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SINCE THE ADDITION OF SUBCHAPTER S to the 1954 Internal Revenue Code in 1958,[1] many articles have been written on the interpretation and application of the provisions of this Chapter to various factual situations. Conjecture and uncertainty were the bywords for a large number of these articles, for at the time of their publication, the final Regulations and pertinent Internal Revenus Service Rulings on the subject had not been promulgated. The subsequent promulgation and issuance of these Regulations and Rulings,[2] therefore, had the effect of abrogating many of the proposals which had been advocated in these articles. These Regulations and Rulings did not answer all of the questions, and until such time as there is case law on the subject, there will remain many unanswered questions.

This article could not, and it does not, deal with the complex Subchapter S provisions of the Code in light of their impact upon each particular fact situation, but it is the hope of this author that the considerations brought forth herein will be of value in assisting the attorney to better appraise his client's situation in relation to Subchapter S.

History of Subchapter S

The 1954 Internal Revenue Code, as enacted, contained legislation permitting proprietorships and partnerships to elect to be taxed like corporations.[3] There was not any provision in the Code permitting stockholders of a corporation to elect to be taxed on corporation income on their individual tax returns, and to forego the tax at the corporate level.

Such a provision was recommended by President Eisenhower in his Budget Message to the Eighty-third Congress when he said:

(Editor's Note: This article should not be taken to represent the official views or policies of the Internal Revenue Service. Unless otherwise indicated, section references are to sections of I. R. C. 1954.)

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1 Technical Amendments Act, Public Law 85-866, Sec. 64 (1958).

2 24 Fed. Reg. 1911 (1959), approved Dec. 1959.

3 Sec. 1361.

> Small businesses should be able to operate under whatever form of organization is desirable for their particular circumstances without incurring unnecessary tax penalties. To secure this result, I recommend that corporations with a small number of active stockholders be given the option to be taxed as partnerships . . . .[4]

This provision was not enacted. In 1958, the Senate and the President's Cabinet Committee on Small Business urged the enactment of such a provision, and the President reaffirmed his earlier position on the subject.[5] This time, the views of the President, the Committee and the Senate prevailed, and a provision, such as the one recommended by the President, was enacted in 1958.[6]

Sections 1371 through 1377 were incorporated into the 1954 Internal Revenue Code to cover the provision in question, and in tax parlance, a corporation which availed itself of the election, came to be known as either a Subchapter S corporation, a small business corporation, a tax option corporation, a Section 1371 corporation, an electing corporation, or a pseudo-corporation.

The Provision in General

Generally speaking, the provision, as enacted, enables shareholders of certain corporations to elect to have corporation income, whether distributed or not, taxed to them as shareholders on their individual federal tax returns in lieu of the corporation paying taxes on such income at the corporate level.[7] There are certain restrictions in regard to the dividend exclusion and credit to the shareholders on the corporate income which is included in their returns, as well as a restriction in regard to the amount of corporate capital gains, which can be reported as such by the shareholders.[8] In the case of corporation net operating losses, each shareholder is entitled to a deduction, within specific limits, for a portion of the loss, depending upon the per cent of stock ownership and the holding period of the stock.

Since the provisions of Sections 1371 through 1377 only apply to certain types of corporations, it becomes necessary to deter-

[4] Such a provision had been advocated each year since the enactment of the 1954 I. R. C.

[5] S. Rep. No. 1983, 85th Cong., 2d Sess. 87 (1958).

[6] Subchapter S, I. R. C., 1954.

[7] Sec. 1373(b).

[8] Sec. 1375.

mine what the requirements are for a corporation to be eligible to make the election. Section 1371 sets forth the requirements, which in essence are:

(1) The corporation must be a domestic corporation.

(2) The corporation must not be a member of an affiliated group (defined in Section 1504 of the 1954 Internal Revenue Code).[9]

(3) The corporation cannot have more than ten shareholders.

(4) Every shareholder must be either an individual or an estate.

(5) A shareholder cannot be a non-resident alien.

(6) The corporation cannot have more than one class of stock.

In addition to the above requirements, Section 1372 sets forth further obstacles to a valid election. They are as follows:

(1) An election shall terminate for any taxable year of the corporation in which such corporation derives more than eighty per cent of its gross receipts from sources outside of the United States.

(2) An election shall terminate for any taxable year of the corporation in which such corporation derives more than twenty per cent of its gross receipts from royalties, rents, dividends, interest, annuities and the sale or exchange of stock or securities (only to the extent of gains on such sales or exchanges).

Several of the enumerated requirements deserve further elaboration. The provision that a corporation cannot have more than ten shareholders has been clarified by an amendment to Section 1371 which added the proviso to that Code section,[10] that a husband and a wife will be considered as one shareholder when the stock is held as community property or when it is held as joint tenants, tenants by the entirety, or as tenants in common.[11] Internal Revenue Bulletin No. 21, issued in 1959, contained Internal Revenue Ruling No. 59-187 which held that the constructive ownership of stock provisions utilized in conjunction

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[9] But see Treas. Reg. 1.1371-1(c) (1959).

[10] Treas. Reg. 1.1371-1(d) (2) (1959); 1959 Int. Rev. Bull. No. 45, at 22.

[11] This amendment applicable only to years beginning after December 31, 1959.

with Section 542 of the Code, for determining personal holding company status, will not have any application in determining the number of shareholders under Section 1371. The Ruling went on to say that:

> Where there are more than ten shareholders of a corporation, the corporation does not qualify as a small business corporation under Section 1371 of the Code, even though the shares are held by related individuals. For this purpose, each individual is considered as a shareholder.

Persons for whom stock in a corporation is held by a nominee, agent, guardian, or custodian will generally be considered shareholders of the corporation.[12] The fact that every shareholder must be either an individual or an estate, will prohibit a corporation which has a partnership as a shareholder from being eligible to make a valid election when the stock is owned by the partnership; for in such a case, the partnership, and not the individual partners, is considered the shareholder.[13] The requirement that the corporation must have only one class of stock refers to one class of stock issued and outstanding.[14] It is important, though, to point out at this time, that outstanding stock which appears to be one issue, due to the fact that it carries one identical name, such as the term common stock, will, in essence, be considered as separate stock issues if the shares are not identical with respect to the rights and interests which they convey in the control, profits and assets of the corporation. Also, to be considered is the fact that certain instruments purporting to be debt obligations may actually be a second class of stock.

At the time of the issuance of the provisions, one of the most perplexing questions raised was, what constitutes rental income? This was an important determination, due to the twenty per cent limitation outlined previously. The Regulations alleviated this dilemma by defining the term rents.[15]

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[12] Treas. Reg. 1.1371-1(d) (1959).

[13] Rev. Rul. 59-235, 1959 Int. Rev. Bull. No. 28, at 13.

[14] Treas. Reg. 1.1371-1(g) (1959).

[15] Treas. Reg. 1.1372-4(b) (5) (iv) (1959).

How the Election is Made

Essentially, the election is made by anyone who is authorized to sign the information return for the corporation which is required to be filed in accordance with Section 6037 of the Code together with the elections of all of the shareholders.[16] The individual submitting the election for the corporation, utilizes Form 2553 for this purpose. The individual shareholders' consents must accompany the corporate election when it is submitted to the Internal Revenue Service. The Regulations and the Code contain elaborate and detailed provisions and requirements in regard to the information to be disclosed in the election form and the consents, the procedure to be followed by an individual or estate who becomes a shareholder after the election is filed, and the dates controlling the filing of the election and the consents.[17]

In passing, it is important to note that the decedent and the estate are two different shareholders. Therefore, it is necessary for the executor or administrator of the estate to consent to the election within the prescribed period of time in order to prevent the election from terminating.

Considerations in Incorporating

The important aspect of incorporation, in regard to Subchapter S, is foresight rather than hindsight. Without exception, serious consideration to the provisions and requirements of Section 1371 must be given at the time the client contemplates the corporate entity as a form of enterprise. This is true, whether or not it is considered at the time of incorporation, to make the Subchapter S election. These considerations could alleviate the time-consuming, and many times involved, capital structure adjustments and financial expenditures which would otherwise be necessary when the shareholders, at a date subsequent to the date of incorporation, wished to avail themselves of the election.

It is obvious that certain corporations, due to the size and type of the operations, and the complex capital structure involved, will be unable to consider the exacting requirements of the Code in regard to Subchapter S. Therefore, it follows that

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[16] The Internal Revenue Service Form for this return is presently Form 1120-S.

[17] Sec. 1372; Treas. Regs. 1.1372-2 and 1.1372-3 (1959). See also Rev. Rul. 60-183, 1960 Int. Rev. Bull. No. 19, at 22, stating that an extension of time for filing the election will not be granted.

we are only talking of the corporations which can, by serious deliberation, and without interference with the operations of the organization, establish a corporate form of enterprise, which will enable the shareholders to avail themselves of the tax-option status in the future, without first undergoing the detailed, costly, and time-consuming programs involving changes in the capital structure and the operational pattern of the corporation.

Incorporation, followed by the election of the tax-option status, may be ideally suited for individuals operating certain unincorporated enterprises where it is advantageous to obtain the limited liability, continuity of existence, flexibility, or credit position of a corporation.[18]

It may also be beneficial to incorporate to obtain the benefits in the area of sick pay plans,[19] qualified pension and profit-sharing plans and group insurance plans.[20] All of these advantages may be obtained while the income of the corporation continues to be taxed to the shareholder, who was the sole proprietor, or to the shareholders, who were the partners.

The corporation may also be availed of in order to postpone the payment of income tax due on a portion of the business income by shifting income between years. For example, an individual proprietor of a business reports the total of the business income for the entire year on his individual federal tax return for such year. The corporation, in electing a fiscal year as the annual accounting period,[21] may properly defer income from one year to another. This can be done by declaring and paying a dividend to the shareholders in the calendar year falling within the first part of the fiscal year of the corporation; the shareholders would report this dividend as income in the year of receipt. This distribution will reduce the remaining undistributed taxable income of the corporation which must be reported by the shareholders in the calendar year when the fiscal year of the corporation closes.[22] Therefore, depending on the circumstances

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[18] Willis, Incorporate and Elect Subchapter S? Pros and Cons for Proprietors, Partners, 11 J. Taxation 66 (1959); Caplin, Partnership or S Corporation? A check list of the tax factors in the choice, 12 J. Taxation 32 (1960); Use of Subchapter S for Incorporated Talent, 108 J. Accountancy (3) 80, Tax Clinic (1959); A Tax Comparison of the Limited Partnership and the Subchapter S Corporation, 43 Minn. L. R. 964 (1959).

[19] Sec. 105.

[20] Sec. 401. See also Sec. 501.

[21] Sec. 441.

[22] Sec. 1373(b).

of each particular factual situation, it is possible to level the tax brackets to some extent for a period of at least two years, and if the corporation can properly control the receipt of income, the equalization of rates can be correspondingly increased for a longer period of time.

The Corporate Client and Subchapter S

In regard to the corporate client, there may be many advantages in making the election. Among the more prevalent considerations are the following:

(1) The tax brackets of the individuals may be less than the corporate tax bracket.[23]

(2) Double taxation will be avoided in the case of shareholders who are not drawing salaries as employees of the corporation, and who can only receive a share of the corporate earnings through the medium of the dividend.

(3) When the corporation can not avail itself of the net operating loss provisions of Section 172 of the Code, the shareholders may be entitled to deduct such losses. The deductions allowable to the shareholders would be limited to their investment in the corporation.[24] It may also be advantageous to allow the shareholders the deduction for the corporate losses when they are in a higher tax bracket than the corporation.

(4) The issues of excessive officers' compensation,[25] accumulated earnings and thin incorporation may be abrogated.[26]

(5) Personal service income could be taxed to the individual without incurring the personal holding company tax liability.[27]

(6) Election of Subchapter S, during a corporate liquidation, may solve some of the problems which result when

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[23] S. Rep. No. 1983, 85th Cong., 2d Sess. (1958).

[24] Sec. 1374(c) (2).

[25] But see Sec. 267(a) (2).

[26] *Be Careful*, the indebtedness may actually be considered as a second class of stock, and the repayment of the indebtedness would be considered as equity capital.

[27] Sec. 541.

liquidation is contemplated under Section 337 of the Code.[28]

Among the disadvantages of electing the tax-option status are the following:

(1) The corporation loses all of the benefit of the net operating loss carryback and carryover provisions of Section 172 of the Code. The shareholders' deduction for corporate operating losses is limited to their investment in the corporation.[29] The result of this is that the portion of the losses not allowable as a deduction to the shareholders would be lost as a tax deduction.

(2) The corporate earnings may be taxed at a higher rate to the shareholders than they would be taxed to the corporation.[30] If the shareholders could postpone the withdrawal of earnings, and still not be subject to the accumulated earnings tax,[31] it might be more beneficial to allow the corporation to incur the tax on the earnings, and to pass the earnings on to the shareholders at a later date via the route of the liquidation.[32] In such a case, it may be that the overall corporation income tax and individual capital gains tax would be less than the taxes which would be due under an election.

(3) A termination, voluntary or involuntary, or a revocation of the election once made,[33] will cause any subsequent distribution to shareholders of undistributed taxable income of prior years to be taxed as a dividend in the year of distribution, even though this income was taxed in prior years to the shareholders.[34] An example

[28] Sec. 337 of the Code requires that operating losses be offset against the income before the distribution of the income as capital gains. An election under Subchapter S might take the capital gain out of Sec. 312 definition of earnings and profits. Therefore, the operating loss could be deducted by the shareholders under Sec. 1374, and the liquidation under Sec. 337 would allow the shareholders to report the entire capital gain notwithstanding the capital gain limitation set forth in Sec. 1375(a) (1).

[29] Sec. 1374(c) (2); Treas. Reg. 1.1374-1(b) (4) (1) (1959).

[30] Corporation profits are taxed at the rate of 30% on the first $25,000.00 of taxable income and at the rate of 52% on the excess over that amount.

[31] Sec. 531.

[32] Secs. 331-337, 346.

[33] Sec. 1372(c).

[34] Treas. Reg. 1.1375-4 (1959) requires that the corporation must be an electing corporation at the close of its taxable year to enable it to make tax free distributions of prior years undistributed income within such year.

of an involuntary termination is where the number of shareholders exceeds ten when a shareholder dies and the stock of this shareholder is transferred to any number of legatees, thereby bringing the total number of shareholders over the limitation. It may be feasible to attempt to avoid this situation by the adoption of a buy-and-sell agreement among the shareholders or between the shareholders and the corporation.

(4) One of the objects of electing, in the case of a corporation which has sustained operating losses, is to enable the shareholders to avail themselves of these losses. This objective would not be fulfilled when a shareholder acquires the stock at or near the end of the taxable year of the corporation, for the operating loss is apportioned among the shareholders based upon the number of shares held and the holding period of such shares.[35]

(5) It may be that a net operating loss of the corporation could be carried back to a year when the corporation was in the fifty-two per cent bracket. It may, therefore, be more advantageous to apply the loss against this prior year rather than to elect, for the shareholders may be in a lower tax bracket.

(6) Corporations with net operating loss carryovers in effect at the time of an election will not receive any benefit from these carryovers, for the taxable income of an electing corporation is computed without regard to such carryovers.[36] Also to be considered is the fact that the years in which the corporation has made an election count as years to which the corporation's operating losses are carried over or back.[37]

(7) The taxable income of an electing corporation is computed without regard to the otherwise allowable corporate deductions enumerated in Sections 241 through 247 of the Code. One of the more important of these deductions is the eighty-five per cent dividend credit.[38] Therefore, it is possible that the benefit to be derived from an election, in that the shareholders are in a lower

[35] Sec. 1374.

[36] Sec. 1373(d).

[37] Treas. Reg. 1.1374-1(a) (1959).

[38] Sec. 243.

tax bracket than the corporation, would be offset by the fact that the shareholders will pay tax on the entire dividends.

(8) An electing corporation is still subject to the collapsible corporation provisions of Section 341 of the Code.[39]

State Taxation and Subchapter S

The results which an election may have on state taxation depends upon the types and methods of taxation in effect in each particular state. Inasmuch as many of the states have not yet announced their position, it is not possible at this time to explore all of the ramifications of the election on state taxation. Several of the more interesting questions are:

(1) If the state has a corporation income tax, will the tax continue to be assessed on the corporation's income at both the corporate level and at corporate tax rates? If the tax is to be assessed against the shareholders, will it be a tax based only on the distributed income as a dividend, or will it be on the entire income, distributed and undistributed alike?

(2) If the state income tax is assessed upon the corporation, will the corporation be entitled to a deduction on the state return for federal taxes paid on the income by the shareholders?

(3) If the state tax is levied upon the shareholders on the distributed income only, will the shareholders, in the year of distribution and taxation by the state, be entitled to a deduction for federal taxes paid in prior years when the income was included in the federal tax returns of the shareholders as undistributed taxable income of the corporation?

(4) Will the undistributed taxable income included in the federal returns of the shareholders be included in the intangible personal property tax returns of the state?

(5) Corporation franchise tax in many states is based upon a computation of the net income of the corporation. What effect will an election have on this computation?

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[39] Treas. Reg. 1-1372-1(c) (8) (1959) in regard to collapsible corporation provisions; Treas. Reg. 1.1375-1(d) (1959) in regard to limitation on capital gains taxed to shareholders under Subchapter S.

From these brief but perplexing questions, it is obvious that the ramifications of state taxation must be considered in every situation where the election of Subchapter S is contemplated.

What Are the Answers

How are gross receipts under the installment sales method computed? [40] What effect does the election have on a subsequent change in the annual account-period of the corporation? [41] Where does the taxable income of an electing corporation fit into the scheme of the declaration of estimated tax? [42] Will a self-employed person who is not eligible for social security benefits, inasmuch as he has self-employment income, be entitled to incorporate and elect Subchapter S? If the individual could separate himself from the self-employment income, it would mean that:

(1) He would be eligible to receive social security benefits, for the distribution of the self-employment income from the corporation would now be considered a dividend.

(2) He would avoid paying self-employment tax.

(3) If he was married, it would be possible for his wife to receive as much as one-half of his monthly benefit check.

Will the repayment of loans by the corporation to the shareholders create capital gains income or ordinary income, when the shareholders have previously availed themselves of the basis of such loans in deducting net operating losses?

These are only a few of the many unanswered questions which remain today in regard to Subchapter S. It appears, though, that notwithstanding these ambiguous areas, the availability of Subchapter S in certain situations has enabled small businesses to elect a form of organization which is not based solely on the tax considerations which are peculiar to any one type of enterprise. The only words of caution needed at this point are—Look Before You Leap.

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[40] Roberts, Determination of Gross Receipts; Installment Sales-Subchapter S, 108 J. Accountancy (2) 78, Tax Clinic (1959).

[41] Change of Fiscal Year After Filing Form 2553, 109 J. Accountancy (5) 84, Tax Clinic (1960).

[42] Farrand, Partner's Use of Subchapter S in Declaration of Estimated Tax, 108 J. Accountancy (4) 79 (1959); Farrand, Tax Clinic, 109 J. Accountancy (5) 80 (1960).