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# Current Uses of Subchapter S

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FOR A GOOD MANY YEARS the main thing wrong with Subchapter S has been the Internal Revenue Service's interpretation of this section. Of course, this reaction extends to a good many other sections of the Code. When Subchapter S was first introduced into the Internal Revenue Code in 1958, for many taxpayers it appeared to be an ideal solution. They could select whatever form of business organization they desired and hopefully the income tax consequences would be predictable. To me it appears quite clear that this is what Congress intended, but then the IRS started issuing regulations. These regulations created a brier patch for the small-business man. Often he did not have access to competent tax advice, the advice he got often cost him more than he wanted to pay, and the accounting personnel to provide him with the information he needed when he needed it was lacking.

## REQUIREMENTS FOR SUBCHAPTER S ELECTION

Most of you are certainly familiar with the requirements that must be met in order to make and maintain a valid Subchapter S election, but a brief review may bring things more clearly into focus. A wise man once said, "The easiest way to get into trouble is to be right at the wrong time." This could be particularly true of a Subchapter S election. In brief, then, the requirements for the valid election include: (1) Shareholders must be either individuals (none of whom are nonresident aliens) or estates; (2) shareholders can number no more than ten, each must make a positive election, and the corporation must also make an election; (3) the corporation may have only 20 per cent of its gross receipts in certain types of passive, personal-holding-company type income; (4) there can be only one class of stock; (5) the corporation may not have a subsidiary in which it owns more than 80 per cent of the stock; (6) the corporation may not derive more than 80 per cent of its gross receipts from sources outside the United States. During the period since Subchapter S was first introduced, Congress, by passing new and modifying legislation, has made Subchapter S easier to apply. The remaining area that can give tax advisors fits is loss of the election through either the improperly made Subchapter S election or the subsequent unknown, involuntary termination. My thought is that everyone should approach Subchapter S with caution and restraint. As we shall see later on, an improperly made election or unknown, involuntary termination can be a very expensive proposition, especially if the corporation is a profit-making organization.

## CURRENT SUPERVISION OF SUBCHAPTER S STATUS

Every Subchapter S corporation should, in my view, receive a letter from its tax advisor pointing out the various ways in which it is possible to lose the Subchapter S election. Unfortunately, the IRS may be able to come up with some new ways of terminating the election that haven't been thought of; so my recommendation is that this Subchapter S warning letter be repeated every two or three years. Some accountants go so far as to write a new letter every January. These letters should point out not only the pitfalls mentioned previously, but also the new ways of losing the election that recent court cases have brought to their attention.

If such a letter is not too technical, it may be wise to send the client enough copies so that he can provide each shareholder with a copy. Emphasize to the client the importance of seeing to it that the shareholders, in their wills, do not make the mistake of leaving the stock in a trust. Suggest even that the will itself point out that the executor has only thirty days from the date of his appoinment by the court to consent to the election. Another area that must be emphasized to clients is the transfer of shares to a new shareholder. The new shareholder must also make an election within thirty days.

## TAX PLANNING TO AVOID PROBLEMS

So far in this paper the emphasis has been on the Subchapter S problems, and this aspect will be discussed further under recent court cases. Briefly, however, some ideas that can come under the heading of avoiding Subchapter S problems or affirmative tax planning are:

- The use of options and warrants in a commencing corporation

- Some ideas to eliminate a 20 per cent personal-holding-company type income problem
- Last-minute income shifting through Subchapter S
- Using the 2½-month rule
- Instalment sales to avoid capital gains tax at the corporate level
- Loans v. capital contributions
- The election to have distributions considered taxable instead of return of capital
- Always consider a section 1244 election
- Taxable property distributions to reduce taxes
- The effect of reorganizations on the Subchapter S election
- Fringe benefits and Subchapter S
- Advantages obtained by using a fiscal year for the Subchapter S corporation
- The use of a Subchapter S election for a corporation that is going to liquidate

## STOCK OPTIONS AND WARRANTS

Revenue Ruling 67-269 presents the opportunity for some affirmative tax planning, especially in the area of the commencing corporation. When two people start up a corporation, it often happens that one is the money man and the other the operations or idea man. Since in the early years a commencing corporation will often have losses, the money man is interested in seeing that those losses are available to offset his other income, while the operations or idea man is limited in his income to his salary from the corporation. This Revenue Ruling holds that options and warrants may be issued by a Subchapter S corporation so long as they have none of the attributes of immediate stock ownership. It would be perfectly natural to issue most or all of the presently outstanding stock to the money man, who wants the losses, and to give options or warrants, to be exercised at some future time, to the idea or operating man. It is not the purpose in this paper to go into the ramifications of restricted or unrestricted stock options but, of course, the problems inherent there must also be considered.

## PASSIVE INCOME

A circumstance that has been receiving more of the interest of the Internal Revenue Service is the taxpayer's running afoul of the 20 per cent limitation on passive, personal-holding-company-type income. As this test is based on gross receipts, it may be possible to beat the Internal Revenue Service at their own numbers game. It would seem perfectly acceptable for a corporation worried about approaching the 20 per cent figure to go into a cattle-feeding program with a feed-lot operator. Such a program can result in a substantial increase in gross receipts. It has even been suggested that a corporation might be able to purchase a large number of cattle a week to ten days before the end of its fiscal year and sell those same cattle on the last day of the corporate year, with little income consequences but with substantial tax benefits through retaining the Subchapter S election. Granted, in a desperate situation, desperate moves are sometimes called for. It would seem, however, that a step such as this could be attacked by the Internal Revenue Service as lacking substance and thus the Subchapter S election might not be saved.

Another way to get around the 20 per cent limitation is to reduce the passive income itself. For example, if rent is part of the passive income that is giving the taxpayer difficulty, why not revise the rent agreement to provide for the lessee's assuming a good many of the direct costs in exchange for a reduction in the rental payment. For example, the lessee could pay property taxes, maintenance upkeep, or insurance costs for a corresponding reduction in the rental payment.

## INCOME SHIFTING

Subchapter S is one area of the Code where last-minute income shifting is possible. For example, a parent can give stock in the corporation to one of his children, and the child will be taxed on the child's share of the profits attributable to that stock for the entire year. As we shall see later on, courts will look quite closely at gifts of Subchapter S stock to children if the children's rights and ownership of the stock are subsequently disregarded by the parent.

As most tax men know, the 1966 change to the Subchapter S law added the 2½-month rule pertaining to distribution of dividends shortly after the close of the corporation's year. It is no longer so important for a corporation to determine its taxable income before the end of the year and to distribute such income. The Subchapter S corporation may now make a dividend distribution close to the end of the year and a final distribution by way of a dividend within two and a half months after the end of the year.

## CAPITAL GAINS

That same 1966 change removed one of the unintended Subchapter S benefits, which was the "one-shot" Subchapter S election. Under the previous law, if the corporation saw that it was going to have a very large capital gain, it could elect Subchapter S for the one year in which the gain was recognized, which meant that the gain would be passed through to the shareholder without a second tax at the corporate level. The new law requires the corporation to have been a Subchapter S corporation either for three years before its election or for at least the term of its existence if it is a new corporation with a life of less than three years. If the corporation does not so qualify under the provision, then the corporation will be taxed on the capital gain, if it exceeds both 50 per cent of the corporation's income and $25,000.

This combination of a test of three years as a Subchapter S corporation and a $25,000 capital gain has led to some rather unusual instalment sales. Taxpayers have discovered that if the gain recognized under the instalment rules is less than $25,000 a year for the first three years, then they can collect the rest of the gain without penalty.

In setting up such an oddball capital gain instalment sale, taxpayers must be careful to include interest income or they will run into the imputed-interest rules; at the same time, they must calculate the effect of such interest (imputed or otherwise) or their other passive income to make sure they don't fall outside the 20-per-cent-passive-income test.

## SHAREHOLDER LOANS VS. CAPITAL CONTRIBUTIONS

When it comes to putting more money into the corporation, shareholders of a Subchapter S corporation are faced with somewhat of a dilemma. Most shareholders would prefer to make such advances as loans, so that later they may be withdrawn without any tax consequences. If all shareholders make advances to the corporation in roughly the same proportion as their share holdings, they run the risk that the Internal

Revenue Service will consider such advances as capital investment and therefore stock interest. The courts have held, however, that if the shareholders do make such advances in roughly the same proportion as their share holdings, then such advances may be considered capital investment, but will not be considered a second class of stock.

The other side of the coin is that if the shareholders make the advances disproportionate to their share holdings, they greatly reduce the risk of having such advances considered as capital investments (capital stock), and thus the interest paid on such advances would be a good deduction by the corporation. The possibility exists, however, that the Internal Revenue Service may assert such advances to be capital, and if such assertion were successful, the result would be that the advances would be considered a second class of stock and the Subchapter S election would be terminated. Perhaps the answer is that in view of the danger to the Subchapter S election, shareholders in a Subchapter S corporation should give up their ability both to withdraw funds free of tax and to receive interest payments that are deductible to the corporation. If the corporation is going to use notes in proportion to share holdings and does not have any accumulated earnings and profits, then all contributions should be considered capital, since notes will not provide any advantage over capital stock; i.e., whether shareholders have Subchapter S income or interest income on an advance makes no difference: repayments of the advance will be tax-free so long as there are no earnings and profits to make such a distribution taxable as a dividend.

## ESTIMATED TAX

Owing to a change in the law that pertained only to regular corporations and had nothing whatsoever to do with Subchapter S corporations, there is a new danger to the latter, though admittedly a minor one. This is a one-time problem and relates to the year of termination, whether intentional or inadvertent. Once a corporation reverts to regular corporate status, it will probably have to declare and pay an estimated corporate tax. A tax advisor can do very little about estimated tax payments on involuntary terminations of the election, unless it is to see that any remaining payments are made; this is a factor that must be considered, though, when intentional terminations of the election are made some time after the first three and a half months of the corporation's fiscal year. Under-estimation penalties are frustrating and very embarrassing to the tax practitioner, and this is just something he will have to look out for.

## ELECTION TO TREAT DISTRIBUTIONS IN EXCESS OF EARNINGS AS A TAXABLE DIVIDEND

A very unusual provision is contained in regulation 1.1375-4. It says:

> An electing small business corporation may, with the consent of all of its shareholders, elect to treat distributions which are in excess of its earnings and profits for the taxable year as distribution out of accumulated earnings and profits, if any, rather than as distribution of previously taxed income. For any taxable year for which such election is made, the statement of election shall be filed with the timely return under section 6037 for such year. Such election applies to all distributions during such year. An election applies only for the year for which it is made, but a new election may be made for any subsequent year.

I have never heard of this election being used, but possibly there could be a situation in which it could properly be done. Occasionally a taxpayer is willing or even eager to recognize income in the current year rather than postpone recognition till some future year. This can happen if net operating losses will expire without being used or if income for the current year is so low that itemized deductions will exceed income and be effectively wasted. Thus, under this election, if the Subchapter S corporation has accumulated earnings and profits, either during the Subchapter S period or during its regular corporate existence prior to Subchapter S election, it can make such a distribution election, and the distribution instead of being the return of previously taxed income will be taxable and will increase the income of the shareholder for that year.

## SECTION 1244 ELECTION

Another election that, in my opinion, should automatically accompany the Subchapter S election is one under section 1244 of the Internal Revenue Code. A section 1244 election, if properly made, cannot, as I see it, create any additional tax problems for the client, and there will be a few instances in which such an election will provide an additional saving. The section 1244 election, it will be remembered, is one that will give the taxpayer an ordinary loss, as compared with a capital loss, on the sale of section 1244 stock. Thus, if our new Subchapter S corporation does not do too well and our client has to sell out at a loss, he would do much better having an ordinary loss than a capital loss, and this election will provide him with just such a result. There is a limitation of $50,000 of such ordinary loss on a joint return and the remainder of any loss would be capital loss. Admittedly, there will not be many instances when such an election will be of benefit. This is true because the losses of the Subchapter S corporation go to reduce the basis of the shareholder's stock, and after a few years it just may very well be that he will have a zero basis for his stock and could not recognize any kind of loss upon its sale or other disposition. If your client is one who likes to move quickly, however, and is willing to take his loss early in the game before the corporation has actually sustained it, an election under section 1244 just may help retain a client.

## DISTRIBUTION OF PROPERTY PRIOR TO SALE TO THIRD PARTY

Earlier I commented upon the use of an instalment sale to eliminate a capital gain tax to the Subchapter S corporation. There are many times when a taxpayer does not want to keep the payments so low in proportion to the total due it that they would hold the recognized gain below $25,000 a year. Of course, this circumstance applies only to huge capital transactions. There are a few isolated instances in which there is an even better way of handling this large capital transaction with a smaller tax to the shareholder client. For example, let us say that during the year we have made cash distributions equivalent to our current year income and that we have a piece of real estate with a zero basis, which we are planning on selling for $100,000. If we sell that real estate of the corporation we understand that we will also subject the corporation to a tax, with the rest of the gain being considered passed through to the shareholders. A distribution of that property to the shareholders as a dividend in kind, so long as there are no other accumulated earnings and profits, will result in lower taxes. The danger here, of course, is whether or not there have been sufficient prior negotiations to bring the issue within the findings in the *Court Holding Company* case. First of all, there will be no tax at the corporate level, and the individual will have possession of the property with a basis equal to its fair market value, so that upon the subsequent sale there will be no tax to the individual.

The tax to the individual shareholder is upon his receipt of the property as a dividend. Since in our example there are no accumulated earnings and profits, the distribution will have no ordinary income consequences to the shareholder, but instead will, first of all, be considered a return of capital; and to the extent that the fair market value exceeds the basis of his stock, the distribution will be a capital gain. Since our shareholder can then sell the property with no additional tax consequences to him, he has saved the tax both on the entire gain at the corporate level and to the extent of the remaining basis in the Subchapter S stock at the shareholder level. In an attempt to make the point clearer, the facts in this example have been intentionally over-simplified. The determination of whether or not there are accumulative earnings and profits can be quite complex, and if such a property distribution is planned, a very slow and deliberate reading of the regulations in this area is recommended together with some very careful calculations.

## REORGANIZATIONS

A situation that has been referred to in some of the tax reporting services is the effect upon the Subchapter S election when the corporation is acquired in an "A", "B", or "C" reorganization. The consensus seems to be that the Subchapter S election will not be retroactively terminated (as of the beginning of the taxable year) in either an "A" reorganization (statutory merger) or a 'C" reorganization (stock for assets). In these reorganizations the Subchapter S corporation will go out of existence, and its taxable year will terminate at the close of business on the day before the reorganization takes place. Therefore, the Subchapter S corporation will not be a member of an affiliated group nor will the acquiring corporation be considered to be a shareholder during the short year.

A "B" reorganization is something else again. In a "B" (stock for stock) reorganization, the corporation stays in existence, and its year does not terminate. The Subchapter S corporation, thus, is not only a member of an affiliated group for its taxable year, but also has a corporation for a shareholder, and obviously the election is terminated. The Internal Revenue Service's interpretation of these three reorganizations does not present too much of a problem.

But I do have difficulty with one very specialized aspect of the "B" reorganization. Ordinarily, as remarked before, with a "B" reorganization the Subchapter S election is retroactively terminated as of the beginning of the Subchapter S corporation's year. The unanswered question, or perhaps it should be called the unsatisfactorily answered question, concerns the effect on the Subchapter S election when the acquiring corporation already files a consolidated return. In this situation, when the Subchapter S corporation is acquired, it becomes a part of the consolidated group and must join the consolidated return. Its year will terminate as of the date of the acquisition, and it will file a return for that short period, while the remainder of its year will be included in the consolidated return. Why such a situation should be any different from the "A" reorganization, where the Subchapter S election was not terminated because the year of the corporation did end, is difficult to understand. It appears as if the difference lies in the one day on which the Subchapter S corporation is acquired. In the "A" reorganization, the termination of the corporation's year is considered to take place with the close of business on the day before the stock is acquired or the merger takes place. In the "B" reorganization, apparently, the short year includes the day on which the stock was acquired, and therefore on the last day of the short year the Subchapter S corporation had another corporation for a shareholder, thus retroactively terminating the election.

The Internal Revenue Service has not issued any official pronouncements relating to this situation, but we have been advised informally that this is the present Internal Revenue Service position.

## REFORM BILL OF 1969 AFFECTS SUBCHAPTER S EMPLOYEE BENEFIT PLANS

If we get a new tax law, one obvious benefit that may be changed is the availability to the shareholder-employee of a Subchapter S corporation of fringe benefits that are not available to a sole proprietor or to a partner. Such things as pension and profit-sharing plans, health insurance, group life insurance, sick pay, and payment of medical expenses are included here. Proper use of this area of tax planning could produce sufficient savings to make the Subchapter S election practicable.

## BENEFITS OF A FISCAL YEAR

Until the 1966 Subchapter S change, I had been a strong advocate of not using a fiscal year in connection with a Subchapter S corporation—

assuming, of course, that calendar-year shareholders are being dealt with. Problems such as determining the nature of dividends paid after the close of the fiscal year but before the end of the calendar year—were they all or partly capital gain, ordinary income, regular dividends or what? And the technical complications of the inability to pay out previously taxed income between the end of the fiscal year and the end of the calendar year make the proper handling of a Subchapter S election available only to the taxpayer lucky enough to have expert advice in this field. With the advent of the throwback rule, however, so that previously taxed income may be distributed shortly after the close of the fiscal year of the corporation my thinking has changed, and I recommend consideration of the fiscal-year corporation.

Prudent use of the fiscal year can lead to a "one-shot" permanent tax deferment. Selection of a January 31 fiscal year will lead to a permanent 11-month deferment. The effect of this deferment can be spread over a two-year period if desired. If a sole proprietorship incorporates on June 30 and elects Subchapter S status, then in the year of incorporation the only income to be included in the return of its sole shareholder is the income for the first six months of the year (up to the date of incorporation). Selecting a January 31 fiscal year for the corporation means that the first return of the Subchapter S corporation will include only seven months of income, i.e., the income from July 1 to January 31. And this is the only income that the shareholder would reflect in that year's individual income tax return, unless he draws salary from the corporation. Thus, for the first two years that are affected by the Subchapter S election, only thirteen months of income would be included in the return of the shareholder.

Selection of a fiscal year should be given very early and serious consideration. Many taxpayers do not understand that a Subchapter S corporation does not qualify for automatic permission to change its accounting period that is available to a regular corporation. Furthermore, the national office of the Internal Revenue Service will not, ordinarily, grant permission for a Subchapter S corporation to change to a fiscal year ending earlier in the calendar year.

## USE OF SUBCHAPTER S ELECTION IN LIQUIDATIONS

Any corporation contemplating liquidation should consider making a Subchapter S election. The primary purpose would be to pass the liquidating losses and expenses through to the shareholders, since many liquidating corporations find they cannot get any tax benefit from the expenses in the final year of existence. In addition, such an election would allow the prospective purchaser of the assets to pay for those assets in instalments and for the shareholders to report the income in the same way, provided, of course, that the shareholder comes within the provisions of capital gain income and Subchapter S elections commented upon earlier. If your corporation can fit within these provisions so that it does not have to pay a capital gains tax, a problem common to liquidating corporations may be overcome, i.e., the problem met with in negotiations with the purchaser who will not buy the stock and must pay in instalments for the assets purchased. Under these circumstances, the ordinary corporation must either stay in business and pick up the gain (and resultant tax) in instalments or else liquidate, with the shareholders not getting the benefit of instalment reporting. By using a Subchapter S election and not liquidating the instalment, privileges pass through to the shareholders, and the corporation does not have to pay a second tax on the gain.

## RECENT DEVELOPMENTS

Earlier I mentioned that I was going to discuss not only current uses of Subchapter S but also recent developments. Within the past year [1969] there have been a few court cases that are important to the tax advisors of clients who have elected Subchapter S. It would be appropriate to discuss some of these cases.

### Lansing Broadcasting Tax Court Decision

In May of this year, the Tax Court handed down its decision in the case of Lansing Broadcasting Company. A great many of the court cases relating to Subchapter S revolve around the question of whether or not the election under Subchapter S has been either improperly made or involuntarily terminated. The result in either case is that the corporation ceases to qualify as a small-business corporation. It is these involuntary terminations or improper elections that provide the biggest booby trap. In the Lansing situation, the election was terminated and resulted in a deficiency of $275,000 plus interest.

Well then, just what was Lansing's mistake that put it in such a tax bind? It liquidated a 53-per-cent-owned subsidiary. The liquidation was under section 337 of the Internal Revenue Code, which, after a corporation has adopted a plan of liquidation, allows it to sell its assets without recognizing gain upon the sale of those assets. The subsequent liquidation, of course, must occur within twelve months after the adoption of the plan of liquidation. This, apparently, was done in the Lansing situation and the subsidiary made cash payments to Lansing of $187,000 in 1962 and approximately $45,000 in 1963, at which time the liquidation was completed. The 1962 payments exceeded the cost basis for the stock of the subsidiary by $166,000, and this excess was reported on the return of Lansing as a net long-term capital gain.

Unfortunately, the gross receipts of Lansing in this year, including the long-term capital gain, were only $751,000, which meant that the maximum amount of passive income that could be received without terminating the election was about $150,000. Lansing had the $166,000 of capital gain and $6,000 or $7,000 of rent and interest income, and that was sufficient to terminate its election.

Both the Code and the regulations speak of sales or exchanges of stock as coming within the passive or holding-company type income, along with royalties, rents, dividends, interest and annuities. About the only defense the Lansing corporation had was that a liquidation under section 337 did not constitute a sale or exchange of stock and securities, and the court was unable to agree to this defense.

Lansing owned 53 per cent of the subsidiary and therefore it must be assumed that it could have controlled the receipt of the liquidating dividends at least within the time limit provided by section 337. If Lansing had recognized its danger it must be assumed it could have reduced the payments it received in 1962 and increased the payments received in early 1963 in an attempt to keep itself outside the 20 per cent limitation of Subchapter S. Once again, an innocuous booby trap of Subchapter S exploded in the face of an unwary taxpayer.

## Michael F. Beirne Tax Court Decision

Another tax court case was also decided in May of this year [1969]; it is that of Michael F. Beirne. Mr. Beirne organized a corporation by contributing assets and had the stock issued, 100 shares to himself and

300 shares to each of his three children. His announced intention, in the minutes of the corporation was to make a gift, at that time, to his children. A Subchapter S election was executed by the corporation and the shareholders shortly after the incorporation. About a year later, a fourth child was born to the Beirnes, and the minutes reflect that each of the three children was to transfer 75 shares to the new child, so that the 900 shares of the children would be equally divided among the four children. At the same time, Mrs. Beirne was declared to be custodian of the stock for the children instead of her husband, but, unfortunately, new stock certificates reflecting the transfer of shares or the change in custodian were never issued.

During the years from 1960 to 1965, the corporation's earnings were about $130,000, which was allocated for income tax purposes to the shareholders in accordance with their holdings, i.e., 10 per cent to the father and 90 per cent divided equally among the children. During this same period, distributions of only $24,000 were made, primarily to the children to permit them to pay their taxes; the father borrowed about $73,000 from the corporation through unsecured advances. There were some repayments of these advances and a few payments on interest, but the larger repayments were often borrowed back again a few months later. The questions before the court were whether or not gifts had been made and, if they had, were they to be allocated to the father under section 1375(c).

Section 1375(c) permits the Secretary of the Treasury or his delegate to allocate or apportion dividends among shareholders who are members of a family group as defined. Such apportionment or allocation is to be based on the need to reflect properly the value of services rendered to the corporation by the shareholders. The court found that Mr. Beirne exercised complete control over the stock after his purported gift. He had reapportioned the shares among his children after another child was born, had changed the custodian (neither action being reflected in the outstanding certificates), had paid as dividends to the children only enough money to pay their income taxes, and had availed himself of the use of the tax-paid funds thus generated through unsecured borrowings from the corporation, for which most of the repayments and payments of infrequently accrued interest were suspect. The court was able to decide that there was not a true and complete gift and therefore that all the income of the corporation should be taxable to Mr. Beirne because he was the true owner of the Subchapter S stock. Therefore, the court did not have to concern itself with the question of whether or not the income should be allocated to Mr. Beirne under section 1375 (c) as he already had all the income allocated to him. As we shall see later on, section 1375(c) is a vehicle being used by the Commissioner with more frequency to upset tax-planning ideas.

### Thomas E. Bone Tax Court Decision

A very recent case—the decision was handed down a little more than two weeks ago—is that of Thomas E. Bone, which was decided in the Tax Court on September 8 of this year [1969]. Mr. Bone was attempting to develop a citrus orchard, with some financial help from his father. They filed partnership returns for a couple of years, when it was explained to them that the senior Mr. Bone was exposing himself unnecessarily to liabilities incurred by the partnership. In August 1963, articles of incorporation were filed with the Secretary of State. On the same date, a corporation meeting was held at which time officers were elected, the form of the corporate seal and stock certificates approved, and bank accounts authorized, and the fiscal year was designated as commencing September 1 and ending August 31. At the same meeting it was decided that 95 per cent of the shares would be issued to Mr. Bone and 5 per cent to his father, subject to receiving a permit from the Commissioner of Corporations to issue such share. Mr. Bone was to transfer to the corporation the undeveloped citrus orchard in exchange for his 95 per cent of the stock.

Two months later, on October 7, 1963, Mr. Bone executed a deed to the corporation covering the citrus orchard, and on the same day the deed was recorded in the County Recorder's office. On the same day, the corporation executed an "application for permit to sell and issue stock"; however, this application was not filed with the Commissioner of Corporations until March 12, 1964. On October 28, 1964, over one year after the incorporation, a permit to sell and issue stock was issued by the Commissioner of Corporations, and the first stock certificates were issued to Mr. Bone and his father.

On November 16, 1964, the corporation mailed to the District Director Form 2553, Election by a Small Business Corporation, together with signed consents of Mr. Bone and his father. On the same date, Form 1120S covering the period January 1, 1964 to August 31, 1964 was filed with the District Director. There are other more confusing facts, such as Corporate State Income Tax Returns that were filed for the period August 16, 1963 to August 31, 1963, then another State return for the period January 1, 1964 to August 31, 1964, and transfers between Mr. Bone and his father which resulted in Mr. Bone's owning only 30 per cent of the stock during the Subchapter S years.

The result of all this was to disallow to Mr. Bone any losses in connection with the development of the citrus orchard subsequent to October 7, 1963, the date when the real property was transferred to the corporation. The court viewed quite narrowly the Subchapter S requirements that the election should be filed within a 30-day period before and after the commencement of the taxable year and was thus unwilling to recognize that an election filed in November 1964 could apply to a taxable year beginning in September 1963 or September 1964. A couple of years ago, under somewhat similar facts, the court did allow an election equivalent to the November 1964 election to be effective with the year commencing the following September 1, 1965. This is considered to be a rather liberal interpretation of 30 days, and in the Bone case the court did not comment on the Subchapter S status of the corporation commencing September 1, 1965. Once again, a taxpayer's misunderstanding of the complexities of Subchapter S resulted in an improper election and an individual taxpayer's forfeiting his opportunity to claim as a deduction the loss from his business.

## Walter J. Roob Tax Court Decision

Apparently the first case to get to court wherein the Commissioner allocated income under section 1375(c) is the Tax Court case of Walter J. Roob, which was decided one year ago [1968]. Mr. and Mrs. Roob were both prominent photographers. They had incorporated their photography business in 1962 and at the same time made an appropriate election under Subchapter S. Approximately 20 per cent of the stock was issued to Mr. and Mrs. Roob on incorporation in exchange for their partnership assets. At about the same time the corporation issued approximately 80 per cent of the stock equally to the Roobs' seven, later on eight, children. The dividends paid each year amounted to almost the entire net income of the corporation. Separate savings accounts were maintained for the children, and the dividends paid on the stock were deposited in these savings accounts. This is quite a different situation from the Beirne case discussed earlier, although except for the fact that the dividends were paid out and deposited in the children's savings accounts, the case does not tell us whether or not Mr. and Mrs. Roob indicated in any other way that the children were the actual owners of their own certificates. The Commissioner did not attempt to attack the validity of the original transfer of the stock to the children; instead, he determined that Mr. Roob had not been taking down sufficient salary. In the three years in question, Mr. and Mrs. Roob each had taken down salaries of $10,000, $12,000, and $12,000 a year.

The Commissioner did not attempt to increase the salary of Mrs. Roob, although she apparently worked equally hard in the business. Perhaps he concluded that any woman with eight children is not going to be able to devote full time to a photography business. In any event, he increased Mr. Roob's salary for the three years in question by $4,000, $5,000, and $8,000, respectively.

Mr. Roob's only defense was to submit figures compiled by the Professional Photographers of America. The court determined that the statistics represented such a small percentage of the members eligible to participate in the survey that the statistics were meaningless and the court ignored them. Since this was the only defense submitted by the Roobs to support the salary paid to Mr. Roob, and since in such situations the Commissioner's determination is presumed to be correct, the court had no other alternative but to accept the increases to Mr. Roob's salary that had been determined by the Commissioner.

The case is included not as an example of unfortunate Subchapter S planning, but rather as an example of what the Commissioner is and will be doing with respect to allocating income among family members of a Subchapter S corporation. In this case, the court went so far as to comment on how little support for their position had been submitted by the Roobs and at least the impression is gathered that the Commissioner's allocation would not have been accepted at 100 per cent if the Roobs had been able to show the court more and better reasons why the salary paid was appropriate.

## Tax Reform Act of 1969

When I began looking into the Tax Reform Act of 1969, I was a little surprised to find that there was only one change in Subchapter S. The change is: section 541 of the Act, which adds section 1379 to the Code. This section says that contributions to a pension, profit-sharing, or stock-purchase plan on behalf of a shareholder-employee shall be includable in the income of the employee to the extent the contributions exceed the lesser of $2,500 and 10 per cent of the compensation paid to such employee. Any income taxed to the employee under this provision is added to the employee's basis in the pension, profit-sharing, or stock-bonus plan to be recovered under the annuity rules when the retirement income is received. If the shareholder-employee quits or for some other reason does not get any benefits under the plan, he is allowed a deduction at that time for the income previously included. Although this proposed new law does reduce one of the benefits previously available to a shareholder-employee of a Subchapter S corporation, other fringe benefits have not been affected. As mentioned previously, these would include health insurance, group life insurance, sick pay, and the payment of medical expenses.

**Suggested Legislation**

There are two areas concerning which I should like to have seen legislation and concerning which I believe it would have been fair to expect some action since it would have made Subchapter S more useful to many shareholders. One of the problems caused by an involuntary termination is locked-in, previously taxed income. It should be possible to write legislation so that previously taxed income could be withdrawn free from tax after the corporate election had been involuntarily terminated or after the death of a shareholder. Admittedly, there are some forms of involuntary termination that are hardly involuntary, such as transfer of a stock to a corporation or acquisition of an 80 per cent or more owned subsidiary.

It seems to me that there should be a period of a year or so after it is determined that the election has been involuntarily terminated, in which the corporation could declare a dividend equal to the undistributed previously taxed income, which dividend to the shareholders would be merely a reduction in the basis of their stock. The same could apply to a deceased shareholder, with the payment being received by his estate.

Another area where I believe we should see adjustment concerns losses in excess of basis for the stock and notes. The legislation should probably take a form similar to the rules for partners relating to obtaining a deduction through the repayments of losses in excess of allowable amounts.

In many instances in this paper I have been rather hard on Subchapter S, but then Subchapter S is a very deceptive area. In certain instances, I still recommend its use for clients, so in some respects I guess Subchapter S is like a definition of Wagnerian music I once heard: "It is better than it sounds." With proper controls and supervision, Subchapter S can be a helpful tax planning tool.