SPECIAL SUBCHAPTER S SITUATIONS— REGULATIONS RUN RAMPANT

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Although subchapter S was designed to free a small business which needs to incorporate from any additional tax burden,¹ it did not purport, even for tax purposes, to equate shareholders of the electing corporation with the partners of a partnership. Many differences between the two are apparent:²

(1) Principals of a tax option corporation may qualify as "employees" under pension and profit sharing plans.³

(2) With the exception of certain capital gains discussed later, the income of a tax option corporation does not retain its corporate character in the hands of its shareholders.⁴

(3) Limitations on deductible amounts and other rules applicable to ordinary business corporations apply for the most part to tax option corporations.⁵

(4) As with corporations in general, liquidation or redemption remains a taxable event,⁶ and the character of the gain, if any, is not dependent upon the nature of the underlying assets.⁷

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¹ S. REP. NO. 1983, 85th Cong., 2d Sess. 87 (1958).

² Proposed amendments to the 1954 Code, never enacted, would have made the two virtually identical by taxing qualifying corporations under subchapter K of the Code. S. REP. NO. 1622, 83d Cong., 2d Sess. 118-19 (1954).

³ INT. REV. CODE OF 1954, §§ 401-07.

⁴ Compare INT. REV. CODE OF 1954, §§ 651, 661 (distributable net income concept applicable to trusts).

⁵ *E.g.*, INT. REV. CODE OF 1954, §§ 170(b)(2) (limitation on charitable contributions), 178 (amount of bonus depreciation). See also INT. REV. CODE OF 1954, § 48(e), which makes investment credit limitation applicable at the shareholder level. It is not clear whether the electing corporation is a "new" taxpayer for purposes of § 481 (requiring adjustments to prevent distortion upon change in accounting methods). See E. Morris Cox, 43 T.C. 448, 459 (1965).

⁶ INT. REV. CODE OF 1954, § 331. Compare INT. REV. CODE OF 1954, § 731. However, a corporation which has been a tax option corporation from its inception will generally be able to obtain substantial relief through a one-month liquidation. See INT. REV. CODE OF 1954, § 333.

⁷ Compare INT. REV. CODE OF 1954, §§ 736, 751.

Despite such intended differences, passage of subchapter S was clearly designed to offer equality of tax treatment to tax option corporations and partnerships through two essential principles:

(1) Taxation of an option corporation's income to the shareholders when earned, with consequent tax free withdrawal of these earnings;⁸ and

(2) Deductibility of operating losses at the shareholder level.⁹

This article will examine the extent to which even these limited objectives have been accomplished. Knowledge of the basic statutory requirements for tax option status will be assumed. Our concern will be with the more esoteric, often obscure, ramifications of certain requirements and the difficulties taxpayers confront in satisfying them.

I. QUALIFICATION REQUIREMENT OF ONE CLASS OF STOCK

Section 1371(a)(4) of the Internal Revenue Code defines a "small business corporation," as one which, among other requirements, does not "have more than one class of stock." Although the origin of this limitation is completely unexplained in the committee reports accompanying the 1958 act, the 1954 committee reports, accompanying proposed predecessor legislation, claim simplicity of procedure as the motivation: "If this requirement were not made, undistributed current earnings could not be taxed to the shareholders without great complications."¹⁰

It is nowhere suggested that this requirement was meant to insure that all shareholders be active participants in the corporate business. Indeed, the legislation ultimately enacted in 1958 conspicuously omitted the requirement, found in the proposed 1954 legislation, that each shareholder of an electing corporation must be "actively engaged in the conduct of the business of the corporation—i.e., such shareholders must all occupy managerial positions."¹¹

The "one class" limitation is thus of humble origin, its genesis offering no suggestion of the importance and emphasis now assigned to it by the Internal Revenue Service. For the IRS, there is more than "one class of stock" if there is any "difference" among stockholders, even one having no relationship to computations. Thus for the Service, the requirement of "one class of stock" has resulted in development of a novel application of the familiar debt-equity theory,

⁸ INT. REV. CODE OF 1954, § 1373; see text accompanying note 60 *infra*.

⁹ INT. REV. CODE OF 1954, § 1374; see text accompanying note 75 *infra*.

¹⁰ S. REP. NO. 1622, 83d Cong., 2d Sess. 453 (1954).

¹¹ *Ibid*.

again restrictive of subchapter S eligibility. A section designed for "simplicity" has therefore generated a complicated and highly conceptual dispute.

For example, Treasury Regulation 1.1371-1(8) provides:

If the outstanding shares of stock of the corporation are not identical with respect to the rights and interest which they convey in the control, profits, and assets of the corporation, then the corporation is considered to have more than one class of stock. Thus, a difference as to voting rights, dividend rights, or liquidation preferences of outstanding stock will disqualify a corporation. However, if two or more groups of shares are identical in every respect except that each group has the right to elect members of the board of directors in a number proportionate to the number of shares in each group, they are considered one class of stock. If an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock.

Presumably, the next to last sentence of this regulation would protect the corporation in a situation where advances, although considered stock, are exactly in proportion to stockholdings. However, once there is a disproportion, although this circumstance might actually be helpful to the taxpayer on the question of debt versus equity, the regulation would hold that a second (disqualifying) class stock has come into existence.

In a controversial and far reaching 1963 ruling,¹² the Internal Revenue Service demonstrated the extreme to which it will advance this interpretation. Here there was of record only one class of stock—voting common stock issued upon the incorporation of a partnership consisting of eight active and two limited partners. As might be expected, the shareholders entered into an agreement pursuant to which the inactive shareholders granted the active ones an irrevocable proxy to vote their stock. Eligibility for subchapter S was denied; since only some of the shareholders could "vote," *i.e.*, direct policy, two classes of stock existed.

Not only did this ruling on its facts jeopardize conventional business practices—voting trusts, executive committees, loan agreements with voting restrictions, etc.—its broad language went beyond the specific facts and condemned "any other type of voting control device or arrangement . . . which has the effect of modifying the voting rights of part of the stock so that particular shares possess disproportionate voting power as compared to the dividend rights or liquidation

¹² Rev. Rul. 63-226, 1963-2 CUM. BULL. 341.

rights of those shares and as compared to the voting, dividend and liquidation rights of the other shares of stock.”¹³

Although the response of the business community and of legal commentators has been dismay,¹⁴ it should be observed in defense of the IRS that the ruling while seemingly harsh in the case of a revocable or short term proxy, is arguably justifiable in the case of an irrevocable proxy. Furthermore the Service's position does have the merit of treating identical restrictions identically, without regard to whether they have been created by corporate charter or by agreement.

Nonetheless the “substance over form” approach here is questionable because of the doubtful effectiveness of such stockholders' agreements against outsiders unaware of their contents¹⁵ or even against new shareholders. In addition to the absence of support in the legislative history for the Service's position, the test enunciated in the 1963 ruling is uncomfortably similar to that which has been utilized in determining whether certain unincorporated “associations” are to be taxed as corporations.¹⁶ Any such equation is untenable. There is nothing in the statute itself¹⁷ or in the legislative history which even suggests that an association taxable as a corporation is per se disqualified from electing subchapter S treatment.¹⁸

Another aspect of the Service's sweeping attack upon apparent “one class of stock” situations is found in its novel treatment of the typical debt versus equity problem: where purported “debt” is found to be equity, that equity per se constitutes a “second class of stock” and subchapter S status is unavailable. Thus in *Catalina Homes, Inc.*,¹⁹ already somewhat of a *cause celebre*, a single principal owned fifty-one of the one hundred shares of corporate stock. The principal's wife and children retained fourteen shares subject to a voting trust agreement whereby the principal's wife and children gave to him, as voting trustee, the exclusive right to vote their stock for a period of ten years. Upon the sale of the remaining thirty-five shares to an outsider, a shareholder's agreement was executed including certain terms and

¹³ *Id.* at 342.

¹⁴ The ruling has been soundly criticized. Notes, 20 TAX L. REV. 391, 392-94 (1964); 22 J. TAXATION 166, 168 (1965).

¹⁵ *Ibid.*

¹⁶ See, e.g., *Morrissey v. Commissioner*, 296 U.S. 344 (1935); *Helvering v. Combs*, 296 U.S. 365 (1935); *Swanson v. Commissioner*, 296 U.S. 362 (1935).

¹⁷ Section 1371(a) defines a “small business corporation” as a domestic corporation which meets certain requirements. Section 7701(a)(3) provides: “The term ‘corporation’ includes associations”

¹⁸ Such election might indeed be advisable in a doubtful case, although there is the immensely practical problem of the effect of filing the election and the possibility of underscoring the problem. The result with regard to “professional corporations” poses an interesting question.

¹⁹ 23 CCH Tax Ct. Mem. 1361 (1964).

conditions concerning corporate management and the transferability of corporate stock. The two principals then made loans to the corporation, not in proportion to their stockholdings, bearing interest at five percent and payable from time to time at the discretion of the board of directors—"dividends," however, could not be paid until the payment of all corporate debts. The two principals then made substantial "advances" to the corporation. The IRS contended, and the court agreed, that the purported debt was actually equity.²⁰ But then the court in a mere memorandum opinion proceeded to accept the Service's subchapter S contention: the loan *treated as* stock was a priori a second class of stock.

Lest the last sentence of Treasury Regulation 1.1371-1(8), appear to have gained judicial confirmation it should be noted that the taxpayer appears not to have specifically challenged the validity of the regulation, nor has any taxpayer to date done so in court. Thus the Service has not been required to assume the unenviable burden of establishing that the standards and reasons for classifying alleged debt as equity are germane to determining whether such equity differs materially from investment formally identified as equity.

Even the *Catalina Homes* court felt compelled to question the reasonableness of at least one aspect of the 1963 ruling, the "voting stock" language, again still untested in the courts. Although the court refused to rule upon the government's contention that stock in voting trusts constitutes a second class of stock because of its loss of voting power,²¹ the court by dictum did "deem it appropriate to note our reservations as to whether these arguments represent a reasonable interpretation of the applicable statutory provisions and the intent of Congress in enacting Subchapter S."²² Such language offers hope for taxpayers in the further litigation which obviously is to be expected.²³ The severe interpretations of the Service in this area also lead to perplexing questions with regard to corporations financed by bank loans guaranteed by their shareholders. In one recent case, *Murphy Logging*,²⁴ the Service successfully contended that such loans were in substance loans by the bank to the shareholders who, in turn, invested the moneys in the corporation. Although this was not a

²⁰ *Id.* at 1367; *accord*, *Montclair, Inc. v. Commissioner*, 318 F.2d 38 (5th Cir. 1963) & cases cited therein; *Gooding Amusement Co. v. Commissioner*, 236 F.2d 159 (6th Cir. 1956) (*affirming* 23 T.C. 408 (1954)), *cert. denied*, 352 U.S. 1031 (1957); *Isidor Dobkin*, 15 T.C. 31 (1950), *aff'd per curiam*, 192 F.2d 392 (2d Cir. 1951).

²¹ It also avoided deciding whether the voting trusts were shareholders "other than individuals" which would violate the requirements of § 1371(a)(2) of the Code. See text accompanying note 42 *infra*.

²² 23 CCH Tax Ct. Mem. at 1368.

²³ See *Henderson v. United States*, 245 F. Supp. 782 (M.D. Ala. 1965).

²⁴ *Murphy Logging Co. v. United States*, 239 F. Supp. 794 (D. Ore. 1965).

subchapter S case, there would appear to be no reason why the doctrine of this case, together with the *Catalina* principle, could not affect the subchapter S area. One writer has recently pointed out that these decisions together place the small business corporation on the horns of a dilemma no matter which way its operations are financed.²⁵ Although the same writer expresses the view that the *Murphy Logging* case will be very narrowly applied, it is understood that field agents have been applying this principle and it is submitted that this is an area which taxpayers must tread with extreme caution.

II. TERMINATION OF SUBCHAPTER S ELECTION

During the course of a taxable year a corporation may discover that its election of tax option status either was ill advised from the outset or, in light of the then current operating situation, will not prove beneficial. At this point the shareholders must consider, from a long range point of view, whether the status should nevertheless be continued or whether it should be terminated.

The simplest means of termination is through filing with the Commissioner a statement of revocation accompanied by the consent of all shareholders.²⁶ This method of termination, however, under both the statute and the regulations²⁷ is effective for a given taxable year only if filed within the first month of that year. Otherwise, the termination is effective only for the succeeding year. The statute and the regulations further provide that, in any event, the termination, even if made in the first month, cannot be effective for the first year of the election.²⁸

The other methods of termination²⁹ do affect the taxable status for the year in which the termination occurs even though the terminating event occurs after the first month of the year. These methods are brought about by events which constitute "termination"—a statutory phrasing which might suggest that termination was considered an unfavorable event which occurs despite the intentions of the taxpayer.

²⁵ 23 J. TAXATION 194 (1965).

²⁶ The purpose of the consent requirement is to prevent a tax decision by less than all shareholders which will affect all shareholders. A shareholders' agreement providing for consent is likely to prove ineffective in this situation. If any shareholder violates his agreement (either by refusing to consent to termination or by effecting termination where none is intended), the corporation or nonviolating shareholders apparently could not assert against the government that termination is nevertheless effected. Since the statute does not recognize such agreements, the nonviolating shareholders would probably be limited to an action for damages against the violator.

²⁷ INT. REV. CODE OF 1954, § 1372(e) (2); Treas. Reg. § 1.1372-4(c) (1959).

²⁸ *Ibid.* Because of the availability of other means of termination, it would seem that this provision is of little practical significance.

²⁹ INT. REV. CODE OF 1954, § 1372(e) (1), (3), (4), (5). Paragraphs (1), (4) and (5) are not discussed in detail in this paper.

In practice, however, it has generally been accepted that these methods of termination may be used affirmatively by a taxpayer who seeks to discontinue an election but finds that it is too late in the year to do so by revocation.³⁰ For example, after the first month of a taxable year, the taxpayer may purposely transfer certain shares to a trust or to a new shareholder, or he may formally create a second class of stock. Cautious practitioners, however, are aware of the possibility that terminations deliberately created in this manner may not be recognized by the Commissioner if they are lacking in substance, for example, where the number of shares transferred to the trust or to a nonconsenting shareholder is nominal.³¹

The regulations dealing with termination by means other than revocation³² require that notification be given to the Commissioner of the termination. Where the termination is unintended, however, the necessity of such a requirement is difficult to see since the Commissioner may, in any event, assert that the election has been terminated, while it is hardly punitive to refuse a taxpayer the right to terminate where he did not desire termination. Where the termination is deliberate, however, it is obviously better practice to notify the Commissioner, although there do not appear to be any cases or rulings in which the Commissioner has refused to recognize a termination simply because of failure to file the notice.³³

The most perplexing aspect of termination occurs where the termination is not only unintended but is also unknown. This is most likely to occur in a situation like that in *Catalina Homes* where the taxpayer in good faith might not even suspect that it has violated the "one class of stock" requirement. Here, disaster may result from a belated assertion by the IRS that the status has been terminated *ab initio*. Assume a corporation which in the first year of its existence elects tax option status. In that first year a portion of the initial capital is supplied in the form of shareholder loans or shareholder guarantees of bank loans. In subsequent periods, or perhaps even later in the same year, these loans (or apparent loans) are repaid. Several years

³⁰ Treas. Reg. § 1.1372-4(b) (1959), as amended, T.D. 6707, 1964-1 CUM. BULL. 316, as amended, T.D. 6841, 1965 INT. REV. BULL. No. 34, at 35, suggests that the Commissioner is fully aware that an election may be terminated deliberately by a means other than revocation.

³¹ Although the regulations make no reference to such a possibility, ample authority is readily available to justify IRS's assertion of such a result. See, e.g., *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Higgins v. Smith*, 308 U.S. 473, 477-78 (1940).

³² Treas. Reg. § 1.1372-4(b) (1), (3)-(5) (1959), as amended, T.D. 6707, 1964-1 CUM. BULL. 316, as amended, T.D. 6841, 1965 INT. REV. BULL. No. 34, at 35.

³³ Compare T.I.R. 702, 1965-1 CUM. BULL. 154, where, after much uncertainty about the matter, the Service ruled that the failure to file form 966 was not fatal to a plan of liquidation.

later, the Commissioner asserts that the initial loans really constituted a second class of stock and that the election was therefore either invalid from its inception or terminated in the year it began. Assume further that several years later the Service's position is sustained in litigation. Although an election normally, even if terminated, can be reinstated as a matter of right five years after termination,³⁴ the taxpayer, unaware of termination, never considered a new election. Moreover, since the regulations³⁵ provide that an election has a "continuing effect and need not be renewed annually," strategic considerations would dictate against a taxpayer filing an "election" the year after he learned of the possible but contested termination. Of course, once the issue is raised by the Service, the taxpayer should file a new "election" each year thereafter although he is still contending that the initial election remains effective. Strategy and prudence, thus, lead the taxpayer in different directions. To free the taxpayer from this dilemma, the law should be amended to provide that wherever the taxpayer, in good faith, does not believe that the election has been terminated and proceeds on the assumption that it is still effective, the status is automatically restored in the first year in which the terminating cause is no longer operative.³⁶

The above mentioned five year rule thus remains available and effective to prevent the principal abuse at which it is directed: indiscriminate, purposeful terminations of tax option status. The statute even today grants the Commissioner discretion to reinstate the tax option status, upon application by the taxpayer, at an earlier date.³⁷ Furthermore the regulations explicitly recognize that in some instances the five year rule will work an undue hardship and, accordingly, provision is made that: "Consent to the new election will ordinarily be denied unless it can be shown that the event causing the termination was not reasonably within the control of the corporation or shareholders having a substantial interest in the corporation, and was not part of a plan to terminate the election in which plan such shareholders participated." ³⁸

However, the IRS nowhere suggests that the above dilemma of inadvertent termination can be considered an event "not reasonably within the control of the corporation or shareholders" even if shareholders acted in good faith.

The typical "events" to which this regulation appears to refer include the death of a shareholder and the attendant transfer of his

³⁴ INT. REV. CODE OF 1954, § 1372(f).

³⁵ Treas. Reg. § 1.1372-2(c) (1959).

³⁶ Quite possibly, especially in view of the high degree of restrictive regulations in this area, this result could be accomplished by regulation.

³⁷ INT. REV. CODE OF 1954, § 1372(f).

³⁸ Treas. Reg. § 1.1372-5(a) (1959).

stock to a nonqualifying shareholder. Although the statute itself permits an estate to be a shareholder,³⁹ the executor, like any new shareholder, is required by the regulations to file his consent within thirty days after his qualification⁴⁰ or, in any event within thirty days following the close of the corporation's taxable year in which the estate became a shareholder.⁴¹ However, suppose the will requires that the stock be distributed to one or more trusts—nonqualifying shareholders—even though the trustee is able and willing to distribute the stock immediately to the beneficiary.⁴² There are rulings—apparently unpublished—which hold that this falls within the status of an “event not reasonably within the control of the corporation.”⁴³ These rulings appear to be eminently fair except in the unlikely situation where the shareholder in creating the trust deliberately planned to cause a termination after his death.

However, even though some relief is granted in the case of such trusts, reinstatement of the election cannot take place until the year after the termination, unless the distribution to the trust has occurred in the first month of the taxable year and, even then, only if within that month the taxpayer has been able to obtain the required approval. It is unclear whether he could obtain such approval after the fact. Good planning, therefore, demands that where an executor desires to distribute stock through a trust to a qualifying beneficiary he should obtain approval of the Commissioner in the year prior to the year of distribution and then make the distribution through the trust in the first month of the corporation's succeeding taxable year. This should permit the corporation, with the beneficiary as a shareholder, to file a new election for the then current taxable year without any interruption in tax option status.

Such planning would not, of course, handle the situation where the trustee was forbidden, or felt it unwise, to distribute the stock to the beneficiary. Here apparently the parties will have to suffer disqualification at least so long as the trustee holds the stock. For once

³⁹ INT. REV. CODE OF 1954, § 1371(a)(2).

⁴⁰ Treas. Reg. § 1.1372-3(b) (1959).

⁴¹ Here again the regulations appear to impose an unwarranted burden on the taxpayer. Suppose that a shareholder dies on the last day of a corporation's taxable year. Literally, the regulation would appear to require that the consent be filed within thirty days of that date regardless of when the executor qualified. Suppose there is a will contest or some other event which leaves the estate without an executor for thirty days. Does this mean the election is per se terminated?

⁴² Apparently, there would still be a technical termination since momentarily the trustee would have held the stock, albeit only for the purpose of conveying to the beneficiary. Suppose the executor, with the trustee's approval, sold the stock to the beneficiary for the latter's promissory note, which note was then given to the trustee. The trustee could then distribute his own note to the beneficiary.

⁴³ Tax Management, Portfolio No. 60.

the fault lies not with the regulations, but with the statute itself—apparently the requirement eliminating a trust from the class of qualifying shareholders is a vestige of the former “active management” rule.⁴⁴ This provision intrudes in a most unwarranted fashion on sound estate planning without at the same time really correcting any abuse. At present the only means of avoiding this difficulty would seem to be a form of shareholders’ agreement under which the corporation or the surviving shareholders could require the estate to sell its stock whenever a transfer in trust was contemplated.⁴⁵ Of course the unfavorable effect of trust ownership can legitimately be delayed—provided that the executor is agreeable—until the termination of actual administration of the estate. Let taxpayers not conclude that this offers a means of indefinitely postponing the problem. The recent Tax Court decision in *Old Virginia Brick Co.*,⁴⁶ indicates that the period of delay must be reasonable. The court there held that the unduly prolonged administration of an estate (apparently, about eighteen years at the time of the tax option election) necessitated treatment of the corporate stock, for subchapter S purposes, as though it were actually owned by a testamentary trust. The result, although perhaps justified on the facts of this case, is astonishing. However, the basic principle there enunciated is well supported by existing case law⁴⁷ and regulations.⁴⁸

III. WITHDRAWAL OF CORPORATE EARNINGS

A principal reason for electing tax option status is to gain tax treatment for corporate shareholders similar to that accorded partners. Shareholders of a tax option corporation are thus taxed on their pro rata share of corporate earnings whether distributed or not.⁴⁹ Where some portion of corporate earnings are actually distributed during the course of a taxable year, the regulations provide that such earnings, to the extent of the current year’s earnings and profits, are considered dividends when distributed.⁵⁰ The amount of the corporation’s taxable income not distributed during the year is taxed as a dividend, pro rata, to the corporate shareholders on the last day of the year as though distributed on that date.⁵¹

⁴⁴ See the discussion concerning the “one class of stock” requirement, p. 681 *supra*.

⁴⁵ But see note 26 *supra*.

⁴⁶ 44 T.C. 724 (1965).

⁴⁷ *Josephine Stewart*, 16 T.C. 1, *aff’d*, 196 F.2d 397 (5th Cir. 1952); *Marian Caratan*, 14 T.C. 934 (1950).

⁴⁸ Treas. Reg. § 1.1371-1(e) (1959); Treas. Reg. § 1.641(b)-3(a) (1956).

⁴⁹ INT. REV. CODE OF 1954, § 1373(b).

⁵⁰ Treas. Reg. § 1.1373-1(d) (1959). Compare INT. REV. CODE OF 1954, § 316(a).

⁵¹ Treas. Reg. § 1.1373-1(a) (1) (1959).

The scheme outlined above clearly permits a corporation and its shareholders to elect, to some degree, the year in which the corporate earnings will be taxed to the shareholders. If the corporation's taxable year ends on a date different from that of its shareholders,⁵² current distributions might fall in one taxable year while the "deemed distributed" earnings were taxed in another year.⁵³ It is important to note that the regulations⁵⁴ interpret the statute as pertaining only to those persons who are shareholders on the last day of the taxable year of the corporation. In marked contrast to the rules governing sale of partnership interests⁵⁵ it would, therefore, appear possible for a shareholder to sell his stock prior to the end of the year (generally at capital gains rates) and avoid tax on undistributed corporate income. This would clearly require price adjustments to be made with an unrelated buyer.

Recognizing that the statute offers a fertile area for tax planning, especially but not exclusively, within a family group, the regulations provide:

A donee or purchaser of stock in the corporation is not considered a shareholder unless such stock is acquired in a bona fide transaction and the donee or purchaser is the real owner of such stock. The circumstances, not only as of the time of the purported transfer but also during the periods preceding and following it, will be taken into consideration in determining the bona fides of the transfer. Transactions between members of a family will be closely scrutinized.⁵⁶

In addition to this regulation, the would be tax planner in this area must hurdle the provisions⁵⁷ permitting the Commissioner to allocate dividends to other members of a family group—rather than only to a single shareholder—to reflect the value of a particular share-

⁵² This can easily be arranged because there is no provision requiring tax option corporations to have the same taxable year as their shareholders. Compare INT. REV. CODE OF 1954, § 706(b), with respect to taxable years of partnerships. Compare § 63 of the Omnibus Tax Bill of 1965, introduced in the first session of the present Congress. H.R. 11450, 89th Cong., 1st Sess. (1965). This provision was not included in the bill passed by the Senate early this year. H.R. 9883, 89th Cong., 2d Sess. (1966).

⁵³ The import of the provision that both distributed and undistributed income shall be treated "as a dividend" is not clear, since § 1375(b) provides that for purposes of the dividends received credit, (INT. REV. CODE OF 1954, § 34 (repealed for years after 1964)), the retirement income credit, § 37, and the one hundred dollar exclusion, § 116, the distributions are not considered dividends. Perhaps, it is support for the ruling that subchapter S income is not includable in computing self-employment tax. Rev. Rul. 59-221, 1959-1 CUM. BULL. 225.

⁵⁴ Treas. Reg. § 1.1373-1(a)(2) (1959).

⁵⁵ INT. REV. CODE OF 1954, § 706(c)(2).

⁵⁶ Treas. Reg. § 1.1373-1(a)(2) (1959).

⁵⁷ INT. REV. CODE OF 1954, § 1375(c). The statute deals with shifting income among shareholders. Suppose a father rendered services to a corporation in which he owns no shares and from which he draws no salary. May this section be invoked by the IRS?

holder's services.⁵⁸ Apart from these restrictions, a timely gift program may achieve substantial income shifting.⁵⁹

Since corporate earnings are taxed to the shareholder whether distributed or not, a companion part of the statute⁶⁰ quite logically provides in essence that a shareholder may withdraw previously taxed but undistributed income without suffering further dividend consequences. However, the regulations⁶¹ provide that this "benefit" of nondividend distribution is "personal" and cannot "in any manner" be transferred to another. While superficially this provision might seem equitable in view of the fact that the buying shareholder has never been taxed on these earnings, it is nevertheless true that he has in effect paid for such earnings. The proper planning technique, if permitted by the corporate working capital position, would provide for the selling shareholder first to withdraw the amount of earnings he is permitted to withdraw tax free followed by sale of the stock at a reduced price.⁶² Alternatively, of course, a shareholder might follow the traditional approach and sell a lesser number of shares while having the balance of his shares redeemed by the corporation.⁶³ While this procedure occasionally will not produce the desired results in the ordinary case,⁶⁴ it should be effective here because even a nonqualifying redemption should not be treated as a dividend to the extent of previously taxed but undistributed earnings.

One vital question not specifically answered by the provisions relating to distribution of previously taxed income is the status of an existing shareholder who acquires additional shares which bear a portion of undistributed income. The apparent sense of the regulations⁶⁵ would be to disallow nondividend distribution treatment with respect to any shares acquired after particular undistributed income

⁵⁸ See Henry D. Duarte, 44 T.C. 193 (1965). The abuse here was patent, and the court simply refused to find a bona fide transfer to young children. Although the father reduced his salary after the transfer, the case relies more upon the regulation than upon the specific statute, § 1375(c).

⁵⁹ Similar planning is not available with respect to losses. They are pro rated according to the period for which the stock is held. INT. REV. CODE OF 1954, § 1374 (c) (1).

⁶⁰ INT. REV. CODE OF 1954, § 1375(d).

⁶¹ Treas. Reg. § 1.1375-4(e) (1959).

⁶² Of course, such distribution must be in cash or else, pursuant to Regulation 1.1373-1(d), it will not be considered a dividend distribution for purposes of reducing undistributed taxable income. Therefore, if necessary, the corporation should borrow on existing assets rather than make a property distribution.

⁶³ Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954).

⁶⁴ Suppose, for example, that the selling shareholder is required by conditions of the business to remain as an officer or employee; or, suppose the withdrawing shareholder to be the father of a continuing shareholder to whom he gave some stock within the past ten years. In these cases, because of the application of the family attribution rules, the redemption would not constitute a complete termination under § 302(b) (3) and therefore would probably not qualify for capital gains treatment.

⁶⁵ See note 61 *supra* and accompanying text.

was earned. Conversely, there is the question of the amount which may be withdrawn as a "nondividend distribution" by a shareholder who sells some, but not all, of his stock. Here it would seem that the permissible withdrawal should not be correspondingly reduced.

A yet more disturbing problem introduced into this area by the regulations relates to the nature of previously taxed but undistributed income after termination of tax option status. The regulations provide: "If an election is terminated under Section 1372(e), the corporation may not, during the first taxable year to which the termination applies or during any subsequent taxable year, distribute previously taxed income of taxable years prior to the termination as a nondividend distribution pursuant to this section [1375]." ⁶⁶

Again, there does not appear to be any support for this position either in the statute itself or in the legislative history. Quite to the contrary, the general purpose of the legislation suggests that Congress intended to permit a shareholder to withdraw earnings tax free after they had once been taxed. While the termination of tax option status prevents the shareholder from so doing with respect to future profits, there is no reason why it should so affect past profits. This problem is further complicated by a subsequent provision that: "If a new election is made subsequent to a termination under Section 1372(e) of a prior election, a shareholder's net share of previously taxed income is determined solely by reference to taxable years which are subject to the *new* election." ⁶⁷

Even granting, for argument's sake, the validity of the rule preventing tax free withdrawal of previously taxed earnings while tax option status is ineffective, it is hard to justify preventing tax free withdrawal once the election is reinstated. Taken literally, the last mentioned provision of the regulations would apply even in the case earlier discussed of a distribution to a trustee for immediate redistribution to the beneficiary. Even with the aid of the time honored rule that regulations not clearly contrary to a statute must be sustained,⁶⁸ these restrictions on withdrawal of earnings are not likely to be given a very favorable reception by the courts.

Yet another unexpected problem may arise where a corporation attempts to distribute previously taxed income after a loss year. Since the amount of the loss reduces the amount available for tax free distribution,⁶⁹ distribution *after* the loss year will constitute a distribution first of current year's earnings and then of accumulated earnings, if any, of a preelection year. The latter distribution will constitute a

⁶⁶ Treas. Reg. § 1.1375-4(a) (1959).

⁶⁷ Treas. Reg. § 1.1375-4(d) (ii) (1959). (Emphasis added.)

⁶⁸ *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948).

⁶⁹ Treas. Reg. § 1.1375-4(d) (1959).

dividend or, after preelection earnings have been exhausted, will be applied against basis (of stock only)—any excess over basis being considered capital gain.⁷⁰

One suggestion advanced for circumventing these problems is to have the shareholders withdraw the amount of undistributed, already taxed earnings before the end of each calendar year (to be absolutely safe) or at least prior to the beginning of a taxable year in which the shareholders know that the tax option status will be terminated.⁷¹ The amount of moneys so withdrawn, or some portion thereof, would then be "loaned" back to the corporation. This procedure would entail two clear risks: (1) under the *Catalina* approach the loan itself might effect a termination of the tax option status; and (2) the Commissioner might argue that the transaction was lacking in substance.⁷² At the very least, therefore, the loans back into the corporation should be in different amounts than the original withdrawals.

As with other subchapter S special situations, a fully satisfactory solution to the problems caused by unreasonable regulations remains to be found.

IV. BASIS ADJUSTMENTS

Consistent with the partnership provisions,⁷³ a shareholder's basis for his stock in a tax option corporation is increased by his share of undistributed income.⁷⁴ Likewise, since each shareholder, as a normal attribute of tax option status, enjoys a pro rata portion of corporate net operating losses,⁷⁵ the basis of a shareholder's stock is required to be reduced, but not below zero, by the shareholder's pro rata share of the corporate net operating loss.⁷⁶ The statute further provides that after the basis of a shareholder's stock has been reduced to zero, further

⁷⁰ INT. REV. CODE OF 1954, § 301(c).

⁷¹ Wood, *How To Avoid the Unexpected Tax Problems and Subchapter S*, 21 J. TAXATION 168 (1964). Apparently a mere bookkeeping entry crediting "dividends payable" would not satisfy the regulations. Some relief is afforded by § 1 of H.R. 9883, already passed by the Senate, see note 52 *supra*, which would permit distributions within two and one-half months of the close of a taxable year to be treated as distributions of that year's income.

⁷² Cf. *United States v. General Geophysical Co.*, 296 F.2d 86 (5th Cir. 1961).

⁷³ See INT. REV. CODE OF 1954, §§ 705, 733.

⁷⁴ INT. REV. CODE OF 1954, § 1376(a). The statute says that this adjustment is permitted only to the extent that the previously undistributed amount was included in gross income, or would have been were an income tax return required, see Treas. Reg. § 1.1376-1 (1959). The fact that the particular shareholder actually paid no tax is immaterial. Since all such amounts *should* be included in gross income, the only apparent purpose of this provision is to prevent a basis increase with respect to amounts erroneously omitted from income in earlier years where the statute of limitations prevents correction of the error.

⁷⁵ INT. REV. CODE OF 1954, § 1374(b)(1). The loss can also be used in computing the net operating loss deduction. Just as the basis increase applies regardless of tax paid, so the decrease applies regardless of "tax benefit." However, there is no provision comparable to that discussed in note 74 *supra*, to protect a shareholder who inadvertently fails to claim a loss in a year barred by the statute.

⁷⁶ INT. REV. CODE OF 1954, § 1376(b)(1).

losses are applied in reduction of the basis of any indebtedness which the shareholder might hold against the corporation.⁷⁷

Since the shareholder's ordinary loss deduction for his pro rata share of corporate net operating losses is limited to his combined adjusted bases for his stock and indebtedness,⁷⁸ it is clear that a shareholder receives no benefit from losses beyond his investment. Although the statute and regulations are silent on the point it would seem that losses should also be allowed to the extent that the shareholder has guaranteed indebtedness to others.⁷⁹ By way of contrast, the partnership provisions, although they limit a partner's loss to his basis⁸⁰ do permit an increase in that basis for liabilities of the partnership⁸¹ even though such liabilities may be limited to specific partnership property with no personal liability upon the partners.⁸² The above provisions give rise to a serious but often overlooked limitation upon the effective utilization of losses generated by a tax option corporation. As indicated above,⁸³ the corporation's operating losses are deductible by the shareholders in proportion to their stock ownership. At the same time the losses allowed are applied against the bases of both the stock and the loans. The interrelationship of these rules can lead to the curious situation where one shareholder would be entitled to losses but has no basis against which to absorb them while another shareholder has adequate remaining basis but no losses to deduct. Suppose, for example, that stockholders A and B each contribute 5,000 dollars to a corporation and each receive one-half of the corporate stock in return. Shareholder A then loans 10,000 dollars to the corporation. If the entire 20,000 dollar investment is consumed by deductible expenditures creating a 20,000 dollar loss, A and B would each have 10,000 dollars of the loss allocated to him. However, since B has only a 5,000 dollar basis for his total investment, his deductible loss would be limited to 5,000 dollars and the remaining 5,000 dollars of his share of the loss would never produce a tax benefit. On the other hand, A, with a 15,000 dollar basis for his total investment, would be entitled only to a 10,000 dollar deduction.

Important in this regard is a recent ruling⁸⁴ on shareholder indebtedness, the basis of which has been reduced through the application

⁷⁷ INT. REV. CODE OF 1954, § 1376(b) (2).

⁷⁸ INT. REV. CODE OF 1954, § 1374(c) (2).

⁷⁹ Of course, this conclusion assumes that such guarantees do not create a second class of stock under the doctrine of *Murphy Logging Co. v. United States*, 239 F. Supp. 794 (D. Ore. 1965).

⁸⁰ INT. REV. CODE OF 1954, § 104(d).

⁸¹ INT. REV. CODE OF 1954, § 752(a).

⁸² Treas. Reg. § 1.752-1(e) (1956).

⁸³ See note 75 *supra*.

⁸⁴ Rev. Rul. 64-162, 1964-1 CUM. BULL. 304.

of the above provisions. As a result of the basis adjustments, when the face amount of the loan is repaid to the shareholder there will clearly be a gain. However, this ruling holds that the gain falls under the general statutory provision dealing with retirement of corporate indebtedness⁸⁵ and, therefore, with certain exceptions not here pertinent, the gain would qualify as capital gain. For that matter, assuming that the corporation has no accumulated earnings and profits from non tax-option years, amounts paid in "retirement" of stock should be subject to the same treatment⁸⁶—notwithstanding that the redemption is otherwise nonqualifying. It would appear, especially in view of the points discussed in the preceding two paragraphs, that, contrary to the situation of a conventional corporation, the tax option corporation is generally better advised to be capitalized entirely with capital stock and no loans. This would solve the *Catalina Homes* problem while, at the same time, permitting full utilization of losses and not interfering with withdrawal of corporate earnings.

V. CAPITAL GAINS

As we have seen, items of income and expense of the tax option corporation generally do not retain their character in the hands of the shareholders. One notable exception to this rule occurs in the case of long term capital gains.⁸⁷ Each shareholder is entitled to treat as long term capital gain that portion of the corporation's long term capital gain in excess of short term capital losses which the dividends distributed or deemed distributed⁸⁸ to him bear to the total dividends includable in the gross income of all shareholders.

This provision offers an obvious advantage to any corporation which enjoys a substantial capital gain in one taxable year.⁸⁹ However, it is to be noted that this section does not broadly transmit all capital gains intact at the shareholder level. Net short term capital gains are merely included with other income and thus are not available to absorb the shareholder's capital losses from other sources. Likewise, since capital losses are deductible by corporations, including subchapter S corporations,⁹⁰ only to the extent of capital gains,⁹¹ net capital losses of a tax option corporation would not be available to offset other

⁸⁵ INT. REV. CODE OF 1954, § 1232.

⁸⁶ INT. REV. CODE OF 1954, § 301(c).

⁸⁷ INT. REV. CODE OF 1954, § 1375(a).

⁸⁸ INT. REV. CODE OF 1954, § 1373, discussed pp. 689-93 *supra*.

⁸⁹ *Caveat*: If the capital gains are from the sale of stock or securities, and such gains, together with rental, dividend, and other such income exceed 20% of gross income, the tax option status will terminate, see INT. REV. CODE OF 1954, § 1372(e) (5). In such a situation, an installment sale might be used to prevent termination.

⁹⁰ See text accompanying notes 3-7 *supra*.

⁹¹ INT. REV. CODE OF 1954, § 1211(a).

capital gains earned by a shareholder. There is, of course, a five year carryforward for corporate capital losses,⁹² and there would appear to be nothing to prevent a tax option corporation from using that carry-over to offset its subsequent capital gains even though such gains are actually passed on to the shareholders.⁹³ The shareholders would report as long term capital gain the net amount after application of the carryforward.

It would also seem clear that the character of gains as section 1231 gains (dealing with real or personal property used in the trade or business) does not pass through to the shareholders. Thus, a qualifying corporation might have gain from the sale of section 1231 assets, while the individual shareholder might have had ordinary losses on similar dispositions or vice versa—he would not be required or permitted to net the two items against each other.

One unsettled question in this area involves the characterization of particular assets as "capital assets." Generally speaking, it appears that a shareholder's "dealer" activities are not imputed to a corporation, not even to his solely owned corporation.⁹⁴ There is nothing in the statute to suggest that the same rule would not apply to a tax option corporation. However, the regulations, again questionably, provide:

[I]f an electing small business corporation is availed of by any shareholder or group of shareholders owning a substantial portion of the stock of such corporation for the purpose of selling property which in the hands of such shareholder or shareholders would not have been an asset, gain from the sale of which would be capital gain, then the gain on the sale of such property by the corporation shall not be treated as a capital gain.⁹⁵

As in the case of distributions generally,⁹⁶ distributions of capital gains lose their original character if they are distributed after the termination of tax option status. In addition, if a corporation earns a substantial capital gain in one tax year but does not distribute it until a succeeding year, it may be that, even in the absence of the termination, the distribution will be taxed as a dividend.⁹⁷ These

⁹² INT. REV. CODE OF 1954, § 1212(a).

⁹³ However, net *operating* losses incurred prior to election of subchapter S status are of no avail unless and until the status is terminated. After termination, the corporation may deduct the loss, providing the five year time period, see INT. REV. CODE OF 1954, § 172, including years of tax option status, has not expired.

⁹⁴ Ralph E. Gordy, 36 T.C. 855 (1961), *acq.*, 1954-1 CUM. BULL. 4; cf. S. Nicholas Jacobs, 21 T.C. 165 (1953).

⁹⁵ Treas. Reg. § 1.1375-1(d) (1959).

⁹⁶ INT. REV. CODE OF 1954, § 1375(d); see text accompanying note 66 *supra*.

⁹⁷ To the extent of earnings and profits of the later year, see INT. REV. CODE OF 1954, § 1373; Treas. Reg. § 1.1373-1(d) (1959), this may exceed earnings otherwise taxable to the shareholder in that year.

hardships were partly alleviated by the Revenue Act of 1964 which introduced a provision⁹⁸ to the effect that a corporation may distribute on or before the fifteenth day of the third month following the close of its taxable year the proceeds of the sale of capital assets or section 1231 assets. Such distributions will be treated as though made on the last day of the taxable year providing they are made pursuant to a resolution adopted before the close of the taxable year.

It is apparent that the transmission of capital gains intact to the shareholders can lead to a situation where a corporation files a "one shot" election in order to distribute the proceeds of one substantial capital gain. The Service apparently does not question that this can be accomplished under existing laws. Election of tax option status can accomplish this more effectively, and with more certainty, than a partial liquidation. The tax option route would also be a useful alternative in a twelve month liquidation⁹⁹ where assets are sold on the installment basis. Generally, to avoid corporate tax, the seller is obliged to distribute the note. Such distribution in effect negates the installment basis.¹⁰⁰

However, at the request of the Service, legislation has been introduced in the present session of Congress to correct this result.¹⁰¹ Under the proposed bill a corporation would have been denied tax option treatment where in any taxable year it earned a capital gain in excess of 25,000 dollars and such capital gain exceeded the corporation's income unless the corporation had been a tax option corporation for at least three years. Although the proposal was not enacted in 1965, the Treasury is likely to continue to seek the correction. This could create an undue hardship to corporations not in existence for three years or for those corporations which, for their own reasons, had not chosen tax option status until the year of the gain. A better, although less easily administrable, solution would lie in requiring the taxpayer to demonstrate that its election was not motivated primarily by its desire to distribute the proceeds of a capital gain to its shareholders.

CONCLUSION

Subchapter S, enacted to afford tax relief to small businessmen, has had engrafted upon it congeries of complications, mostly resulting from regulations and rulings of the Internal Revenue Service, mostly in effect negating the congressional purpose of tax relief. The complexity

⁹⁸ INT. REV. CODE OF 1954, § 1375(e).

⁹⁹ INT. REV. CODE OF 1954, § 337.

¹⁰⁰ INT. REV. CODE OF 1954, § 453(d).

¹⁰¹ H.R. 9883, 89th Cong., 2d Sess. (1966).

of these regulations has resulted in the legislation's failure to accomplish another of its avowed purposes—simplicity, particularly in the areas of "classes of stock" and withdrawal of earnings. There is thus an urgent need for correction of many of the principles enunciated by the regulations. Corrective legislation would be the most effective method. For the present, however, it is probable that these principles will be seriously questioned only in litigation. The results of such litigation will determine what ultimate success the IRS will have in interpreting the statute in a manner inconsistent with its remedial purposes.