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SECTION 1244 AND SUBCHAPTER S — TWO ALLIES OF THE CLOSE CORPORATION

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The investor in a modern-day close corporation is continually faced with two problem areas of major tax consequence. He is concerned with the question of how to best utilize a loss on his investment should one occur. The more speculative an investment, the more reluctant an investor is to participate if his possible loss will be treated as a capital loss rather than an ordinary one.

Section 1244 of the Internal Revenue Code offers a solution to the first problem area, that of maximum utilization of a loss on a capital investment in a close corporation. Section 1244 is not only important in the original issue of stock of a newly formed corporation, but also important in any subsequent addition of new capital and issuance of new stock.

The second problem area the investor is concerned with is realizing his share of the corporate earnings without double taxation, that is, the corporate tax on corporate earnings and then the individual tax on his share of earnings passed to him as dividends. This problem is particularly distressing to a stockholder who is not an officer or employee of the corporation because he has no salary income that is deductible by the corporation. The avoidance of double taxation can be accomplished by strict compliance with the special provisions of sections 1371 through 1377 of the Internal Revenue Code of 1954, commonly referred to as Subchapter S. Although consideration of these special provisions is essential in the initial planning and formation of a corporation, the tax impact in future business years is of primary importance.

These are two major tax areas in which the lawyer can be of assistance to the owners of the close corporation — the two areas in which faulty legal advice can be most disastrous.

SECTION 1244

When an investment in the stock or securities of a corporation results in a loss, it is usually treated as a capital loss and is available as a deduction from capital gain.[1] In contrast to the capital loss treat-

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1. INT. REV. CODE OF 1954, §1212, as amended, Revenue Act of 1964, §230, 78

ment of most stockholder investments in a corporation, the individual proprietor or partner who participates in a losing venture is usually entitled to deduct his share of the losses incurred in the business directly against ordinary income.

In an attempt to mitigate the effect of capital gains treatment accorded losses, investors often financed corporated operations by loans; if a loan was in fact recognized as a legitimate business debt within the meaning of section 166 of the Internal Revenue Code, then the loss sustained on the loan might have been treated as an ordinary loss. Since the *Whipple*[2] case was decided, however, a shareholder's chances of obtaining an ordinary loss deduction on a bad debt resulting from his advances to his corporation have been substantially reduced. From the result in that case, it would appear that the ordinary loss deduction will be allowed only if the lender is in the business of lending money or his advances are directly related to some other business conducted by him.

Investors in more speculative enterprises sometimes utilize the partnership form of doing business in the early years when the risk of loss is greatest and incorporate only after success seems likely. This mode of operation, while usually protecting the ordinary loss status of the investment, does not afford the investor with the corporate shield of limited liability.

In 1958 Congress enacted an important change in the Code that has served to reduce the disparity between the stockholder and the proprietor or partner. This significant change is section 1244, the purpose of which was to "encourage the flow of new funds into small business" and to place shareholders of small corporations "on a more nearly equal basis with . . . proprietors and partners."[3]

There will be no penalties or new problems for him. The relief offered by section 1244 accords a limited *ordinary* loss to individuals for a realized loss on stock of a qualified "small business corporation." A newly organized domestic corporation may issue up to $500,000 of common stock, either voting or nonvoting, which may be qualified under section 1244.[4] If the stock issue complies with the technical requirements of the section, any loss sustained by the individual in-

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Stat. 99 (1964). [Hereinafter all reference to Internal Revenue Code of 1954 will be to the amended version, unless otherwise indicated.] Treas. Reg. §1.1212-1 (1957) provides that any excess of capital losses, after 1963, for individual taxpayers may be carried forward for an unlimited period and used to offset capital gains and a maximum of $1,000 of ordinary income each year. The carryover is treated as short-term or long-term, depending on its classification in the year incurred. Pre-1964 losses are carried over as a short-term loss.

2. United States v. Whipple, 313 U.S. 193 (1963).

3. H.R. REP. No. 2198, 85th Cong., 2d Sess. 2, 4 (1958).

4. INT. REV. CODE OF 1954, §1244 (c) (2) (A).

vestor on its sale, exchange, or worthlessness will be allowed as an ordinary income deduction, limited however in any year to $25,000, or $50,000 in the case of married taxpayers filing joint returns.[5]

Section 1244 represents a rarity in our tax law in that it can only operate to a taxpayer's benefit. If the stock issue should not qualify, the shareholders will be in the same position as if they had made no attempt.[6] Most other tax savings plans generally require the parties to elect an option that may work to their disadvantage if the plan is not executed successfully. Such is not the case under section 1244 which not only is applicable to new corporations, but also to stock issued by existing corporations. This tax benefit is of such major importance that every attorney who represents corporate clients should be aware of the section and fully utilize it whenever possible.

Eligibility and Qualifications of Stock

The requirements for qualifying section 1244 stock are found in subsection (c). All but one of the requirements may be determined at the time the stock is issued, while the remaining one is determined at the time the shareholder sustains a loss on the stock. The requirements, discussed in more detail later, are:

(1) the stock must be common stock;[7]

(2) it must be issued by a domestic corporation;[8]

(3) the issue is made pursuant to a plan adopted by the corporation after June 30, 1958, to offer stock for a specified period not exceeding two years from the date the plan is adopted;[9]

(4) the stock is issued by a corporation, which at the time the plan was adopted was a "small business corporation" as defined in section 1244 (c) (2) ;[10]

(5) the consideration paid by the shareholder on the issuance of the stock must be money or other property, not including stock or securities;[11]

(6) in excess of fifty per cent of the corporation's gross receipts for a prescribed period must be derived from sources of other than certain investment type income. This is the the "gross receipts"[12] rule, and is determined at the time the loss occurs.

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5. INT. REV. CODE OF 1954, §1244 (b).
6. H.R. REP. No. 2198, 85th Cong., 2d Sess. 126 (1958).
7. INT. REV. CODE OF 1954, §1244 (c) (1).
8. *Ibid.*
9. INT. REV. CODE OF 1954, §1244 (c) (1) (A).
10. INT. REV. CODE OF 1954, §1244 (c) (1) (B).
11. INT. REV. CODE OF 1954, §1244 (c) (1) (D).
12. INT. REV. CODE OF 1954, §1244 (c) (1) (E).

Moreover at the time the plan is adopted, no portion of a prior stock offering can be outstanding (section 1244(c)(1)(C)), and no new offering of stock can be made by the corporation subsequent to the adoption of the plan before all the stock is issued pursuant to the plan.[13]

Common Stock. Although the House report[14] states that "stock" may be either voting or nonvoting it does not shed any other light on the meaning of the term "common stock." The term is generally conceded to mean stock that entitles its owners to a prorata share in the profits of the corporation, in its assets upon dissolution, and in the management of its affairs.[15]

The Regulations[16] specifically provide that nonvoting as well as voting stock may qualify. Therefore, the nonpreferential right to share in the profits and assets is emphasized more than the share of control in operation of the affairs of the corporation. This position is consistent with the legislative objective to stimulate investment of risk capital in small business corporations whether or not the investor actively participates in the management and affairs of the corporation. The term "common stock," however, specifically excludes a security that is convertible into common stock or common stock convertible into other securities of the corporation.[17]

Domestic Corporation. Neither section 1244 nor the Regulations contain a definition of the term "domestic corporation." However, the commonly accepted definition of the term is a corporation "created or organized in the United States or under the laws of the United States or of any state or territory."[18] There is no indication that this Code provision should not be followed with reference to section 1244.

Written Plan. Qualified section 1244 stock must be issued pursuant to a plan. The issuance, for this purpose, entails an increase in the number of outstanding shares of a corporation. A contribution to capital that merely produces an increase in basis of already outstanding stock is *not* an issuance.[19]

Before the stock is issued some action must be taken by the corporation to adopt the plan in writing.[20] Ordinarily the action will be

13. INT. REV. CODE OF 1954, §1244(c).
14. H.R. REP. No. 2198, 85th Cong., 2d Sess. 8 (1958).
15. 13 AM. JUR. *Corporations* §200 (1938).
16. Treas. Reg. §1.1244(c)-1(b) (1963).
17. *Ibid.*
18. INT. REV. CODE OF 1954, §7701(a)(4).
19. Treas. Reg. §1.1244(c)-1(c)(1) (1963).
20. *Ibid.*

taken by the board of directors that has the authority to issue stock.[21] The plan should be set forth in the minutes of the board of directors' meeting; the resolution or plan should specifically state in dollars the maximum amount to be received by the corporation and the period of time, not to exceed two years after the date of adoption of the plan, during which the stock may be issued. It is also generally advisable to include a statement of intention that the stock qualify under section 1244. In creating new corporations or amending charters to provide for additional stock, appropriate section 1244 language may be included in the "capitalization clause" of the charter itself and in the bylaws.

If stock is issued pursuant to a plan that fails to specify a particular period of time during which the issue may be offered or which does not provide for a maximum period of two years, the stock will be disqualified under section 1244. This is true although the stock is issued in fact within the required two-year period.[22] This possible pitfall emphasizes the importance of advance planning and close adherence to the technical requirements of the statute.[23]

"Small Business Corporation." A corporation is considered a "small business corporation" (1) if at the time of adoption of the plan the sum of the total amount offered under the plan and the total amount received by the corporation does not exceed $500,000; and (2) the sum of the total amount offered under the plan and the equity capital of the corporation on the date of adoption of the plan does not exceed $1 million.[24]

The $500,000 limitation restricts the favorable tax treatment to stock received for the first $500,000 invested in the corporation after June 8, 1958.[25] For purposes of determining the amount previously paid for stock already issued, whether as a contribution to capital or as paid-in surplus, cash contributions are of course computed at the dollar value. Transfers of property to the corporation are valued at the adjusted basis (for determining gain) of the property when it was received by the corporation. This basis is then reduced by any liabilities to which the property was subject if assumed by the corporation at the time of transfer.[26]

With reference to the amount to be paid for the new stock, the Regulations[27] refer to "the aggregate dollar amount to be paid for

21. FLA. STAT. §608.14 (1963).
22. Treas. Reg. §1.1244 (c)-1 (c) (1) (2) (1963).
23. See APPENDIX for a sample qualified plan.
24. INT. REV. CODE OF 1954, §1244 (c) (2).
25. INT. REV. CODE OF 1954, §1244 (c) (2) (A).
26. INT. REV. CODE OF 1954, §1244 (c) (2) (A) (ii).
27. Treas. Reg. §1.1244 (c)-2 (b) (1) (1960).

the stock which may be offered under the plan." If all or a portion of the consideration for the stock is to be paid in property, the Regulations[28] indicate that its adjusted basis to the corporation immediately after its acquisition would control. Therefore if the stock is issued as part of a section 351 "swap," the value of the property would be computed at its adjusted basis to the transferor.[29]

In computing the maximum amount that may be offered under a qualified plan, prior amounts paid for stock after June 8, 1958, whether paid as a contribution to capital or as paid-in surplus, must be deducted from $500,000. Any organizational expenses that the organizers treat as contributions to capital or paid-in surplus must likewise be deducted from $500,000 in order to determine the maximum offering under a qualified plan.[30]

A "small business corporation" has a second limitation. The maximum amount that may be offered under the plan is $1 million minus the "equity capital" of the corporation at the time of adoption of the plan.[31] Equity capital is defined as the sum of the corporation's money and other property taken into account at its adjusted basis for determining gain, less the amount of its indebtedness to persons other than shareholders.[32] This limitation is relevant only if the equity capital at the time of adoption of the plan is more than $500,000. If it is not, however, the $500,000 limitation will always impose a lower ceiling on the maximum amount to be offered.

These two limitations are in keeping with legislative intent to restrict section 1244 treatment to stock issued in the smaller business corporations.

Consideration Paid. Consideration paid for the stock must consist of money or other property, not including stock or securities.[33] This is a personal requirement to each particular shareholder. One shareholder's failure to obtain his shares without paying proper consideration has no effect on other shareholders who properly acquire stock for money or other property.

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28. Treas. Reg. §1.1244 (c)-2 (d) *Example* (2) (1960).

29. INT. REV. CODE OF 1954, §351 provides for the tax-free transfer of property to a controlled corporation. No gain or loss will be recognized if property of any kind is transferred to a corporation by one or more persons solely in exchange for stock or securities of the same corporation and, if immediately after the transfer the transferor owns at least 80% of the voting stock and 80% of all other stock of the corporation.

30. Treas. Reg. §1.1244 (c)-2 (d), *Example* (1) (1960).

31. INT. REV. CODE OF 1954, §1244 (c) (2) (B).

32. Treas. Reg. §1.1244 (c)-2 (c) (1960).

33. INT. REV. CODE OF 1954, §1244 (c) (1) (D).

Services rendered or to be rendered are not proper consideration.[34] Stock issued for services rendered or to be rendered to the corporation will not qualify. An allocation between stock issued for money and property, and stock issued for services must be made if both types of consideration are used in combination. Nor are stock or securities proper consideration. This prohibition is not limited to stock and securities of the issuing corporation, but includes stock or securities from any source.[35] The restriction prohibits converting an ordinary security investment into one qualified for favored tax treatment by exchanging it for newly issued section 1244 stock.

Code sections other than section 1244 provide a broad definition of "stock and securities."[36] An obligation of the corporation may be treated as a security if it has certain long-term characteristics. Although no definite rule has been established, an obligation with a term of less than five years will probably not be treated as security,[37] while one with greater than ten years will be so treated.[38] Obligations with terms ranging between five and ten years will or will not be regarded as securities depending on the facts of each case.[39]

The Regulations[40] indicate that stock issued in consideration for the cancellation of an indebtedness of the issuing corporation shall be considered issued in exchange for money or other property, unless the indebtedness is evidenced by a security or arises out of the performance of personal services.

An exception to the general rule that stock must be received in exchange for money or other property, not including stock or securities, is that the receipt of a nontaxable stock dividend on the section 1244 stock or stock obtained in exchange of stock for section 1244 stock pursuant to a taxfree reorganization under subparagraphs (E) or (F) of section 368(a)(1).[41] It should be noted, however, that the mere addition to capital and increase in the basis of stock already owned will not qualify.

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34. Treas. Reg. §1.1244(c)-1(f)(1) (1963).

35. *Cf.* text accompanying note 39 *infra*, for a limited exception.

36. See INT. REV. CODE OF 1954, §§354, 331, 351, 355; in a different context, the Regulations on §1244 define "stock and securities" by referring to the personal holding company definition in Treas. Reg. §1.543-1(b)(5)(i) (1964).

37. Commissioner v. Sisto Financial Corp., 139 F.2d 253 (2d Cir. 1943); Lloyd-Smith v. Commissioner, 116 F.2d 642 (2d Cir.), *cert. denied*, 313 U.S. 588 (1941); Wellington Fund, 4 T.C. 185 (1944); Neville Coke & Chem. Co., 3 T.C. 113, *aff'd*, 148 F.2d 599 (3d Cir.), *cert. denied*, 326 U.S. 726 (1945).

38. Helvering v. Watts, 296 U.S. 387 (1935); Commissioner v. Neustadt's Trust, 131 F.2d 528 (2d Cir. 1942); Dillard, 20 CCH Tax Ct. Mem. 137 (1961).

39. Camp Wolters Enterprises, 22 T.C. 737 (1951), *aff'd*, 230 F.2d 555 (5th Cir.), *cert. denied*, 352 U.S. 826 (1956).

40. Treas. Reg. §1.1244(c)-1(F)(1) (1963).

41. INT. REV. CODE OF 1954, §1244(d)(2); Treas. Reg. §§1.1244(d)-3, -2 (1960).

Gross Receipts. All the requirements discussed thus far must be met at the time the plan is adopted or the stock is issued. The "gross receipts" test, however, is applied at the time the investor realizes the loss on his section 1244 stock. During the five most recent years preceding the date of the loss, it is necessary that more than half the aggregate receipts of the corporation be derived from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.[42] If the corporation was not in existence for five complete years, the percentage test is applied to the period of the taxable years ending before such date during which the corporation has been in existence. If the loss is sustained during the first taxable year of the corporation, the test is applied to the period commencing with the first day of the taxable year and ending on the day before the loss is sustained.[43] In applying the gross receipts test to a successor corporation involved in a stock for stock reorganization described in section 368 (a) (1) (F), the successor is treated as the same corporation as its predecessor.[44]

The test is applied on a stockholder-by-stockholder basis, and therefore the measuring period for various shareholders may differ depending upon when each realizes his loss.

"Gross receipts" may be defined generally as the total amount accrued (or received if the corporation is on a cash basis) from all sources including sales or exchanges of property, investments, and services rendered. In a sale or exchange, only the gain is taken into account. Gross receipts do not include amounts received from a loan, the repayment of a loan, a contribution to capital, or issuance by the corporation of its own stock. Gains received in nontaxable sales or exchanges are not included as gross receipts for purposes of section 1244, except if they are received on sales or exchanges made within twelve months prior to the complete liquidation of the corporation. This applies even though the sale or exchange may be nontaxable under a section 337 liquidation.[45]

If the amount of the corporation's "allowable deductions" exceeds its gross income for the measuring period, the gross receipts test will not apply. However, excluded in computing "allowable deductions" are net operating loss carryovers or carryback deductions and any special corporate deductions allowed for partially tax-exempt interest or for dividends received from other corporations.[46]

The gross receipts test is designed to limit section 1244 treatment to corporations actively engaged in trade or business, as opposed to in-

42. INT. REV. CODE OF 1954, §1244 (c) (1) (E).
43. Treas. Reg. §1.1244 (c)-1 (g) (1) (i) (a) (1963).
44. Treas. Reg. §1.1244 (c)-1 (g) (3) (1963).
45. Treas. Reg. §1.1244 (c)-1 (g) (1) (i) (a) (1963).
46. Treas. Reg. §1.1244 (c)-1 (g) (2) (1963).

vestment type corporations. If more than fifty per cent of the receipts come from investments, including rentals, royalties, interest, and annuities the test is not satisfied. However, to protect the active business, the term "rentals" does not include amounts received for the use of property if significant services are also rendered to the occupant as in a motel or hotel.[47] Maid service would qualify, but furnishing heat, electricity, and other similar items would not constitute "significant services to the occupant."[48]

The term "royalties" includes all royalties, including mineral, gas, and oil royalties regardless of percentage of gross income. The term also includes amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and like property.[49]

"Interest" is any amount received for the use of money. Tax exempt interest is taken into account because the section 1244 test is in terms of gross receipts rather than gross income.[50]

"Annuities" are defined as the entire amount received under an annuity, endowment, or life insurance contract regardless whether only part of such amount would be included in gross income under section 72 of the Code.[51]

For purposes of the gross receipts test, gains on the sale of stock or securities are included. Here, the term "stock or securities" is broadly defined to include shares or certificates of stock, stock rights or warrants, notes, certificates, participation in any profit-sharing agreement or in any mineral property or lease, voting trust certificates, bonds, debentures, et cetera.[52]

Miscellaneous. Stock may qualify even though subscribed for prior to adoption of the plan, provided it is not in fact issued prior to the adoption.[53] The safest procedure to follow with respect to preincorporation agreements is to have the parties agree that they will purchase a designated amount of stock to be offered pursuant to a qualifying plan to be adopted at the first meeting of the board of directors.

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47. Treas. Reg. §1.1244 (c)-1 (g) (1) (iii) (1963).

48. Rev. Rul. 65-40, 1965 INT. REV. BULL. No. 9, at 28, while dealing with a Subchapter S corporation where the term "significant services" is also important, concedes that an automobile rental firm rendered "significant services" in its business through outside sources.

49. Treas. Reg. §1.1244 (c)-1 (g) (1) (ii) (1963).

50. Treas. Reg. §1.1244 (c)-1 (g) (1) (v) (1963).

51. Treas. Reg. §1.1244 (c) (1) (vi) (1963).

52. Treas. Reg. §1.1244 (c)-1 (g) (1) (vii) (1963), which refers to the holding company definition of stock or securities in Treas. Reg. §1.543- (1) (b) (5) (i) (1964).

53. Treas. Reg. §1.1244 (c)-1 (c) (3) (1963).

Thereafter the board should adopt a resolution to offer stock that satisfies all the requirements of section 1244.[54]

Stock issued pursuant to an otherwise proper 1244 plan will not qualify if any portion of a prior offering of stock remains unissued.[55] Authorization in the corporate charter to issue stock different from or in excess of the stock offered under the plan, is not of itself a prior offering. Rather, the corporation must have taken some affirmative action to offer the stock either to the general public or to a particular person or persons. Because of this, if any person has the right to acquire stock through the exercise of any outstanding stock rights, stock warrants, options, or through securities convertible into stock at the date of the adoption of the plan for the new stock issue, such a right will be deemed to be a prior offering and thereby disqualify the stock issued under the plan. Moreover, any former resolutions of the board of directors relating to a prior offering that may still be in effect, must be terminated and any remaining stock subject to that offering must be withdrawn. Affirmative action of the board to withdraw the prior offering must be taken "prior to the time that the plan is adopted."[56]

A possible trap may result if the board decides that an additional offering of stock should be made once the plan is put into effect. If a subsequent offering is made after adoption of the 1244 plan, stock issued thereafter pursuant to the original plan will not qualify.[57] Although the subsequent offering will disqualify only stock issued in point of time after such second offering, it should be noted that the second offering itself may not be qualified stock because of the existence of remaining stock on the first offering. In this case, both new and old stock would be disqualified.

Eligibility and Qualifications of Stockholders

The ordinary loss treatment provided by section 1244 is available only to losses sustained by stockholders who are individuals, who have acquired their stock by issuance directly from the corporation, and who have continuously held the stock from the date of issuance. Stock of a corporation, trust, or estate, regardless of how acquired, and stock of an individual that has been acquired in any manner from a shareholder is not eligible for the ordinary loss treatment of 1244.[58]

An individual partner may be entitled to the benefits of section 1244 on his proportionate share of the loss on stock owned by the

54. See APPENDIX for a sample director's resolution.
55. Treas. Reg. §1.1244 (c)-1 (e) (1963).
56. *Ibid.*
57. Treas. Reg. §1.1244 (c)-1 (h) (1) (1963).
58. Treas. Reg. §1.1244 (a)-1 (b) (1960).

partnership. A loss sustained by a partnership on 1244 stock issued to it may qualify as an ordinary loss deduction to the extent allocated to partners who are individuals. If, however, the partnership itself distributes the stock to the partners, the transfer destroys the ordinary loss benefit. Furthermore, an individual partner is not entitled to ordinary loss treatment unless he was a partner at the time the section 1244 stock was issued from the corporation to the partnership.[59]

A problem arises when the corporation issues its stock through an underwriter. If the underwriter acts as a principal, that is, purchases the stock and then resells it on his own behalf, a purchaser from the underwriter would not be an original investor. However, if the underwriter participated merely as an agent for the corporation, that is, agreeing to sell the stock for the corporation on a best efforts basis, the purchaser would be deemed an original investor.[60]

Effect of the Qualification

For the taxable year in which the loss is incurred, a taxpayer filing a separate return may have up to $25,000 qualify as an ordinary loss, and taxpayers who file a joint return are limited to a maximum of $50,000. The annual limitation is imposed on the aggregate amount of loss by the individual on his 1244 stock for the year regardless of the number of corporations involved. Any amount sustained during the taxable year in excess of these annual limitations must be treated as a capital loss. If the loss is sustained by a partnership, the limitation is determined separately as to each partner by reference to the type of return that he files for the year in which the partnership's taxable year terminates.[61] A partner's share of the loss must be aggregate with his individual losses on all other section 1244 stock and the limitation is imposed upon the aggregate amount.[62]

After taking into account the annual limitation, if the loss that qualifies under section 1244 exceeds the ordinary income of the taxpayer for the year, the excess is treated as attributable to a trade or business for purposes of section 172 and is therefore available as a net operating loss carryback or carryover.[63]

A further special rule prevents the use of section 1244 as a method of converting the capital loss into ordinary loss when stock is issued in a section 351 taxfree exchange for property that has decreased in value, that is, property that has an adjusted basis for determining loss

59. *Ibid.*
60. *Ibid.*
61. Treas. Reg. §1.1244 (b)-1 (1960).
62. Treas. Reg. §1.704-1 (b) (2) (1956).
63. INT. REV. CODE OF 1954, §1244 (d) (3).

in excess of its fair market value.[64] In such a case, the basis of the section 1244 stock is reduced by an amount equal to the excess, at the time of exchange, of the adjusted basis of the property over its fair market value.[65]

SUBCHAPTER S

Although the corporate form of organization is attractive because of its characteristics, including limited liability, businessmen are often unable to withdraw a substantial portion of the earnings of the corporation without the imposition of a double tax (income taxes paid by the corporation and thereafter by the stockholder on the distribution as a dividend). Partial relief from this problem has been afforded the owners of "small businesses" upon the enactment of Subchapter S in 1958.

Subchapter S encompasses sections 1371 through 1377 of the Internal Revenue Code of 1954 and was enacted as part of the Technical Amendments Act of 1958. Its purpose is to allow "businesses to select the form of business organization desired without the necessity of taking into account major differences in tax consequences."[66] In order to obtain this objective, certain corporations are permitted to make an election under which they cease to be separate taxpayers of corporate income tax and have their gains and losses passed through to their individual shareholders.[67]

Because there is no "double taxation" of an electing corporation's income, the Subchapter S stockholders are denied several tax benefits enjoyed by regular corporations: the dividends received exclusion of section 116, the pre-1965 dividends received credit of section 34 of the Code, and the retirement income credit of section 37. Presumably the latter benefit is denied because individual proprietors and partners may not treat their business income as "retirement income."

Stockholders of a new corporation will usually find it advisable to consider electing under Subchapter S when:

> (1) shareholders are in a lower tax bracket than the corporation;
>
> (2) there is an intention to pay out substantially all of the corporation's profits to the owners, especially when it is doubtful that all of the income may be paid out in the form of deductible payments, such as salary, interest, and other proper corporate expenditures; and

64. INT. REV. CODE OF 1954, §1244 (d) (1).
65. See Treas. Reg. §1.244 (d) (1) (1960).
66. S. REP. No. 1983, 85th Cong., 2d Sess. 68 (1958).
67. INT. REV. CODE OF 1954, §§1373, 1374.

(3) the corporation will operate at a loss in its earlier years, and these losses can be of use to the shareholders on their individual returns.

It is of particular interest to note with reference to the latter situation, that a new corporation can elect a "short" year by "cutting off" its first taxable year at the end of any month prior to the expiration of twelve calendar months from its activation.[68] Thereafter it must operate on the full twelve-month fiscal year elected. By electing to terminate the first fiscal year at the point at which the corporation commences to show a profit, the various operating expenses involved in starting a business may be "passed through" to the individual shareholders as an ordinary loss on their tax returns, while income is deferred until the next year.

Another advantage may be gained in the fiscal year election by the Subchapter S corporation in which profits are predicted in the first year. If the shareholders are on a calendar year basis for tax purposes, an election to end the first fiscal year of the corporation on January 31, for example, will defer individual tax on the profits for one year since the corporation's income is passed through to shareholders as of the last day of its fiscal year.[69] All income of the corporation in its first "short" year will become taxable to the shareholder on January 31 of his new taxable calendar year.

Corporations Eligible To Elect

In order to qualify for the election a corporation must be a "small business corporation" as defined in the law:[70]

(1) it must be a domestic corporation that is not a member of any affiliated group;[71]
(2) it may not have more than ten stockholders;
(3) all of its stockholders must be individuals or estates;
(4) no stockholder may be a nonresident alien; and
(5) there may be only one class of stock.

Additionally, no more than eighty per cent of the corporation's gross receipts may be derived from sources outside the United States[72] and no more than twenty per cent of the corporation's gross receipts may fall into the category of "personal holding company" income, specific-

68. INT. REV. CODE OF 1954, §441.
69. INT. REV. CODE OF 1954, §1373 (b).
70. INT. REV. CODE OF 1954, §1371 (a).
71. INT. REV. CODE OF 1954, §1504 defines an affiliated group; the Subchapter S regulations have not been amended to reflect the repeal of §1504 (b) (8).
72. INT. REV. CODE OF 1954, §1372 (e) (5).

ally royalties, rents, dividends, interest, annuities, and the gains on sales or exchanges of stock or securities.[73]

If these requirements are satisfied at the time of the election, the election automatically remains in effect until such time as the stockholders consent to a revocation or until it is terminated because of failure to meet all the requirements. An involuntary termination of an election relates to the beginning of the taxable year in which the act constituting the involuntary termination occurs. A voluntary revocation must be made within the first month of the taxable year in order to be effective for that year.[74]

An electing corporation should not be considered as having ceased to be a corporation for federal income tax purposes, but rather one exempt from the imposition of the corporate income tax. It continues to be treated as a corporation for many federal tax purposes including corporate reorganizations, redemptions, liquidations, and other transactions governed by the tax laws applicable to corporations rather than to partnerships.

Each of the eligibility requirements of the small business corporation has further ramifications that are discussed below.

Number of Shareholders

A corporation will not qualify for a Subchapter S election if it has more than ten shareholders.[75] However, stock owned jointly by husband and wife, whether as joint tenants, tenants-by-the-entireties, tenants-in-common, or community property is treated as owned by only one shareholder.[76] The exception is not applicable for any joint ownership other than that of husband and wife and will not apply if they own separate shares individually. Moreover, the attribution of ownership rules of section 318 may not be availed of to reduce the number of shareholders to comply with the requirement.[77] All stockholders, except husband and wife jointly, are individuals whether or not they may be considered as one for other corporate tax purposes because of the relationship between them.[78]

Shareholders Must be Individuals or Estates

A corporation is ineligible to qualify under Subchapter S as a "small business corporation" if any of its shareholders is "a person

73. INT. REV. CODE OF 1954, §1372 (e) (5).
74. INT. REV. CODE OF 1954, §1372 (e).
75. INT. REV. CODE OF 1954, §1371 (a) (1).
76. INT. REV. CODE OF 1954, §1371 (c).
77. See Treas. Reg. §1.1371-1 (D) (1) (1963).
78. Although stock may be held by husband and wife jointly, Treas. Reg.

(other than an estate) who is not an individual."[79] This excludes a corporation, trust, or partnership. The Regulations further provide that the term "trust" includes a voting trust and trusts on which the grantor or other person is taxed directly on the income.[80]

However, the Internal Revenue Service has ruled that stock held by a custodian under the Uniform Gifts to Minors Act is owned by the minor and is not considered to be held in trust for tax purposes, therefore, such stock will not disqualify a corporation from treatment as a "small business corporation."[81]

The Commissioner's position in defining "individual" seems to be inconsistent and conflicting. An agency type relationship is apparently approved by the Regulations: "[P]ersons for whom a stock in a corporation is held by a nominee, agent, guardian, or custodian will generally be considered shareholders of the corporation."[82] But immediately following this statement is a prohibition against ownership by a grantor trust. A revocable and amendable trust in substance is not far from an agency arrangement, yet in the case of a grantor trust the "person for whom a stock . . . is held" is not an individual under the statute.

Another point of possible conflict involves the imputation of stock ownership to the partners of a partnership. The Regulations state "if stock is owned by a partnership, such partnership and not its partners is considered to be the shareholder."[83] Yet, Florida apparently "follows the common law view that a partnership is not a legal entity apart from the members composing it."[84]

No Stockholder May Be a Nonresident Alien

All the shareholders of a qualifying corporation must be either citizens of the United States or aliens who reside in the United States.[85] This of course means that all of the stockholders, rather than just the nonresident alien individually, lose the benefits of Subchapter S.

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§1.1371-1 (d) (2) (b) requires that both must sign the Consent of Shareholders; see text accompanying note 107 *infra*.

79. INT. REV. CODE OF 1954, §1371 (a) (2).

80. Treas. Reg. §§1.1371-1 (d) (1), (e) (1963).

81. TIR No. 113, P-H Fed. 1958, ¶55211.

82. Treas. Reg. §1.1371-1 (d) (1) (1963).

83. *Ibid.*

84. 24 FLA. JUR. *Partnerships* §16 (1959) citing Epstein v. First Nat'l Bank, 92 Fla. 796, 110 So. 354 (1926).

85. Treas. Reg. §1.1371-1 (f) (1963).

One Class of Stock

A corporation with more than one class of stock outstanding does not qualify as a "small business corporation."[86] A potential trap arises in this connection. The Regulations provide that in order to satisfy this requirement the outstanding stock must be identical with respect to the rights and interest that it conveys in the control, profits, and assets of the corporation.[87] Treasury stock and unissued stock of a different class will not disqualify the corporation.[88] If any debt obligation of the corporation is actually a second class of stock for tax purposes, the corporation will be deprived of the right to make an election. In *Catalina Homes, Inc.*,[89] advances to the corporation from two stockholders were preferred over common stock. A second class of stock, therefore, was found created even though it was not represented by a note or other evidence of indebtedness and it did not have a fixed maturity date. The Service has ruled that a "side agreement" between shareholders that affects their voting rights will be deemed to have created a second class of stock.[90]

Member of an Affiliated Group

If the corporation is a member of an affiliated group it is not eligible to elect under section 1371 (a) of Subchapter S. As defined in section 1504 of the Code, an affiliated group is one that owns eighty per cent or more of both the voting and nonvoting stock of any other domestic corporation.

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86. INT. REV. CODE OF 1954, §1371 (a) (4).

87. Treas. Reg. §1.1371-1 (g) (1963).

88. *Ibid.*

89. CCH Tax Ct. Mem. 1361 (1964). In Henderson v. United States, 245 F. Supp. 782 (M.D. Ala. 1965), the court and the Treasury used the "thin incorporation" attack to destroy the pseudo-corporation status in the same manner as it used that attack against regular corporations to disallow regular corporations interest deductions and to treat loan repayments as dividends. In *Henderson* the corporation was formed in 1959 with $3,000 paid in capital. In early January 1960, the corporation borrowed $30,000 pro rata from the stockholders and later borrowed further sums from them. The stockholders were given 8% demand notes covering their loans. The corporation elected the pseudo-corporation treatment and passed-through a $22,000 operating loss in its first year. In determining that the election was not valid, the court held that the loans from the stockholders to the corporation were intended to be subject to the risks incident to a capital stock investment. The loans were really a form of capital stock and not loans. The notes received for the loans constituted a second class of stock that barred the Subchapter S election. Therefore, the corporate losses could not be deducted by the stockholders on their individual returns, but had to be deducted by the corporation itself, whether or not that gave any tax benefit.

90. Rev. Rul. 63-226, 1963-2 CUM. BULL. 341.

However, the Revenue Act of 1964[91] created a limited exception under which the ownership of stock in another corporation may not prevent the corporation from electing under Subchapter S. The law now specifically authorizes an affiliation provided: (1) the corporation whose stock is owned has not begun business at any time on or after the date of its incorporation and before the close of the taxable year of the Subchapter S corporation, and (2) the other corporation does not have taxable income for the period included within the taxable year of the Subchapter S corporation.

This new exception to the general rule eliminates the denial of a Subchapter S election merely on the grounds that the corporation owns stock of completely inactive subsidiaries. It is a common practice for corporations to reserve their corporate names in states in which they are not yet doing business by establishing inactive subsidiaries in those states with names that are the same or similar to their own. It was for this purpose that the amendment was enacted.[92] The Regulations for Subchapter S have not yet been amended to reflect the change.

As the exception in the new additional subsection is phrased in terms of *taxable* income rather than gross income it appears that the subsidiary might have some nonbusiness income from investments, such as interest or dividend income, without disqualifying the parent provided that deductions eliminate a taxable net income.

Domestic Corporation

An electing corporation must be a "domestic corporation"; it must be created or organized in the United States under the laws of the United States or of any territory or state.[93] The term "corporation" would apparently include an association involuntarily treated as a corporation for tax purposes, but the Regulations specifically exclude an unincorporated business enterprise that has elected to be taxed as a corporation under section 1371. The latter exclusion is, of course, correct because the 1371 election is irrevocable.[94]

Nature and Source of Income

Included in the statute are two rules relating to the nature of the income received by the corporation. It is disqualified (1) as of the beginning of the taxable year if more than eighty per cent of its gross

91. INT. REV. CODE OF 1954, §1371 (d), added by Revenue Act of 1964, §233, 78 Stat. 112 (1964).

92. S. REP. No. 830, 88th Cong., 2d Sess. 146 (1964).

93. Treas. Reg. §1.1371-1 (b) (1963) referring to INT. REV. CODE OF 1954, §7701 (a) (3).

94. INT. REV. CODE OF 1954, §1361 (d).

receipts for the year are derived from sources outside the United States,[95] or (2) if more than twenty per cent of its gross receipts are derived from royalties, rents, dividends, interest, annuities, and gains on sales and exchanges of securities or stock.[96]

The Regulations[98] provide a liberal interpretation of the term "rents," which excludes from the definition those amounts received for the use of property if significant services are rendered. The definition is almost identical with the section 1244 meaning previously discussed;[98] the term "rents" is not intended to include amounts received in the active conduct of the business as distinguished from passive rental income.

A recent ruling[99] has broadened the "significant services" concept. Prior to the ruling, a question had arisen as to the possible limitation of "significant services" to situations in which the lessor corporation itself furnished the significant services, rather than providing them through independent contractors. The ruling sanctions an election by an automobile rental firm that rendered significant services partly through its own employees and partly through outside independent sources. It would appear that the same result should obtain even if all services rendered were "farmed out."

The definitions of other types of personal holding company income, including royalties, interest, annuities, and the sale of stock or securities are also substantially similar to those of section 1244.[100] There is, however, a different position taken with regard to losses on sales or exchanges of stock or securities. The Subchapter S Regulations[101] state that such losses do not offset gains for purposes of computing gross receipts.

The term "gross receipts" for purposes of Subchapter S is not synonymous with "gross income."[102] Included is the total amount received or accrued by the corporation from all sources including gains on sales or exchanges of property, investments, and services rendered. But loans to the corporation, amounts received by it on the repayment of loans, and contributions to capital are not included in "gross receipts."[103]

Except in the instance in which there is a sale or exchange made

95. INT. REV. CODE OF 1954, §1372 (e) (4).
96. INT. REV. CODE OF 1954, §1372 (e) (5).
97. Treas. Reg. §1.1372-4 (b) (5) (iv) (1964).
98. See text accompanying note 46, *supra*.
99. Rev. Rul. 65-40, 1965 INT. REV. BULL. No. 9, at 28.
100. See text accompanying notes 47-52 *supra*; compare Treas. Reg. §§1.1244 (c)-1 (g), 1.1372-4 (b) (5).
101. Treas. Reg. §1.1372-4 (b) (5) (viii) (1964).
102. Treas. Reg. §1.1372-4 (B) (5) (ii) (1964).
103. *Ibid.*

within twelve months prior to the complete liquidation of the corporation, amounts received in nontaxable sales or exchanges are not included in gross receipts except to the extent of realized gain.[104]

Engaged in Trade or Business

Foxcatcher Livestock Co. was owned by William duPont. He and his wife, Margaret, filed a joint return that reflected that William lost over $36,000 in the cattle business carried on by Foxcatcher, his Subchapter S corporation. The loss was denied on the theory that William's principal purpose in acquiring Foxcatcher was the evasion or avoidance of taxes. William sought a refund of the $30,000 assessment he paid. The Commissioner contended that the loss as a tax deduction may only be claimed if Foxcatcher's operation constituted a trade or business entered into for profit. The court, however, examined the evidence and the law and found that the venture was in fact a trade or business and was operated for profit.[105]

HOW AND WHEN TO MAKE THE ELECTION

Failure to follow all the procedures in making the timely election may invalidate the election from the beginning and the corporation will be treated as a separate tax entity for all subsequent years until a proper election is filed. There are two steps to follow in making the election:[106] (1) filing a statement of election by the corporation on form 2553, and (2) filing a statement of consent by the corporation's shareholders. Once made, a valid election has a continuing effect and applies until voluntary or involuntary termination.

The statement of election by the corporation, IRS form 2553, must be signed by any authorized corporate officer. The information to be supplied on the form includes names and addresses of stockholders, number of shares owned, date of incorporation, business activity, taxable year, and similar particulars. Attached to the election form is the Consent Statement signed by all of the stockholders. It sets forth the name and address of the corporation and of each stockholder, the number of shares owned by each, the dates of acquisition, and the specific statement that each consents to the elections. The consenting stockholders must include all of the persons owning stock at the beginning of the corporation's taxable year or on the date of election, whichever is later. No particular form for the consent is required.[107]

104. *Ibid.*
105. DuPont v. United States, 234 F. Supp. 681 (D. Del. 1964).
106. Treas. Reg. §1.1372-2 (1959).
107. A suggested form that may be used appears in the APPENDIX.

The qualifications of a Subchapter S corporation must be satisfied on the date the election is made and thereafter. A timely election may be made either during the first month before the beginning of the taxable year or the first month of such taxable year.[108] Once the decision to elect is tentatively made, it may be advisable to defer filing the election until the last part of the first month in order to obtain the best possible projection of the corporation's income for the year. Similarly, if the qualifications are not met, the owners may utilize the first month of the year in adjusting its affairs to meet the requirements. In the case of a new corporation, its first month does not begin until the corporation has shareholders, acquires assets, or begins doing business, whichever occurs first. If there is a change of stock ownership after the election and consents are filed, the new shareholder must file his consent within thirty days after he becomes a stockholder. If he fails to do so, the election will be lost to all stockholders for the entire taxable year.[109]

The election and consent must be filed with the District Director of the Internal Revenue Service with whom the annual return for the corporation is filed in the district in which the corporation's principal place of business or principal office or agency is located.[110]

The Internal Revenue Service has ruled[111] that it has no authority to grant extensions of the period for filing the election and consent. The Service bases its position on the theory that section 6081 of the Code, which gives the Secretary the power to grant extensions, applies only when a statement or return is required. As a corporation is not required to file an election under Subchapter S, the Service contends that it has no authority to grant extensions.

However, if the election itself is timely filed, but there is a defect in the consent caused by failure of any shareholder to sign before the end of the first month, the election may not be invalid if: (1) reasonable cause for the failure to file is shown and it is also shown that the interests of the Government will not be jeopardized by treating such election as valid, (2) the shareholder files the proper consent within the extended period of time granted, and (3) all shareholders affected by the election file their new approvals within such extended period of time as may be granted by the District Director.[112]

If a husband and wife own property jointly or as community prop-

108. INT. REV. CODE OF 1954, §1372 (c) (1).
109. Treas. Reg. §1.1372-3 (b) (1964).
110. Treas. Reg. §1.1372-2 (a) (1959).
111. Rev. Rul. 60-183, 1960-1 CUM. BULL. 625.
112. Treas. Reg. §1.1372-3 (c) (1964).

erty, both must consent to the election.[113] A minor's consent is made by his guardian and that of an estate by the personal representative.[114]

Voluntary and Involuntary Termination

Once the valid election is made, it continues in effect indefinitely unless terminated under the specific provisions of the statute.[115]

There are five circumstances that involve termination of the election of the Subchapter S corporation after it is once in effect:[116] (1) the voluntary revocation by all shareholders, (2) the failure of a new shareholder to file a timely consent after acquiring stock, (3) failure to meet eligibility requirements as a "small business corporation," (4) receipts by the corporation from sources outside the United States aggregating more than eighty per cent of its income, and (5) receipts by the corporation in excess of twenty per cent from personal holding income.

The voluntary revocation appears to be unnecessarily restrictive because of the various other methods of disqualifying the corporation if that end is desired. The voluntary termination may apply only to a taxable year of the corporation after the first taxable year for which the election was made. It must be accompanied by the signed consents of all the persons who were stockholders on the date of filing and it must be filed before the end of the first month of the taxable year for which the revocation is to be effective.[117] If the revocation is made after the first month of the taxable year or in the first month of the first taxable year, it will not become effective until the beginning of the following year.[118] Assuming all stockholders do not agree, or the decision to terminate occurs after the first month, the termination may still be accomplished by "involuntary" termination if, for example, an interest were sold to another nonconsenting shareholder.

Any person who becomes a stockholder after the beginning of the taxable year or after the date of the election, whichever is later, must also file a consent to the election within thirty days beginning with the day on which the new stockholder becomes a stockholder.[119] If the new shareholder is an estate, the thirty-day period commences with the date of the qualification of the personal representative, but in no

113. Treas. Reg. §1.1372-3 (a) (1964).
114. *Ibid.*
115. Int. Rev. Code of 1954, §1372 (e).
116. *Ibid.*
117. Int. Rev. Code of 1954, §1372 (e) (2).
118. Treas. Reg. §1.1372-4 (c) (1959), as amended, T.D. 6707, 1964-1 Cum. Bull. 315.
119. Treas. Reg. §1.1372-3 (b) (1959), as amended, T.D. 6615, 1962-2 Cum. Bull. 205, T.D. 6707, 1964-1 Cum. Bull. 315.

event may it commence later than thirty days following the close of the taxable year in which the estate becomes a shareholder.[120]

A new shareholder's consent contains the same matters as the consent of an original shareholder, but must also include the name and address of the person from whom the shares were acquired and the date of acquisition. The consent should be executed in duplicate because the corporation must attach a copy of the consent to its annual information return. Failure to file the required consent will cause an involuntary termination of the election as of the beginning of the taxable year in which the new shareholder acquired his stock.[121]

If the corporation ceases to be a "small business corporation" it will similarly lose its elective status.[122] Should there be a failure to meet any of the requirements of eligibility, the election will be automatically terminated. The corporation should notify the District Director immediately of any such termination setting forth the cause of termination, the date thereof, and full and complete details regarding it.[123]

If more than eighty per cent of the gross receipts of the corporation are from sources outside the United States, the election is terminated.[124] Sections 861 and 864 are used in determining the source of gross receipts.[125] As with other terminations, a termination under this rule is effective as of the beginning of the taxable year of the corporation for which it has excessive gross receipts from foreign sources. If more than twenty per cent of the corporation's gross receipts are derived from rents, royalties, dividends, interest, annuities, and sales or exchanges of stock or securities, the election is terminated as of the beginning of the taxable year in which the excess occurs.[126] In both cases, the entire year's income is considered; if, for example, at the end of the first six months the corporation had an excess of the disqualifying income, the election would not be terminated since additional income during the remaining portion of the year may reduce the percentage of gross receipts below the prohibited maximums.

Once an election has been terminated, whether voluntarily or involuntarily, the corporation or any successor corporation may not make a new election during the taxable year for which the termination was first effective and for the next four taxable years, unless the

120. *Ibid.*

121. INT. REV. CODE OF 1954, §1372 (e) (1).

122. INT. REV. CODE OF 1954, §1372 (e) (3).

123. Treas. Reg. §1.1372-4 (b) (3) (1959), as amended, T.D. 6707, 1964-1 CUM. BULL. 315.

124. INT. REV. CODE OF 1954, §1372 (c) (4).

125. Treas. Reg. §1.1372-4 (b) (4) (1959), as amended T.D. 6707 1964-1 CUM. BULL. 315.

126. INT. REV. CODE OF 1954, §1372 (e) (5).

corporation secures the consent of the Commissioner to a new election.[127]

A "successor corporation" in this context is a corporation in which fifty per cent or more of the stock is owned, either directly or indirectly, by the same persons who also owned fifty per cent or more of the acquired small business corporation; and who acquire a substantial portion of the assets of the terminating corporation, or a substantial portion of the assets, which included assets of the terminating corporation.[128]

If a corporation whose election has been terminated secures the consent of the Commissioner, it may make a new election before expiration of the five-year period. The Regulations show two grounds for a successful request for a consent to the new election: (1) if there has been a substantial change in stock ownership since the election was terminated, that is, if at the time the request is made "more than 50% of the stock in the corporation is owned by persons who did not own any stock in the corporation during the first taxable year for which the termination is applicable";[129] (2) if it can be shown that "the event causing the termination was not reasonably within the control of the corporation or shareholders having a substantial interest in the corporation, and was not part of a plan to terminate the election in which plan such shareholders participated."[130]

A request for the Commissioner's consent to a new election should be addressed directly to the Commissioner of Internal Revenue in Washington, D.C. and not to the District Director, as he has no authority to grant the request. Although the consent may be granted, elective treatment for at least one taxable year will probably be lost because it may be received too late to make the new election.

Should an electing corporation merge into another corporation, which has not made the election, the electing corporation remains under Subchapter S for its final taxable year ending on the date of the merger.[131] The determination whether the acquiring corporation is under Subchapter S will depend upon whether the corporation has made an election in its own right and on the effect of the merger on the corporation.

Effect of the Election

The Subchapter S corporation is a hybrid for tax purposes. It is bypassed as a separate taxpaying entity, as in the case of a partnership,

127. INT. REV. CODE OF 1954, §1372 (f).
128. Treas. Reg. §1.1372-5 (b) (1959).
129. Treas. Reg. §1.1372-5 (a) (1959).
130. *Ibid.* This fact "will tend to establish that consent should be granted."
131. *Ibid.*

but other general corporate provisions are applied to it with some specific exceptions.[132] The tax exemption of the corporation extends to the personal holding company tax and the accumulated earnings tax, as well as to the normal income tax and the surtax imposed by section 11 of the Code.[133]

The Regulations[134] give a full and complete treatment of the manner in which the corporation's taxable income is computed. Even though an electing corporation is exempt from income tax, its taxable income still must be computed in order to determine the amount to be included as income of the shareholders of the corporation. The computation is made in the same manner as that of a nonelecting corporation except that the following are not allowed: (1) dividends received exclusion of section 243; (2) deductions allowable under section 242 for partially tax exempt interest on certain United States obligations or obligations of corporations organized under Act of Congress; (3) dividends received deduction allowed by section 244 for dividends received on certain preferred stock; and (4) deduction allowed by section 172 for net operating loss carrybacks or carryovers.[135] Net operating loss carryovers and carrybacks from nonelection years may be carried undiminished to other nonelection years.

As in the case of an ordinary corporation, a distribution of an electing corporation is a dividend only if it comes from earnings and profits, either current or accumulated.[136] These are computed in the same manner as in any other corporation, except for three special rules applicable to electing corporations:[137] (1) accumulated earnings and profits are reduced to the extent that undistributed taxable income is required to be included in the gross income of the shareholder;[138] (2) no reduction may be taken for any amounts that are not allowed as a deduction in computing taxable income for the year; and (3) if the corporation sustains a net operating loss for any taxable year, the income and deductions taken into account in determining that loss do not enter into the computation of earnings and profits.

Shareholders of a Subchapter S corporation are affected by the election, and their treatment differs from that of shareholders of a regular corporation in six respects:

(1) treatment of distributions not in exchange for stock;
(2) yearend constructive distributions;

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132. Rev. Rul. 64-94, 1964-1 CUM. BULL. 317.
133. Treas. Reg. §1.1372-1 (c) (1959).
134. INT. REV. CODE OF 1954, §1372 (a).
135. Treas. Reg. §1.1372-1 (1959).
136. INT. REV. CODE OF 1954, §1372 (d).
137. INT. REV. CODE OF 1954, §316.
138. INT. REV. CODE OF 1954, §1377.

(3) a possible allocation of distributions among members of families;
(4) certain distributions after the close of the year;
(5) treatment of net operating loss; and
(6) special basis adjustments for stock and indebtedness.

Distributions Not in Exchange for Stock

A distribution to the shareholders of an electing corporation, other than a distribution in exchange for stock, will have different tax implications from those of a similar distribution by a regular corporation.

If the electing corporation realizes a long-term capital gain during the year of distribution, it may be considered as capital gain by the stockholder rather than a dividend taxed as ordinary income.[139] This "capital gains pass-through" provides that if during the taxable year the corporation had net long-term capital gain in excess of short-term capital loss, a portion of each distribution that is deemed to come from current earnings and profits will be treated as long-term capital gain to the recipient shareholder.[140] If however, total taxable income of the corporation is less than the long-term capital gain for the year, or stated another way — if the capital gain exceeds the taxable income of the corporation — the full amount of the gain will not be available to the shareholders. This provision eliminates the possibility of the shareholder taking capital gain and operating loss in the same year.[141] The Regulations[142] provide four steps for determining each shareholder's prorata share of the long-term capital gain. The computation may be made mathematically as follows:

$$\text{X (prorata share)} = \text{Lesser of} \begin{cases} \text{(1) Net long-term capital gain} \\ \text{Short-term capital loss} \\ \text{or} \\ \text{(2) Taxable income} \end{cases} \times \frac{\text{Shareholder's dividends from current earnings and profits}}{\text{All dividends from current earnings and profits}}$$

139. As the word "required" is used, the reduction apparently should be made without regard to whether the shareholder actually includes the amount in his gross income.
140. INT. REV. CODE OF 1954, §1375 (a) (1).
141. INT. REV. CODE OF 1954, §1375 (a).
142. Treas. Reg. §1.1375-1 (b) (1959).

The amount treated as a capital gain to a shareholder pursuant to this formula is allocated ratably over the various distributions if a shareholder has received during the year more than one distribution of dividends from current earnings, including the year-end constructive dividend.[143]

Subject to one important exception, capital gains and losses of an electing corporation are determined in the same manner as those of a nonelecting corporation. In the situation in which an electing corporation is "availed of by any shareholder or group of shareholders owning a substantial portion of the stock of such corporation for the purpose of selling property which in the hands of such shareholder or shareholders would not have been an asset, gain from the sale of which would be capital gain, then the gain on the sale of such property by the corporation shall not be treated as a capital gain."[144] This "shareholder's reference test" provides for inquiry into the individual activity of the shareholder to determine the character of assets held by the corporation; its purpose is to prevent the use of Subchapter S as a method of converting ordinary income into captital gain. For the purpose of determining what character the assets would have in the hands of the shareholder, "the activities of other electing small business corporations in which he is a shareholder shall be taken into consideration."

It should be noted that a severe tax trap may result for innocent shareholders since the capital gain treatment will be denied *all* shareholders if a substantial shareholder "contaminates" the transaction. For example, one of several shareholders is a "dealer" in the type of asset sold so that his gain would be ordinary income if he sold the asset individually. By application of the "shareholder reference test" the sale may be treated as an ordinary income transaction of the corporation and thus the innocent shareholder would lose capital gain advantages.

A stockholder's prorata share of the capital gain pass-through is taken into account on his individual tax return as a composite long-term capital gain; it need not be broken down into the various categories of assets that gave rise to the gain. As is the case of a nonelecting corporation, capital losses of the electing corporation do not pass through to the shareholders, but must be carried over and deducted from capital gains the corporation may realize in future years.

Under Subchapter S, there are significant differences between dividends out of current earnings and dividends out of accumulated earnings. For dividends out of *current* earnings, the dividend credit and the retirement income credit may not be utilized. However, for divi-

143. Treas. Reg. §1.1375-1 (c) (1959).
144. Treas. Reg. §1.1375-1 (d) (1959).

dends out of *accumulated* earnings of an electing corporation these benefits may be used.[145] In determining undistributed taxable income (the amount that will be charged to shareholders as a year-end constructive dividend) a deduction may be taken for cash distributions made out of current earnings and profits.[146] As already noted,[147] dividends from current earnings may also have capital gain characteristics.

The portion of each distribution that is not regarded as out of current earnings and profits is considered a dividend out of available accumulated earnings on the date of distribution. If the corporation has previously taxed income [hereinafter referred to as PTI] there may be an exception to this general rule.

A major danger in operating under Subchapter S is that undistributed PTI may become "locked in." In order to withdraw this income tax-free in later years, all current earnings and profits for that year must be first distributed. If the shareholder to whom the income was taxed transfers his stock he loses his right to a tax-free distribution of PTI. Moreover, if the election is terminated, whether voluntarily or involuntarily, the special rule permitting distribution of PTI may no longer be applicable and the general corporate rules apply, that is, distributions by the corporation would be taxable as dividends to the extent of both current and accumulated earnings and profits.[148]

In the normal situation, a distribution to a shareholder is from PTI and therefore nontaxable to the extent of the recipient shareholder's net share of PTI if: (1) the distribution is in money and (2) but for this special rule the distribution would have been a dividend from accumulated earnings and profits.[149] If the distribution meets these qualifications it is considered a return of capital, which reduces the basis of the stock to the shareholder, and it does not reduce earnings and profits. It should be noted that a distribution of PTI may be made only in money distributed during the year in excess of current earnings and profits for that year. Further, the right to distribute PTI applies only if the distribution is made during the taxable year of the corporation for which an election is in effect.

In order to be considered a tax-free distribution of PTI, the distribution must not exceed the recipient shareholder's "net share of undistributed taxable income." The Code[150] refers to this term as the

145. INT. REV. CODE OF 1954, §1375 (b).
146. INT. REV. CODE OF 1954, §1373 (c).
147. INT. REV. CODE OF 1954, §1375 (a) (1).
148. Treas. Reg. §1.1373-1 (1959).
149. Treas. Reg. §1.1374-4 (1959).
150. INT. REV. CODE OF 1954, §1375 (d) (2).

sum of the amounts included in the gross income of the shareholder as a year-end constructive dividend for all of his taxable years ending before the distribution, less the sum of (1) the amount of his share of net operating loss allocable as a deduction from his gross income for all of his taxable years ending before the distribution, and (2) the amount previously distributed to the shareholder during his current taxable year and all his prior years, which was considered a tax-free distribution of PTI.

The right to withdraw the PTI accrues *only* to the shareholder who actually included that amount in his income. His stock transferee does not have the right to the tax-free distributions of PTI.[151] Therefore, if the shareholder dies, sells his stock or gives it away, the right to receive his prorata share of PTI taxfree is lost.

Constructive Distributions

Subchapter S treatment of undistributed profits of an electing corporation parallels that of a partnership. A shareholder of an electing corporation on the last day of its taxable year must include in his individual gross income the amount he would have received as a dividend if the corporation had distributed pro rata to its shareholders an amount equal to its "undistributed taxable income" for that year.[152] This constructive distribution is "received" by the shareholder as of the close of the taxable year of the corporation. It is computed by subtracting the cash dividends made during the year from the taxable income of the electing corporation. This amount is then pro rated among the shareholders.

Only the stockholders on the last day of the corporation's taxable year are charged with any part of the constructive distribution, regardless of how long a time any one or more may have held the stock during the year.[153] However, the Regulations[154] warn that in order for a shift of the year-end income to a transferee to be upheld, it must be a bona fide transaction.

Illustrations of the constructive distribution rule are provided in the Regulations.[155]

Distributions Among Family Members

The district director has authority under section 1375 (c) to allocate dividends of an electing corporation, including the year-end con-

151. Treas. Reg. §1.1375-4 (e) (1959).
152. INT. REV. CODE OF 1954, §1373 (b).
153. Treas. Reg. §1.1373-1 (a) (2) (1959).
154. Treas. Reg. §1.1373-1 (a) (2) (1959).
155. Treas. Reg. §1.1373-1 (g) (1959).

structive dividend, from one shareholder to another who is a member of the same family. This allocation may be made when it is deemed to be essential in order to reflect the value of services rendered to the corporation by such shareholders. The term "family" is limited to a shareholder's spouse, ancestors, and lineal descendants.

Applicable only where the family member performing the services is a shareholder, the rule is designed to prevent the shifting of income from a high income tax bracket member to a low tax bracket member through the payment of inadequate salaries.

Distributions After Close of the Year

Generally a distribution is considered as made only at the time it is actually received by the shareholder,[156] and earnings and profits of an electing corporation are not reduced as a result of the distribution before that time. A distribution therefore that is received after the close of the taxable year is not a deduction in determining the amount of the year-end constructive dividend.

A limited exception dealing with sales of capital assets or section 1231 (b) property was enacted in 1964.[157] Distributions of money made on or before the fifteenth day of the third month following the close of the taxable year of the electing corporation may be treated as made on the last day of the taxable year, if the directors of the corporation pass a resolution authorizing such a distribution. The exception is applicable only if the corporation during the taxable year made one or more sales of capital assets or property described in section 1231 (b) of the Internal Revenue Code. In addition, all of the stockholders on the date of the distribution must own the same interest as they did on the last day of the taxable year, and they must file their consent to the special treatment.

Net Operating Loss

Any net operating loss for a taxable year of an electing corporation may be taken as a deduction on the individual tax returns of persons holding stock in the corporation at anytime during that year;[158] it may not be used by the corporation as a carryback or carryover. The net operating loss is the excess of the corporation's allowable deductions over its gross income. The corporation is not entitled to certain deductions[159] in determining whether such an excess exists. Moreover,

156. Treas. Reg. §1.1373-1 (f) (1959).
157. INT. REV. CODE OF 1954, §1375 (e) (1) (B).
158. INT. REV. CODE OF 1954, §1374.
159. Treas. Reg. §1.1374-1 (b) (1) (1959), as amended, T.D. 6667 (1963).

it is not entitled to any deduction for net operating loss carryover or carryback from other taxable years.

An individual does not have to be a shareholder of an electing corporation on the last day of the corporation's taxable year in order to be entitled to utilize a portion of the net operating loss. Anyone who was a shareholder of such a corporation during its taxable year is entitled to a deduction for his prorata share of the loss on a daily basis.[160] This treatment is contrary to that of undistributed taxable income, which is taxed as a constructive dividend only to shareholders as of the last day of the year.

The Regulations[161] set out the method for determining each shareholder's prorata share of the loss. The aggregate amount of the deduction is limited to the basis of the stockholder's investment in the corporation. This basis is his basis in stock plus the basis of any indebtedness of the corporation held by him.

In order to determine his basis in stock, a shareholder must total the basis of all stock held by him at the end of the corporation's taxable year in which the loss was sustained, and the basis of any stock sold or otherwise disposed of by him during the taxable year. His basis of an indebtedness is determined as of the end of the taxable year, if he holds stock in the corporation; if he no longer holds the stock at that time, then the basis of the indebtedness is computed as of the last day of the most recent year on which he did hold stock of the corporation.

If an individual stockholder's share of the net operating loss exceeds the amount that he may take as a deduction, the excess is wasted;[162] it may not be carried over by the individual to some later year nor may it be used by other shareholders in the same corporation. The deduction, to the extent allowable should be taken by the individual on his return for a taxable year in which or with which the loss year of the corporation ends.[163] If the stockholder dies during the taxable year of the electing corporation, his prorata share of any net operating loss should be taken on his final return.

The deduction for a net operating loss is allowed in computing the adjusted gross income of the individual taxpayer because it is treated as a deduction attributable to a trade or business.[164] Therefore, it may be taken whether or not the individual elects to take the standard deduction. He may use it as a carryover or carryback to other years

160. Treas. Reg. §1.1374-1 (b) (3) (1959), as amended, T.D. 6667 (1963).

161. *Ibid.*

162. Treas. Reg. §1.1374-1 (b) (4) (1959), as amended, T.D. 6667, 1963-2 CUM. BULL. 343.

163. INT. REV. CODE OF 1954, §1374 (b).

164. INT. REV. CODE OF 1954, §1374 (d).

if there is not sufficient income against which to apply the total loss in the initial year of pass-through. The loss pass-through is confined, however, to net operating losses and does not apply to capital losses sustained by the electing corporation; nor may it be used as a net operating loss carryback to taxable years beginning before January 1, 1958.

Adjustments in Basis

Both the year-end constructive dividend and the loss pass-through will affect the income tax basis of the investment in the hands of the shareholder. An adjustment is made in the basis of stock and the indebtedness and will prevent a double tax on the constructive dividend and a double benefit on a loss pass-through.

A stockholder is entitled to increase the basis of his stock in the electing corporation by the amount of any constructive dividend included in income on his return.[165] This basis increase applies only to those shares owned by the stockholder on the last day of the corporation's taxable year, and it is allocated in equal portions to each such share. The increase is effective as of the date on which the constructive dividend was received, and it remains with the stock even if the election is later terminated.[166]

The basis of stock and indebtedness held by an individual during the taxable year of an electing corporation is reduced by the individual's share of any net operating loss sustained by the corporation for such year. The reduction is applied first against stock, then it is applied against any indebtedness held by the individual,[167] but of course only to the extent that the share of the loss exceeds the basis of the stock. In no event may the basis of any share of stock or the basis of any indebtedness be reduced below zero.

If the individual has not held the same number of shares at all times that he was a stockholder during the loss year, the adjustment to the basis is determined by allocating his daily share of the net operating loss equally over the shares held by him on each day. If the reduction that is applied to any one share exceeds its basis, the excess is applied against the remaining shares. The reduction in basis is made at the end of the corporation's taxable year in which the loss occurred as to stock that is held at that time; stock disposed of during the taxable year is adjusted as of the close of the day prior to disposition.[168]

165. Treas. Reg. §1.1376-1 (1959).
166. *Ibid.*
167. Treas. Reg. §1.1376-2 (b) (1959).
168. Treas. Reg. §1.1376-2 (a) (1959).

When the basis of an indebtedness has been reduced, and the indebtedness is subsequently paid off by the corporation, the Internal Revenue Service has ruled that any gain on the repayment is a capital gain if the indebtedness is a capital asset in the hands of the holder.[169] If the individual holds more than one indebtedness of the corporation, and more than one of them is affected by the basis reduction, the reduction should be applied to each indebtedness in proportion to the basis of the various debts.[170]

CONCLUSION

Since the Subchapter S election permits the pass-through of current losses to the shareholders in the year they were sustained, the importance of the section 1244 ordinary loss provisions may be diminished if the corporation also makes that election. However, the investors in the corporation should still endeavor to qualify the stock under section 1244 since no burden is imposed on either the corporation or its shareholders. The possible voluntary or involuntary termination of the Subchapter S election may eliminate the opportunity of obtaining ordinary loss except through section 1244.

The provisions of Subchapter S that relate to the deductibility of losses offer several advantages that are not available under section 1244. The more important of these are:

(1) under Subchapter S the losses are allowed currently as sustained;

(2) there is no restriction under Subchapter S that the ordinary loss treatment is available only to those who acquired the stock directly from the corporation;

(3) there is no limitation under Subchapter S as to the amount of the capitalization of the corporation;

(4) under Subchapter S there is no limitation as to the amount of the ordinary loss deduction available.

There are, however, several situations in which the advantages of section 1244 will be available, but Subchapter S may not be utilized:

(1) section 1244 treatment may be gained even though the corporation has more than ten stockholders;

(2) if the corporation has shareholders who are not individuals, section 1244 stock may still be issued to individual shareholders;

169. Rev. Rul. 64-162, 1961-1 CUM. BULL. 304.
170. Treas. Reg. §1.1376-2(b)(3) (1959).

(3) if a corporation has a nonresident alien shareholder, it may not elect under Subchapter S, but it may issue stock to nonresident aliens who qualify under 1244;

(4) if the corporation has more than one class of stock, it is not eligible to elect under Subchapter S, but it may issue common stock qualified under 1244, while a second class of stock is outstanding.

The provisions of Subchapter S and section 1244 are not mutually exclusive; the stockholders may use both and should consider qualifying stock of the corporation under section 1244 whether or not they elect to have Subchapter S apply.

APPENDIX

SAMPLE, QUALIFIED PLAN

Plan for Issuance of Stock

1. The corporation shall offer and issue under this Plan, a maximum of _____ shares of its common stock at a maximum price of _____ ($_____) per share.

2. This offer shall terminate no later than two (2) years after the date hereof, unless sooner terminated by:

(a) Complete issuance of all shares offered hereunder, or

(b) Appropriate action terminating the same by the Board of Directors and the Stockholders, or

(c) By the adoption of a new Plan by the Stockholders for the issuance of additional stock under Section 1244, Internal Revenue Code.

3. No increase in the basis of outstanding stock shall result from a contribution to capital hereunder.

4. No stock offered hereunder shall be issued on the exercise of a stock right, stock warrant, or stock option, unless such right, warrant, or option is applicable solely to unissued stock offered under the Plan and is exercised during the period of the Plan.

5. Stock subscribed for prior to the adoption of the Plan, including stock subscribed for prior to the date the corporation comes into existence, may be issued hereunder, provided however, that the said stock is not in fact issued prior to the adoption of such Plan.

6. No stock shall be issued hereunder for a payment which, along or together with prior payments, exceeds the maximum amount that may be received under the Plan.

7. Any offering or portion of an offer outstanding which is unissued at the time of the adoption of this Plan is herewith withdrawn. Stock rights, stock warrents, stock options or securities convertible into stock, which are outstanding at the time this Plan is adopted, are likewise herewith withdrawn.

8. Stock issued hereunder shall be in exchange for money or other property except for stock or securities. Stock issued hereunder shall not be in return for services rendered or to be rendered to, or for the benefit of, the corporation. Stock may be issued hereunder however, in consideration for cancellation of indebtedness of the corporation unless such indebtedness is evidenced by a security, or arises out of the performance of personal services.

9. Any matters pertaining to this issue not covered under the provisions of this Plan shall be resolved in favor of the applicable law and regulations in order to qualify such issue under Section 1244 of the Internal Revenue Code. If any shares issued hereunder are finally determined not to be so qualified, such shares, and only such shares shall be deemed not to be in this Plan, and such other shares issued hereunder shall not be affected thereby.

10. As of the date of adoption of this Plan the total equity capital of the corporation is $_____.

11. The sum of the aggregate amount offered hereunder plus the equity capital of the corporation amounts to $_____.

12. The date of adoption of this Plan is _____, 19____.

Sample, Directors' Resolution

A plan was read and (unanimously) adopted for the issuance of common stock of the corporation to qualify the same as "small business corporation" stock under the provisions of Section 1244 of the Internal Revenue Code of 1954. The Secretary was directed to place a copy of the Plan immediately following these minutes.

Sample, Capital Stock Provision for Articles of Incorporation

The maximum number of shares of stock that this corporation is authorized to have outstanding at any one time is _____ shares of common stock (without) (having a) nominal or par value of _____ Dollars ($_____) per share. The consideration to be paid for each share shall be fixed by the Board of Directors. Common stock of the corporation shall be issued as "small business corporation" stock in accordance with a plan or plans under the provisions of Section 1244 of the Internal Revenue Code of 1954.

Sample, Capital Stock paragraph for By Laws

The maximum number of shares of capital stock which may be issued by this corporation shall be _____ shares of common stock (without) (having a) nominal or par value of _____ Dollars per share. Said common stock may be paid for in cash or property, real, personal or mixed, except stock or securities, at a just valuation to be fixed by the Board of Directors. Said common stock may not be issued for stock, securities, labor or services.

Sample, Shareholders' Consent to Subchapter S Election

_____, 1965

We, the undersigned, being all of the stockholders in _____, a Florida corporation, hereby consent to the election under Section 1372 (a) to be treated as a small business corporation for income tax purposes, and submit the following information:

Name and Address of Corporation:

Name and Address of Stockholders: *No. of Shares* *Date Acquired*

_____

_____

_____