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Active "Passive" Income Under Section 1372(e)(5)

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ACTIVE "PASSIVE" INCOME UNDER SECTION 1372(e)(5)

Sections 1371 through 1379 of the Internal Revenue Code of 1954 constitute Subchapter S. If a corporation meets the requirements of section 1371(a)[1] and makes the election provided by sections 1372(a) and (c),[2] the special rules of Subchapter S apply. A properly electing corporation is not subject to corporate income taxes,[3] except for tax on capital gains under certain circumstances.[4] The undistributed taxable income of an electing corporation is included in the gross income of its shareholders proportionately to their shareholdings.[5] Conversely, any net operating loss sustained by an electing corporation is allowed to the individual shareholders as a deduction, with certain limitations.[6]

The rules of Subchapter S are highly advantageous in many business settings, and the availability of such benefits is often a pivotal consideration in tax planning. Where the benefits of Subchapter S are desired, failure to meet the statutory requirements will almost surely produce unwanted or even disastrous tax consequences. The possibility of an unintended termination of the Subchapter S election is a serious and continuing concern.

Section 1372(e) provides five instances in which a Subchapter S election will be terminated. Section 1372(e)(2) permits voluntary revocation of the election. Sections 1372(e)(1) and (3) provide, in effect, for termination for a year during which the initial eligibility requirements are not met.[7] Sections 1372(e)(4) and (5) effect a termination of the election of a corporation whose foreign income and passive investment income exceed specified limits.[8] The latter two

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1. Generally, INT. REV. CODE OF 1954, §1371(a), requires that the corporation have but one class of stock and no more than 10 shareholders, each of whom must be an individual (or an estate), and that no shareholder be a nonresident alien.

2. The election of Subchapter S status must be made with the consent of all shareholders, INT. REV. CODE OF 1954, §1372(a). Both the consent and the election must be filed in written form. TREAS. REG. §§1.1372-2(a), -3(a). The election may be made only during the first month of the corporation's taxable year or the month preceding such first month. INT. REV. CODE OF 1954, §1372(c). Once made, the election is valid for the year made and all succeeding years, unless terminated. INT. REV. CODE OF 1954, §1372(d).

3. INT. REV. CODE OF 1954, §1372(b)(1).

4. INT. REV. CODE OF 1954, §1378.

5. INT. REV. CODE OF 1954, §1373. Since §1375(d) provides that subsequent distributions of the amounts which previously had been taxed as undistributed taxable income are received by the shareholders free of tax, actual distributions by an electing corporation have a neutral tax effect.

6. INT. REV. CODE OF 1954, §1374.

7. INT. REV. CODE OF 1954, §1372(e)(1), requires a termination when a new shareholder fails to consent to the election within 30 days after becoming a shareholder. *See also* TREAS. REG. §§1.137-3(b), 4(b)(1). INT. REV. CODE OF 1954, §1372(e)(3), requires termination during any year in which the corporation ceases being a "small business corporation" as defined in §1371(a), such as when it has more than 10 shareholders, or has as a shareholder a nonresident alien. See note 1 *supra*.

8. The termination of Subchapter S status is effective for the taxable year during which the termination is made and for all succeeding taxable years of the corporation. INT. REV. CODE OF 1954, §§1372(e)(1)-(5). In the case of a voluntary revocation of election, which requires the consent of all shareholders, if the revocation is made after the close of the first

provisions are least subject to control or manipulation by the corporation and its shareholders and are thus more nearly true involuntary termination provisions. This paper is concerned with one aspect of section 1372(e)(5), requiring termination for any year during which the corporation's "passive investment income" exceeds twenty percent of its gross receipts. Section 1372(e)(5)(C) defines "passive investment income" as gross receipts from interest, royalties, rents, and gain on the sale of stock and securities.[9]

Since first enacted, section 1372(e)(5) and the regulations promulgated thereunder have been a source of concern, controversy, and litigation for small loan companies and securities dealers whose income is limited by the statute. The Internal Revenue Service has consistently maintained that elections by such corporations are invalidated by section 1372(e)(5), a position first stated in 1958 in T.I.R. 113:

> Question 2. Can a bank or a licensed personal finance company, the income of which consists largely of interest but which is specifically exempted from the personal holding company provisions of the Internal Revenue Code, make an effective election under section 1372?
>
> Answer. No. Under the provisions of section 1372(e)(5) the election is terminated for any year in which any corporation derives more than 20 percent of its gross receipts from interest, and no exemption from the operation of this provision is provided for a bank or a licensed personal finance company.[10]

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month of the corporation's taxable year, the revocation does not take effect until the following taxable year. *Id.* §1372(e)(2).

9. INT. REV. CODE OF 1954, §1372(e)(5), currently reads as follows:

"(5) Passive Investment Income—

"(A) Except as provided in subparagraph (B), an election under subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20 percent of which is passive investment income. Such termination shall be effective for the taxable year of the corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation.

"(B) Subparagraph (A) shall not apply with respect to a taxable year in which a small business corporation has gross receipts more than 20 percent of which is passive investment income, if—

"(i) such taxable year is the first taxable year in which the corporation commenced the active conduct of any trade or business or the next succeeding taxable year; and

"(ii) the amount of passive investment income for such taxable year is less than $3,000.

"(C) For purposes of this paragraph, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross reecipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). Gross receipts derived from sales or exchanges of stock or securities for purposes of this paragraph shall not include amounts received by an electing small business corporation which are treated under section 331 (relating to corporate liquidations) as payments in exchange for stock where the electing small business corporation owned more than 50 percent of each class of the stock of the liquidating corporation."

10. T.I.R. No. 113, Nov. 26, 1958, *quoted in* 6 CCH 1958 STAND. FED. TAX. REP. ¶6818, at 63,671.

Notwithstanding this announcement, loan companies and securities dealers have sought to circumvent the limitations of section 1372(e)(5) in a number of litigated cases. Since in many of the cases the taxpayers relied on the legislative history of section 1372(e)(5) in their arguments, a brief discussion of that history is appropriate.

Subchapter S, including section 1372(e)(5), first appeared as a Senate amendment to the Technical Amendments Act of 1958.[11] Originally, section 1372 (e)(5) was captioned "Personal Holding Company Income" and consisted of one paragraph requiring termination of the election when more than 20 percent of the corporation's gross receipts consisted of, *inter alia,* interest or dividends.[12] Committee reports regarding the limitation, however, are vague and quite general. The Senate Report accompanying the bill states only that "the election terminates if more than 20 percent of the corporation's gross receipts are derived from interest, dividends, rents, royalties, or other forms of passive income."[13] In the technical explanation, the Report stated that termination occurs where the corporation has gross receipts "more than 20 percent of which are derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities."[14] These two segments constitute the entire reference to the limitation in the Senate Report. Subsequent congressional references to the limitation are similarly brief.

In 1966, the statute was amended to partially exempt corporations during the first two years of business life.[15] This provision now appears as section 1372(e)(5)(B) and was added to avoid the hardship of termination during construction and similar start-up activities where construction funds on deposit were drawing interest income and the corporation had no other receipts.[16] To effect this change, the 1966 amendment divided the former single paragraph into the present three paragraphs. At the same time, the caption for the section was changed from "Personal Holding Company Income" to "Passive Investment Income." The relevant committee report regarding this amendment is quite brief, stating that, under existing law, a corporation's election terminates "automatically where more than 20 percent of a corporation's gross rereipts are derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities."[17] The report states that, as a result of the amendment, a corporation's election is not to terminate "merely because its

11. Act of Sept. 2, 1958, Pub. L. No. 85-866, §64, 72 Stat. 1606.

12. Originally, INT. REV. CODE OF 1954, §1372(e)(5), read as follows:

"(5) Personal holding company income—An election under subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20 percent of which is derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). Such termination shall be effective for the taxable year of the corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation."

13. S. REP. No. 1983, 85th Cong., 2d Sess. (1958), 1958-3 CUM. BULL. 922, 1010.

14. *Id.* at 1139.

15. Act of April 14, 1966, Pub. L. No. 89-389, §3(a), 80 Stat. 111.

16. S. REP. No. 1007, 89th Cong., 2d Sess. (1966), 1966-1 CUM. BULL. 527, 532-33.

17. *Id.*

passive investment income exceeds 20 percent of its gross receipts during the first 2 taxable years in which it carried on the active conduct of a trade or business if its passive investment income for the year in question is less than $3,000."[18]

Prior to 1970, these remarks constituted the entire congressional expression of intent with respect to termination under section 1372(e)(5). It is noteworthy that in neither instance did the relevant report contain any discussion of the terms "active trade or business" or "passive income." Although the 1958 legislation utilized the caption "Personal Holding Company Income," the 1958 report made no reference to that caption, to personal holding companies, or to the concept of passive income. The 1966 report failed to discuss the significance, if any, of the caption's change to read "Passive Investment Income." Finally, it is significant that the Senate Report on the 1958 legislation gives no indication of why the limitation was included in the first place.

The need for the limitation is, at best, questionable. Under Subchapter S, the corporate tax is eliminated except for the operation of section 1378. Instead, all income is taxed at the shareholder level and at individual rates. As a consequence, a Subchapter S corporation in no way can be used to "shelter" income at corporate rates. Thus, the section 1372(e)(5) limitation does not operate to avoid sheltering passive income, as does the personal holding company tax of section 541.[19] Additionally, the pass-through of the net operating loss of an electing corporation achieves no tax advantage that could not be obtained by operating the business as a proprietorship or partnership. The presence of large amounts of passive income in corporate form would therefore not present any danger to the revenue. The only legislative history addressing the reason for limitation is speculative in nature and relates to a 1971 amendment to section 1372(e)(5).

Prior to the 1971 amendment, amounts received by a parent corporation on the liquidation of a subsidiary were treated as gain from the sale or exchange of stock for purposes of section 1372(e)(5).[20] Thus, the twenty percent limitation on passive investment income was sometimes exceeded by a corporation engaged in an active business solely because of the liquidation of a subsidiary. To avoid termination of the Subchapter S election in such situations, the 1971 amendment added the last sentence of section 1372(e)(5)(C) to exclude from "gross receipts derived from the sale or exchange of stocks or securities" the gain realized by a corporation in receiving amounts on the liquidation of a corporation when the electing corporation owns more than fifty percent of the liquidating corporation. The Senate Report speculates on the reason for the limitation:

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18. *Id.* at 533.

19. Generally, INT. REV. CODE OF 1954, §541, imposes a punitive tax on the undistributed income of a corporation deriving large amounts of income from passive sources. The purpose of this statute is to discourage the incorporation of passive income investments in order that the income therefrom can be sheltered at corporate rates. Accordingly, the additional tax can be avoided only by distributing such income as dividends.

20. *See* INT. REV. CODE OF 1954, §331.

> Probably the principal reason why this limitation on passive investment income was adopted was to reduce the incentive to incorporate one's investment activities merely to obtain tax deferral benefits accorded to pension, profit-sharing, and similar plans. However, with the imposition by the Tax Reform Act of 1969 of the H.R. 10-type of limitation on pensions, etc., paid to a shareholder-employee of a subchapter S corporation, this reason for denying the subchapter S treatment for passive income has disappeared. Furthermore, elimination of the passive income limitation was included in the legislative proposals presented by the Treasury Department (both the 1968 and the 1969 recommendations) to simplify subchapter S and to deal with a series of other problems, such as the inadvertent terminations of elections.[21]

As will be discussed later, the conclusion of the report is questionable. It is also questionable whether the report is authoritative to any degree in construing the 1958 or 1966 statutes. Nevertheless, the report remains the sole expression of congressional intent with respect to the passive income limitation. It is against this sparse historical background that the litigation involving the passive income limitation as applied to small loan companies and securities dealers has arisen.

The first loan company case arising under section 1372(e)(5) was *Valley Loan Association v. United States*.[22] At issue was the validity of a regulation[23] under section 1372(e)(5) stating that, for purposes of the statute, the corporation could not include loan principal repayments in its "gross receipts." Had such inclusion been permitted, interest income would have represented but a small percentage of gross receipts. Under the regulation, however, "gross receipts" were composed almost entirely of interest income. Whether the corporation's interest income was of the type limited by the statute was not at issue. In deciding the case for the taxpayer, the court stated that the regulation nearly always had the effect of excluding small loan companies from the benefits of Subchapter S and that nothing in the statute or in its legislative history indicated that such a result was intended. The court noted that "Congress intended §1372(e)(5) to apply only to personal holding company income, for that is the subheading of that particular statute,"[24] and that since 1958, loan companies such as the taxpayer had been excluded from the personal holding company definition.[25] The court concluded that the statute neither expressly nor by implication excluded loan principal repayments from "gross receipts" and that the challenged regulation was invalid in requiring such exclusion.[26]

The next case on point, arising in 1969, was also concerned with amounts to be included in "gross receipts" for purposes of applying the twenty percent limitation. *Buhler Mortgage Co.*[27] involved a corporation engaged in the

21. S. REP. No. 91-1535, 91st Cong., 2d Sess. (1970), 1971-1 CUM. BULL. 614. For the limitation on pensions paid to a shareholder-employee, *see* INT. REV. CODE OF 1954, §1379(b).

22. 258 F. Supp. 673, 1966-2 U.S.T.C. ¶9683 (D. Colo. 1966).

23. Treas. Reg. §1.1372-4(b)(5)(ii) (1966) (now TREAS. REG. §1.1372-4(b)(5)(iv)).

24. 258 F. Supp. at 676, 1966-2 U.S.T.C. ¶9683, at 87,235.

25. *Id.*

26. *Id.*

27. 51 T.C. 971 (1969), *aff'd per curiam*, 443 F.2d 1362, 1971-2 U.S.T.C. ¶9558 (9th Cir. 1971).

mortgage brokerage business. The corporation bought and sold deed of trust notes, collected interest, and received fees for servicing loans. At issue was whether the notes were "securities," only the gain from the disposition of which is included in gross receipts for purposes of section 1372(e)(5). The parties had stipulated as to the amount of the corporation's "personal holding company income" for the years in issue.[28] If "gross receipts" included all proceeds from the sale of the notes, the statutory limitation was not exceeded. If, however, only the gains from such sales were included, the limitation was exceeded and the election had terminated.

The taxpayer first argued that the regulations defining securities[29] did not include deed of trust notes of the type sold by the corporation. The court found that such notes were clearly included in the definition of "securities" under the regulations. The taxpayer then argued that the regulation was invalid, relying on statements in the legislative history of the 1958 Subchapter S enactment[30] that Subchapter S is to be available only to small corporations engaged in an active trade or business and that section 1372(e)(5) was included to deny use of the subchapter to corporations with large amounts of investment-type income. The taxpayer urged that, since all its income resulted from active aggressive pursuits, the income it earned was not, therefore, within the definition of personal holding company income or passive investment income.[31] The court agreed that section 1372(e)(5) was intended to exclude from the benefits of Subchapter S corporations with large amounts of investment-type income, as opposed to income earned in an active trade or business. However, the court continued:

> [W]e cannot find that the nature of the income changes simply because the corporation earning it must engage in many activities and exert a great deal of effort in doing so. The standard used by the Code . . . does not permit us to look behind the normal characterizations of a corporation's receipts in order to classify them as active or passive.[32]

In its argument, the taxpayer had cited a regulation[33] under the personal holding company provisions of the Code that excluded from personal holding company income amounts received on the sale of securities by a securities dealer. The court found the cited regulation inapplicable to the issue, noting that section 543(a)(2) contains a specific provision excluding gains on the sale of securities by a dealer. Subchapter S contains no similar exclusion. Accordingly, the corporation's Subchapter S election had been terminated.

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28. 51 T.C. at 976. The caption of the statute for the years in issue was "personal holding company income." However, by the time the Tax Court opinion was written, the caption had been changed to "passive investment income." The opinion uses the captions interchangeably.

29. Treas. Reg. §1.1372-4(b)(5)(viii) (1966) (now TREAS. REG. §1.1372-4(b)(5)(x)) adopts the definition of "stock or securities" found in TREAS. REG. §1.543-1(b)(5)(i).

30. S. REP. No. 1007, *supra* note 16.

31. "Personal holding company income" and "passive investment income" are the statutory captions adopted in 1958 and 1966, respectively.

32. 51 T.C. at 977.

Next in the line of cases was *Jasper L. House, Jr.*,[34] in which the taxpayers were the stockholders of a number of small loan companies. The Treasury contended that the Subchapter S elections of the corporations had terminated by virtue of section 1372(e)(5). In the Tax Court, the taxpayers argued that small loan companies, per se, were exempt from the provisions of that section. Drawing support from the statements of the court in *Valley Loan Association*,[35] the taxpayers asserted that if so applied, section 1372(e)(5) would eliminate all small loan companies from Subchapter S status and there was no indication in the legislative history indicating such a result was intended. Citing its holding in *Buhler Mortgage Co.*,[36] the court held that there was no statutory foundation for the wholesale exemption of loan companies from section 1372(e)(5). The holding in *Valley Loan Association* addressed only the issue of the validity of a regulation excluding loan principal repayments from "gross receipts." Had the holding in *Valley Loan Association* been that section 1372(e)(5) was not applicable to small loan companies, the court noted, there would have been no reason to hold the regulation invalid.[37]

On appeal the Court of Appeals for the Fifth Circuit reversed.[38] Although the case dealt with taxable years prior to the 1966 caption change, the court placed great emphasis on both the former caption, "personal holding company income," and the present caption, "passive investment income." In so doing, the court noted without comment the taxpayers' argument that the change in captions was in itself significant.[39] The court held that the 20 percent test was to be applied only to items of income which are "passive," as opposed to "active." The Treasury argued that the statute is to be read with no meaning or emphasis ascribed to the paragraph captions, that no reference to the personal holding company provisions of the Code are authorized in section 1372(e)(5), and that the statute makes no distinction between "active" and "passive" interest. The court disagreed, observing that Congress did use the words "personal holding company income" and "passive investment income." Subchapter S does not define or make reference to "personal holding company income" other than in section 1372(e)(5). The court ruled, therefore, that reference to section 542 is proper to define or clarify the language of section 1372(e)(5).[40] Finally, the court found nothing that would forbid reference to section 542, citing *Valley Loan Association* for the proposition that the statute is intended to apply only to personal holding company income.[41]

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33. TREAS. REG. §1.543-1(b)(5)(ii).
34. 29 CCH Tax Ct. Mem. ¶30,130 (1970).
35. See text accompanying notes 22-26 *supra*.
36. See text accompanying notes 27-33 *supra*.
37. 29 CCH Tax Ct. Mem. ¶30,130, at 538.
38. House v. Commissioner, 453 F.2d 982, 1972-1 U.S.T.C. ¶9163 (5th Cir. 1972).
39. *Id.* at 985, 1972-1 U.S.T.C. ¶9163, at 83,674.
40. In support of this reference, the Court cites Lansing Broadcasting Co. v. Commissioner, 427 F.2d 1014, 1970-2 U.S.T.C. ¶9461 (6th Cir. 1970) which approved reference to §331 in determining that amounts received in liquidation of a corporation are to be treated as amounts received on the "sale or exchange of securities" within the meaning of §1372(e)(5), and found such sections *in pari materia* and to be construed together.
41. 453 F.2d at 987, 1972-1 U.S.T.C. ¶9163, at 83,675-76.

With these observations, the court then held that the word "interest" in section 1372(e)(5) could not be read in isolation, and that the caption of the section evidenced a legislative purpose that only interest representing "personal holding company income" or, after 1966, "passive income" is to be included for purposes of the statutory limitation.[42] The court stated that subheading cannot be read to destroy a statute's clear meaning, but where no conflict exists between the two, both are to be consulted in arriving at a total meaning of the statute.[43] Further, the court stated that the Government's contentions would lift the word "interest" from its context and give it a meaning that does violence to the legislative purpose.[44] Accordingly, the election was held not to have terminated.

Surprisingly, the Government did not argue, nor did the court discuss, the applicability of section 7806(b), which expressly provides that paragraph captions are to be given no consideration in construing any provision of the Internal Revenue Code. Rather, the court placed strong emphasis on both the pre-1966 and post-1966 captions to section 1372(e)(5) and discussed a number of cases sanctioning such references in the analysis of a statute.[45]

In subsequent cases the Tax Court rejected the holding of the Fifth Circuit in *House*. In *I. J. Marshall*,[46] the corporation involved was engaged in the small loan business. Arguing against termination of its Subchapter S status under section 1372(e)(5), the taxpayer contended that under *Valley Loan Association*, loan repayments were to be included in gross receipts,[47] and that its interest income was not "passive" as required by the Fifth Circuit in *House*.[48] The Tax Court rejected the holding in *Valley Loan Association*, finding that the underlying rationale in that case — that section 1372(e)(5) was inapplicable to corporations specifically excluded from personal holding company status — had been rejected in *Buhler Mortgage Co.*[49] The taxpayer's other contention, that *House* required that only "passive" interest could terminate a Subchapter S election, was also rejected.[50] The Tax Court declined to follow the Fifth Circuit, citing its own opinion in *Buhler Mortgage Co.*, which it maintained had been misread by the Fifth Circuit in *House*.[51]

The Tax Court's opinion in *Marshall* was appealed to the Tenth Circuit,

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42. *Id.* at 987, 1972-1 U.S.T.C. ¶9163, at 83,676.
43. *Id.*
44. *Id.*
45. See cases cited 453 F.2d at 987-88, 1972-1 U.S.T.C. ¶9163, at 83,675-76.
46. 60 T.C. 242 (1973), *aff'd*, 510 F.2d 259, 1975-1 U.S.T.C. ¶9160 (10th Cir. 1975).
47. 60 T.C. at 248.
48. *Id.* at 250.
49. *Id.* at 248-49.
50. *Id.* at 252.
51. *Id.* at 250-52. The Tax Court's opinion in *Marshall* was reviewed by the court and is the only case on point so reviewed. The single separate opinion, a concurring opinion by Judge Sterrett, made the observation that, in view of the change in the caption made by the 1966 legislation, it is possible that under some circumstances interest may not be passive income. To date, this is the only indication from the Tax Court that it might consider the nature of the activity producing interest income, an undertaking which the court rejected in *Buhler Mortgage Co. Id.* at 253 (Sterrett, J., concurring).

which affirmed.[52] The court made relatively short work of the appeal, stating that the taxpayer's position was based on *Valley Loan Association* and *House*, both pre-1966 cases, and that after 1966 it could not be argued that section 1372(e)(5) was inapplicable to corporations excluded from the definition of personal holding company.[53] It also declined to hold that interest "actively" earned is not to be included in the termination percentage.[54] Responding to the taxpayer's reliance on *House*, the court asserted that the Fifth Circuit had relied on the 1966 change in captions as indicating that Congress had attached some significance to the original caption.[55] If that is so, the *Marshall* court stated, then the 1966 caption change was "a calculated effort [by Congress] to erase utterly any implication that a small corporation must be a personal holding company before it can be excluded from Subchapter S treatment by Section 1372(e)(5). The opinion of the Fifth Circuit in *House* is pregnant with this very implication . . . ."[56]

It appears that the Tenth Circuit failed to read accurately the opinion of the Fifth Circuit. As noted earlier, the Fifth Circuit in *House* did not discuss whether the 1966 caption change was significant.[57] Rather, the court stated that the purpose of the caption both before and after 1966 was to define more fully the interest income that could result in termination, presupposing a similarity of purpose in the two captions. Clearly, the statement in *Marshall* that *House* emphasized the 1966 caption change is incorrect.

Four months after its decision in *Marshall*, the Tax Court decided *Joseph B. Zychinski*.[58] In *Zychinski*, the corporation was a licensed and registered securities dealer. A large portion of its gross receipts was composed of gain on the sale of securities for its own account, all of which was ordinary income. Arguing against termination of the corporation's election, the taxpayers relied on *House* for the proposition that the legislative history of Subchapter S indicates that Subchapter S status is to be denied only to corporations with large amounts of investment-type income and is not to be denied to those deriving substantially all income from an active business.[59] The Tax Court again declined to follow *House*, reaffirming its position that the Code does not permit the court to look beyond the usual characterization of corporate receipts to classify them as active or passive.[60]

The taxpayers next argued that the term "gains from sales or exchanges of stocks or securities" as used in section 1372(e)(5) does not include ordinary receipts of a dealer, but only those resulting from a dealer's capital or invest-

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52. Marshall v. Commissioner, 510 F.2d 259, 1975-1 U.S.T.C. ¶9160 (10th Cir. 1975).
53. *Id.* at 263, 1975-1 U.S.T.C. ¶9160, at 86,206.
54. *Id.* at 264, 1975-1 U.S.T.C. ¶9160, at 86,207.
55. *Id.* at 263-64, 1975-1 U.S.T.C. ¶9160, at 86,207.
56. *Id.*
57. See text accompanying note 39 *supra*.
58. 60 T.C. 950 (1973), *aff'd*, 506 F.2d 637, 1974-2 U.S.T.C. ¶9834 (8th Cir. 1974), *cert. denied*, 421 U.S. 999 (1975). See note 79 *infra* and accompanying text.
59. 60 T.C. at 955.
60. *Id.* at 956.

ment-type transactions.[61] The taxpayers urged that this position was not inconsistent with the regulations, which provide in part:

> Gross receipts from the sale or exchange of stocks and securities includes gains received from such sales or exchanges by a corporation even though such corporation is a regular dealer in stocks and securities.[62]

The taxpayers argued that the sales referred to in the regulation were only those transactions involving stocks or securities held for investment, not those held in inventory and in which the corporation made a market. This novel argument was also rejected since the court found no statutory authority to differentiate between business and non-business activities.[63]

On appeal, the Eighth Circuit rejected the taxpayers' contention that the corporation's gains from sale of stocks and securities could not be "passive investment income" because they were neither "passive" nor derived from "investments."[64] The court characterized the argument as an attempt "to define colloquially a term which is already defined statutorily"[65] in section 1372(e)(5)(C) and held that the statute permitted no "active" and "passive" test with respect to an item of income enumerated in the statute.[66] The court was not persuaded that the broad generalizations in the legislative history, stating that Subchapter S would be available to "active" types of businesses, could override "the plain meaning of the specific language" of the statute.[67] Additionally, the court expressed concern about the difficulties which could arise, if the taxpayers' position were adopted, in determining whether a business was sufficiently "active" to fall outside of section 1372(e)(5).[68]

Against the background of these developments, there have arisen two anomalous cases which seem to demand a final resolution of the issue. The taxpayers in *Kenneth W. Doehring*[69] and *Paul E. Puckett*[70] each owned half the stock of the same small loan company. The Treasury determined the corporation's election under Subchapter S to have terminated under section 1372(e)(5). The cases were reported in separate opinions, both rejecting any "personal holding company income" or "active – passive income" test. The court in

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61. *Id.* at 956-57.

62. TREAS. REG. §1.1372-4(b)(5)(x), *cited*, 60 T.C. at 957.

63. 60 T.C. at 957.

64. Zychinski v. Commissioner, 506 F.2d 637, 1974-2 U.S.T.C. ¶9834 (8th Cir. 1974).

65. *Id.* at 638, 1974-2 U.S.T.C. ¶9834, at 85,731.

66. *Id.* at 638-39, 1974-2 U.S.T.C. ¶9834, at 85,732.

67. *Id.* at 639, 1974-2 U.S.T.C. ¶9834, at 85,732.

68. In a footnote, the court stated it doubted whether any income derived from the fluctuation of market prices could be termed "active." This last statement, which could apply to all competitive retail operations, was unfortunate and unwarranted. However, it appears to have little potential for influence on the issue discussed herein.

69. 33 CCH Tax Ct. Mem. ¶32,762 (1974), *rev'd*, F.2d , 76-1 U.S.T.C. ¶9114 (8th Cir. 1975). See notes 80-82 *infra* and accompanying text for a discussion of the Eighth Circuit's reversal.

70. 33 CCH Tax Ct. Mem. ¶32,763 (1974), *aff'd per curiam*, F.2d , 75-2 U.S.T.C. ¶9481 (5th Cir. 1975). See notes 80-82 *infra* and accompanying text for a discussion of the Fifth Circuit's decision.

Puckett, however, held the corporation was not a personal holding company and thus was not subject to section 1372(e)(5), since an appeal in the case would be taken to the Fifth Circuit, which had adopted such a rule in *House*.[71] The election was held terminated in *Doehring* because the appeal would be taken to the Eighth Circuit, which had declined to follow *House*. Thus, the election of one corporation was held at the same time, by the same court, both to have terminated and not to have terminated. *Puckett* and *Doehring* are on appeal to the Fifth and Eighth Circuits, respectively, at the time of this writing.

In all of the foregoing cases, the taxpayers have urged that, notwithstanding the fact that corporate income is included in the items enumerated in section 1372(e)(5), the legislative history of Subchapter S indicates that the limitation is to apply only if the income is derived from a truly passive source or is personal holding company income. This position has been accepted in *Valley Loan Association* and *House*. However, as noted earlier, the legislative history lends no support to any argument that the Code's captions were intended to define more fully the types of prohibited income. Neither does it support an assertion that the 1966 caption change was a deliberate device to eliminate entirely any reference to personal holding company provisions, a view which, as noted above, the Tenth Circuit in *Marshall* erroneously ascribed to the Fifth Circuit's opinion in *House*. Both the 1958 and 1966 reports use the terms "passive income" and "passive investment income," but in context give no indication of the importance to be attached to the use of such terms. The legislative history, standing alone, does not suggest that "passive" income is to be characterized further by the activity producing it.

As noted earlier,[72] only the Senate Finance Committee report regarding the 1971 amendment contained any reference to a reason for including the limitation in the original legislation, and that reference was purely speculative. Moreover, even if the original purpose, as stated in the report, was to avoid the incorporation of investment portfolios in order to obtain tax benefits accorded qualified pension and profit-sharing plans,[73] the Committee's conclusion that the imposition of H.R. 10-type limitations on the qualified plans of Subchapter S corporations[74] eliminated the problem is inaccurate. Under the H.R. 10 rules,

71. In Jack E. Golsen, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985, 1971-2 U.S.T.C. ¶9497 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971), the Tax Court announced it no longer would apply its former "one law" rule, but would decide a case on the basis of the law applied by the court of appeals for the circuit to which an appeal would lie. The application of the "Golsen rule" in *Puckett* and *Doehring* produced the different results for stockholders of the same corporation.

72. See text accompanying note 21 *supra*.

73. Basically, qualified plans enjoy several benefits: contributions by the employer are deductible when made, INT. REV. CODE OF 1954, §404(a); the employees on whose behalf contributions are made are taxed only as the funds accumulated under the plan are paid or made available to them, INT. REV. CODE OF 1954, §402(a); and the trust established under the plan is exempt from taxation, INT. REV. CODE OF 1954, §501(a).

74. See INT. REV. CODE OF 1954, §1379, added by the Tax Reform Act of 1969. This provision essentially taxes a shareholder-employee of a Subchapter S corporation on plan contributions to the extent they exceed the limits on qualified plan contributions applicable to self-employed individuals.

a plan may cover individuals with "earned income,"[75] which means income from self-employment as defined in section 1402(a).[76] That section includes only income derived from "carrying on a trade or business,"[77] which is interpreted by the statute to exclude all forms of passive income. Thus, H.R. 10 plans may not be adopted by an individual with respect to income derived from his investment portfolio. As a consequence, the H.R. 10-type limitations on Subchapter S qualified plans would not, in themselves, prevent the prohibited practice. In the absence of section 1372(e)(5), an individual could incorporate his investment portfolio, elect Subchapter S, and adopt a qualified pension or profit-sharing plan. Although the plan adopted would be subject to the H.R. 10-type limitations contained in section 1379, the incorporated investor would not thereby be placed on an equal footing with the individual investor, for as noted earlier, such an individual is not permitted to adopt an H.R. 10 plan for himself, because of the absence of an active trade or business. Accordingly, the enactment of section 1379 did not eliminate the problem stated by the 1971 report to have been the reason for the original enactment of section 1372(e)(5).

If the statements in the 1971 Senate Finance Committee Report are accepted as the authoritative statement of legislative intent, and section 1372 (e)(5) is viewed as the manifestation of that intent, the position of the taxpayers in all cases discussed herein is consistent with such intent, and the propriety of an analysis of a particular item of income in order to determine whether it is derived from the active conduct of a business gains significant support. The fact remains, however, that the unqualified limitation is extant. Additionally, the failure of Congress to repeal the limitation, as noted in the report, vitiates the taxpayers' argument. Consequently, doubt remains regarding the reason for and the reach of section 1372(e)(5).

Clearly, the question of whether "passive" income derived from the active conduct of a trade or business should terminate a Subchapter S election requires resolution. The 1971 report indicated that such resolution by Congress probably will be a long time in coming. In the meantime, the courts must deal with the issue.

As of the date of this writing, the taxpayer in *Zychinski* has petitioned for certiorari, but no action on the petition has been taken. *Puckett* has been appealed to the Fifth Circuit and *Doehring* to the Eighth. The best approach for resolving the issue would probably be for the Supreme Court to deny certiorari in *Zychinski* and grant it in the *Puckett* and *Doehring* cases following their respective appeals. Then the Court would have before it the conflicting opinions of two Circuits on the issue of whether the election of the same corporation was terminated under section 1372(e)(5). The Court would be in a position to settle the issue, giving appropriate regard to the statement of intent contained in the 1971 report. It is submitted that in resolving this conflict the Court would be properly influenced by the failure of the statute itself to recognize any "active – passive" test with respect to the enumerated income

75. INT. REV. CODE OF 1954, §401(c)(1).
76. INT. REV. CODE OF 1954, §401(c)(2).
77. INT. REV. CODE OF 1954, §1402(a).

items,[78] and the difficulty, as noted by the Eighth Circuit in *Zychinski*, of establishing effective operating criteria for determining the level of activity which would make "passive" income "active." In the absence of any statutory authority for the application of such a test, the Court should reject it as a judicial solution and adopt the reasoning of the Tax Court in *Buhler Mortgage Co.* Such a solution would be proper until Congress provides otherwise.

JAMES A. MCNABB, JR.

ADDENDUM

Since the foregoing article was written, higher courts have reviewed three of the cited cases. The Supreme Court denied certiorari in *Zychinsky*.[79] The Fifth Circuit, denying the request of the Commissioner for a full-court reconsideration of its opinion in *House*, affirmed, *per curiam*, the Tax Court's *Puckett* opinion.[80] The most interesting development was the Eighth Circuit's reversal of the Tax Court in *Doehring*,[81] in which the Eighth Circuit adopted the *House* rule for pre-1966 years as to corporations that specifically are exempted from the personal holding company provision of the Code and reaffirmed its holding in *Zychinsky* for post-amendment years. The Eighth Circuit found significance in the 1966 caption change, as the Tenth Circuit, in *Marshall*, erroneously ascribed to the Fifth Circuit.[82] As a consequence of the foregoing, there is no split in authority between the Fifth and Eighth Circuits in the *Puckett* and *Doehring* decisions, respectively. Thus, it would appear unlikely that a final resolution of this issue will be obtained in the foreseeable future; however, the double-edged approach adopted by the Eighth Circuit in *Doehring* makes such a final resolution even more imperative.

78. The statutes easily could have provided for termination of the Subchapter S election for any year during which the electing corporation was a "personal holding company" within the meaning of §542 and thereby have achieved the interpretation and results urged by the taxpayers in all cases discussed herein. The failure of Congress to apply such a test to the limitation is significant and invites an inference that the limitation is to have a broader reach than does §542.

79. Zinchinsky v. Commissioner, 421 U.S. 999 (1975). For a discussion of this case, see notes 58-68 *supra* and accompanying text.

80. Puckett v. Commissioner, F.2d , 75-2 U.S.T.C. ¶9481 (5th Cir. 1975). For a discussion of this case, see notes 69-71 *supra* and accompanying text.

81. Doehring v. Commissioner, F.2d , 76-1 U.S.T.C. ¶9114 (8th Cir. 1975). For a discussion of this case, see notes 69-71 *supra* and accompanying text.

82. *Marshall* is discussed at notes 52-58 *supra* and accompanying text.