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the vagrancy statute. This will minimize or eliminate constitutional difficulties to a large degree.

(4) Since many municipalities still have vagrancy provisions that are probably unconstitutional, action should be taken by the legislature to abolish vagrancy laws throughout the state.

If these recommendations are followed, an answer may yet be imminent to Justice Douglas's query: "How can we hold our heads high and still confuse with crime the need for welfare or the need for work?"[245]

WILLIAM F. MAHER
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INTERRELATIONSHIP OF SUBCHAPTER S AND SUBCHAPTER C*

The ratification of the sixteenth amendment to the United States Constitution in 1913 injected a new consideration into all business relations. In more recent years, with tax rates on individuals and corporations climbing to alltime highs, careful examination of the tax ramifications of every commercial transaction has become indispensable. "Lest the tail wag the dog," Congress made an attempt to neutralize to some extent the tax aspects of business planning by the passage of Subchapter S in 1958. Under Subchapter S, a corporation meeting the standards of section 1371 is extended an opportunity to elect to be treated as a "modified" corporation, with income subjected in most instances to only one tax at the shareholder level.

Subchapter S corporations have been incorrectly referred to as corporations taxed as partnerships. A Subchapter S (or tax option) corporation *is* a corporation and is governed by the provisions of Subchapter C (taxation of corporations) unless inconsistent with specific sections of Subchapter S. It is wholly independent of Subchapter K (taxation of partnerships) although the 1969 tax reform proposal of the Nixon administration would have altered the mechanics of Subchapter S as they presently exist and brought them more into line with Subchapter K.

The object of this note is to explore the relationship between Subchapter S and Subchapter C, as well as other miscellaneous corporate provisions, and to analyze the similarities and dissimilarities between the two. No attempt is made to explain or define the mechanics involved except insofar as to show any relationships that might exist.

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245. Douglas, *supra* note 226, at 12.

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CORPORATE FORMATION

According to the Regulations, other provisions of the Code not inconsistent with the provisions of Subchapter S "will apply with respect to both the electing small business corporation and its shareholders in the same manner that they would apply had no election been made."[1] Therefore, a corporation that elects Subchapter S is eligible for nonrecognition of gain upon the transfer of property to a corporation controlled by the transferor under section 351. However, both newly formed and already existing corporations should insure that they meet the requirements set out in section 1371 (a) for an S election. Of special interest to the newly formed corporation are the Commissioner's requirements of corporate existence[2] and strict compliance with the Regulations.[3]

What Constitutes Stock?

To be eligible for nonrecognition under section 351 the transferors must be in control of the corporation immediately after the transfer,[4] and the transfer must be solely in exchange for stock and securities of the transferee corporation.[5] This is an area of special concern for the Subchapter S corporation since it is allowed only one class of stock.[6] The Commissioner has closely scrutinized the second class of stock area in dealing with purported debt obligations received by the shareholders on formation, which appear to be securities or some other form of equity investment. Prior to the 1966 amendment the regulations[7] stated that "if an instrument purporting to be a debt obligation is actually stock, it *will* constitute a second class of stock."[8] However, no court explicitly accepted the Commissioner's argument. In the first three cases in this area the courts ignored the Regulations and reached their decisions on independent grounds.[9] In *Catalina Homes*,[10] the Tax Court stated that the substance of the transaction would determine whether the instrument is what it purports to be in form. Among the various criteria considered by the court in determining whether the obligation was a true debt were:

(1) presence or absence of a maturity date,
(2) right of the creditor to enforce the payment of the principal and interest,

1. Treas. Reg. §1.1372-1 (c) (1959).
2. Homer W. Forrester, 49 T.C. 499 (1968); William Pestcoe, 40 T.C. 195 (1963). In both cases the court found that the election had not been timely filed.
3. Treas. Reg. §1.1372-3 (a) (1959).
4. INT. REV. CODE of 1954, §368 (c) [hereinafter cited as CODE].
5. CODE §351; Treas. Reg. §1.351-1 (1955).
6. CODE §1371 (a) (1), (4).
7. Treas. Reg. §1.1371-1 (g) (1959).
8. *Id.* (emphasis added).
9. Henderson v. United States, 245 F. Supp. 782 (M.D. Ala. 1965); Seven Sixty Ranch, 66-1 U.S. Tax Cas. ¶9293 (D.C. Wyo. 1966); Catalina Homes, CCH Tax Ct. Mem. 1361 (1964).
10. 23 CCH Tax Ct. Mem. 1361 (1964).

(3) participation in management,
(4) whether the creditor subordinates his debts to those of other corporate creditors,
(5) whether the corporation is adequately capitalized,
(6) identity of interest between creditor and stockholder,
(7) whether the advance was made at the time of the organization of the corporation, and
(8) the ability of the corporation to obtain loans from outside sources.

The court there found that these criteria were not fulfilled and that the shareholders' open account advances, which were in fact preferred over their no-par common stock, constituted a second class of stock.

In *Henderson v. United States*,[11] the district court quoted with approval from *United States v. Title Guarantee & Trust Co.*[12] the distinction between a stockholder and a creditor:[13]

> The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure taking the risks of loss attendant upon it, so that he may enjoy the chances of profit. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them.

After examining the equity capital versus indebtedness criteria, the court found without further discussion that Henderson's advances constituted a second class of stock. In *Seven Sixty Ranch Co.*,[14] the district court found that true debt existed, and that therefore the notes in question did not constitute a second class of stock.

In 1966 the Tax Court faced the question of the validity of this regulation[15] in the case of *W. C. Gamman*.[16] The court found that the Commissioner had in effect applied a "meat ax" in requiring that all instruments purporting to be debt obligations, but in fact representing equity capital, should be held to be a second class of stock. The court held that this was beyond the scope of the statute and beyond the intent of Congress in enacting Subchapter S, the intent of Congress being "to permit businesses to select the form of business organization desired, without the necessity of taking into account the major differences in tax consequences."[17] In light of the provision in section 1376 for the adjustment of the shareholder's basis in any indebtedness owed to him by the electing corporation by the shareholder's prorata share of the corporation's net operating losses (NOL), the

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11. 245 F. Supp. 782 (M.D. Ala. 1965).
12. 133 F.2d 990 (6th Cir. 1943).
13. *Id.* at 993.
14. 66-1 U.S. Tax Cas. ¶9293 (D.C. Wyo. 1966).
15. Treas. Reg. §1.1371-1 (g) (1959).
16. 46 T.C. 1 (1966).
17. *Id.* at 7.

court decided that there could be valid debts or equity contribution without necessarily creating a second class of stock. The court found that in determining the character of the instruments by reference to the substance of the underlying transaction, the Treasury should also look to the economic realities to determine whether the instruments, even though they might represent equity capital, actually gave the holders any rights or interests in the corporation different from those owned by themselves as the holders of the nominal stock.[18] Noting that the advances in question were made in direct proportion to their stockholding and that the notes gave no preference over creditors, the court held that "whatever preferences the notes gave [the stockholders] . . . in the income and assets of the corporation, if enforced, were preferences only over themselves as stockholders."[19] The court accordingly concluded that though the notes did not constitute indebtedness, they were not a second class of stock, but were instead capital contributions of the same character as the stock already held in the corporation.

Although a majority of the judges in *Gamman* did not think it was necessary to question the validity of the regulation, the Commissioner has since amended the Regulations to read:[20]

> Obligations which purport to represent debt but which actually represent equity capital will generally constitute a second class of stock. However, if such purported debt obligations are owned *solely by the owners of the nominal stock of the corporation in substantially the same proportion as they own such nominal stock,* such purported debt obligations will be treated as contributions to capital rather than a second class of stock.

In the cases decided since this amendment, the courts have indicated that although proportionality is the key factor, its absence may be overcome by special circumstances.[21]

In *Milton T. Raynor,*[22] shareholder advances could not be made proportionately, but the shareholders agreed among themselves to share the burdens and benefits of the corporation in proportion to their shareholding. The court held this agreement sufficient to overcome the disproportionality

18. *Id.* at 9.

19. *Id.* at 9.

20. Treas. Reg. §1.1371-1 (g) (1966) (emphasis added).

21. Brennan v. O'Donnell, 68-1 U.S. Tax Cas. ¶9314 (M.D. Ala. 1968) (the court did not discuss proportionality, but merely said that looking to the realities of the situation (the advances were evidenced only by entries on the ledger sheets of the corporation) the obligations were not a second class of stock); August F. Nielsen Co., 27 CCH Tax Ct. Mem. 44 (1968) (the court found special circumstances indicating that although there had been a shift in the proportionality of the holding of the nominal stock and the purported debt, the amounts ultimately received by either party would be the same); Lewis Bldg. & Supply, Inc., 25 CCH Tax Ct. Mem. 844 (1966) (the court found that amounts contributed were equity capital, but that there was proportionality and the shareholders did not receive any interests different from those due them as shareholders).

22. 50 T.C. 762 (1968).

and to meet the test of regulation 1.1371-1 (g). Another way of avoiding the second class of stock pitfall is to have the Subchapter S corporation issue options, warrants, or convertible debentures to some individuals instead of stock. The Service has ruled[23] that these will not constitute a second class of stock as long as they have none of the attributes of immediate stock ownership, such as the right to receive dividends or to vote. The selective use of options, warrants, or convertible debentures as a tool in tax planning permits shareholders to direct the flow of corporate income and net operating losses to designated individuals.

In considering "thin capitalization"[24] arguments, the *Gamman* court stated it had some doubt as to its applicability as a factor in determining the existence of a second class of stock for the purposes of Subchapter S.[25] This doctrine has been established by the courts to prevent the avoidance of the double tax in the normal corporate situation by a corporate distribution of earnings to the shareholders in the form of interest or repayment of their loans instead of in the form of dividends. In light of this purpose its relevance to the Subchapter S area is tenuous at best, since the overriding intent of Subchapter S is to eliminate double taxation by taxing all amounts directly to the shareholders whether or not distributed. However, this procedure apparently may still be used to avoid even the single tax at the shareholder level by passing funds out as a repayment of shareholder loans.

On a completely "tax free" exchange under section 351 (a) the shareholders take a substituted basis for the stock and securities received from the corporation,[26] and the corporation takes a transferred basis in the assets received from the shareholders on the exchange.[27] However, in dealing with a Subchapter S corporation there seems to be a preference for the use of the "boot" provisions of section 351 (b). Under this provision the shareholders recognize any gain they had on the transfer to the extent of the boot[28] received on the exchange. At the corporate level this gain recognition will give rise to a stepped-up basis[29] of the assets for purposes of depreciation and determination of gain or loss on a later sale by the corporation. Also, by the selective use of short-term notes[30] or installment obligations[31] on formation, the corporation can deflect income to identifiable shareholders through the use of interest payments.

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23. Rev. Rul. 67-269, 1962-2 CUM. BULL. 298.
24. *E.g.*, Gooding Amusement Co. v. Commissioner, 236 F.2d 159 (6th Cir. 1956).
25. 46 T.C. 1, 12 (1966).
26. CODE §358 (a).
27. CODE §362 (a).
28. CODE §351 (b) (1) (A), (B) (the amount of money plus the fair market value of any other property received).
29. CODE §362 (a).
30. Short-term notes are considered to be other property and take a fair market value under CODE §358 (a) (2).
31. Installment obligations are not considered to be a security for purposes of CODE §351, Warren H. Brown, 27 T.C. 27 (1956).

Net Operating Losses

At the shareholder level the stepped-up stock basis[32] is particularly beneficial because the allowance of net operating loss deductions[33] is keyed to the shareholder's basis in the stock and debt obligations of the corporation. In light of this limitation, consideration should be given to the factors that determine the basis of the shareholder's stock and the existence of a valid debt relationship between the shareholders and the corporation. Since Subchapter S does not specifically define "adjusted basis," the Tax Court has said that the general code provisions on basis should apply.[34] In *Byrne v. Commissioner*,[35] the taxpayer claimed that the basis of his stock was its fair market value on the effective date of the Subchapter S election. The Commissioner, on the other hand, asserted that the true basis was the original cost to the taxpayer increased by any contributions he had made to the corporation's capital. In determining the taxpayer's stock basis the court agreed with the Commissioner and held that retained earnings did not constitute contributions to capital for basis purposes.

In *Plowden v. Commissioner*,[36] the taxpayer contended that the limitation of section 1374(c) should be read together with section 172, thereby making the full corporate loss available to the shareholders even when the loss exceeds the basis of the shareholder's investment in the corporation. However, the court found that the wording of section 172(h) [37] prohibited this interpretation. Under the language of the statute the loss could confer no benefit beyond the basis of the shareholders' stock since the loss belonged to the corporation and not to the shareholders individually. It therefore seems that the basis of a shareholder's stock in a Subchapter S Corporation is its cost to him, regardless of its fair market value at the date of election, with proper adjustments for contributions to capital, constructive distributions of UTI,[38] and the pass-through of corporate net operating losses.[39]

Besides the criteria set out earlier for determining the existence of a true debtor-creditor relationship, further consideration must be given to ascertain whether the obligation runs from the corporation to the shareholders. This determination is particularly crucial for the purpose of ascertaining the proper net operating loss deduction allowable to the shareholders. The fact that the shareholders may be primarily liable on the indebtedness of the corporation to third parties does not necessarily mean that this is a debt of the corporation running to the shareholders. The courts have held

32. CODE §§351(b)-358(a).

33. CODE §1374(c)(2).

34. Joe E. Borg, 50 T.C. 257 (1968).

35. 361 F.2d 939 (7th Cir. 1966).

36. 48 T.C. 666 (1967), *aff'd*, 398 F.2d 340 (4th Cir. 1968).

37. CODE §172(h) states that there shall be disregarded for the purposes of subsection (a) "the net operating loss for such corporation for any taxable year for which such corporation is an electing small business corporation . . . ."

38. CODE §1376(a) (undistributed taxable income).

39. Joe E. Borg, 50 T.C. 257 (1968); Milton T. Raynor, 50 T.C. 762 (1968); William H. Leonhart, 27 CCH Tax Ct. Mem. 443 (1968); CODE §1376(b).

that no form of indirect borrowing, be it guarantee, surety, accommodation, co-making or otherwise, gives rise to indebtedness from the shareholders until and unless the shareholders assume part or all of the obligation.[40] Prior to that crucial time liability may exist, but it is not a debt to the shareholders, and only those amounts directly traceable to lendings by the individual shareholders constitute indebtedness of the corporation for the purposes of net operating loss pass-through.[41] The Service has recently ruled that for the purpose of the net operating loss pass-through, debts owed a corporation are not indebtedness to the shareholders even though the shareholders own a majority interest in the corporation.[42]

Upon repayment of these debts, amounts received by the creditor-shareholders are treated as a return of capital rather than a dividend. Where, as a result of the reduction under section 1376 (b) (2), the basis of the indebtedness is exceeded by its face value, then a portion of the payments received will be considered income and the remainder a return of capital. The portion is determined by multiplying the amount received by a fraction, the numerator of which is the difference between the face amount and the basis of the debt, and the denominator of which is the face amount of the debt.[43] In *Joe M. Smith*,[44] the taxpayer contended that this general rule did not apply because the indebtedness in question was not evidenced by a note or other writing, but was merely held on the open accounts of the corporation. The court held that the general rule was not predicated on the presence or absence of evidence of the debt. The court also held that because of the lack of any evidence of the indebtedness, the taxpayer could not take advantage of section 1232, and therefore all the income would be considered as generated by a discount on an open account, thus giving rise to ordinary income. If there had been evidence of the indebtedness, section 1232 would have treated the amounts received in retirement of the bonds as received in exchange therefor. Since the bonds would be considered capital assets in the creditor-shareholder's hands, the income would be taxed at capital gains rates.[45] A problem peculiar to the S corporation is that once the basis of the indebtedness has been reduced to zero it will never be increased by any constructive undistributed taxable income (UTI) distributions.[46] Under Subchapter S, only the shareholder's stock basis is increased by these distributions.[47] However, even this problem has aspects beneficial to the shareholders because it permits exchanging net operating losses for capital gains. Once the basis of the debts has been reduced to zero through the NOL pass-through, payments

40. Joe E. Borg, 50 T.C. 257 (1968).

41. Byrne v. Commissioner, 361 F.2d 939 (7th Cir. 1966); Joe E. Borg, 50 T.C. 257 (1968); William H. Perry, 47 T.C. 159 (1966), *aff'd*, 392 F.2d 458 (8th Cir. 1968); Haywood P. Marton, 38 T.C. 188 (1962); William H. Leonhart, 27 CCH Tax Ct. Mem. 443 (1968).

42. Rev. Rul. 69-125, 1969 INT. REV. BULL. No. 12.

43. Darby Inv. Corp., 37 T.C. 839 (1962), *aff'd*, 315 F.2d 551 (6th Cir. 1963).

44. 48 T.C. 872 (1967).

45. Baker Commodities, Inc., 48 T.C. 374 (1967); Rev. Rul. 64-162, 1964-1 CUM. BULL. 304.

46. CODE §1373 (b).

47. CODE §1376 (a).

received in retirement of the bonds would still be capital gains under section 1232 (provided there is evidence of the debt).

What Constitutes Property?

Determining what is property on corporate formation is a problem that is common to all corporations, but one deserving special consideration in the newly born Subchapter S corporation. Where the prior business involved the performance of services by the various partners or individuals a question may arise on formation as to whether part of the stock was received in exchange for prior services.[48] In *United States v. Frazell,*[49] the taxpayer had rendered services to a partnership that dissolved and later incorporated with the taxpayer receiving thirteen per cent of the stock. The Commissioner claimed that the stock was received partly in exchange for services, that section 351 (a) did not apply, and that the taxpayer should recognize the value of the services as gross income under section 61 (a). The court agreed, stating that no matter what the realities of the transaction, the taxpayer would have to recognize the consideration he received in exchange for his services:

> (1) if the taxpayer's partnership interest had become possessory upon the termination of the partnership, then to the extent the interest was received as compensation for service, it was taxable under regulation 1.721-1 (b) (1) and then the transfer could be made tax-free under section 351(a):
> (2) if the stock was a substitute for the original partnership interest, then as much of the stock as was exchanged for services was gross income and section 351 (a) does not apply.

In determining whether services rendered in connection with a transfer of property will affect the tax-free nature of the transaction, consideration must be given to whether the services are merely ancillary and subsidiary to the property transfer. The Service has ruled that this is a fact question to be determined on a case-by-case basis.[50]

Assignment of Income

Assignment of income possibilities on the formation of an S corporation is another area that deserves attention. Under regulation 1.453-9 (c) (2) the transfer of installment sales obligations to a corporation can be brought within the protection of section 351 (a). This seems to be a classic example of assignment of income since the transferor-shareholder has done all he is required to do on the original transaction and retains merely the naked right to receive the deferred gain. When he transfers the obligations to the corporation he has realized the value of the future installments by the receipt of

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48. In such a case the transaction would be wholly under §351.
49. 335 F.2d 487 (5th Cir. 1964), *cert. denied,* 380 U.S. 961 (1965).
50. Rev. Rul. 64-56, 1964-1 CUM. BULL. 133.

stock equal to the fair market value of the obligations. If gain were recognized to the transferor-shareholder, the corporation would receive a stepped-up basis in the obligations equal to the gain recognized, and the receipt of future installments would be treated wholly as a return of basis. This situation seems clearly to fall within the holding of *Commissioner v. P. G. Lake, Inc.*,[51] that if an otherwise nonrecognition-type exchange under section 112(b)(5) of the 1939 Code (now section 351(a)) also amounts to an anticipatory assignment of income, such income would be taxable notwithstanding the fact that it arises from a nonrecognition type of transfer. The Fifth Circuit, in *Jack Ammann Photogrammetic Engineers, Inc. v. Commissioner*,[52] stated that it would have found this argument persuasive as to the taxability of gain realized on a transfer of installment obligations to a corporation under section 351 had the question of the shareholder's taxability been before the court.

The potential of assignment of income through midstream incorporation of going concerns is particularly attractive to the S area with its attendant possibilities of income splitting among family members and close associates. Relying on cases such as *Lucas v. Earl*[53] and *Helvering v. Horst*,[54] the Commissioner has here also overridden the nonrecognition provisions of section 351 and taxed the shareholders who have merely exchanged income rights for their stock.[55] The potential for shifting income from bonds, stocks, rental properties, et cetera is curtailed by the requirement of section 1372(e)(5) that no more than twenty per cent of the "gross receipts" of the corporation can be derived from securities, rent, royalties, and the like. This seems to limit the election of Subchapter S to corporations engaged in an active trade or business. The strict election requirements[56] and the capital gains limitation[57] have also combined to negate the one-shot election of Subchapter S to pass through and disburse capital gains. Also, the fact that the election must be made in the first month of the corporation's taxable year and will continue until terminated, together with the provision that once terminated a Subchapter S election cannot be remade for five years, serves to foreclose the possibility of delaying the election until the relative levels of individual and corporate income are known.[58]

In making the Subchapter S election, care must also be taken that the corporation is in existence at the time of the election. In *J. William Frentz*,[59]

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51. 356 U.S. 260 (1958).
52. 341 F.2d 466 (5th Cir. 1965) (dictum).
53. 281 U.S. 111 (1930).
54. 311 U.S. 112 (1940).
55. Commissioner v. Fender Sales, Inc., 338 F.2d 924 (9th Cir. 1964) (taxpayer cancelled his claim for unpaid salary against a controlled corporation in exchange for its stock); Adolph Weinberg, 44 T.C. 233 (1965) (taxpayer transferred growing crops shortly before they were to be harvested).
56. CODE §1372(c).
57. CODE §1378, *as amended by* the Tax Reform Act of 1969, §511(c)(4).
58. Note, *Assignment of Income: Possibilities Under Subschapter S*, 23 TAX L. REV. 213 (1968).
59. 44 T.C. 485 (1965), *aff'd*, 375 F.2d 662 (6th Cir. 1967).

the corporation was held not to have been in existence on the date of the election, and therefore the election was held ineffective. The taxpayer argued that there was a de facto corporation, but the court held that this would be the case only if there had been an attempt to perfect an organization under state law. In this case, the court found no evidence of such attempt until the articles of incorporation were filed, which occurred after the purported election.

Another aspect of corporate existence to be examined is whether the corporation is actually carrying on a trade or business. The expense deductions[60] will be allowed only if the taxpayer is carrying on a trade or business. This is important in the S area because of the attractiveness of incorporating a hobby without incurring an additional corporate tax. In making this factual determination the courts have considered the following evidentiary criteria: whether the taxpayer's intention was to engage in the venture for profit or merely for pleasure[61] and whether the profit motive was the "dominant hope" of the taxpayer.[62] In considering the taxpayer's profit motive the courts have held that the expectation need not even be a reasonable one.[63] Though the prospect of eventual profits does have a bearing on the taxpayer's good faith, a good faith expectation of making a profit is all that is required.[64] The business will be considered to be a valid and active one even though the taxpayer derives pleasure therefrom, and the mere fact that the business was previously carried on as a hobby will not preclude a finding that it is a trade or business.[65]

Voting Trusts

Another problem peculiar to Subchapter S is the denial or the use of the voting trust, because it supposedly constitutes either a second class of stock[66] or an ineligible stockholder.[67] In taking this tack the Commissioner seems to be allowing the form rather than the substance of the situation to control. The purpose of the S election is allow the businessman to select the form he desires, be it proprietorship, partnership, or corporation, without the necessity of taking into account the major differences in tax consequences.[68] The apparent aim of the shareholder and class of stock requirements is to limit the size of the corporation and thereby the problems of income allocation. In considering the voting requirements of regulation

60. CODE §§161-175.

61. Tatt v. Commissioner, 166 F.2d 697 (5th Cir. 1948).

62. Hirsch v. Commissioner, 315 F.2d 731 (9th Cir. 1963); Brooks v. Commissioner, 274 F.2d 96 (9th Cir. 1959); Rowe B. Metcalf, 22 CCH Tax Ct. Mem. 1402 (1963).

63. Hirsch v. Commissioner, 315 F.2d 731 (9th Cir. 1963).

64. Lamont v. Commissioner, 339 F.2d 377 (2d Cir. 1964).

65. Dupont v. United States, 234 F. Supp. 681 (D.C. Del. 1964); Norman C. Demler, 25 CCH Tax Ct. Mem. 620 (1966).

66. Treas. Reg. §1.1371-1 (g) (1959).

67. Treas. Reg. §1.1371-1 (e) (1959).

68. Byrne v. Commissioner, 361 F.2d 939 (7th Cir. 1966); W. C. Gamman, 46 T.C. 1 (1966).

1.1371-1 (g) it seems that the thrust of the Commissioner's attack is at corporate action, which causes a difference in the voting rights of the shareholders. This type of corporate action was held to terminate the S election in the case of *Samuel Pollock*.[69] There the court found that the difference in voting rights had been created by the corporation and adhered to each share regardless of the owner's desires. On the other hand, with a voting trust or pooling agreement each share retains identical voting rights as well as all other rights, and any modification is made solely by the owners of the stock. Since the corporation has the sole power to create and issue classes of stock, no mere shareholder agreement, be it formal or informal, should be able to create preferred stock from common or in any other way alter the rights to the holder with respect to the corporation.

Since a voting trust is made up of individuals who are already stockholders of the corporation, it would in no way affect the size of income allocation of the corporation, as would stockholding by another corporation, a partnership or a normal trust.[70] In *Catalina Homes*,[71] although the court did not directly reach the voting trust question, it did admit to uncertainty as to whether the regulations represented a proper interpretation of the statute. The court found that the congressional purpose of simplifying the determination of who is to receive corporate income distributions would not be hindered by shareholders' arrangements of this nature. In *Fulk & Needham, Inc. v. United States*,[72] the district court interjected "tax substance" as being a controlling factor in determining whether a trust has become a shareholder. In so doing the court declared regulation 1.1371-1 (e) and Revenue Ruling 63-226[73] invalid to the extent that they required a different result.[74] Nowhere in the Code is there a provision that treats a voting trust as a separate entity capable of holding stock or being subject to taxation.

With this in mind, one should consider regulation 1.1371-1 (d) (1), which states that persons "who would have to include in gross income dividends distributed with respect to their stock" will generally be deemed to be stockholders of a corporation. For example, when the titular owner of stock under state law holds it solely as security for an obligation of the beneficial owner, the latter will still be held to be the shareholder for Subchapter S purposes.[75] Also, even though title to a decedent's property may pass directly to the devisees on the owner's death, if the property is subject to administration and possession by the personal representative, the estate is the shareholder during the period of administration.[76] Special care should be taken that the administration of the estate is not unduly prolonged, thereby enabling the

69. 45 T.C. 92 (1966).
70. Old Virginia Brick Co. v. Commissioner, 367 F.2d 276 (4th Cir. 1966).
71. 23 CCH Tax Ct. Mem. 1361 (1964).
72. 68-2 U.S. Tax Cas. ¶9517 (M.D.N.C. 1968).
73. 1963-2 CUM. BULL. 341.
74. United States v. De Bonchamps, 278 F.2d 127 (9th Cir. 1960); A & N Furniture & Appliance Co. v. United States, 271 F. Supp. 40 (D.C. Ohio 1967).
75. Alfred N. Hoffman, 47 T.C. 218 (1966), *aff'd*, 391 F.2d 930 (5th Cir. 1968).
76. Rev. Rul. 61-116, 1961-2 CUM. BULL. 207.

Commissioner to assert that the estate has terminated and that a testamentary trust has come into existence.[77] Under this line of reasoning it is unlikely that a "voting trust" established by the shareholders would cause a termination of an S election. The trust itself has no "tax substance" and all the income will be taxed to the shareholders of record. Any other holding would be allowing mere form to control over the actual substance of the relationship.

NONLIQUIDATING DISTRIBUTIONS

The taxation of distributions made by a tax option corporation is determined under the general distribution sections of Subchapter C[78] unless contrary or modifying provisions are contained in Subchapter S.[79] This section will compare and contrast the tax treatment of nonliquidating distributions of both Subchapter S and Subchapter C corporations.

Cash Distributions

All distributions of money by a C corporation are treated as dividends to the extent of current or accumulated earnings and profits (E & P).[80] These cash distributions serve to reduce E & P and are deemed to have come from the most recently accumulated E & P.[81] Such distributions are fully taxable as ordinary income to the recipient shareholders although an annual 100 dollar dividend exclusion is provided as relief (although token at best) from the burden of double taxation.[82] If the cash distributed exceeds current and accumulated E & P, the shareholder's basis will be reduced to the extent of such excess, but not below "0."[83] Any further excess will be treated as received in a sale or exchange of the stock unless such distribution is within the ambit of section 341 (a) (3).[84]

The rules governing cash distributions by C corporations also apply to S corporations but with several modifications. Section 1377 (b) of Subchapter S states that *current* E & P of an S corporation will not be reduced by any item that is not allowable as a deduction in computing taxable income as defined in section 1373 (d). Since cash dividends are not deductible in computing taxable income, current E & P of an S corporation will therefore not be reduced by cash distributions. This, of course, is contrary to the result under section 312 (a) for C corporations. However, cash distributions during the year will reduce E & P accumulated at the end of the year. The ostensibly different effect of cash distributions on E & P resulting from the operation of section 1377 (b) is, as a practical matter, misleading. Section 312 (a) (1) re-

77. Old Virginia Brick Co. v. Commissioner, 367 F.2d 276 (4th Cir. 1966).
78. CODE §§301-395.
79. Treas. Reg. §1.372-1 (c) (1959).
80. CODE §316 (a).
81. *Id.*
82. CODE §116.
83. Meyer v. Commissioner, 7 T.C. 1381 (1946); CODE §301 (c) (2); Treas. Reg. §1.1377-2 (a) (2) ex. 2 (1959).
84. CODE §301 (c) (3) (A).

quires that E & P be reduced by the amount of money distributed, but section 316 (a) (2), which defines dividends, requires that distributions first reduce current E & P and, secondly, that current E & P be computed "as of the close of the taxable year without diminution by reason of any distributions made during the taxable year . . . ." It is apparent that the dividend status of cash distributions for both C and S corporations, insofar as *current* E & P is concerned, will be determined by the extent of current E & P accumulated at the end of the year. There is only one practical effect resulting from section 1377 (b) of Subchapter S that differs from Subchapter C. It is possible under Subchapter C to have taxable income exceed current E & P, with the result that a distribution of all the taxable income of the current year (an unlikely event) would not be fully subject to the second tax at the shareholder level, assuming no accumulated E & P existed at the time (an equally unlikely event in a C corporation setting).[85] Under Subsection S, it is impossible for taxable income to exceed current E & P since section 1377 states that current E & P will not be reduced by any deduction not also allowable as a deduction from section 1373 taxable income. However, this is not particularly important and has little practical significance. The actual purpose of section 1377 (b), which will become more apparent in the discussion of undistributed taxable income below, is to prevent the taxable income of an S corporation from escaping the single tax imposed by Subchapter S at the shareholder level.

Subchapter S introduces another slight deviation from the section 312 and section 316 treatment of E & P on cash distributions. Regulation 1.1373-1 (e) creates a "three tier" structure, somewhat analogous to the tier structure of Subchapter J (taxation of estates and trusts), for the purposes of allocating E & P. Under this structure, cash distributions are in the first tier, with the consequence that E & P is first allocated to cash distributions. If any E & P remains, it is allocated to the second tier (UTI and property distributions), with any further excess allocated to the last tier (distributions in exchange for stock). No such tier discrimination exists under Subchapter C.

Another modification with regard to cash distributions under S pertains to distributions within two and one-half months after the close of the taxable year. Such cash distributions are deemed to be distributions of undistributed taxable income (UTI) of the prior year to the extent of such person's share of UTI for the year.[86] These distributions are not dividends and do not reduce either current or accumulated E & P pursuant to section 1375 (f). A companion section to section 1375 (f), section 1375 (d), provides that cash distributions[87] in excess of current E & P will be considered distributions of the previously taxed undistributed taxable income (PTUTI) of *all* prior S election years.[88] This section eliminates only the dividend status that would

85. As an example, E & P would be reduced by federal income taxes paid, but taxable income would not.

86. CODE §1375 (f) (1).

87. CODE §1375 (d) does not limit its applicability to cash distributions in the body of the statute. However, Treas. Reg. §1.1375-4 (b) (1968) imposes a cash distribution limitation on its application.

88. By contrast, CODE §1375 (f) applies only to the immediately preceding year.

have arisen due to the existence of accumulated E & P. If any current E & P exists, section 1375 (d) will not become operative.

A further distinction in the treatment of cash distributions under Subchapters C and S lies in the availability of the section 116 dividend exclusion. Section 116 was enacted to relieve the shareholder of the burden of double taxation on corporate earnings. Section 1375 (b) understandably denies the shareholder of an S corporation the benefit of the section 116 exclusion on dividends from *current* E & P since Subchapter S income is not subjected to the double tax.[89] However, since section 1375 (b) denies the section 116 exclusion to dividends from *current* E & P only, presumably section 116 would be available to dividends from accumulated E & P. Section 1375 (b) likewise provides that the section 37 retirement income credit will not be available to the shareholders of a Subchapter S corporation.

A final distinction lies in the characterization of the income recognized by shareholders of C and S corporations on cash dividends. In C corporations, cash distributions from E & P are taxed as ordinary income. This, however, is not always the case in S corporations, and herein lies one of the unique and most desirable features of the Subchapter S corporation. Under Subchapter S, amounts distributed as dividends will be characterized as long-term capital gain to the extent of the *current* E & P, and to the extent of the individual shareholder's prorata share of the excess of net long-term capital gain over short-term capital loss.[90] Subchapter S thus effects a "pass-through" of long-term capital gain to its shareholders that results in a tax savings to them.[91] The determination of capital gains, particularly in regard to sales or exchanges of section 1231 assets, is made at the corporate level (but see regulation 1.1375-1 (d)). The Subchapter S pass-through does not, however, extend to capital losses.[92] The presence of a capital gain pass-through in S corporations led to numerous abuses through "one-shot" elections whereby taxpayers who were contemplating a sale of assets involving large capital gains would elect under Subchapter S in order to have the proceeds of the sale subject to only one tax at capital gains rates. After the sale, the corporation would distribute the proceeds and terminate the S election.[93] Congress sought to remedy this situation by passing section 1378, which imposed a penalty tax on an S corporation if the net long-term capital gain over the short-term capital loss in any one year exceeded 25,000 dollars, and exceeded fifty per cent of the taxable income, and if the taxable income of the corpo-

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89. CODE §1372 (b). However, the penalty tax of §1378 may apply.

90. CODE §1375 (a), *as amended by* the Tax Reform Act of 1969, §301 (b) (11). For purposes of the long-term capital gain pass-through the excess of net long-term gain over short-term capital gain cannot exceed the corporation's taxable income for the year. CODE §1375 (a) (1).

91. *See* CODE §§1201 (b), 1202 for the applicable long-term capital gain rates.

92. CODE §1375 (a) deals only with capital *gains*. Since no provision of Subchapter S treates *capital* losses, presumably such losses would be covered by CODE §1211.

93. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 272 (1966) [hereinafter cited as BITTKER & EUSTICE]. The tax-free distribution could be accomplished under CODE §1375 (f).

ration exceeded 25,000 dollars for the year. However, it is submitted that Congress fell somewhat short in its endeavor to prevent the one-shot election in that S corporation status still often produces less of a tax burden to the shareholders, even with the penalty tax of section 1378, than if the sale had been carried out by a C corporation. Moreover, the tax paid at the corporate level under section 1378 serves to reduce UTI by the amount of the tax paid, thereby reducing the amount of the shareholder's taxable income and thus avoiding a complete double taxation. In addition, the exceptions to the section 1378 tax provided in section 1378 (c) further reduce the effectiveness of this section. The flexibility for manipulation under section 1378 (c) is evident when it is realized that the corporation could keep long-term capital gain below 25,000 dollars (or below fifty per cent) by electing to report gain under the installment method (section 453). If continued for three years the corporation would no longer be eligible for the application of section 1378.

The capital gains pass-through under Subchapter S also might provide the taxpayer with an instrument to circumvent the collapsible corporation provisions of Subchapter C.[94] The use of C corporations for this purpose will be discussed below.

Undistributed Taxable Income

The concept of undistributed taxable income (UTI), as it exists under Subchapter S, has no counterpart in Subchapter C. The purpose of UTI is somewhat akin to the tax treatment of partnerships under Subchapter K in that both are designed to directly tax the shareholders (or partners) on all taxable income produced during the year.[95] However, any similarity between Subchapter S and Subchapter K ends, for the most part, at this point. Section 1373 (a) requires that the UTI of an S corporation be included in the gross income of the shareholders. Section 1373 (b) effectuates the policy statement in section 1373 (a) by adopting a Subchapter C dividend concept rather than the Subchapter K conduit approach. Under section 1373 (b) every shareholder of an S corporation who is a shareholder on the last day of the taxable year is deemed to have received a *dividend* equal in amount to his prorata share of the corporation's UTI for the year. This amount will be taxed to the shareholders as ordinary income to the extent that it is treated as a distribution out of current E & P. Section 1373 (c) defines UTI as being the taxable income of the corporation minus: (1) any taxes imposed on the corporation under sections 1378 and 56, and (2) any *money* distributions made during the year. The UTI dividend, like the cash distribution, is a modified version of the Subchapter C dividend. Current E & P, as has already been established, is not reduced by a UTI dividend.[96] Also, under the tier structure established by the regulations for the allocation of E & P,[97] UTI dividends share a second

94. *See* CODE §341.
95. *See* CODE §§701-771.
96. CODE §1377 (b).
97. Treas. Reg. §1.1373-1 (e) (1959).

priority with property distributions. Consequently, current E & P will only be allocated to UTI distributions to the extent that it exceeds distributions of cash (unless such cash distributions fall under section 1375 (f)). The effect of distributions of property on the allocation of E & P to UTI will be explored below.

The major distinction between the UTI dividend and a dividend under Subchapter C lies in the fact that UTI is not an actual distribution of cash or property as is required under Subchapter C.[98] A UTI dividend is treated as though it were a distribution to the shareholders who, in turn, are deemed to have reinvested it in the corporation as a capital contribution. Just as an actual capital contribution increases the shareholder's basis in his stock, section 1376 (a) requires a corresponding increase in basis for a UTI dividend.

The constructive UTI distribution is determined by the taxable income of the corporation, which is computed in the same manner as if it were a C corporation except for the following: (1) no deduction for net operating loss is allowed and (2) the deductions under sections 241-247 (relating to special deductions for corporations) are also disallowed.[99] In relation to the computation of taxable income, a number of problems that often arise in a C corporation setting also arise under Subchapter S, but in a somewhat modified form. One area of frequent litigation for C corporations arises under the "reasonable salary" provision of section 162 (a) (1). The double tax imposed on C corporations offers substantial inducement for shareholder-employees to fix excessive salaries for themselves in order to both lower corporate taxable income and to facilitate a direct distribution of earnings to themselves while avoiding the second dividend tax bite. The Commissioner usually attacks these salary deductions on the ground that they are not reasonable in light of the services rendered.[100] The problem of salary deductions arises in reverse under Subchapter S. Since an S election eliminates the double taxation of corporate earnings, the incentive to have excessively high salaries does not exist. However, shareholder-employees of S corporations frequently attempt to set excessively *low* salaries for themselves and couple this with a dispersal of their stock to members of their families in an attempt to "climb down the surtax ladder." This, of course, is accomplished through the reallocation of UTI or cash dividends among family members who are in lower tax brackets. Here again the Commissioner has ample grounds to attack such a maneuvering of taxable income. The "reasonable salary" argument used by the Service against C corporations was also successfully utilized to attack unreasonably small salary deductions in S corporations in one recent case.[101] Moreover, Subchapter S itself provides the Commissioner with an effective weapon in section 1375 (c). This section provides that dividends from S cor-

98. *See* CODE §§316, 317 (a).

99. CODE §1373 (d). The reasons for the disallowance of net operating loss deductions will be explained *infra*. The deductions under CODE §§241-247 are basically designed to relieve the bite of double taxation on the corporation and, hence, are inapplicable.

100. *See* CODE §162 (a) (1). *See also* Miller Mfg. Co. v. Commissioner, 149 F.2d 421 (4th Cir. 1945).

101. Roob v. Commissioner, 50 T.C. 891 (1968).

porations may be apportioned or reallocated among shareholders who are members of the same family in order to reflect the value of services rendered to the corporation by such shareholders. The Regulations sound an ominous warning of the Commissioner's intent to utilize this section by stating that all transactions among members of a family (for example, stock transfers by the shareholder employee to his wife and children) will be closely scrutinized. Section 1375 (c) was successfully applied by the commissioner in the recent case of *Krahenbuhl v. Commissioner.*[102] In *Krahenbuhl,* the taxpayer and his wife, who together owned all the outstanding shares of the corporation, transferred blocks of shares to their children. The court invoked section 1375 (c) to allocate taxable income to the taxpayer on the grounds that the salary deductions taken did not accurately reflect the value of his services. A third alternative is the invocation of the assignment of income doctrine.[103] In *Duarte v. Commissioner*[104] the taxpayer transferred twenty-five per cent stock interests to his two sons (ages eight and fifteen years) in conjunction with a "surprise move" of the board of directors that almost simultaneously voted to reduce his salary from 30,000 dollars to 15,600 dollars per year. Although mentioning section 1375 (c), the court in *Duarte* appeared to rely principally on assignment of income, form versus substance, and other common law of taxation doctrines to reallocate taxable income to the taxpayer. If *Duarte* is any indication, the Commissioner has a broad arsenal from which to draw in combating any attempts by shareholders of S corporations to evade taxes via manipulations of salary deductions.

One further question should be raised at this point. In attempting to bolster the Commissioner's position, the Regulations state that a donee of stock in an S corporation will not be considered as a shareholder unless such stock was acquired in a "bona fide transaction" and such donee is the true owner of the stock.[105] This regulation therefore raises some doubts as to whether *any* gratuitous transfer of stock can be effectuated in a family setting. The result, of course, will depend on what interpretation is placed upon a "bona fide transaction." It is submitted that intra-family conveyances should be upheld so long as all employees are adequately compensated and the donees exercise effective control over the stock. Such an interpretation would effectively eliminate the flagrant abuses of the statute while still upholding the corporate concept of Subchapter S.

LOCKED-IN EARNINGS

The UTI constructive dividend creates an unusual and often hazardous situation in S corporations that, paradoxically, is accepted as the "way of life" under Subchapter C. The problem lies in the area of double taxation

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102. 21 CCH Tax Ct. Mem. 155 (1968).
103. *See* Helvering v. Eubank, 311 U.S. 122 (1940); Helvering v. Horst, 311 U.S. 112 (1940); Lucas v. Earl, 281 U.S. 111 (1930).
104. 44 T.C. 193 (1965).
105. Treas. Reg. §1.1373-1 (a) (2) (1959).

of corporate earnings. Under Subchapter C, taxable income is taxed first to the corporation[106] and then again to the shareholders as it is distributed in the form of taxable dividends.[107] One of the primary reasons for the adoption of Subchapter S was the elimination of the double taxation of corporate earnings and the substitution of a single direct tax on corporate income to the shareholders.[108] If taxable income is not actually distributed but is taxed to the shareholders by way of the constructive UTI dividend,[109] the earnings are retained by the corporation and the shareholder is faced with the problem of reclaiming his previously taxed undistributed taxable income (PTUTI) from the corporation without paying a second tax on the distribution.[110] As was pointed out above, Subchapter S provides two means by which this tax free reclamation may be carried out. Section 1375 (f) insures that all cash distributions made on or before the 15th day of the third month following the close of the taxable year will be deemed a distribution of the prior year's PTUTI (to the extent of the recipient's share of PTUTI), even if the corporation has lost its S status at the time of the distribution, provided that the corporation was an S corporation in the immediately preceding year. Section 1375 (d) produces the same result but is limited in application to instances in which no current E & P exists and the corporation must be an S corporation at the time of the distribution. If, however, the S election is terminated after the two and one-half month grace period provided by section 1375 (f), which may occur quite unexpectedly due to the Commissioner's strict enforcement of the section 1372 (e) termination provisions,[111] neither section 1375 (f) nor section 1375 (d) will be available. The result of this undesirable situation is that the PTUTI is "locked-in" and the shareholders will probably be forced to pay a considerable amount of tax to reclaim it. Some commentators believe, however, that the concept of locked in PTUTI is a fiction.[112] They premise their argument upon the generally accepted theory that UTI (and PTUTI) is first distributed to the shareholders and then recontributed by them in the form of a capital contribution. They reason that PTUTI is, therefore, nothing more than capital that is privileged over other forms of capital in that it may be distributed out of the corporation tax-free via sections 1375 (d) and 1375 (f).[113] The locked-in con-

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106. *See* CODE §§11, 1201 (a), 531.

107. *See* CODE §§301, 316, 312.

108. CODE §1372 (b).

109. *See* CODE §1373.

110. As has already been pointed out, a cash distribution from an S corporation will fall under CODE §§301, 311, 312 and will be treated as a dividend unless §1375 (f) or §1375 (d) applies. *But see* CODE §1377 in regard to the application of §312.

111. *See, e.g.*, Old Virginia Brick Co. v. Commissioner, 367 F.2d 276 (4th Cir. 1966).

112. Note, *Locked-In Earnings — How Serious a Problem Under Subchapter S?*, 49 VA. L. REV. 1516 (1963).

113. The tax-free nature of CODE §1375 (f), (d) distributions only extends to the shareholder's pro rata share of PTUTI. In addition, if such a distribution exceeds the shareholder's basis it will be treated under §301 (c) (3) (A) as being received in a sale or exchange of the stock. *See* Treas. Reg. §1.1375-4 (a) (1959); *e.g.*, Treas. Reg. §1.1375-6 (a) (1) (1968).

cept that these commentators attack conceives of PTUTI becoming locked-in a former S corporation in such a way that the shareholder must receive taxable *dividends* in order to get it out.[114] This reasoning, according to their theory, is fallacious since PTUTI is *capital* and distributions of capital are never dividends.[115] They conclude that, in the sense that PTUTI is locked-in due to the necessity of a dividend distribution to reclaim it, there is no such tax concept as locked-in earnings. The only effect a true distribution of PTUTI will have, according to their theory, is to reduce basis under section 301 (c) (2) and produce capital gain under section 301 (c) (3) (A).

The observation as to the capital status of PTUTI is correct, and insofar as the above-mentioned theory attacks the dividend status of post-termination (and non-section 1375 (f)) distributions, it also appears to be correct. However, for all practical purposes, PTUTI *can* become locked-in. The controversy here is a definitional one — that is: What is "locked-in PTUTI?" It is submitted that, in popular usage, "locked-in" is a practical term meaning that PTUTI is not readily accessible without suffering an additional tax burden to redeem it. Even though PTUTI is capital and distributions of capital can never be dividends, it is small comfort to a client-shareholder of a former S corporation to tell him that his PTUTI is not *really* locked-in, and that if the corporation will only distribute *all* of its current and accumulated E & P, *then* he can receive his PTUTI under section 301 (c) (2) and section 301 (c) (3) (A). This is, at the very least, impractical and probably impossible from the standpoint of corporate liquidity. The additional tax burden — probably of mammoth proportions — generated by the distributions of current and accumulated E & P, which paved the way for the PTUTI distributions, must also be considered. Consequently, as a practical matter, it is apparent that PTUTI may well become locked-in.[116]

One final problem might arise in PTUTI distributions under the collapsible corporation provisions of Subchapter C.[117] If distributions under section 1375 (d) or section 1375 (f) exceed the shareholder's basis in his stock, the remaining portion of the distribution is treated under section 301 (c) (3) (A) as being received in exchange for the stock.[118] If the corporation is "collapsible" under section 341 (b), such distributions will be transformed into ordinary income under section 341 (a) (3). This would probably be a most unexpected occurrence considering the intended nature of the distribution. However, income averaging under section 1301 might be available to ease some of the burden.

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114. *See, e.g.,* Treas. Reg. §1.1375-4 (a) (1959) referring to nondividend and dividend treatment.

115. CODE §301 (c) (2), (c) (3); Treas. Reg. §1.316-2 (a) (1955).

116. There is one minor consolation to the stockholder. His basis would be increased under §1376 (a) by the amount of PTUTI. Assuming the corporation experienced no net operating losses that would reduce basis under §1376 (b), any profit on a subsequent sale of the stock would be correspondingly reduced by the increase in basis.

117. CODE §341.

118. 48 T.C. 666 (1967), *aff'd,* 398 F.2d 340 (4th Cir. 1968).

DISTRIBUTIONS OF PROPERTY

The treatment of property distributions under Subchapters S and C differs in several respects. The contrast is immediately apparent upon comparing the Subchapter S definition of "property" with that of Subchapter C. Under section 317 (a), property includes money, securities, and any other property except stock in the distributing corporation. Under Subchapter S, however, money is not treated as property,[119] but receives special treatment under section 1373. However, this is the only difference in what is encompassed by the term "property" and, presumably, the case law under Subchapter C pertaining to what constitutes property would also be applicable to Subchapter S corporations insofar as money distributions are not involved.[120]

Under Subchapter C, property distributions are treated as dividends to the extent fair market value is covered by E & P.[121] However, due to the tier structure allocation of E & P under Subchapter S, property dividends do not enjoy the equal priority with cash distributions that exists under Subchapter C. The Regulations under section 1373 call for the allocation of E & P first to any cash distributions, with any remaining E & P allocated *ratably* between the constructive UTI dividend and property distributions.[122] For the purposes of determining the ratable shares of E & P, the fair market value of the property rather than its basis is used.[123] This produces an unintended distortion due to the application of section 312 (of Subchapter C) that controls the effect of property distributions on E & P to the extent not inconsistent with the tier structure of section 1373. This distortion is caused by the requirement of section 312 (a) (3) that E & P be reduced by the *adjusted basis* of the property distributed. Consequently, it is possible to create accumulated E & P through a property distribution under Subchapter S. This possibility is illustrated in the following example:[124]

> An S corporation has current E & P of $50,000 and no accumulated E & P. The UTI for the taxable year is $50,000, and the corporation made a distribution of property with a fair market value of $50,000 and an adjusted basis of $10,000. The shareholders cannot be taxed on more than $50,000.[125] Under the Regulations, E & P would be allocated (50,000/100,000 x 50,000 E & P) = $25,000 to UTI and an equal amount (50,000/100,000 x 50,000 — 25,000) to property. E & P is

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119. *See* Treas. Reg. §1.1373-1 (d), (e) (1969), which refers to "property other than money."

120. *See, e.g.*, United States v. Frazell, 335 F.2d 487 (5th Cir. 1964); Rev. Rul. 64-56, 1964-1 CUM. BULL. 133.

121. Treas. Reg. §1.316-1 (a) (3) (1962). *But see* Commissioner v. Godley's Estate, 213 F.2d 529 (3d Cir. 1954); Commissioner v. Hirshon Trust, 213 F.2d 523 (2d Cir. 1954).

122. Treas. Reg. §1.1373-1 (e) (1959). It should be pointed out that a third tier exists if any E & P remains after allocation to the first two tiers.

123. Treas. Reg. §1.1373-1 (g) ex. 3 (1959).

124. Example taken from an address by Professor J. J. Freeland entitled "Application of General Corporate and Other General Tax Provisions of Subchapter S Corporations and Shareholders," 1968 University of Iowa Tax Institute.

125. CODE §§316, 301 (c).

then reduced by the $25,000 UTI deemed distributed,[126] but (and herein lies the distortion) E & P is only reduced by the $10,000 *adjusted basis* of the property distributed.[127] This creates $15,000 of accumulated E & P.

This is one of the rare instances in which accumulated E & P can be created under Subchapter S. This "distortion" would be nonexistent under Subchapter C if, instead of UTI, a 50,000 dollar cash distribution were made in conjunction with a distribution of the same property.[128] In such a case, all E & P would be exhausted leaving an "0" basis in the accumulated E & P account.

One problem that has plagued taxmen for years in regard to property distributions under Subchapter C might very well extend to Subchapter S corporations. This is the so-called *"Godley-Hirshon"* area, named after two well-known cases decided under the 1939 Code.[129] The problem in this area stems from the fact that shareholders are taxed on property dividends to the extent of the *fair market value* of the property received, while E & P is reduced by the *adjusted basis* of the property. If property is distributed with a fair market value of 100 and a basis of 50, and E & P is 50, to what extent has the shareholder received a dividend? The *Godley* and *Hirshon* cases held that so long as E & P was sufficient to cover the adjusted basis, the shareholder would be deemed to have received a dividend equal in amount to the full *fair market value* of the property distributed. Consequently, in the example above, the shareholder would be taxed on a dividend of 100 when E & P was only 50. However, the Regulations under the 1954 Code specifically state that distributions of property will be taxed as dividends to the extent that *fair market value* is covered by E & P.[130] Although it is conceivable that a *Godley-Hirshon* interpretation could be placed on the present statute, in light of the position of the Regulations it is doubtful that this problem will arise in either Subchapter C or S today.

It should also be noted that one distinction that existed between Subchapter C and Subchapter S treatments of cash distributions does not exist in property distributions. It will be remembered that cash distributions may be nondividend distributions under Subchapter S due to sections 1375 (d) and 1375 (f). Section 1375 (f) specifically provides that a property distribution would not qualify as a return of PTUTI under its provisions. Although section 1375 (d) does not expressly contain such a provision, the Regulations' interpretation is such that it also excludes property distributions.[131]

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126. CODE §1377 (a).

127. CODE §312 (a) (3).

128. Although the Code and Regulations under §§316 and 312 are not clear on this point, it is generally agreed that E & P would be allocated ratably between cash and property distributions. Likewise, the ratable allocation would probably be based on the adjusted basis of the property. *See* BITTKER & EUSTICE, *supra* note 93, at 192.

129. Commissioner v. Godley's Estate, 213 F.2d 529 (3d Cir. 1954); Commissioner v. Hirshon Trust, 213 F.2d 523 (2d Cir. 1954).

130. Treas. Reg. §1.316-1 (a) (3) (1962). *See also* Harry H. Cloutier, 24 T.C. 1006 (1955).

131. Treas. Reg. §1.1375-4 (b) (1959).

STOCK DISTRIBUTIONS

Section 305 (a) excludes from income distributions of stock made by a corporation with respect to the stock of the corporation. This section would also apply to a Subchapter S corporation with the exception of section 305 (b) (1), which deals with stock distributions in discharge of preference dividends.[132] However, it appears certain that in the near future section 305 will be modified by Congress so that stock distributions in conjunction with taxable dividends on other stock *will be* taxable income to the extent that the distribution increases the shareholder's proportionate interest in the corporation. This change will apply to Subchapter S as well as to Subchapter C. One possible caveat under Subchapter S is the possibility that the stock distributed might be deemed a second class of stock, which would terminate the S election under section 1372 (e) (3). In order to prevent this occurrence, care must be taken to insure that the stock issued is identical in respect to rights and interests in the control, profits, and assets of the corporation. The Commissioner has been quick to enforce the involuntary termination measures, and S shareholders must be ever careful to avoid this possibility.

One of the express requirements of section 305 (a) is that the stock be distributed *with respect to the stock of the corporation*. Consequently, if stock is issued to an employee or independent contractor by the corporation as compensation for his services, it is not in respect to the stock of the corporation and would be taxable income to him.[133] This would be true under both Subchapters C and S. The validity of this point has been contested in a situation in which a shareholder-employee owning 100 per cent of the stock of the corporation was issued a "stock dividend" in discharge of the salary due him by the corporation. The taxpayer argued on the basis of *Eisner v. Macomber*,[134] one of the most famous cases in the annals of tax history, that he received nothing of value (since he owned 100 per cent of the stock of the corporation before *and* after the distribution) and that he had recognized no gain. Two courts of appeal reached opposite conclusions on this matter and the dispute has never been resolved.[135] However, in view of the recent development of the assignment of income doctrine, it seems clear that such a distribution would be held to be a taxable dividend today.[136]

REDEMPTIONS

Redemption of stock by a corporation, as defined in section 317 (b), is governed by the provisions of section 302, which treats redemption distributions to shareholders either as sales or exchanges of the stock, or as dividends.

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132. Under §1371 (a) (4), Subchapter S corporations may have only one class of stock that, presumably, would rule out the possibility of preferred stock.

133. Treas. Reg. §1.61-2 (d) (4) (1966).

134. 252 U.S. 189 (1920).

135. *See* Commissioner v. Fender Sales, Inc., 338 F.2d 924 (9th Cir. 1964); Joy Mfg. Co. v. Commissioner, 230 F.2d 740 (3d Cir. 1956).

136. *See* Note, *Stock Distributions in Discharge of Salary Obligations:* Fender Sales *Curbs* Taxpayer's Joy, 22 U. FLA. L. REV. 129 (1969).

The provisions of section 302 apply to tax option corporations as well as ordinary corporations. However, due to the unique features of the S corporation, various aspects of redemption take on a different importance under Subchapter S.

In order for a redemption of stock to be treated as a sale or exchange under section 302(a), it must meet one of the three tests set out in section 302(b).[137] Under section 302(b)(1), a redemption will qualify for sale or exchange treatment if it is "not essentially equivalent to a dividend." A great deal of uncertainty shrouds this provision, and it was formerly thought to apply only to redemption distributions to minority shareholders who had no control over the corporation.[138] However, in *Himmel v. Commissioner*[139] a shareholder who held all of the nonvoting preferred stock of the corporation in addition to his common stock, gave his shares of common to his son and the corporation then redeemed all of his preferred stock. This transaction did not meet either of the other section 302(b) tests,[140] but the court found the stockholder's right to share in corporate earnings and in net assets on liquidation was significantly altered. The court held that the *net effect* of this transaction was not essentially equivalent to a dividend. The expanded scope of section 302(b)(1) might have a special application in a Subchapter S setting. If a shareholder who desires to sell part of his stock in an S corporation, the sale of which would terminate the S election,[141] has a portion of his shares redeemed by the corporation, it seems this would be sufficient to qualify under section 302(b)(1) as "not essentially equivalent to a dividend."

The "substantially disproportionate distribution" test of section 302(b)(2) would certainly apply to Subchapter S and the necessary calculations under this section would be facilitated by the one class of stock requirement.[142] The termination of interest provision of section 302(b)(3) would also be applicable to Subchapter S.

At the corporate level, a redemption that qualifies for section 302(a) treatment (the determination of which is made at the shareholder level) will have last priority for E & P allocation under the three tier system of Subchapter S.[143] If E & P is not exhausted in the first two tiers, a section 302(a) redemption will reduce E & P in accordance with the rather nebulous section 312(e) provision of Subchapter C.[144] It should be noted that a dis-

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137. CODE §302(b) actually contains four "tests" but the fourth, which applies to certain redemptions of stock issued by railroad corporations in reorganizations, is rarely applicable.

138. *See* Treas Reg. §1.302-2 (1955); Rev. Rul. 56-183, 1956-1 CUM. BULL. 161.

139. 338 F.2d 815 (2d Cir. 1964).

140. CODE §§302(b)(2), (b)(3) both utilize the family attribution rules of §318 and, hence, the common stock held by his son was attributed to the shareholder and voting control remained unchanged. The §302(c) waiver of the family attribution rules with regard to a §302(b)(3) termination did not apply.

141. This could occur under §1372(e) if, for example, the shareholder sold stock to an eleventh shareholder (§1371(a)(1)) or to a corporation (§1371(a)(2)).

142. CODE §1371(a)(4).

143. Treas. Reg. §1.1373-1(e) (1959).

144. CODE §312(e) provides that the portion of a redemption chargeable to the

tribution of money that falls under section 302 (a) will not reduce UTI since section 1373 (c) states that only money distributed as a *dividend* will have this effect. Redemption distributions that fail to qualify under section 302 (a) (to the extent of E & P) receive correspondingly different treatment under Subchapter S. If stock is redeemed for cash under section 302 (d), it will have first priority for the reduction of E & P. The Regulations state that cash distributions will be in the first tier of E & P allocation if they are not made in exchange for the stock.[145] Such a distribution will also reduce UTI to the extent it is a dividend out of current E & P.[146] Property distributions, on the other hand, would fall under the second E & P tier, with E & P being allocated ratably between it and UTI.[147] Cash, but not property, distributions under section 302 (d) presumably will qualify for nondividend treatment under section 1375 (f) or section 1375 (d) since both sections apply to any money distributions not received in exchange for the stock.[148] If the corporation has no E & P, a redemption under section 302 (d) would be preferable to a section 302 (a) redemption since the shareholder would have no taxable income at all (as opposed to a taxable capital gain under section 302 (a)). In this regard, an additional benefit exists under Subchapter S if the corporation has no current E & P but does have accumulated E & P.[149] A section 302 (d) cash redemption in such an instance would not be a taxable dividend under section 1375 (d) to the extent of the shareholder's PTUTI. This treatment would, of course, not be available under Subchapter C.

Section 303, which treats certain redemptions of stock included in the gross estate of a decedent as received in exchange for the stock, will apply to an S corporation. Care should be taken in this situation to insure that the settlement of the estate is not unduly prolonged or, alternatively, that the stock is redeemed as early as possible to prevent the Commissioner from invoking regulation 1.641 (b)-3 to transform the estate into a trust (if a testamentary trust is provided for in the will) and terminate the S election.[150] Section 305 would not be applicable to Subchapter S corporations due to section 1371 (a) (2), which prohibits a corporation from being a shareholder in an S corporation. Likewise, section 306 is not applicable to S corporations because of the one class of stock limitation of section 1371 (a) (4).

One particularly useful aspect of redemptions is evident in the utilization of a "boot strap" sale of the stock of a corporation. A boot strap sale involves

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"capital account" will not be treated as a distribution of E & P. By implication, therefore, E & P will be reduced by the portion of the distribution not chargeable to the capital account. For a discussion of the meaning of "capital account" and what portion is chargeable to the capital account, see Edelstein & Korbel, *The Impact of Redemptions and Liquidation Distributions on Earnings and Profits*, 20 TAX L. REV. 479 (1965).

145. Treas. Reg. §1.1373-1 (e) (1) (1959) *incorporating* Treas. Reg. §1.1373-1 (d) (1959).

146. CODE §1373 (c).

147. Treas. Reg. §1.1373-1 (e) (2) (1959).

148. *See* Treas. Reg. §1.1375-4 (b) (1959); Treas. Reg. §1.1375-6 (a) (2) (iii) (1968).

149. It is possible for a Subchapter S corporation to have accumulated E & P. The accumulated E & P may be carried over from its prior Subchapter C years or may have been created, for example, by the receipt of tax exempt interest by the corporation.

150. *See* Old Virginia Brick Co. v. Commissioner, 367 F.2d 276 (4th Cir. 1966).

a conveyance of a portion of the corporate stock, followed by a redemption by the corporation of the remaining stock. The proceeds of the sale and of the redemption are treated as having been received in exchange for the stock and are therefore capital gains (caveat section 341).[151] This enables a purchaser to acquire all the stock of a corporation with a minimum cash investment. This method of disposing of all (or a substantial portion) of the corporate stock would be equally available to both ordinary and tax option corporations but only to those with a more than adequate cash position. In *Zenz v. Quinlivan*,[152] the Commissioner challenged the application of section 302(a) to a boot strap redemption on the ground that, had the redemption *preceded* the sale, it would have been a dividend. It was argued that this should also be the case where the redemption was prearranged before the sale.[153] The court rejected this argument on the grounds that the shareholder intended to effectuate a complete termination and met the requirements of section 302(b)(3). In a subsequent case[154] the court upheld section 302(a) treatment even where the redemption *preceded* the sale on the grounds that the redemption and sale should be viewed as a single transaction. However, in *Wall v. United States*[155] one shareholder purchased a portion of the stock of another shareholder, obligating himself to purchase the remainder of his stock in the future. When the purchasing shareholder then caused the corporation to redeem the seller's remaining shares, the purchaser's obligation was discharged. The court found this to be a constructive dividend to the purchaser. The *Wall* limitation on boot strap sales was subsequently narrowed in a later case involving similar circumstances except that the purchaser only obtained *an option* to buy the remaining shares of the seller.[156] The purchasing shareholder then assigned the option to the corporation, which in turn exercised it by redeeming the seller's shares.

If a boot strap sale is to be used in conveying the stock of an S corporation, it should be arranged in such a manner that will enable the seller to obtain his share of PTUTI from the corporation. If a shareholder's interest in the corporation is terminated, he loses his right to reclaim his share of PTUTI[157] unless he was a shareholder at the close of the taxable year and received a distribution within two and one-half months thereafter under section 1375(f). Consequently, if PTUTI is not reclaimed prior to or during the boot strap sale, it will be lost unless the shareholder can avail himself of the rather limited section 1375(f) situation.

One possible means of accomplishing the boot strap sale under Subchapter S while still preserving the right to reclaim PTUTI might involve a sale coupled with a redemption of all but one share through the issuance

151. The redemption will fall under §302(a) by virtue of §302(b)(3).

152. 213 F.2d 914 (6th Cir. 1954).

153. See discussion of *Zenz* in BITTKER & EUSTICE, *supra* note 93, at 294.

154. United States v. Carey, 289 F.2d 531 (8th Cir. 1961).

155. 164 F.2d 462 (4th Cir. 1947).

156. Holsey v. Commissioner, 258 F.2d 865 (3d Cir. 1958).

157. Treas. Reg. §1.1375-4(e) (1959). This regulation also states that if the former shareholder again becomes a shareholder in the future he regains his PTUTI.

of notes by the corporation. The redemption would probably qualify under section 302 (b) (2) as substantially disproportionate unless prevented by the family attribution rules. This method would have the advantage of leaving cash in the corporation (an otherwise major *disadvantage* of a boot strap sale) while at the same time preserving the seller's interest in PTUTI through the retention of the one share. There are, however, disadvantages to this method. The possibility that the Commissioner might declare the notes issued to be a second class of stock should not be lightly dismissed. Such a determination, if upheld by the court, would terminate the S election.[158] However, in light of several recent cases[159] the danger of termination seems minimal if the notes are proper in every other respect. Another disadvantage insofar as the seller is concerned is that he must forego the use of a portion of his sale proceeds. In this regard also, the question must be raised as to whether the gain on the redemption must be recognized in the year of sale, or whether he could utilize the installment method under section 453[160] and defer the recognition of his gain to later years. If the redemption is treated as a separate transaction, section 453 would be available since the proceeds in the year of sale, exclusive of evidence of indebtedness of the purchaser, do not exceed thirty per cent of the selling price.[161] However, the rationale of *United States v. Carey*[162] treating a two-step boot strap sale as a single transaction, might be invoked to include the proceeds of the *sale* in the payments test of section 453 (b) (2). Since this would probably make section 453 unavailable for the reporting of the gain, the entire gain would then be recognized in the year of sale.[163] It should also be noted that the basis in the one share of stock retained will probably be less than the seller's interest in PTUTI. Consequently, a portion of any section 1375 (f) distribution of PTUTI will be taxed to the seller-shareholder under section 301 (c) (3) (A), although probably at long-term capital gains rates.

Another possible alternative would involve having the corporation distribute the seller's share of PTUTI to him under section 1375 (f) prior to the boot strap sale. This would give the seller full and immediate use not only of the entire amount of the sale proceeds, but also of his share of PTUTI as well. This, of course, is even more of a disadvantage to the seller since the corporate cash account is depleted not only by the redemption but also by the PTUTI distribution. This would have the effect of obviating any possibility of the boot strap sale in all but the most liquid corporations.

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158. CODE §§1372 (e) (3), 1371 (a) (4).

159. *See* Alfred N. Hoffman, 47 T.C. 218 (1966); August F. Nielsen Co., Inc. v. Commissioner, 27 CCH Tax Ct. Mem. 44 (1968).

160. Although capital gains are involved, the availability of §453 reporting may still be important to the seller if he has held his stock less than six months or if he is in a position to utilize the alternate capital gains determination.

161. *See* CODE §453 (b) (2).

162. 289 F.2d 531 (8th Cir. 1961).

163. CODE §1001 (b); *cf.*, A. Hovey-King, 9 CCH Tax Ct. Mem. 297 (1950); Ennis v. Commissioner, 17 T.C. 465 (1951).

PARTIAL LIQUIDATIONS

Under section 331, distributions qualifying as partial liquidations under section 346 are treated as received in exchange for the stock. Section 346 in turn requires that distributions fall into one of three classifications in order to receive section 331 treatment: (1) the distribution may be a part of a series of distributions in redemption of all the stock of the corporation,[164] (2) the distribution may involve a "corporate contraction,"[165] or (3) the distribution may be in termination of one of two or more active businesses carried on by the corporation (subject to other requirements in section 346 (b)). One of the primary applications of partial liquidations to Subchapter S corporations is, again, in the boot strap sale. Under the boot strap sale and partial liquidation, the seller receives desired assets from the corporation in redemption of his shares. This device was attacked by the Commissioner on a theory similar to that advanced by him in the boot strap redemption case of *Zenz v. Quinlivan*.[166] In *Standard Linen Service v. Commissioner*[167] it was contended that this was nothing more than a step transaction with the objective of selling the assets of a division of the corporation. The court, however, found this to be a valid corporate contraction. However, the opposite result was reached by the Eighth Circuit Court of Appeals in *Idol v. Commissioner*[168] in the application of a "form versus substance" test. Consequently, the validity of this transaction is not without doubt.

Subchapter S provides a possible means to evade some of the pitfalls of the partial liquidation boot strap sale as they exist under Subchapter C. If the shareholder who was to receive the assets on the distribution intended to resell them, the necessity of meeting any corporate contraction test under section 346 may be obviated by arranging for the *corporation* to sell the assets. This will result in a single capital gains tax that, under section 1375 (a), will pass through to the shareholders. The distribution of the proceeds in redemption of the remaining portion of the seller's stock will effectively eliminate the additional E & P generated by the sale.[169]

NET OPERATING LOSSES

Under the net operating loss provision of Subchapter C, section 172, small businesses are often unable to take full advantage of losses due to the lack of earnings during the prescribed three-year carryback and five-year carryforward periods.[170] One of the unique provisions of Subchapter S has remedied this situation by providing that net operating losses are passed directly to the shareholders, thus enabling them to offset any other income

164. CODE §346 (a) (1).
165. CODE §346 (a) (2).
166. 213 F.2d 914 (6th Cir. 1954).
167. 33 T.C. 1 (1959).
168. 319 F.2d 647 (8th Cir. 1963).
169. CODE §1375 (a) applies to cash as well as UTI dividends.
170. CODE §172 (b) (1). *See* BITTKER & EUSTICE, *supra* note 93, at 729.

they might have.[171] The net operating loss provision of Subchapter S also lends itself especially to new corporations that expect losses in the formative years and to older corporations that expect nonrecurring losses.[172]

Like section 172, section 1374 of Subchapter S applies only to *operating* losses. Capital losses are not passed through and only serve to offset capital gains at the corporate level. Excess losses presumably may be carried forward five years under section 1212. Section 1374 is also similar to section 172 (c) in that it limits net operating loss treatment to *allowable* deductions. Consequently, for example, hobby deductions would not be deductible.[173] One significant distinction between section 172 and section 1374 is that E & P of an S corporation is not affected by any items of gross income or any deductions taken into account in determining net operating losses.[174] The reason for this provision is obvious when it is remembered that net operating losses are passed directly to the shareholders.. If E & P were reduced by net operating losses, the shareholders would receive an unwarranted second benefit in subsequent years.

It should be noted that net operating losses are limited to the extent of the shareholder's basis in his stock and any indebtedness owed him by the corporation.[175] If the shareholder's prorata share of net operating loss exceeds this limitation, then the three-year carryback and five-year carryforward of Subchapter C will apply. However, net operating losses of S corporations may not be carried over to a nonelection year under section 172 (h), and net operating losses of nonelection years may not be carried over to election years.[176]

LIQUIDATION

Now that the formation of, and distributions by, a Subchapter S corporation have been traced, a consideration of the interrelation of the Subchapter C sections relating to termination is in order. The S corporation with its one tax at the shareholder level presents an opportunity for corporate liquidation without the need to follow the strict rules set out in sections 333 and 337.

Before examining the advantages and disadvantages of S corporations on corporate liquidation, consideration should be given to the procedures under sections 333 and 337. Section 333 permits a "quick" liquidation, provided a valid election is filed by enough qualified shareholders[177] and all of the transactions involved in the liquidation take place within one calendar month.[178] Since an S corporation can have only individuals (or their estates)

171. CODE §1374.

172. *See* BITTKER & EUSTICE, *supra* note 93, at 729.

173. *See* DuPont v. United States, 234 F. Supp. 681 (D. Del. 1964); BITTKER & EUSTICE, *supra* note 93, at 731.

174. CODE §1377 (c). *See* Treas. Reg. §1.1377-3 (b) (1959).

175. CODE §1374 (c) (2).

176. CODE §1373 (d) (1).

177. CODE §333 (c).

178. CODE §333 (a) (2).

as shareholders, the gain, if any, will be determined under section 333 (e). On liquidation the shareholders' recognized gain is limited to the greater of their ratable share of earnings and profits or their ratable share of money received and the fair market value of stocks and securities acquired by the corporation after December 31, 1953.[179] In a section 333 liquidation the corporation's earnings and profits account is crucial. In the S corporation, because of the constructive dividend provision,[180] there will be little if any accumulated earnings and profits, so therefore it would be advisable to plan the liquidation for the calendar month immediately following the close of the corporation's taxable year when current earnings and profits are at a minimum. In this manner not only is one measure of recognized gain reduced, but also the possibility of the gain being characterized as ordinary income rather than long-term capital gain[181] is diminished.

The provisions of section 333 (e) (2) requiring gain to be recognized to the extent of cash and stock and securities acquired after December 31, 1953, are easily understood in light of the basis provisions for section 333 liquidations.[182] The recognition of the cash gain cannot be postponed until the shareholder spends the money since his economic gain has been fully realized. The rationale is the same with the post-1953 stock and securities because of the ready market that exists for them. As with earnings and profits, steps can be taken to reduce or eliminate these gain producing assets. They can be used to pay off the corporation's liabilities prior to the liquidation, to purchase assets other than stock (especially assets that the shareholders intended to purchase anyway), or to distribute selectively the corporate assets.[183] The S corporation will in most cases be troubled only by the cash aspect of section 333 (e) (2) because of the possible passive investment income problems presented by interest and dividends.[184] The shareholders take a substituted basis in the assets received, determined by reference to the basis of their stock exchanged, decreased by the money received and increased by the gain recognized.[185]

The effect to the corporation of the section 333 liquidation is that generally no gain or loss is recognized by the corporation's distribution of assets in complete liquidation.[186] However, the statutory exemptions of section 453 (d) on the disposition of installment obligations and the depreciation recapture provisions of sections 1250 and 1245 do bite in to produce gain. This presents a problem because the gain recognized can give rise to an increase in earnings and profits, which in turn will affect the amount of gain recognized by the shareholders. In a section 333 liquidation the earnings and profits are irrelevant except to the extent that they determine the amount

179. CODE §333 (e) (1), (2).
180. CODE §1378 (b), *as amended by* the Tax Reform Act of 1969, §511 (c) (4).
181. Treas. Reg. §1.333-4 (c) (1955).
182. CODE §334 (c).
183. BITTKER & EUSTICE, *supra* note 93, at 359.
184. CODE §1372 (e) (5); Treas. Reg. §1.1372-4 (b) (vii), (viii) (1965).
185. CODE §334 (c).
186. CODE §336.

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and character of gain recognized by the shareholders. Severe problems may be present in a section 333 liquidation of a C corporation followed by a sale of the assets by the shareholders.[187] However, with the S corporation's elimination of the tax at the corporate level, the problems in this area and in the assignment of income area are minimized, unless the character of the gain would have been different if the property had been sold by the corporation rather than by the shareholders. The problems presented by the liquidation of a collapsible corporation[188] continue to apply, and also section 337 is inapplicable to a section 333 liquidation.[189] Consideration should also be given to the fact that for section 333 to apply, the liquidation must occur within one calendar month.

Under section 337 there is no gain or loss recognized at the corporate level on a sale of substantially all the assets of the corporation within twelve months following adoption of the plan of complete liquidation.[190] The idea of complete nonrecognition must be modified to properly consider the character of the assets sold by the corporation,[191] the concept of assignment of income, the bites of sections 1245 and 1250,[192] and the inability to pass on preelection installment obligations.[193] In *Williamson v. United States*[194] a cash method corporation with large amounts of uncollected receivables was liquidated, and the receivables later collected by the taxpayer shareholders. Here, the corporation had a fixed right to the amounts due and all that remained to be done was collection. Over taxpayer arguments that the cash method used by the corporation precluded the Commissioner from applying accrual notions, the court held that even where the "taxpayer does not receive payment in money or property, realization may still occur when the last step is taken by which he obtains the fruition of the economic gain that has already accrued to him."[195] Also, in *Commissioner v. Kuckenberg*[196] where the corporation sold completed construction contracts on liquidation, the court agreed with the Commissioner that the corporation's method of accounting should be changed to the accrual method to clearly reflect income realities.

Another drawback to a liquidation under section 337 is the nonavailability in most cases of the installment method of reporting the gain on the sale of corporate assets. Under section 453 (d) (4) (B) a distribution of such obligations to the shareholders in a section 337 liquidation constitutes a taxable disposition. Even in those cases where the installment method is

187. Court Holding Co. v. Commissioner, 324 U.S. 331 (1945).

188. CODE §341.

189. CODE §337 (c) (1) (B).

190. CODE §337 (a).

191. CODE §337 (b).

192. Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965); West Seattle Nat'l Bank, 33 T.C. 341 (1959), *aff'd*, 288 F.2d 47 (9th Cir. 1961).

193. CODE §453 (d).

194. 292 F.2d 525 (Ct. Cl. 1961).

195. *Id.* at 526. Helvering v. Horst, 311 U.S. 112 (1940); Commissioner v. First State Bank of Stratford, 168 F.2d 1004 (5th Cir. 1948), *cert. denied*, 335 U.S. 867 (1948).

196. 309 F.2d 202 (9th Cir. 1962) (reversing the Tax Court).

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available to the corporation,[197] bunching of income results to the shareholders when the obligations are received in exchange for their stock. The obligations take a fair market value for the purposes of determining the shareholder's gain[198] and basis.[199] Some consolation can be taken from the fact that such bunching will be at capital gains rates.

However, this does not mean that all potentially ordinary income items are within the scope of the Commissioner's disallowance of the applicability of section 337. For example, the tax benefit argument has been held inapplicable to an attempted recapture of expense deductions on the sale of operating assets. In *D. B. Anders,*[200] the court held that the operating assets — the fruit — was property used in the business clearly within section 337 (b) (1). Even if the items had been inventoried, section 337 (b) (2) would have applied nonrecognition since the transaction amounted to a bulk sale.

Section 337 was enacted to solve the problems that arose following the *Court Holding Co.*[201] and *Cumberland Public Service Co. v. United States*[202] decisions by providing the same result whether the corporation sells the assets and then liquidates or liquidates and then the shareholders sell the assets. Even if the sale is imputed to the corporation under *Court Holding Co.*, the gain will go unrecognized under section 337 provided the sale takes place within the twelve-month timetable. Meeting this twelve-month timetable presents many of the problems of a section 337 liquidation. Connected with this is the provision of section 337 that disallows losses along with gains.[203] Faced with this problem, the corporation might attempt to straddle section 337 by selling its loss assets and then adopting the plan of liquidation and selling the appreciated assets under the shelter of section 337. However, section 337 applies only to a sale of substantially all the assets of the corporation before the date of adoption (thus recognizing both its gain and its losses) or after that date (thus subjecting both gains and losses to nonrecognition of section 337). If the corporation splits its sales, the Regulations provide that "the date of the adoption of the plan of liquidation shall be determined from all the facts and circumstances."[204] Under this rationale the Government might assert that the plan had been informally adopted when the corporation first sold assets at a loss. This predating of the plan may make section 337 applicable to all sales thereby applying nonrecognition to the loss, or it may make section 337 totally inapplicable if more than twelve months have elapsed between the predated plan and the final sale or distribution in liquidation. The Service, however, has not had much success in applying this rationale to corporate straddles.[205]

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197. CODE §453 (d) (4) (B) (ii).
198. CODE §331 (a).
199. CODE §334 (a).
200. 48 T.C. 815 (1967).
201. 324 U.S. 331 (1945).
202. 338 U.S. 451 (1950).
203. CODE §337 (a).
204. Treas. Reg. §1.337-2 (b) (1955).
205. City Bank of Washington, 38 T.C. 713 (1962); Virginia Ice & Freezing Corp., 30 T.C. 1251 (1958). In Rev. Rul. 57-140, 1957-1 CUM. BULL. 118, the Service ruled that a

Another problem presented by both sections 333 and 337 is the requirement of complete liquidation within the specified timetable. The Regulations modify this by allowing some assets to be retained to meet contingent claims against the corporation.[206] However, the Regulations also state that the term "claims" does not include amounts due the shareholders with respect to their stock.[207] In order to avoid this stringent requirement, the corporation can distribute to an escrow agent or trustee the assets needed to satisfy the contingent claims of shareholders or creditors.[208] It should be noted that all that is required is a complete liquidation, not a complete dissolution of the corporation. The corporation may be kept alive to protect the corporate name.[209] However, care should be taken in any dealing with the corporation or its distributed assets that it not be construed as a reactivation of the corporation inconsistent with its claimed liquidation.[210] This problem is avoided with an S election since the corporation can remain in existence and continue operations while selling its assets subject only to the passive investment income limitations.[211]

The S corporation with its one tax at the shareholder level presents an ideal method for corporate liquidation without having to follow the strict requirements of sections 333 or 337. As this possibility became more obvious the Commissioner sought means for avoiding the "one shot election" followed by a sale of the corporate assets and a pass-through of the gain to the shareholders. The Commissioner first attempted to regulate against the availability of an election to a corporation contemplating liquidation or in the process of a complete liquidation.[212] However, this attempt was based on rather dubious statutory authority and was dropped prior to final adoption.[213] In section 1378 the Commissioner has a weapon that can limit the use of "one shot election" in some cases by restricting the amount of capital gains a newly elected S corporation can have without the imposition of a surtax. However, this would appear to be avoidable through careful timing of the election to meet the three-year requirement,[214] or through use of the installment method with limited payments in the first three years.

The use of Subchapter S also removes any worries as to the time a plan of liquidation is adopted or the meeting of a fixed timetable. Under S, the corporation can sell as many or as few assets as it desires at any time it wishes to do so. Any losses the corporation sustains will be passed through

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sale of corporate assets at a loss following the adoption of a plan of complete liquidation would be accepted only on convincing proof that the earlier sale was not in contemplation of a later liquidation.

206. Treas. Reg. §1.337-2(b) (1955).

207. *Id.*

208 *E.g.*, Rev. Rul. 65-257, 1965-2 CUM. BULL. 89; Treas. Reg. §1.337-2(b) (1955).

209. Rev. Rul. 54-518, 1954-2 CUM. BULL. 142.

210. *E.g.*, James Armour, Inc., 43 T.C. 295 (1965); David T. Grubbs, 39 T.C. 42 (1962).

211. CODE §1372(e)(5).

212. Proposed Treas. Reg. §1.1372-1(a)(2), 23 Fed. Reg. 4528 (1958).

213. Hauptman v. Commissioner, 309 F.2d 62 (2d Cir. 1962) (the court held that a corporation could still elect Subchapter S even though it was in the process of liquidating).

214. CODE §1378(c)(1).

to the shareholders either in the form of net operating losses[215] or as a reduced UTI distribution.[216] Another advantage of the S election is that the asset sales can be made on the installment method with the corporation kept alive to pass the gain through to the shareholders. With the S corporation's one tax at the shareholder level there is no need to distribute the obligations to the shareholders. Therefore, no disposition within the meaning of section 453 (d) occurs. The problem of the section 1378 surtax is present only for newly elected S corporations[217] and ceases to be of concern in the fourth year of the payout. A question may arise whether amounts received from installment obligations constituted passive investment income giving rise to a possible termination of the election under section 1372 (e) (5). However, since these amounts are received from the sale of corporate assets they do not have the passive investment taint. The only passive income received in the transaction would be the real or imputed[218] interest on the installment notes. Since the test for section 1372 (e) (5) is a "gross receipts" test, and since the gross receipts would include the cash received under the contract, it does not appear that the section 1372 (e) (5) ceiling would be exceeded. As discussed earlier, an S election prior to liquidation might be advantageous to a potentially collapsible corporation since sections 333 and 337 may be unavailable.[219]

In some instances the corporation may find that an S election would produce results less favorable than those available under section 337. For example, if sale of the corporate assets would produce ordinary income,[220] then section 337 nonrecognition is preferable to the S pass-through of ordinary income to the shareholders. Another situation meriting consideration is one in which the shareholder's stock basis is greater than the corporation's basis for its assets:

> *A*'s basis in his *X* Corporation stock is $300. *X* Corporation has a basis of $200 and fair market value (FMV) of $600 in its assets. On the sale of the assets, *X* Corporation would realize $400 gain that would be passed through to *A* and serve to increase the basis of his stock to $700.[221] Upon a subsequent liquidation *X* would distribute $600 to *A*, who would thereby recognize a $100 capital loss. If the transaction had been under section 337, *A* would have recognized $100 on the liquidation of *X*, the difference between his stock basis and the FMV of the liquidating distribution.[222]

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215. CODE §1374.
216. CODE §1373 (b).
217. CODE §1378 (a), (b).
218. CODE §483.
219. CODE §337 (c) (1) (A).
220. Dealer-type property, short-term capital, or business-type assets. Section 337 (b) (2) provides for nonrecognition on bulk sales of inventory items.
221. CODE §1376 (a).
222. CODE §§331 (a) (1), 334 (a).

On the other hand, if the corporation's basis for its assets is greater than the shareholder's stock basis Subchapter S is preferable to section 337:

> *A* has a basis of $100 in his *C* Corporation stock. *X* Corporation's assets have a basis of $200 and a FMV of $400. Under section 337 *A* would have a $200 gain on the sale by *X* Corporation and a $100 capital loss on the distribution from *X* of the $400.

In a year during which the liquidating corporation incurs a net operating loss on ordinary operations, but foresees a gain from the sale of all or part of its assets, the decision to elect Subchapter S or section 337 depends upon whether the corporation wants to take advantage of the loss carryback provision (section 337) or whether the corporation considers it more desirable to pass the loss through to the shareholders (S). However, if S is elected part of the gain from the sale of the assets will be offset against the net operating loss, which reduces or eliminates the pass-through to the shareholders. However, this loss pass-through may be preserved if the corporation elects section 337 and S together. Thus, the gain would go unrecognized under section 337 and the loss would pass through undiminished to the shareholders. This also appears to be a way for the corporation to avoid the section 1378 surtax since the capital gains on the sale of its assets will escape recognition under section 337. It is suggested that this is too much of a good thing and that the Commissioner might seek to deny either the S election or the nonrecognition of section 337, arguing that Congress did not intend such double tax benefit.[223] However, this argument seems rather doubtful since there is nothing in the statute expressly prohibiting both elections.[224]

SECTION 341 AND SUBCHAPTER S

The collapsible corporation provisions of the Code were added to prevent individuals from realizing what would normally be ordinary income at capital gains rates through a sale of stock or the liquidation of the corporation. A classic example of this technique is found in the case of *Pat O'Brien*.[225] In that case the taxpayer formed a corporation to make a motion picture; after the picture was completed, but before distribution, the corporation was liquidated and the movie distributed to the shareholders. The shareholders reported the difference between the cost of their stock and the value of their proportionate shares in the completed film as long-term capital gain under section 331(a). The film took its fair market value basis in their hands[226] against which they could offset receipts from distribution rights. Only

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223. BITTKER & EUSTICE, *supra* note 93, at 737.

224. There is nothing in section 337 prohibiting its use by an S corporation. Treas. Reg. §1.1372-1(c) specifically provides that to the extent not inconsistent with the provisions of Subchapter S the provisions of Subschapter C shall apply in the same manner as they would if the election had not been made.

225. 25 T.C. 376 (1955).

226. CODE §334(a).

when their basis was exceeded would the shareholders recognize any additional income from the movie. This device was also popular in the real estate development industry. A corporation would be formed with the shareholder developers transferring the land to be developed in exchange for tax-free stock under section 351. The corporation would then develop the land and build the homes. Upon liquidation, the shareholders would receive their prorata share of the homes in exchange for their stock. Since the homes took a fair market value basis on the liquidation, they could be sold without any further recognition of gain. The only tax paid in these situations would be on the capital gains realized by the shareholders on the liquidation. A similar scheme was favorably employed in the liquor industry.

Though the Commissioner has some nonstatutory weapons at his disposal — additional compensation, assignment of income[227] — he has chosen to attack these maneuvers on statutory authority through the adoption of section 341. The actual interworkings of section 341 are quite complex and beyond the scope of this note. However, its basic principle is simple: a shareholder who disposes of his stock in a corporation possessing collapsible assets in a transaction that would normally give rise to long-term capital gain must instead report the gain as ordinary income. In effect, the shareholder realizes his share of the ordinary income lurking in the corporate assets. However, section 341 applies only if the gain realized on the transaction would have been long-term capital gain[228] and therefore would not apply to a sale of stock held for less than six months or to a sale by a dealer in securities.

Since the shareholder cannot sell his stock without realizing the gain as ordinary income and is unable to liquidate under either section 333[229] or section 337,[230] Subchapter S provides an interesting method for possibly disposing of collapsible assets at capital gains rates if the taxpayer is ineligible for the amnesty provisions of section 341 (e).[231] As stated earlier, under the general scheme of Subchapter S the corporation pays no tax[232] and the taxable income of the corporation is reported pro rata by the shareholders, whether or not distributed.[233] While this is generally treated as ordinary income, section 1375 (a) provides for the pass-through of long-term capital gains flavor to the shareholders.[234] Therefore, it appears that in a situation in which the collapsible corporation qualifies for an S election it can sell the collapsible assets that are capital or section 1231 assets at the expense of a

227. Herbert v. Riddell, 103 F. Supp. 369 (S.D. Cal. 1952); Pat O'Brien, 25 T.C. 376 (1955).

228. CODE §341 does not apply to short-term gain that can be offset against loss. It does not apply to losses in general, and does not of itself make the gain taxable and therefore has no effect on a tax free exchange, *e.g.*, 351 (a).

229. CODE §333 (a).

230. CODE §337 (c) (1) (A).

231. Section 341 (e) is not available if the property would have been dealer property if held directly by the shareholder.

232. *But see* CODE §1378.

233. CODE §1373 (b).

234. Their prorata share of the net long-term gains over the net short-term capital losses for the taxable year.

single capital gain to its shareholders.[235] This escape, however, is available only to transactions that would qualify as a sale of a capital asset.

The Regulations under section 1372 state that the collapsible provisions are applicable to an S corporation, and therefore the sale of stock in a collapsible S corporation will fall under section 341 (a). However, this result can be avoided by the corporation selling the collapsible capital or section 1231 asset at the corporate level, with the pass-through of the capital gain[236] and an increased stock basis to the shareholders resulting.[237] The corporation would then have the corresponding amount of cash or receivables so that it could distribute in liquidation or otherwise to the shareholders tax-free.[238]

Pat O'Brien Area: X Corporation is formed to make a movie and it files a timely election under S. The corporation then produces the movie, but before any amount is realized from its distribution, the corporation sells the picture for $2 million. This amount will be capital gains to the corporation and is passed through to the shareholders under sections 1373 (b) -1375 (a). The corporation will be left with $2 million in cash, or installment notes if the sale was on the installment method.[239] The shareholder's basis has been increased by this amount and therefore the corporation can be liquidated without any additional gain on the transaction. Since the installment method recognizes the gain as it is received, the capital gains will be spread over the payout period. This is not considered to be passive investment income, so the S election will not be threatened. Since the S election has been in existence from the inception of the corporation the surtax of section 1378 would not apply.[240] Even if the corporation had not elected S in the beginning, section 1378 could be avoided if the election had been in effect for the three immediately preceeding years.

Real Estate Area: An S corporation could also be used to construct an apartment building or shopping center. After completion the corporation could sell and pass the capital gains through to the shareholders. Care would have to be taken to insure that the corporation did not realize too great an amount of rent from the assets prior to their sale. Since rent is considered passive investment income, exceeding the twenty per cent limitation could cause a termination of the election.[241] However, the passive investment taint can be avoided if the corporation provides "substantial services" to its tenants.[242] The Regulations state that the "term

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235. This is the same result §341 (e) seeks to achieve, but with S the circumstances are not quite as limited.

236. CODE §1375 (a).

237. CODE §1376 (a).

238. CODE §1375 (d), (f).

239. Rev. Rul. 65-292, 1965-2 CUM. BULL. 319, ruling that if the corporation elected the installment method of reporting long-term gain, the deferred gain could be ratably passed through under §1375 (a).

240. CODE §1378 (c) (2).

241. CODE §1372 (e) (5).

242. Treas. Reg. §1.1372-4 (b) (5) (vi) (1959).

rents does not include payments for the use or occupancy of rooms or other space where *significant services* are also rendered to the occupant, such as for the use of rooms in . . . apartment houses furnishing hotel services . . . . Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only." Such an example is maid service.[243] In the year of the sale gross receipts would include amounts received on the sale of the assets, and it is difficult to see how the rents could exceed twenty per cent of the gross receipts in this situation. Also, all amounts received as rent would be applied toward meeting the substantial realization test. Once the latest gain has been substantially realized the corporation is no longer collapsible.[244]

In order to prevent this use of the S election the Service proposed two regulations, 1.1372-1 (a) (2) and 1.1375-1 (d). Under the former, the S election is available to a corporation in the process of a complete or partial liquidation, or contemplating adoption of such a plan in the near future. This would apply in the above situations in that a sale by the corporation of a major asset followed by a distribution to the shareholders might be treated as a partial liquidation.[245] Under regulation 1.1375-1 (d),[246] if the electing corporation is availed of by a shareholder or group of shareholders owning a substantial portion of the stock for the purpose of selling assets, which in the hands of the shareholders would have produced ordinary income, then the gain on the sale by the corporation will not be treated as capital gain. In determining the character of the asset sold in the hands of the shareholder, the activities of other S corporations in which he holds stock will be considered.[247] Under this regulation the shareholder-dealer taint could cause the corporation to have ordinary income rather than capital gain on the sale of the movie, apartment building, or shopping center. While this regulation, if valid, substantially closes a loophole that exists in the statute, it is also clear, as has been suggested by many noted authors,[248] that the regulation lacks statutory basis. Since there have been no cases on point, only time will tell which view the courts will embrace.

This pass-through of capital gains and avoidance of the collapsible provisions is not without its problems when consideration is given to the other assets of the corporation. If the collapsible asset is sold but there are left in the corporation noncollapsible assets less than three years old,[249] does the corporation still meet the definition in section 341 (b) since the corporation is dissolved before the realization of a substantial portion of taxable income

243. Max Feingold, 49 T.C. 461 (1968).

244. Commissioner v. Kelley, 293 F.2d 904 (5th Cir. 1961); CODE §341 (b) (1) (A).

245. CODE §346.

246. Treas. Reg. §1.1375-1 (d) (1959).

247. This became part of the regulations as finally adopted. Treas. Reg. §1.1371-1 (d) (1968).

248. BITTKER & EUSTICE, *supra* note 93, at 722 n.34; Bolland, *Collapsible Corporations Under the 1958 Amendments*, 17 TEXAS L. REV. 203, 237 (1962).

249. CODE §341 (d) (3).

from the collapsible asset? Presumably it would not because the income, although not recognized, has been realized by the corporation, which then passed it through to the shareholders. It is in this area of "phantom income" that problems may arise. If this income has not been actually realized for purposes of the collapsible provisions,[250] then the provisions will apply with full force regardless of the fact that the asset has been sold.

If there are other collapsible assets in the corporation, what is the effect of this retained cash from the sale of the collapsible assets on the application of the section 341 (d) (2) seventy per cent test? Because undistributed earnings included in income of shareholders increase their stock basis, the gain on the sale of stock or on liquidation would be attributable to the other retained assets if retained cash were ignored. If more than thirty per cent of the gain were attributable to the collapsible assets, section 341 (a) would still apply as far as section 341 (d) (2) is concerned. Although this is not a complete discussion of the relationship of section 341 to Subchapter S it does present some of the possible advantages of an S election.

MISCELLANEOUS CORPORATE PROVISIONS

Pension and Profit-Sharing Plans

Prior to 1970, Subchapter S corporations could avail themselves of the provisions of sections 401-404 and adopt a pension or profit-sharing plan,[251] or both. In the 1969 Tax Reform Act Congress eliminated this option by limiting shareholders of a Subchapter S corporation to the provisions of the Keogh Act — restricting contributions from shareholder-employees to the lesser of 2,500 dollars or ten per cent of income.[252] This new provision may lead many S corporations to terminate their S election where the availability of a pension or profit-sharing plan was a substantial motivating factor behind the original election.

Section 1244

Individual shareholders of a small business corporation (as defined in section 1244 (c)) may convert loss on the sale of their stock from capital to ordinary loss under the provisions of section 1244. Although limited to 25,000 dollars of loss for an individual, and 50,000 dollars for a husband and wife filing a joint return, this is a great benefit to shareholders who otherwise would have been limited to the very restrictive capital loss provisions of section 1211. Section 1244 would be available to the shareholders of an S corporation since there is nothing contained in either section 1244 or Subchapter S that would prevent its application. However, the value of a section

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250. *Cf.* Richardson Foundation v. United States, 69-1 U.S. Tax Cas. ¶9341 (N.D. Tex. (1969).

251. Rev. Rul. 66-218, 1966 CUM. BULL. 120.

252. CODE §1379 (b) (1) as included in the Tax Reform Act of 1969, §531 (a).