously, I.R.C. § 6037 contains no such provision.

484. For a thorough analysis of the partnership entity audit provisions, see Caplin and Brown, *Partnership Tax Audits and Litigation After TEFRA*, 61 TAXES 75 (1983).

485. I.R.C. § 6031.

486. I.R.C. § 6231(a)(7).

487. I.R.C. § 6230(e).

488. I.R.C. §§ 6223(c)(3) and (h).

partners informed of all administrative and judicial proceedings affecting partnership level adjustment of partnership items. While the TMP represents the partnership in its dealings with the Service, any partner may participate in any administrative or judicial proceeding in which his tax liability could be affected.⁴⁸⁹ If settlement is reached, a partner who is entitled to notice under section 6231 will be bound by the settlement only if he consents to it, but the TMP may bind all non-notice partners without their consent.⁴⁹⁰

When the administrative audit proceeding has terminated, the IRS must send notice of the FPAA to all partners entitled to notice.⁴⁹¹ During the 90-day period following issuance of the FPAA, only the TMP may commence a proceeding for judicial redetermination; thereafter, any partner entitled to notice may commence such a proceeding if the TMP has not.⁴⁹² The TMP or any partner who is entitled to notice may appeal an adverse judicial decision.⁴⁹³

A deficiency with respect to any partnership item cannot be assessed against any partner until 150 days after notice of the FPAA was sent to the TMP, if it is not contested, or until a court decision becomes final, if the FPAA is contested judicially.⁴⁹⁴ In addition, new section 6229 sets the statute of limitations for assessing such a deficiency against a partner with respect to a partnership item at three years after the later of the date the partnership return was filed, or the last day on which it could have been filed timely without regard to extensions. The new provisions also contain a procedure by which the partnership may amend its return (filing of a request for administrative adjustment) and procedures for judicial review of the denial of such a request.⁴⁹⁵

A partner who is entitled to notice of administrative proceedings pursuant to section 6223 and fails to receive it may, if the proceeding is still pending, elect to have the partnership items for the taxable year which is the subject of the proceeding become nonpartnership items as to him.⁴⁹⁶ The result of such an election is that the tax consequences to the partner of the partnership items will be unaffected by the determination made at the entity level; the tax consequences to him will have to be determined, as under prior law, in a separate audit of his personal income tax return. Moreover, if the period for applying for judicial review of the FPAA already has expired when he receives notice, the partnership items

489. I.R.C. §§ 6224(a) and 6226(c).

490. I.R.C. § 6224(c).

491. I.R.C. § 6223(a).

492. I.R.C. § 6224.

493. I.R.C. § 6226(g).

494. I.R.C. § 6225.

495. I.R.C. §§ 6227 and 6228.

496. I.R.C. § 6223(e)(3).

will be treated as nonpartnership items with respect to him unless he elects to have the final outcome of the audit apply to him.⁴⁹⁷

The Commissioner is granted general authority under section 6244 to modify these rules for audit of S corporation returns. The committee reports indicate that this authority is intended to be quite broad in order to allow modification of the procedures to take into consideration all differences between the two entities whether or not the differences are tax related.

In general, it appears that the entity audit procedures for S corporations can be simpler than those for partnerships. For example, new section 6243 provides that each shareholder shall be given notice of and opportunity to participate in any administrative or judicial proceeding for the corporate level determination of any Subchapter S item. This provision, and the restriction of eligible shareholders to individuals except in very limited circumstances, renders unnecessary for S corporation entity audits many of the technical rules governing who must receive notice of partnership entity audits.

This requirement of section 6243 also should render relatively simple the solution to a problem the committee reports specifically direct the Commissioner to address. In a somewhat confused statement, the committee reports indicate that Congress believed the procedures for selecting a person to act for the S corporation as the TMP acts for the partnership would have to be different because, unlike general partners, shareholders are not agents for each other or the corporation under state law.⁴⁹⁸ Since every shareholder must receive actual notice of all proceedings and be given the opportunity to participate, it would seem the problem of appointing a spokesperson can be solved fairly easily by requiring the shareholders to designate one of their number to serve in that capacity according to rules similar to those by which S corporation status is elected. Indeed, such a designation could be required as part of the consent form for new elections. Should the shareholders fail to designate a spokesperson, the regulations could provide that the shareholder with the largest percentage of stock—and therefore the largest stake in the tax proceeding—was to be the spokesperson until the shareholders filed a designation.

The regulations under section 6243 will have to supply rules for the effect of final determination in an entity audit as to which a shareholder failed to receive notice. There seems to be no reason why the statutory provisions applicable to a partner who fails to receive notice should not apply.

497. I.R.C. § 6223(e)(2). See SENATE REPORT, *supra* note 22, at 25.

498. SENATE REPORT, *supra* note 22, at 25; HOUSE REPORT, *supra* note 22, at 24.

One area which will require considerable clarification through regulations is the scope of the term "subchapter S item." As noted above, this term is defined by section 6245 as any item "to the extent regulations . . . provide that, for purposes of this subtitle, such item is more appropriately determined at the corporate level." The legislative history of the Revision Act contains no guidance as to Congress' intent in drafting this section, nor does the legislative history of TEFRA elaborate upon section 6231(a)(3), which contains an analogous definition of "partnership item." Clearly, Congress intended to give the Commissioner broad discretion in defining these terms, in light of the general purposes of these provisions to treat items derived from the entity consistently as to all owners of the entity and to increase administrative efficiency by determining as much as possible in one audit proceeding. It would be "more appropriate" to determine any item at the entity level if it must be determined by resort to the books and records of the entity, or if determination of its amount or character with respect to one partner or shareholder will affect the tax liability of another partner or shareholder as to that item or any other item. In other words, most tax determinations will be made at the entity level. In accordance with this analysis, proposed regulations issued under the partnership audit provisions define "partnership item" quite broadly.⁴⁹⁹ First, they contain a list of items which will be considered partnership items. This list is quite extensive, and includes, in addition to each partner's share of each item of income, gain, loss, deduction or credit of the partnership, such other items as guaranteed payments and amounts necessary to enable the partners to compute their amounts at risk under section 465, and their depletion allowances under section 613A. In addition, it includes a group of items that will be considered partnership items for purposes of some determinations but not others. For example, a partner's contribution to the partnership will be a partnership item for purposes of determining its character as a contribution to capital or a loan or a loan repayment, its basis, its amount, if it is money, and the applicability of the investment company rules of section 721(b), but it will not be considered a partnership item for purposes of determining whether the contribution causes recapture under the investment tax credit provisions of section 38 to the extent that the recapture is irrelevant to the partnership. The Commissioner clearly, and quite properly, interprets the language of the statute broadly to favor determination at the entity level. Similar regulations likely will be forthcoming for S corporations under section 6245.

499. Prop. Reg. § 1.6231(a)(3)-1 [1983] STAND. FED. TAX REP. (CCH) ¶ 8956.

The regulations under section 6245 must be drafted consistently with those under sections 1363(b) and 1366, the sections dealing with computation of an S corporation's taxable income and the consequences thereof to the shareholders. Thus, the ambiguities in the language of those sections discussed earlier in this paper,⁵⁰⁰ such as the scope of the word "could" in section 1366(a)(1)(A) and the relationship to other sections of the Code of the statement that an S corporation must be treated as an individual for purposes of computation of its taxable income, must be resolved before the task of drafting regulations under section 6245 can be completed.

An item may become a nonpartnership item as to a particular partner, and, therefore, its tax consequences for that partner will not be determined in the entity audit, if a partner notifies the Commissioner that he will treat the item differently on his personal return; or if he files a request for administrative adjustment under section 6227 which, if favorably acted upon by the Commissioner, would result in treatment of an item on the partner's return inconsistently with its treatment on the partnership return; or if a partner fails to receive notice of a proceeding under the entity audit provisions as described earlier, or in a series of five "special enforcement areas" enumerated in section 6231(c) to the extent the regulations so provide.⁵⁰¹

The S corporation audit provisions contain no such explicit statutory rules. The legislative history authorizes regulations prescribing treatment of the corporate items "as other than corporate items, . . . where special enforcement problems arise;"⁵⁰² however, this seems to refer only to the last of the categories enumerated in the partnership provisions. Thus, it is not clear whether Congress intended to give the Commissioner authority to create by regulation a class of "nonsubchapter S items" analogous to the statutory nonpartnership items. However, because the situations where items are classified nonpartnership items are all situations in which deviation from the entity's return is anticipated and the situations can arise in the course of proceedings dealing with the audit of an S corporation's income tax return it seems likely that the Commissioner does have such authority under the general language of section 6245; such items simply are not more appropriately determined at the corporate level.

Section 6231(a)(i)(B) of the partnership audit provisions contains an exception from the definition of "partnership" for partnerships

500. See text accompanying notes 219-33 *supra*.

501. I.R.C. § 6231(b).

502. SENATE REPORT, *supra* note 22, at 25; HOUSE REPORT, *supra* note 22, at 24.

with ten or fewer partners as long as no partner's share of any partnership item is different from his share of any other partnership item. This exception exempts such partnerships from the entity audit provisions, but the partnership may elect to have these provisions apply. This exception is intriguing because it excepts from the partnership entity audit provisions those partnerships that most closely resemble S corporations. However, there is no similar exception to the S corporation provisions. This disparity injects another difference in the treatment of S corporations and partnerships.

No reason for this exception appears in the legislative history of TEFRA. Apparently, it is simply an exemption from the new entity audit procedures of those partnerships which pose the least administrative burden to the Internal Revenue Service. The owners of most small entities that do not make use of special allocations are likely to elect to have the entity audit provisions apply because they will find the procedure more efficient and less expensive than multiple individual audits. Occasionally, however, the owners will disagree among themselves about how to treat a particular item and might find it more advantageous to treat the item differently on their personal returns rather than to notify the Commissioner of their inconsistent treatment pursuant to the new entity audit requirements. Because the procedure for notifying the Commissioner of inconsistent treatment is available for both partnerships and S corporations, the additional exemption seems unnecessary for both entities. Furthermore, if such an exemption were extended to small S corporations, the entity audit procedures would be elective for the vast majority of S corporations.⁵⁰³

Clearly, the provision dealing with S corporations is preferable for both entities and, if any change is to be made, it ought to be the elimination of the exemption for small partnerships rather than the extension of the exemption to small S corporations.

XII. CONCLUSION

The Subchapter S Revision Act of 1982 represents the culmination of a substantial effort by Congress to rationalize one area of the Code that had not achieved its promise. The results of that effort are mixed. In revising those aspects of prior law that relate to corporations that are solely subject to Subchapter S taxation, the Revision Act has accomplished major and praiseworthy improvements. While the restrictions on eligibility to elect Subchapter

503. The Staff of the Joint Committee on Taxation reported in 1980 that recent statistics showed 97% of all S corporations had seven or fewer shareholders. STAFF REPORT, *supra* note 7, at 9.

S remain more restrictive than necessary, particularly with respect to the number and character of S corporation shareholders, the definition of an eligible corporation has been liberalized substantially in several significant respects. The creation of a safe harbor indebtedness should defuse substantially the nonproductive one class of stock controversy, and the elimination of passive investment income restriction on newly formed Subchapter S corporations will increase materially the flexibility of an S corporation without creating an unfair advantage for S corporation shareholders. In addition, the rules governing the election and termination of Subchapter S status have been rationalized and liberalized and represent a substantial improvement over prior law.

Similarly, in the computation of S corporation income and the allocation of that income to shareholders, the Revision Act largely was successful in disconnecting the pattern of taxing S corporations from corporate tax concepts and then conforming the taxation of S corporations to the taxation of partnerships. While the computation of income of a Subchapter S corporation may not have become more simple, substantial simplification has been achieved by eliminating a third system for the taxation of business entities. On the other hand, the congressional unwillingness to conform completely the taxation of S corporations to the taxation of partnerships was an unfortunate retreat from the broader objectives of the Revision Act. The tax avoidance potential in Subchapter S corporations is no greater than that in partnerships; thus, the more restrictive approach taken in the Revision Act than is permitted in the taxation of partnerships cannot be justified. A rational approach to the tax avoidance potential inherent in special allocations and basis adjustments attributable to entity level borrowing should be applied uniformly to all conduit taxation entities. By arbitrarily failing to provide for S corporation shareholders the special allocations and basis adjustments that are available to partners, Congress simply refused to confront several significant issues in the conduit pattern of taxation.

The provisions of the Revision Act that integrate the taxation of S corporations with the taxation of corporations subject to the regular income tax are far less successful than provisions that solely affect Subchapter S corporations. The treatment of corporations that had accumulated earnings and profits prior to electing to be taxed under Subchapter S is particularly unsatisfactory. While some mechanism must be established to prevent the improper avoidance of tax on distributions by imposing different rules on S corporations depending on whether the corporation has accumulated earnings and profits, Congress has effectively created two classes of Subchapter S corporations, and has needlessly complicated the task of managing S corporations. This undesirable disparity in treatment is particularly unsatisfactory because the penalties imposed

upon corporations that have accumulated earnings and profits is an overbroad, second-best solution. The Revision Act would have been much improved if Congress had addressed more directly the tax avoidance potential of the making of a Subchapter S election for a corporation that has recently accumulated a substantial amount of earnings and profits, for example, by the sale of its business assets.

Given the policy decision made in 1958 and continued in 1982 to permit corporations having accumulated earnings and profits to elect Subchapter S status, the need to identify distributions attributable to those accumulated earnings and profits becomes unavoidable. Under prior law, the PTI account mechanism was one of the least satisfactory aspects of Subchapter S. Under the Revision Act, the mechanism has been revised radically but not improved. The adoption of an entity level accumulated adjustments account was inconsistent with the general movement towards conformity to partnership taxation and can produce serious inequities in the taxation of S corporation shareholders. The shareholder level account of prior law, stripped of the needless restrictions imposed under prior law, would have been a preferable solution.

In summary, the Revision Act could have been better and it should be improved. The substantial improvement in the conduit taxation of S corporations brought about by the Revision Act represents only a major first step towards fulfilling the objectives of the drafters of the original 1958 legislation and of the Revision Act. It can only be hoped that an additional quarter of a century will not pass before Subchapter S again becomes the object of congressional scrutiny.