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# Subchapter S--Election of Small Business Corporations\*

By MORTIMER M. CAPLIN†

Subchapter S of the Code—sections 1371 through 1377—was enacted in September 1958 to permit businesses “to select the form of business organization desired, without the necessity of taking into account major differences in tax consequences.” Under its elective provisions, no corporate tax is paid; rather, the corporation’s current taxable income is included on a per share basis in the gross income of the stockholders. Generally, they report this as ordinary income, except for certain long-term capital gain which retains its character in their hands.

This new tax pattern, publicized as “partnership type tax treatment” was adopted so that subchapter S could operate “in as simple a manner as possible.” In practice, however, subchapter S fails to meet its limited stated purpose. S shareholders are not taxed like partners; and tax planners, who typically were limited to partnership-versus-corporation considerations, now make a tripartite analysis in determining the optimum tax results: partnership-versus-corporation-versus subchapter S. The differences in tax consequences can be “major” and the tax-savings possibilities startling.

In addition—chiefly due to its divergence from partnership taxation—subchapter S is fast becoming an important “tax gadget.” Already, it has been widely publicized as a patented cure-all for a wide variety of serious tax ailments: for family income-splitting and for “employee” fringe benefits, for accumulated earnings and for personal-service personal holding companies, for collapsible corporations and for borderline partial liquidations—in fact, for any liquidation not otherwise assured of a single capital gain.

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Aside from manifesting many policy conflicts with other code sections, subchapter S is also a sophisticated and complex provision. A full understanding of its operation demands knowledge not only of its novel terminology, but also of the refinements of taxing individuals, corporations, as well as partnerships. Comparison of each of these systems of taxation must be made if subchapter S is to be used intelligently

In short, subchapter S has a Lorelei-like quality which can easily entrap the uninitiated. It contains unexpected quirks and reflects dubious policy distinctions. If the continuance of this legislation is still warranted, far-reaching amendments should be made as rapidly as possible.

#### SUBCHAPTER S VERSUS PARTNERSHIP

It is true that an S corporation, like a partnership, is not a taxable entity. Income taxation is imposed upon the respective participants, while the organization itself is merely required to make annual filings in the nature of information returns. But at this point the similarity ceases, for the variations between the two are myriad.

*Taxable year*—A partnership may not adopt or change to a taxable year other than that of all its principal partners unless it demonstrates a business purpose to the Commissioner's satisfaction. In contrast, a new S corporation has complete freedom in selecting an initial fiscal year, permitting deferral of income tax for as much as 11 months along with many other tax-savings possibilities.

*Compensation arrangements*.—A partner is not an "employee" under the Internal Revenue Code; a shareholder of an S corporation could be. Consequently, only the latter could qualify for tax benefits under qualified deferred compensation plans, accident and health plans, "convenience of employer" rules, group term life insurance, employee death benefits, as well as restricted stock options. Numerous compensation arrangements are therefore available to an S corporation but denied to a partnership.

*Character of income and deductions*.—The partnership is a true conduit: the character of receipts or deductions is determined at the partnership level and then transferred to the individual partners. An S corporation operates almost completely contrari-

wise; for its "taxable income" is computed at the corporate level with no carry-through to shareholders of income or deduction characteristics, except as to net long-term capital gain. For example, while interest on the obligations of a municipality is not part of the S corporation's taxable income, it would be included in corporate "earnings and profits" and could bring dividend treatment on actual distribution to shareholders. Similarly, while the S corporation's taxable income is reduced by a percentage depletion deduction, its earnings and profits would only be charged with cost depletion; and actual distributions to shareholders could result in dividends beyond the corporation's taxable income for the year. Another illustration of this noncharacterization rule is the S corporation's receipt of dividends from other corporations: for, regardless of subsequent distribution of these dividends, S shareholders would not obtain a dividends received credit, retirement income credit or §50 exclusion.

*Capital gain.*—The single characterization exception in subchapter S is the special recognition given to a shareholder's pro rata share of the excess of the corporation's net long-term capital gain over its net short-term capital loss. Yet, even in this instance, capital gain treatment is limited to the shareholder's share of the corporation's taxable income and does not conform to the partnership pattern in several important respects.

For example, if an S corporation has a \$100 net gain under section 1231, long-term capital gain is available despite a shareholder's individual \$100 net loss under this same section. In effect, he would pay a 50-percent tax on the \$100 received from the corporation, and would be allowed a full \$100 deduction for his personal section 1231 loss. Under the partnership form, these two transactions would offset each other, which seems the more desirable result.

Again, if there were \$100 net long-term capital gain but \$100 net operating loss, the absence of taxable income would deny capital gain reporting by S shareholders; although, in a partnership, the conduit approach would assure \$100 long-term capital gain as well as \$100 ordinary loss. Further, a net capital loss of an S corporation does not pass through to shareholders, but is apparently available at the corporate level for 5 years as a capital loss carryover. In a partnership, the partners immediately

incorporate any net capital loss into their individual income tax returns.

*Appreciated or depreciated property.*—Property contributed on organization of a partnership or S corporation will usually retain the basis of the transferor participant. And any discrepancies between basis and fair market value may have a sharp effect upon the amount of depreciation or, in a later sale or other taxable event, the amount of gain or loss. In the partnership form, adjustments are allowed among the partners to compensate for this differential; but no similar provision exists under subchapter S.

*Distributive share of income, deductions, etc.*—A partner's distributive share of any item of income, gain, loss, deduction, or credit may be determined by the partnership agreement—if the principal purpose is not tax avoidance. Under subchapter S, such an allocation would not be possible despite a business purpose.

*Limitations in computing taxable income.*—There are a number of dollar or percentage items in the Code limiting the deductibility or exclusion of an item in the computation of taxable income. Examples are: \$50 exclusion for dividends received; \$1,000 deduction limitation for excess capital losses; \$50,000 deduction limitation for so-called hobby losses; \$100,000 deduction limitation for exploration expenditures; percentage limitation on charitable contributions; and percentage limitation on soil and water conservation expenditures. All of these are applicable to partnerships, with the limitations apparently imposed at the individual partner level. The effect, however, is quite different under subchapter S. Thus, in the above examples, the first three would have no application to the S corporation, while the last three would be determined at the corporate level.

*Income shifting and splitting.*—Income shifting through family partnerships is sharply limited by statute and regulations. For example, a transfer of all or part of a partner's interest during the partnership's taxable year would require a proration of current income on a daily basis. Much greater freedom is allowed under subchapter S, particularly the provision which taxes "undistributed taxable income" for an entire year on the basis of share ownership on the last day of the corporation's taxable

year. So long as a transfer of stock is bona fide, a shift of an entire year's corporate income may be accomplished on the last day of the year. The only limitation is that contained in section 1375(c), permitting the Commissioner to apportion and allocate "to reflect the value of services rendered to the corporation" by shareholders within the family group.

Furthermore, with a new S corporation's freedom to select a fiscal year overlapping that of its shareholders, income can be split for the same shareholder between 2 taxable years: with cash distributions early in the corporate year taxed to him in his year of actual receipt, and the balance of the corporation's taxable income taxed to him in his taxable year in which the corporation's fiscal period ends. Had a partnership been involved, both his guaranteed payments and his distributive share of partnership items, actually or constructively received, would be bunched in a single taxable year—his taxable year in which the partnership year ends.

*Net operating losses.*—A partner's distributive share of partnership losses is allowed to the extent of the adjusted basis of his interest in the partnership at the end of the partnership year in which the loss occurred. In addition, a suspense account is established for any excess; and the partner is allowed a deduction at the end of any succeeding partnership year in which his adjusted basis increases sufficiently to offset any remaining unused loss. This flexibility is not available to the S shareholder; for his share of loss—"the sum of the portions of the corporation's daily net operating loss attributable on a pro rata basis to the shares held by him on each day of the taxable year"—is limited to his total adjusted basis for stock and for corporate indebtedness owed to him. To absorb an excess loss, the S shareholder must increase his basis pro tanto not later than the close of the corporation's loss year; otherwise this possible deduction is forfeited forever.

*Inside sales of appreciated property.*—A taxable sale of appreciated property by an organizer may bring different results depending on whether the purchaser is a partnership or an S corporation. Partnership provisions are more restrictive here; for, under section 707, capital gain is denied the partner (a) if the property is not a capital asset in the hands of the transferee—

partnership and (b) if the selling partner, under a broad constructive ownership test, owns more than 80 percent of the capital or profits interests of the partnership. Yet, the S shareholder, under the limited coverage of section 1239, would lose capital gain treatment only if (a) the property was depreciable in the hands of the corporation and (b) the selling shareholder, "his spouse, and his minor children and minor grandchildren" together owned more than 80 percent in value of the outstanding stock.

*Distribution in kind.*—Distributions in kind present few problems to a partner, except for "collapsible" items, *i.e.*, unrealized receivables and substantially appreciated inventory. Generally, no taxable event is involved: in current distributions, the partner takes over the partnership's tax basis; in liquidation, the partner allocates the basis of his interest in the partnership among the distributed assets in proportion to their adjusted bases to the partnership. Subchapter S has an entirely different approach.

Asset distributions are received by an S shareholder at fair market value, and taxation may result under a number of common circumstances. In current distributions, for example, the existence of current or accumulated earnings and profits may bring ordinary dividend treatment to the shareholder. This could follow under the proposed regulations even though his previously taxed income account was greater than the value of the property distribution. Or, it could result from a stock redemption essentially equivalent to a dividend. The best the shareholder could hope for would be capital gain on the excess of the distributed property's value over his stock basis, which would be the automatic rule if there were no earnings and profits. In liquidation, the S shareholder would similarly realize capital gain on the excess value of the property over his stock basis—unless election was made for special treatment under section 333.

*Previously taxed income.*—In the partnership form, no special difficulties arise in withdrawing previously taxed income—whether the distribution be in cash or other property, or whether the withdrawing party be the originally taxed partner, his donee, executor, or outside purchaser of his interest. Generally, gain will be recognized only to the extent that a money distribution exceeds the adjusted basis of the then partner's interest, and this will usually

be treated as capital gain. In contrast, distribution of previously taxed income of an S corporation is surrounded by many qualifications and complexities:

(1) Its benefits are not transferable, and it is treated as a nondividend distribution only if made to the person who paid the tax on the original income. Neither the donee, estate of the shareholder, nor any purchaser of his stock, could take advantage of his previously taxed income account. The transferor-shareholder, however, may regain his preferred position by again becoming a shareholder while the S corporation is subject to the same election.

(2) Under the proposed regulations, it is regarded as a nondividend distribution only if made in cash; for "a distribution of property other than money or a distribution in exchange for stock, or a constructive distribution under section 1373(b) is never a distribution of previously taxed income."

(3) The amount available for nondividend distribution must be reduced not only by prior nondividend distributions but also by net operating losses allowable to shareholders for prior taxable years.

(4) If the subchapter S election is terminated for any reason—whether by disqualification, voluntary revocation or nonconsent by new shareholders following death or otherwise—any undistributed taxed income forever loses its special status.

Of course, the nondividend treatment of previously taxed income has significance only if the S corporation has accumulated earnings and profits of current earnings in excess of taxable income. Otherwise, distributions could still be tax free under section 302(c)(2)

*Collapsible items.*—There is no coordination between the partnership provisions and subchapter S on collapsible items. Nor, for that matter, is there coordination between section 341 for collapsible corporations and the use of subchapter S to avoid this penalty treatment, although the proposed regulations seek to narrow this gap.

Following the distribution of a partnership inventory item, for example, the distributee partner will realize ordinary gain or loss if he disposes of the property within 5 years. There is no such automatic rule for an S shareholder. Again, on a partner's



sale or exchange of his partnership interest, or upon certain disproportionate distributions to him, an allocation is required under objective standards for unrealized receivable and substantially appreciated inventory, with partial ordinary income treatment. In contrast, an S shareholder would have to run the gamut of section 341, with all-or-none ordinary income dependent upon the intention of shareholders and other intricacies of that involved provision. Further, there is no similarity of definition of a collapsible item under section 751 for partnerships and section 341 for corporations, and totally different tax consequences could occur dependent upon the type organization involved.

*Buy-out arrangements.*—On buy-out of the venturer's interest after death or retirement, contrasting tax results may follow dependent upon whether the purchaser is a partnership or S corporation. Liquidating payments by a partnership to a retiring partner or successor of a deceased partner will generally be treated as a purchase of the partner's share of partnership property to the extent of the fair market value of this property. Amounts paid in excess of this value will be treated as a distributive share of partnership income or as a guaranteed payment. Special provisions are made for unrealized receivables and good will of the partnership: payment for the former is never treated as a purchase of the partner's share of partnership property, while payment for the latter is not considered such a purchase unless the partnership agreement so provides. If a "purchase" is involved, payments in excess of basis of the partner's interest in the partnership usually produces capital gain, with the remaining partners receiving no deduction for the amounts paid. But if the payments constitute a "distributive share" or "guaranteed payment," the retiring or successor partner reports this as ordinary income, while the remaining partners are able to reduce their taxable income.

S shareholders must look to general corporate provisions under subchapter C for taxation of their buy-out arrangements. Under section 302(a), the payments may qualify as a purchase with capital gain treatment for any excess over the seller's stock basis. At the same time, the broad constructive ownership rules of sections 302(c) and 318 may convert the redemption into a divi-

dend distribution with ordinary income consequences. Special relief may be found in section 303, treating certain redemptions of a deceased shareholder's stock as a purchase to the extent of death taxes and funeral and administrative expenses. However, in some corporate purchases there also exists the possibility that the continuing shareholders will be threatened with having received constructive dividends. Of course, the existence of current or accumulated earnings and profits would always be a prerequisite to possible dividend consequences.

*Death.*—On the death of a partner, the taxable year of the partnership does not generally close for him before the end of the partnership's regular taxable year. Exceptions to this would occur only on (a) prior termination of the partnership, (b) prior sale of the deceased partner's interest to outsiders or remaining partners, or (c) under the regulations, prior completion of liquidation of his interest. Under the general rule, therefore, his final income tax return does not include even his distributive share for the portion of the partnership year up to his death—whether or not he withdrew this during his lifetime. This portion, along with any remaining distributive share for the balance of the year, is reported in full by his estate or successor in interest in its taxable year in or with which the partnership's taxable year ends. Some tax relief is provided in the regulations by making 691 applicable to decedent's distributive share for the short period ending with his death, and an income tax deduction is available to the recipient of this "income in respect of a decedent" equal to the portion of the estate tax paid attributable thereto.

Death of an S shareholder produces completely dissimilar tax treatment. As a separate legal entity, the corporation continues in existence but its qualification under subchapter S will end unless the estate files a consent within the 30-day period after the appointment of an executor or administrator—such period to begin not "later than 30 days following the close of the corporation's taxable year in which the estate became a shareholder." Further, should the stock pass to a testamentary trust, the election would be lost immediately for such ownership falls outside the definition of a "small business corporation."

If the estate consents to continuing the S election, it will

pay income tax on the entire year's "undistributed taxable income" based upon its proportionate shareholdings at the end of the corporation's fiscal year. This probably will result in both an estate tax and a full income tax, as predeath "undistributed taxable income" does not seem to qualify under section 691. To the extent that decedent received actual distributions out of current earnings and profits, inclusion is required in his final income tax return, with a compensating reduction in the constructive dividend taxable to the estate. In contrast, if the election were continued but the corporation sustained a net operating loss for the year, the estate could claim only a portion of the loss based upon the number of days it held stock during the corporation's taxable year. And, beginning January 1, 1960, the predeath share of the year's loss would be available as a deduction in decedent's final income tax return.

Finally, there is the "locked-in" problem of previously taxed income. As noted above, the right to nondividend distributions of this income is personal in nature and cannot be transferred even by death. Consequently, if the S corporation had accumulated earnings and profits, or if there existed a discrepancy between taxable income and current "earnings and profits," withdrawal by the estate of decedent's previously taxed income would result in ordinary dividend treatment.

*Organizational expenses.*—Organizational expenses are often substantial. They include fees for legal services incident to organization, fees for necessary accounting services, costs of organizational meetings, and fees paid to State and local bodies. For partnerships, the Tax Court has held them to be capital expenditures and not deductible. Since 1954, however, section 248 permits corporations—which would include S corporations—to elect to treat them as deferred expenses deductible ratably over a period of 60 months or more.

*Miscellaneous.*—Many other discrepancies exist between the tax treatment of partners and S shareholders. Examples of unique partnership provisions are: optional adjustment to the basis of undistributed partnership property; optional adjustment to the basis of partnership property on transfer of an interest in a partnership; transferee partner's special basis under section 732(d),

alternative rules for determining adjusted basis of a partner's interest; termination on sale or exchange of 50 percent or more of the total interest in partnership capital and profits, etc.

Subchapter S thus resembles the taxation of partnerships only in the remotest sense. Actually, it creates a new, hybrid, and extremely complex tax system.

#### COMPLEXITIES ARISING FROM "EARNINGS AND PROFITS"

One of the extreme complicating factors inherent in subchapter S is the treatment of "earnings and profits." In its basic form under subchapter C, this elusive concept has as its principal purpose the measurement of dividend distributions. However, its policing problem is much more involved under subchapter S. In the first instance, earnings and profits serve as a ceiling in determining the normal annual taxability of S shareholders on actual and constructive dividends, and in determining the extent of the special treatment to be given to S dividends. At the same time, the definition of earnings and profits is kept flexible enough to reach additional distributions by old corporations with accumulated earnings and profits, corporations in receipt of items not includible in taxable income, and corporations incurring losses or expenditures not allowable as tax deductions.

#### *Current earnings: "three-tier system"*

Subchapter S also emphasizes the importance of distinguishing between current and accumulated earnings and profits. Thus, under section 1373(c), "undistributed taxable income" is computed by subtracting from taxable income all money distributions out of current earnings and profits. And under section 1375(b) only actual or constructive distributions out of current earnings are denied the dividends received credit, retirement income credit and dividends exclusion—but for this purpose, current earnings and profits are deemed to be never greater than the corporation's taxable income. In all events, amounts not allowable as deductions in computing taxable income may not, under section 1377(b), reduce current earnings and profits.

Modification of the current account may accordingly have numerous tax consequences under subchapter S, and additional attention will have to be given to its precise computation. It is of

importance to shareholders that current earnings and profits will be increased by the excess of percentage depletion over cost depletion and by the receipt of all income exempted by statute, such as municipal bond interest and life insurance proceeds. Also of significance is that a net capital loss will generally decrease earnings and profits, but for subchapter S purposes will not affect the current account as it is not an allowable tax deduction.

In view of this pressure on the current account, the proposed regulations establish a "three-tier system" for allocating current earnings and profits. In the first tier are actual money distributions not in exchange for stock—and current earnings and profits must first be allocated here. If there is any excess current earnings, it falls within the second tier and is allocated ratably to (a) constructive distributions of "undistributed taxable income" and (b) actual distributions in kind not in exchange for stock, which, for allocation purposes, are taken into account at fair market value. Finally, in the third tier, the remainder of such earnings is available for allocation to any distributions in exchange for stock—such as distributions under section 302 or 331.

#### *Previously taxed income*

Another complicating factor arises from distributions of previously taxed income ("PTI"). These distributions are not considered dividends and do not reduce earnings and profits. However, in what seems an unnecessary extension of the statute, the proposed regulations grant nondividend treatment only to money distributions of PTI. And, consistent with the foregoing three-tier system, these regulations recognize a PTI distribution only when money distributions exceed the corporation's current earnings and profits.

Before a shareholder receives credit for PTI, therefore, the full current earnings account must be exhausted. Under this interpretation, a shareholder could be taxed in one year on more than the corporation's taxable income, regardless of a large PTI account: on cash distributions equal to the taxable income of the year plus cash distributions equal to the amount by which the determination of current earnings exceeds the computation of taxable income.

Distributions in kind add further PTI problems. Such a distri-

bution, being ineligible for nondividend treatment, would be charged in the second tier against any remaining current earnings. If there were no such excess, then the distribution in kind would be taxable as a dividend to the extent of any accumulated earnings. Thus, despite the existence of large PTI, a shareholder could again be taxed in one year on more than the corporation's taxable income—on cash distributions representing the taxable income of the year plus the value of distributions in kind. Discrepancies between the computation of taxable income and the determination of current earnings and profits might themselves create a current earnings reserve sufficient to convert the distribution in kind into an ordinary dividend.

If there were merely an accumulated earnings account, distributions in kind would be costly while cash distributions equivalent to the PTI account would be tax free. Accordingly, S shareholders may attempt tax savings by first distributing cash and then using these funds to purchase corporate assets. A current tax on capital gain would certainly be preferable on a short-term basis to ordinary dividend treatment for distributions in kind. Of course, if no accumulated or current earnings balance existed, a straightforward distribution in kind would be more advantageous.

As a final fillip, the proposed regulations provide for a new PTI election: the S corporation, with the consent of all shareholders, may elect to treat distributions as coming from accumulated earnings and profits rather than from PTI. In other words, shareholders may decide to have money distributions in excess of current earnings taxed immediately as dividends to the extent of accumulated earnings. If the election is not made, automatic nondividend treatment will follow for the PTI balance.

### *Tax planning*

From all of this, it becomes apparent that a great deal of planning is necessary to determine the optimum tax results for S shareholders. This is particularly true when the S corporation's fiscal year differs from the taxable year of the shareholders.

Distributions in kind, for example, at the beginning of the corporation's year may have their tax treatment completely altered by cash distributions at the year's end. If there had been no cash distribution, the distribution in kind in the share-

holder's taxable year would be a second-tier distribution of current earnings, participating on a parity with undistributed taxable income. However, this would be changed by the corporation distributing its current earnings in cash at the end of its fiscal year—falling in the shareholder's taxable year succeeding his receipt of distributions in kind. The first-tier nature of this subsequent distribution would exhaust current earnings, thus stripping the prior distributions in kind of its current dividend status. Consequently, if there were no accumulated earnings, the prior year's distribution in kind would retroactively be converted into a return of capital, with its value in excess of stock basis qualifying for capital-gain treatment.

Thus, when the taxable year of the corporation includes portions of two taxable years of the shareholder, his prior year's income-tax return may have to be amended to reflect a change in his tax caused by voluntary corporate action at its year's end. This could occur through distributions in kind just described, and could likewise occur through the requirement that capital gains be allocated ratably to the various distributions of current earnings.

#### *Incentives for creating indebtedness*

As noted above, a shareholder's PTI position may be jeopardized by any of the following events: (1) transfer of all his stock by death, gift, or otherwise; (2) termination of the S election for any reason; and (3) corporate net operating losses. S corporations can avoid these problems by distributing by the end of each year the full amount of their current taxable income.

If the corporation cannot spare these funds, shareholders may be called upon to return the distributions by way of loans. The resulting distribution-lendbacks may thus create a whole series of new tax problems: whether the transactions are to be telescoped or disregarded as a "sham", whether they, in fact, constitute distributions of corporate obligations; whether they are contributions to capital rather than true loans; whether, if they initially seem to be loans, they are to be ultimately treated as "equity" under the thin incorporation doctrine.

In other words, the use of shareholder-held debt will be encouraged, and the debt-versus-equity problem will be accentuated in new proportions. The ultimate classification is extremely

crucial under subchapter S; for a determination that "equity" was intended may be held to create a second class of stock, disqualifying the election in its entirety

This special problem under subchapter S has a bearing upon the advisability of adopting a debt-equity ratio rule, similar to the proposed Code section 317(c)—contained in section 10 of H. R. 4459. Before such legislation is approved, its adequacy in the context of subchapter S should be clearly tested.

#### CONCLUSION

Technically, subchapter S contains many structural weaknesses and complexities. Also, distinctions it makes are often indefensible and inequitable. Despite only one year's experience under these provisions, Congress would be justified in striking it from the Code as bad law, not worthy of retention even in modified form.

There may be a desire, however, for continued efforts to draft a statute which would effectively permit "small" businesses to select forms of organization "without the necessity of taking into account major differences in tax consequences." If this pressure exists, subchapter S should be brought as close to partnership taxation as is possible. One approach would be that employed by the Senate Finance Committee in H.R. 8300, *i.e.*, treat the electing corporation as a partnership under subchapter K, subject to modifications contained in the regulations. Or, if this administrative latitude is deemed objectionable, the statute might generally follow subchapter K, but set forth the chief points of divergence required to accommodate the idiosyncracies of the corporate form.

As another alternative, subchapter S might be retained as a skeleton, with major amendments to eliminate its most objectionable features. If this were to be the pattern, legislation along the following lines would seem desirable:

I. The statute should be limited to new corporations. This would avoid the difficulties now encountered in adjusting for pre-election "accumulated earnings and profits." Further, if the "earnings and profits" concept is then retained at all, its definition under subchapter S should coincide with the definition of "taxable income" under section 1373(d)



II. Consideration should be given to modifying the definition of "small business corporation." In addition to the 10-shareholder rule, a dollar ceiling might be added comparable to section 1244(c)(2). Related to this, the statute would seem improved by deleting the prohibitions against foreign income and personal holding company income.

III. Events causing termination of an election should be reconsidered and further limited. Death, for example, need not retroactively defeat the election for the year in which death occurs despite the estate's refusal to give its consent. Transfers of small stock interests, also, might not require automatic termination if the transferee did not consent.

IV. The right to renew an election should be severely curtailed, particularly if the causes of termination are reduced. Freedom to shift back and forth between business forms creates tax-avoidance possibilities which far outweigh the advantages of providing greater flexibility.

V. The corporation's fiscal year should generally be limited to that of the principal shareholders, unless another period is supported by valid business reasons. In all events, a shareholder should be required to report his share of the corporation's full taxable income in his taxable year in which or with which the corporation's taxable year ends.

VI. Taxable income should be allocated among shareholders based upon their proportionate shareholdings for each day of the year—similar to the allocation of net operating losses.

VII. Shareholders should not be considered "employees," except possibly those holding less than five percent of the outstanding stock under a broad constructive ownership test.

VIII. Distributions in kind as well as in money should be charged against current earnings, and should be eligible for effecting PTI distributions when current earnings are accounted for.

IX. The nondividend status of the PTI account should be preserved despite stock transfers or termination of election, and should not be reduced by net operating losses. Further, greater latitude should be allowed in making PTI withdrawals. If only new corporations are permitted to make the S election and if

"earnings and profits" are made to coincide with "taxable income," PTI problems would arise primarily on termination of election.

X. Similar to a partner, the S shareholder should be permitted to claim any unused net operating loss in any year in which his stock or debt basis increases sufficiently to absorb his remaining share of the loss.

These are the major areas calling for modification. A more comprehensive program would involve adopting the partnership rules for (1) characterization of income and deductions, (2) capital gains and losses, (3) collapsible items, (4) dealings between shareholders and corporation, (5) current and liquidating distributions, and (6) payments to a retiring or deceased shareholder. While these additional changes are desirable, it is believed that the separately itemized proposals would eliminate most of the weaknesses, complexities and inequities of the existing statute.

The capital gain pass-through to shareholders has been cited as a principal source of abuse, but this would be minimized if subchapter S is limited to new corporations only. Proper handling of the capital gain problem would require provisions which, like the proposed regulations, test the capital nature of an asset by its character in the hands of the shareholders. It would also involve inquiry into the entire field of multiple corporations—a project worthy of full and immediate study.