[JOINT COMMITTEE PRINT]

DESCRIPTION OF S. 2350 (SUBCHAPTER S REVISION ACT OF 1982)

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FINANCE

ON SEPTEMBER 10, 1982

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

SEPTEMBER 8, 1982

U.S. GOVERNMENT PRINTING OFFICE

98-102 O WASHINGTON : 1982 JCS-32-82

CONTENTS

INTRODUCTION

This pamphlet provides a description of S. 2350 (introduced by Chairman Dole and Senator Long), the Subchapter S Revision Act of 1982. The Senate Finance Committee has scheduled a public hearing on the bill on September 10, 1982.

The first part of the pamphlet is a background on subchapter S of the Code. The second part is a summary of S. 2350. This is followed in part three by a more detailed description of present law and of the provisions of the bill. Part four describes other Congressional action on this matter. Finally, part five is a statement on the estimated revenue effect of the bill.

I. BACKGROUND

Legislative background

For tax purposes, a corporation generally is treated as a separate entity, apart from its shareholders. That is, income earned by the corporation is taxed to it, and distributions from the corporation (either as dividends or in liquidation) also are taxed to the shareholders. A partnership, on the other hand, is not treated as a taxable entity for income tax purposes. Instead, the income of the partnership, whether distributed or not, is taxed to the partners, and distributions by the partnership are generally tax-free.

In many instances, businesses, especially small businesses, may wish to incorporate for business reasons (for example, to obtain limited liability), but would prefer not to have corporate tax treatment. The noncorporate tax treatment may be preferred where the owners wish to have corporate losses pass through to their individual returns (or where most of the owners are taxed at individual income tax rates which are lower than the applicable corporate rate). Alternatively, even if the owners are taxed at individual rates higher than the corporate rate, they may prefer noncorporate tax treatment—assuming they expect to withdraw amounts of the income from the business—in order to avoid the dividend tax on corporate distributions.

In light of these considerations, the Congress enacted subchapter S of the Internal Revenue Code (secs. 1371 through 1379) in 1958. The objectives of the legislation were to minimize the effect of Federal income taxes on choices of the form of business organization, and to permit the incorporation and operation of certain small businesses without the incidence of income taxation at both the corporate and the shareholder levels (S. Rept. No. 1983, 85th Cong., 2d Sess. 87 (1958)).

Because of the passthrough of income and loss to the shareholders of a subchapter S corporation, subchapter S is often described as a method of taxing corporations as if they were partnerships. In fact, there are a number of significant differences in tax treatment under the partnership provisions (subchapter K) and the subchapter S provisions. For example, the partnership provisions provide a complete passthrough of the tax characteristics of the items of income and deduction incurred by the partnership, while the subchapter S provisions do not provide such a passthrough (except for capital gains). Under the partnership provisions, a distribution that does not exceed a partner's basis in his or her partnership interest generally is treated as a nontaxable return of capital. In many instances, a similar distribution to a subchapter S shareholder is treated as a taxable distribution. Under the partnership provisions, a loss carryover is allowed to the extent that losses exceed a partner's basis in his or her partnership interest as of the close of the year; in the comparable subchapter S situation, no loss carryover is available.

The experience of taxpayers with subchapter S attests to many "traps" for those not knowledgeable about its technical provisions. These unintended adverse tax consequences most often involve (1) unintentional violation of the continuing eligibility rules, resulting in retroactive terminations of elections; (2) the making of taxable distributions which were intended to be tax-free distributions of previously taxed income; and (3) a shareholder's having an insufficient basis to absorb his or her share of the corporation's loss, resulting in the permanent disallowance of that part of the loss.

The history of subchapter S also indicates that knowledgeable taxpayers may have derived some unintended benefits from the subchapter S provisions. Examples of such benefits include the deferral of income resulting from the selection of a taxable year for the corporation which is different from that of the majority of its shareholders, and the use of the retroactive termination provisions of subchapter S to prevent the passthrough of a substantial amount of income to the shareholders.

S. 2350

Since the enactment of subchapter S in 1958, various studies undertaken by government and professional groups have recommended revisions of subchapter S to simplify and modify its operation. A study by the staff of the Joint Committee on Taxation to simplify subchapter S was published on April 30, 1980.[1] S. 2350, like an identical House bill (H.R. 6055), is based largely on the recommendations of that study.[2] In addition, comments have been received from the Treasury Department, the staffs of the tax-writing committees, the tax section of the American Bar Association, the Federal tax division of the American Institute of Certified Public Accountants, and other professional groups and individuals. These comments have been taken into account in developing the introduced bills.

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[1] Commitee Print, Joint Committee on Taxation, "Staff Recommendations for Simplification of Tax Rules Relating to Subchapter S Corporations" (JCS-24-80), Apr. 30, 1980.

[2] The bill would vary the revisions recommended in the staff study in a number of respects. Among such variations, for example, would be the retention of a limitation on gross receipts from foreign sources by a subchapter S corporation and retention of an investment income limitation on corporations with accumulated earnings and profits.

II. SUMMARY

In general, S. 2350 (the Subchapter S Revision Act of 1982) is intended to simplify and modify the tax rules relating to eligibility for subchapter S status and the operation of subchapter S corporations. This would be accomplished by removing eligibility restrictions that appear unnecessary and by revising the rules relating to income, distributions, etc., that tend to create traps for the unwary. The principal changes that would be made by the bill are summarized below.

Eligibility

With respect to initial and continued eligibility of a corporation for subchapter S treatment, the following changes would be made:

(1) The number of permitted shareholders would be increased from 25 to 35;

(2) Differences in voting rights in common stock would not violate the one-class-of-stock requirement;

(3) The present law rule which automatically terminates a corporation's subchapter S election if more than 20 percent of a corporation's gross receipts for any taxable year are passive investment income would be eliminated for corporations which do not have accumulated earnings and profits at the close of the taxable year; and

(4) A person who becomes a shareholder of a subchapter S corporation after the initial election of subchapter S status would not have the power to terminate the election by affirmatively refusing to consent to the election. Accordingly, the new shareholder would be bound by the initial election until the election is otherwise terminated.

Elections, revocations, and terminations

The bill would provide that an election made on or before the fifteenth day of the third month of the taxable year would be effective for the entire taxable year if all persons who held stock in the corporation during that year were individuals, estates, and qualified trusts, and if all persons who held stock in the corporation at any time during the year up to the time the election is made consent to the election. If these requirements are not met, or if the election is made later than the fifteenth day of the third month of the taxable year, it would not be effective until the subsequent taxable year.

An event occurring during the taxable year which causes a corporation to fail to meet the definition of an eligible corporation would terminate the election as of the day on which the event occurred (rather than as of the first day of the taxable year in which the event occurred, as under present law). To minimize the effect of inadvertent termination, the bill would provide that the Internal Revenue Service may waive the terminating event so that the corporation may continue to be a subchapter S corporation notwithstanding that event.

The bill would provide that an election could be revoked by those shareholders holding a majority of the corporation's voting stock (as contrasted with the current rule, which requires all shareholders to consent to a revocation). The present law rule allowing a revocation filed during the first month of the taxable year to be effective for that entire taxable year would be modified so that such a retroactive revocation may be filed on or before the fifteenth day of the third month of the taxable year.

Passthrough of income, etc.

The bill would provide that the character of items of income, deduction, loss, and credits of the corporation would pass through to the shareholders in the same general manner as the character of such items of a partnership passes through to partners. Thus, for example, such items as tax-exempt interest, capital gains and losses, percentage depletion, the source of allocation of foreign income or loss, and foreign income taxes would pass through and retain their character in the hands of shareholders.

As is the case under present law with respect to losses, income would be passed through and allocated to shareholders on a per-share, per-day basis.

Selection of taxable year

Under the bill, rules generally similar to those applicable to partnerships would apply to the selection of a taxable year for a subchapter S corporation. The taxable year of a corporation which makes a subchapter S election would be required to be either the calendar year, or any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Treasury Department.

These rules also would apply to corporations currently operating under subchapter S. However, a corporation with a subchapter S election in effect on December 31, 1982, could continue its current taxable year so long as 50 percent or more of the outstanding stock in the corporation on that date continue to be owned by the same shareholder. For purposes of this transitional rule, transfers of stock through inheritance would not be considered changes in ownership.

Carryforward of loss

Under the bill, a subchapter S shareholder would be entitled to carry forward a loss to the extent that the amount of the loss passed through for the year exceeds the aggregate amount of the bases in his subchapter S stock and loans to the corporation. The loss carried forward could be deducted only by that shareholder if and when the basis in his or her stock of, or loans to, the corporation is restored.

Distribution

The rules relating to distributions from subchapter S corporations would be extensively revised.

Under the new rules, a corporation would not have earnings and profits attributable to any taxable year beginning after the date of enactment if a subchapter S election is in effect for that year. For corporations with no earnings and profits, the amount of the distribution (generally, cash plus the fair market value of property) would be tax-free and would reduce the shareholder's basis in his or her stock. To the extent that the amount of the distribution exceeded the amount of the basis in the stock, capital gains would result.

For corporations with accumulated earnings and profits, the distribution would be treated as a distribution by a corporation without earnings and profits to the extent of the shareholder's portion of the undistributed amount of subchapter S gross income less deductible expenses (an "accumulated adjustment account"). Any amount in excess of the accumulated adjustment account would be treated under the usual corporate rules, first as a distribution out of accumulated earnings and profits to the extent thereof.

Under the bill, both taxable and nontaxable income and deductible and nondeductible expenses would serve, respectively, to increase and decrease the subchapter S shareholder's basis in his or her stock in, and loans to, the corporation. These rules are generally analogous to those provided for partnerships. Also, unlike present law, basis would be restored to debt obligations as well as stock. Restoration of basis would be made first to debt (to the extent of prior reductions) and then to stock. Under the bill, gain would be recognized by a subchapter S corporation upon nonliquidating distributions of appreciated property.

Qualified plans and fringe benefits

Under the bill, rules similar to the partnership tax rules would apply to pension and profit-sharing plans of a subchapter S corporation and to employee fringe benefits. For this purpose, persons owning two percent or more of the corporate stock would be treated as partners and a 10-percent owner would be treated as an owner-employee.

Treatment of transactions between corporation and related parties

Under the bill, amounts accruing to any cash-basis shareholder owning two percent or more of the corporation's stock would be deductible only when paid.

Administration

The bill would provide that the items of subchapter S income, deductions, and credits would be determined in audit and judicial proceedings at the corporate level rather than at the shareholder level. Shareholders would be given notice of, and the opportunity to participate in, Internal Revenue Service proceedings with the corporation.

Effective date

The bill generally would be effective for taxable years beginning after December 31, 1982.

III. PRESENT LAW AND DESCRIPTION OF BILL

A. Eligibility for Subchapter S Treatment

Present Law

Under present law, a corporation is eligible to elect and continue subchapter S status only if it (i) has no more than 25 shareholders,[1] (ii) has no shareholder other than an individual who is a citizen or resident of the United States, an estate, or certain types of trusts [2] (grantor trusts, voting trusts, testamentary trusts for a 60-day period, and certain "qualified subchapter S trusts"), (iii) is not a member of an "affiliated group" of corporations, and (iv) has only one class of stock.

A valid subchapter S election will be terminated if a new shareholder affirmatively refuses to consent to the election, if the election is revoked by all the shareholders, if more than 80 percent of the corporation's gross receipts for any taxable year are derived from sources outside the United States, or if more than 20 percent of the gross receipts for any taxable year consist of royalties, rents, interests, dividends, annuities, or gain on the sale or exchange of stock or securities.

Explanation of Provisions

1. Permitted number of shareholders (sec. 1361(b)(1)(A)) [3]

The number of permitted shareholders would be increased from 25 to 35. This number would correspond to the private placement exemption under Federal securities law.[4]

2. One class of stock requirement (secs. 1361(b)(1)(D) and (c)(4))

The outstanding shares of the corporation must continue to be identical as the rights of the holders in the profits and in the assets

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[1] The maximum number was set at 10 when subchapter S was enacted and was increased to 15 for certain corporations by the Tax Reform Act of 1976. The Revenue Act of 1978 set the limit at 15 for all corporations. The Economic Recovery Tax Act of 1981 increased the limit to 25.

For purposes of determining the number of shareholders, a husband and wife are treated as one shareholder.

[2] Trusts were not eligible to be shareholders under subchapter S, as enacted. Voting trusts, grantor trusts, and testamentary trusts became eligible shareholders under the Tax Reform Act of 1976. The Economic Recovery Tax Act of 1981 permitted as shareholders, trusts to which sec. 678 applies (under which a person other than the grantor is treated as the owner), and "qualified subchapter S trusts" (i.e., certain trusts in which the income beneficiary elects to be taxed, as the owner).

[3] References are to sections of the Internal Revenue Code of 1954 as proposed to be amended by S. 2350.

[4] Rule 506 of Regulation D issued pursuant to sec. 4(2) of the Securities Act of 1933.

of the corporation. However, unlike present law, differences in voting rights among shares of common stock would be permitted by the bill.[5]

3. *Affiliated group (secs. 1361(b)(2)(A) and (c)(5))*

The bill would retain the rule that a member of an affiliated group of corporations is not eligible for subchapter S status; that is, an electing corporation cannot own 80 percent or more of the stock of another corporation unless the other corporation has not begun business and has no taxable income. The bill would provide that this rule also applies to the holding of any subsidiary, whether or not the corporation would be eligible to file a consolidated return with its subsidiary.

4. *Eligible shareholders (secs. 1361(b)(1)(B), (c)(2), (c)(3), and (d))*

Present law would be retained. Only individuals (other than nonresident aliens), estates, and certain trusts would be eligible to hold stock in the corporation. Foreign trusts, like foreign corporations and nonresident aliens, would not be eligible shareholders.

5. *Source of income (secs. 1361(b)(2) and 1362(d)(3) and (4))*

The provision of present law that a subchapter S corporation may not derive more than 80 percent of its gross receipts from sources outside the United States would be retained.

The bill would generally repeal the requirement that a subchapter S corporation may not have more than 20 percent of its gross income in the form of passive investment income. However, that requirement would continue to apply to those corporations which have, at the close of the taxable year, accumulated earnings and profits from years prior to electing the new subchapter S provisions.

In addition, a financial institution which is allowed a deduction for bad debts under section 585 or 593, or an insurance company subject to tax under the special insurance company rules of the Code, could not elect subchapter S.[6] These corporations are entitled to certain deductions not generally allowed to individuals. Many of these corporations are not eligible for subchapter S treatment under present law because of the passive income rules.

Possession corporations, DISC's, and former DISC's would continue to be ineligible to elect subchapter S.[7]

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[5] S. 2350 would not amend the present law rule determining whether a purported debt instrument constitutes a second class of stock. The courts have ruled certain instruments are permissible under present law where their existence offered no tax avoidance possibilities, notwithstanding that under traditional tax concepts these instruments would have normally been considered stock for tax purposes (see, e.g., *Portage Plastics Co.* v. *United States*, 486 F. 2d 632 (7th Cir. 1973), and the cases cited therein). The Internal Revenue Service has announced that it will not litigate cases factually similar to the facts in those cases (TIR-1248 (July 27, 1973)).

In addition, under present law, a subchapter S corporation may have outstanding options and warrants to acquire stock or debentures that are convertible into stock (Rev. Rul. 67-269, 1967-2 C.B. 298).

[6] The Internal Revenue Service has ruled that life insurance companies may not qualify as subchapter S corporations under present law (Rev. Rul. 74-344, 1974-2 C.B. 273). The Service has also ruled that stock casualty insurance companies taxable under sec. 831(a) may elect subchapter S treatment (Rev. Rul. 74-437, 1974-2 C.B. 274).

[7] Regulated investment companies and real estate investment trusts would continue to be ineligible because of the numerical shareholder limitations.

B. Election, Revocation, and Termination

Present Law

Under present law, an election to be taxed as a subchapter S corporaton may be made for any taxable year at any time during the preceding taxable year or at any time during the first 75 days of the taxable year.[8] An election continues in effect for subsequent taxable years until it is terminated.

In order for an election to be effective, each shareholder on the day the election is made must consent to the election. If a subchapter S election is terminated, a new election cannot be made by the corporation (or its successor) for any year prior to its fifth taxable year beginning after the taxable year during which the termination is effective, unless the Internal Revenue Service consents to an earlier election.

Under present law, the termination of an election is generally retroactive to the first day of the taxable year in which the terminating event occurred. A termination automatically occurs if the corporation fails to meet any of the eligibility requirements for subchapter S treatment. An election also terminates if all the shareholders of the corporation consent to a revocation. A revocation generally is effective for the following taxable year. Finally, an election can be terminated if a new shareholder affirmatively refuses to consent to the election on or before the 60th day after he or she acquired the stock.

Explanation of Provisions

1. Making an election (secs. 1362(a) and (b))

An election made on or before the fifteenth day of the third month of a corporation's taxable year would be effective for the entire taxable year if the corporation meets all the eligibility requirements (including shareholder eligibility requirements) for that entire taxable year, and if all persons who held stock in the corporation at any time during the portion of the year before the election was made consented to the election.

If the eligibility requirements are not met for the entire year in which the election is made, if consents of all shareholders who had disposed of their stock prior to the making of the election are not obtained, or if the election is made after the fifteenth day of the third month of the year, the election would not become effective until the next taxable year. This rule would eliminate any problem of allocation of income and loss with respect to pre-election stockholders who either were ineligible to hold subchapter S corporation stock or did not consent to the election.

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[8] Prior to an amendment made by the Revenue Act of 1978, the election was required to be made during the two-month period beginning one month before the start of the taxable year.

2. Termination of election (secs. 1362 (d), (e), and (g))

Generally, specific events during the taxable year which cause a corporation to fail to meet the definition of a small business corporation would result in a termination of the election as of the date on which the event occurred (rather than as of the first day of the taxable year, as under present law). The events causing disqualification would be: (1) exceeding the maximum allowable number of shareholders; (2) transfer of stock to a corporation, partnership, ineligible trust, or nonresident alien; (3) the creation of a class of stock other than the voting and nonvoting common stock allowed; and (4) the acquisition of a subsidiary (other than certain nonoperating subsidiaries).

The day before the day on which the terminating event occurs would be treated as the last day of a short subchapter S taxable year, and the day on which the terminating event occurs would be treated as the first day of a short regular (i.e., subchapter C) taxable year. There would be no requirement that the books of a corporation be closed as of the termination date. Instead, the corporation would be required to allocate the income or loss for the entire year (i.e., both short years) on a daily proration basis.

However, the corporation could elect, with the consent of all persons who were shareholders during the short subchapter S year, to report the taxable income or loss on each return (subchapter S and subchapter C) on the basis of income or loss shown on the corporation's permanent records (including work papers). Under this method, items would be attributed to the short subchapter S and subchapter C years according to the time they were incurred or realized, as reflected in such records.

The short subchapter S and subchapter C taxable years would be treated as one year for purposes of carrying over previous subchapter C losses. The income allocated to the subchapter C taxable year would be subject to annualization for purposes of applying the corporate rate brackets. The return for the short subchapter S year would be due on the same date as the return for the short subchapter C year is due.

As under present law, if a corporation's election terminates because the foreign income limitation or the passive income limitation (to the extent still applicable) is violated for any taxable year, the election is terminated for that entire taxable year.

If an election is terminated, a new election cannot be made, without the consent of the Internal Revenue Service, for five taxable years (as under present law).

3. Revocation of election (sec. 1362(d)(1))

An election could be revoked only by action of shareholders holding more than one-half of the corporation's voting stock.

The present law rule allowing a revocation filed during the first month of the taxable year to be effective for that entire taxable year would be modified. Under the bill, a revocation filed up to and including the fifteenth day of the third month of the taxable year would be effective for the entire taxable year, unless a prospective effective date was specified. The period during which a retroactive revocation could be filed thus would correspond to the time period in which a retroactive election may be made. Revocations made after the fifteenth day of the third month of the taxable year would be effective on the first day of the following taxable year unless the revocation stated some other prospective date, in which case it would be effective as of the specified date.

Revocations which designate a prospective effective date would result in the splitting of the year into short subchapter S and subchapter C taxable years with the tax consequences as discussed above in connection with terminations.

A person becoming a shareholder of a subchapter S corporation after the initial election would not have the power to terminate the election by affimatively refusing to consent to the election. He or she would be bound by the initial election.

4. Inadvertent terminations (sec. 1362(f))

If the Internal Revenue Service determines that a corporation's subchapter S election was inadvertently terminated, the Service could waive the effect of the terminating event for any period if the corporation timely corrects the event, and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.

C. Treatment of Income, Deductions, and Credits

Present Law

Under present law, a subchapter S corporation is not subject to the corporate income tax. An exception to this rule is the imposition of a capital gains tax on certain subchapter S corporations, in order to discourage the making of a "one-shot" subchapter S election.

Instead, the undistributed taxable income of the corporation is includible in gross income of the shareholders owning stock on the last day of the corporation's taxable year. Similar rules pass through the credits of the corporation to its shareholders. Any net operating loss of the corporation is passed through to the shareholders, based on each shareholder's pro rata share of ownership in the corporation during the taxable year. Specific items (such as charitable contributions), other than the long-term capital gain portion of income, do not pass through.

Income may be reallocated by the Internal Revenue Service among shareholders who are family members as necessary to reflect the value of services rendered.

A shareholder may deduct a loss only to the extent of the shareholder's adjusted basis in the stock of the corporation plus the shareholder's adjusted basis of any indebtedness of the corporation to the shareholder. Loses in excess of this limitation may not be carried over.

A shareholder's basis in the stock of the corporation is increased by the amount of undistributed taxable income taken into account, and decreased by the shareholder's share of the net operating loss passed through. Losses reduce basis in any indebtedness after the stock basis has been reduced to zero.

Explanation of Provisions

1. Treatment of corporations (secs. 1363(a), 1371(d), and 1374)

As under present law, a subchapter S corporation would not be subject to the corporate income tax, except for the present tax on capital gains. This tax, which is imposed to limit use of subchapter S on a temporary basis in order to pass capital gains through to shareholders, would continue.

Under the bill, the tax imposed under section 47 in the case of an early disposition of property on which an investment credit was claimed would be imposed on the corporation with respect to property purchased by the corporation prior to the effective date of the subchapter S election. The election would not be treated as a disposition of the property by the corporation.

2. *Treatment of shareholders (secs. 1363(b) and (c), 1366, 1367, 1371(b), and 1373)*

In general

The bill would set forth new rules for the taxation of income earned by, and the allowance of losses incurred by, subchapter S corporations. These rules generally follow the present law rules governing the taxation of partners with respect to items of partnership income and loss.

Computation of corporate items

A subchapter S corporation's taxable income would be computed under the same rules presently applicable to partnerships under section 703, except that the amortization of organization expenditures under section 248 would be an allowable deduction. As in the case of partnerships, deductions generally allowable to individuals would be allowed to subchapter S corporations. However, provisions of the Code governing the computation of taxable income which are applicable only to corporations, such as the dividends received deduction, would not apply. Items, the separate treatment which could affect the liability of any shareholder, would be treated separately.

Elections would generally be made at the corporate level, except for those elections which the partners of a partnership may make separately (such as the election to claim the foreign tax credit).

Passthrough of items

The following examples illustrate the operation of the bill's passthrough rules:

a. Capital gains and losses.—Gains or losses from sales or exchanges of capital assets would pass through to the shareholders as capital gains or losses. Net capital gains would no longer be offset by ordinary losses at the corporate level.

b. Section 1231 gains and losses.—The gains and losses on certain property used in a trade or business would be passed through separately and would be aggregated with the shareholder's other section 1231 gains and losses. Thus, section 1231 gains would no longer be aggregated with capital gains at the corporate level and passed through as capital gains.

c. Charitable deductions.—The corporate 10-percent limitation would no longer apply to contributions by the corporation. As in the case of partnerships, these deductions would retain their character as charitable contributions when passed through to the shareholders, at which level they would be subject to the individual limitations on deductibility.

d. Tax-exempt interest.—Tax-exempt interest would pass through to the shareholders as such and would increase the shareholders' basis in their subchapter S stock. Because of the limitation of the earnings and profits account (discussed in III–D, below), subsequent distributions by the corporation would not result in taxation of the tax-exempt income.

e. Foreign taxes.—Foreign taxes paid by the corporation would pass through as such to the shareholders, who would claim such taxes either as deductions or credits (subject to the applicable limitations). However, a subchapter S corporation would not be eligible for the foreign tax credit with respect to taxes paid by a foreign corporation in which the subchapter S corporation is a shareholder; therefore, these taxes would not pass through to its shareholders. Special foreign loss recapture provisions similar to those of section 904(f) would apply to a corporation electing out of subchapter S which had previously passed foreign losses through to its shareholders. Rules concerning the source of income, including the capital gains source rule of section 904(b), and the amount of creditable taxes, such as the rules of section 907(a), would apply at the shareholder level.

f. Credits.—As with partnerships, items involved in the determination of credits (such as the basis of section 38 property for purposes of computing amount of qualified investment eligible for the investment tax credit) would pass through to the subchapter S corporation's shareholders.

g. Depletion.—The present rules governing depletion with regard to partnership interests in minerals would apply to depletion of properties of a subchapter S corporation (see discussion in section III–F, below, for special rules in the case of oil and gas properties).

h. Foreign income and loss.—Domestic losses and foreign losses would pass through separately. If a corporation had foreign losses and domestic income, or vice versa, each would pass through separately to shareholders without aggregation at the corporate level.

i. Other items.—Limitations on the used property investment tax credit (sec. 48(c)), the expensing of certain depreciable business assets (sec. 179), and the amortization of reforestation expenditures (sec. 194) would apply at both the corporate level and shareholder level, as in the case of partnerships.

Carryovers from years in which the corporation was not a subchapter S corporation would not be allowed to the corporation while in subchapter S status.

Shareholder treatment of items

As with the partners of a partnership, each shareholder of a subchapter S corporation would take into account separately his or her pro rata share of items of income, deduction, credit, etc. of the corporation. These rules would parallel the partnership rules under section 702. Each shareholder's share of the items would be taken into account in the shareholder's taxable year in which the corporation's year ends.

For these purposes, a shareholder's pro rata share generally would be determined in the same manner as the present law rule for passing through net operating losses. In cases of transfers of subchapter S stock during the taxable year, income, losses, and credits would be allocated in essentially the same manner as when the election terminates during the year. Thus, the allocation would be made on a per-share, per-day basis unless the corporation, with the consent of its shareholders, elected to allocate according to its permanent records (including work papers).

A "conduit" rule for determining the character of items realized by the corporation and included in the shareholder's pro rata share would be the same as the partnership rule. Also, the "gross income" determinations made by a shareholder would parallel the partnership rule.

Under the bill, items taken into account by members of the family of a shareholder could be adjusted by the Internal Revenue Service as necessary to reflect reasonable compensation to the shareholder for services rendered or capital furnished to the corporation. Both the amount of compensation and the timing of the compensation could be so adjusted.

As under present law, a shareholder's allowable pro rata share of the corporation's loss would be limited to the sum of the shareholder's adjusted basis in the stock of the corporation plus the shareholder's adjusted basis of any indebtedness of the corporation to the shareholder. However, unlike present law, disallowed losses could be carried forward or allowed in any subsequent year in which the shareholder has adequate basis in such stock or debt.

Subsequent to a termination of a subchapter S election, these disallowed losses would be allowed if the shareholder's basis in his stock in the corporation is restored by the later of the following dates:

(1) One year after the effective date of the termination or the due date for the last subchapter S return, whichever is later; or

(2) 120 days after a determination that the corporation's subchapter S election had terminated for a previous year. (A determination would be defined as a court decision which becomes final, a closing agreement, or an agreement between the corporation and the Internal Revenue Service that the corporation failed to qualify.)

3. Basis adjustment (sec. 1367)

Under the bill, both taxable and nontaxable income and deductible and nondeductible expenses would serve, respectively, to increase and decrease a subchapter S shareholder's basis in the stock of the corporation.

These rules would be analogous to those provided for partnerships under section 705. Unlike the partnership rules, however, to the extent property distributions are treated as a return of basis, basis would be reduced by the fair market value of these properties (see scetion III–D, below). Any passthrough of income for a particular year (allocated according to the proportion of stock held in the corporation) would first increase the shareholder's basis in loans to the corporation to the extent the basis was previously reduced by the passthrough of losses.

D. Treatment of Corporate Distributions

Present Law

Under present law, the general rules applicable to distributions to shareholders by regular corporations apply to such distributions by subchapter S corporations. Under the normal corporate rules, distributions of cash or other property are treated as taxable dividends, at fair market value, to the extent the corporation has either current or accumulated earnings and profits. Distributions in excess of earnings and profits are tax-free up to the shareholder's basis in the stock, and any excess is then treated as gain from the sale of the stock.

In addition to the regular rules, special rules also apply to distributions by subchapter S corporations. These rules allow a corporation to make tax-free cash distributions within 2½ months after the close of the taxable year out of the prior year's undistributed taxable income to the extent of the shareholder's portion of that income (sec. 1375(f)). Also, cash distributions which are not distributions of the prior year's undistributed taxable income and which are in excess of current earnings and profits qualify as tax-free distributions of a shareholder's previously taxed income to the extent of that income (sec. 1375(d)). The right to receive previously taxed income is not transferable and terminates when the corporation's subchapter S election terminates.

Property distributions by subchapter S corporations are treated differently from cash distributions in that they do not reduce the amount of the current year's undistributed taxable income taxed to the shareholder and do not qualify as distributions of either undistributed taxable income or of previously taxed income. Also, property distributions reduce earnings and profits by an amount equal to the adjusted basis of the property distributed.

In summary, distributions of money have the following tax consequences in the following order: (1) a tax-free distribution of undistributed taxable income to the extent thereof, if made within 2½ months after the end of the corporation's taxable year; (2) a dividend to the extent of current earnings and profits; (3) a tax-free distribution to the extent of previously taxed income (a special rule reverses the order of items (2) and (3) in the case of certain accelerated depreciation); (4) a dividend to the extent of accumulated earnings and profits (the shareholder may elect to reverse the order of items (3) and (4)); (5) reduction in the shareholder's basis in the stock of the corporation; and (6) a taxable disposition of the stock.

Property distributions have the following tax consequences under present law: (1) A dividend distribution to the extent of either current or accumulated earnings and profits; (2) reduction in the shareholder's basis in the stock of the corporation; and (3) a taxable disposition of the stock.

Generally, distributions have no tax effect on the distributing corporation, except for distributions of LIFO inventory where the "LIFO reserve" is recaptured, or distributions of property where the liability exceeds basis, which results in gain to the extent of the excess (sec. 311(a), (b), and (c)).

Explanation of Provisions

1. Taxation of shareholders (secs. 1368 and 1371(c))

Under the bill, the amount of any distribution to a shareholder would equal the amount of cash distributed plus the fair market value of any property distributed, as under present law.

The amount of a distribution by a corporation without accumulated earnings and profits would be tax-free to the extent of the shareholder's basis in the stock. The distribution would be applied to reduce the shareholder's basis in his stock. To the extent the amount of the distribution exceeds basis, capital gains would result.

No post-1982 earnings of a subchapter S corporation would be considered earnings and profits for this purpose. Thus, under the bill, a corporation would not have earnings and profits attributable to any taxable year beginning after 1982 if a subchapter S election was in effect for that year. However, a corporation could have earnings and profits attributable to (1) taxable years for which an election was not in effect; (2) taxable years beginning prior to 1983 for which an election was in effect; and (3) a corporate acquisition which results in a carryover of earnings and profits under section 381.

A distribution by a subchapter S corporation with accumulated earnings and profits would be treated as if made by a subchapter S corporation with no earnings and profits up to the amount in the corporation's accumulated adjustment account (i.e., gross income less deductible expenses, not previously distributed).[9] Any excess would then be treated as a dividend up to the amount of accumulated earnings and profits; any residual amount would then be applied against the shareholder's remaining basis in his stock; and, finally, any remainder of the distribution would be treated as capital gain.

Thus, under the bill, shareholders of subchapter S corporations with accumulated earnings and profits generally would be assured of tax-free treatment with respect to distributions, regardless of when made, to the extent of the corporation's accumulated adjustment account.

The rules described above would apply to the transferee of stock in a subchapter S corporation regardless of the manner in which the transferee acquired the stock.

2. Treatment of corporation (sec. 1363(d))

Gain would be recognized by a subchapter S corporation on any distribution of appreciated property, other than distributions in complete liquidation of the corporation. This rule results from the com-

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[9] The effect of excluding tax-exempt income from the accumulated adjustments account is to require accumulated earnings and profits to be distributed before tax-exempt income is considered distributed.

bination of the elimination of earnings and profits for subchapter S years and the retention of the fair market value distribution rule. Without this rule, assets could be distributed tax-free (except for recapture in certain instances) and subsequently sold without income recognition to the selling shareholder because of the stepped-up fair market value basis.

E. Taxable Year of Corporation

Present Law

Under present law, shareholders of a subchapter S corporation take into account undistributed taxable income and net operating losses for their taxable years in which the subchapter S taxable year ends. No special rules limit the taxable year which the corporation may select. As a result, a deferral of tax can result if a taxable year ending shortly after the end of the shareholder's taxable year is selected.

Explanation of Provision (sec. 1378)

Under the bill, the taxable year of a subchapter S corporation would be required to be either a year ending December 31, or any other taxable year for which it establishes a business purpose to the satisfaction of the Internal Revenue Service.

A corporation which is a subchapter S corporation during the taxable year which includes December 31, 1982, would be permitted to retain its existing taxable year so long as at least 50 percent of the stock in the corporation is owned by the same persons who owned such stock on December 31, 1982. However, to retain subchapter S status for taxable years beginning after the day on which more than 50 percent of its stock has changed ownership subsequent to December 31, 1982, the corporation would have to conform to the general taxable year rule and either use the calendar year or establish a business purpose for a different year. For these purposes, transfers of shares by reason of the shareholder's death would not be considered changes in ownership.

F. Other Rules

1. Treatment of pension and profit-sharing plans

Present Law

Under present law, a pension or profit-sharing plan of a subchapter S corporation is subject to special rules which are in addition to the tax-qualification requirements applicable to plans of other corporations. However, beginning in 1984, the Tax Equity and Fiscal Responsibility Act of 1982 generally eliminates the distinctions between the qualification rules of different types of entities.

Explanation of Provision (sec. 1372(a))

Under the bill, a pension or profit-sharing plan of a subchapter S corporation generally would be treated as an H.R. 10 plan under the tax qualification requirements of the Code and also for purposes of the other tax rules relating to qualified plans. (Because of the changes made by the Tax Equity and Fiscal Responsibility Act of 1982, this provision of the bill will become redundant after 1983.)

2. Treatment of fringe benefits

Present Law

Under present law, the statutory exemptions for fringe benefits applicable to shareholder-employees of regular corporations also apply in the case of subchapter S corporations. The benefits include the following:

(1) the $5,000 death benefit exclusion (sec. 101(b));

(2) the exclusion from income of amounts paid for an accident and health plans (sec. 105 (b), (c), and (d));

(3) the exclusion from income of amounts paid by an employer to an accident and health plan (sec. 106);

(4) the exclusion of the cost of up to $50,000 of group-term life insurance on an employee's life (sec. 79); and

(5) the exclusion from income of meals or lodging furnished for the convenience of the employer (sec. 119).

Explanation of Provision (sec. 1372(c))

Under the bill, the treatment of fringe benefits of any person owning more than two percent of the stock of the corporation would be treated in the same manner as a partner in a partnership. Thus, for example, amounts paid for the medical care of a shareholder-employee would be deductible by that individual only to the extent personal medical expenses would be allowed as an itemized deduction under section 213.

3. Treatment of oil and gas production

Present Law

Under present law, the allowance for depletion (including depletion with respect to oil and gas wells) for a subchaper S corporation is computed by the corporation and taken into account in determining the taxable income of the subchapter S corporation. The depletion deductions taken into account in determining earnings and profits of a subchapter S corporation are computed based on cost depletion. Thus, when a subchapter S corporation claims percentage depletion, it may generate current earnings and profits in excess of taxable income, and amounts distributed in excess of taxable income may be taxed as a dividend to the shareholders.

The right to claim percentage depletion with respect to oil and gas wells is limited under present law to certain independent producers and royalty owners. To prevent a proliferation of interests eligible for percentage depletion, present law provides anti-transfer rules which limit the ability of transferees to claim percentage depletion on production attributable to an interest in proven oil or gas properties transferred after 1974.

Generally, a transfer from an individual to a subchapter S corporation will result in the loss of percentage depletion unless the special rules provided in section 613A(c)(10) are satisfied. In essence, these rules require that the corporation's stock be issued solely in exchange for oil and gas properties and that there be an allocation of the barrel-per-day limitation on percentage depletion between the corporation and the individuals contributing the property. Similarly, the transfer of an oil and gas property from the subchapter S corporation to one or more of the shareholders would result in the loss of percentage depletion for production from the transferred property. However, the subchapter S election by a regular corporation is not treated as a transfer (Rev. Rul. 80–43, 1980–1 C.B. 133).

Under present law, the windfall profit tax is imposed upon the producer of domestic crude oil. In the case of a subchapter S corporation, the producer of crude oil is the corporation and not the individual shareholders. The transfer of property from or to a corporation would be a transfer resulting in the loss of lower rates on production by independent producers, unless one of the specified exceptions to the anti-transfer rules applied.

Explanation of Provision (sec. 3 (a) and (b) of the bill)

Under the bill, the allowance for depletion in the case of oil and gas properties held by a subchapter S corporation would be computed in a manner similar to that used in the computation of depletion in the case of partnerships. Specifically, the percentage or cost depletion allowance would be available directly to the shareholders of the subchapter S corporation and would be computed separately by each individual shareholder. Each shareholder would be treated as having produced his or her pro rata share of the production of the subchapter S corporation and each shareholder would be allocated his or her respective share of the adjusted basis of the subchapter S corporation in each oil or gas property held by the corporation.

For purposes of applying the anti-transfer rules in the percentage depletion provisions, the subchapter S corporation would be treated as a partnership and the shareholders would be treated as partners, Similarly, an election by a regular corporation to become a subchapter S corporation would be treated as a transfer of all the property of the corporation effective on the day on which the election takes effect. Finally, for purposes of the anti-transfer rules, the termination of a subchapter S election and the reversion to regular status would be treated as a transfer by the shareholders of all the assets of the subchapter S corporation to the regular corporation.

For purposes of the windfall profit tax, a subchapter S corporation would be treated as a partnership. Specifically, any subchapter S corporation which would otherwise be treated as a producer of crude oil would not be so treated; instead, all the crude oil produced by that corporation would be allocated among the shareholders in proportion to each shareholder's pro rata share of the income of the corporation. Each shareholder entitled to an allocation of crude oil would be treated as the producer of that crude oil for purposes of the windfall profit tax. Thus, for purposes of the independent producer lower rates (including the anti-transfer rules), the subchapter S corporation would be treated as a partnership and the shareholders of the subchapter S corporation would be treated as partners of the partnership.

4. Treatment of expenses owed to shareholders

Present Law

Under present law, a subchapter S corporation, in order to obtain a deduction for business expenses or interest payable to a cash-basis shareholder owning (after application of the constructive ownership rules of sec. 267(c)) more than 50 percent of the stock of the corporation, must actually pay such items not later than 2½ months after the close of its taxable year. If the shareholder owns 50 percent or less of the stock, a subchapter S corporation on the accrual method of accounting may accrue the deduction (to the extent otherwise allowable) notwithstanding that the shareholder does not include the amount in income until actually paid.

Explanation of Provision (sec. 3(g) of the bill)

The bill would place a subchapter S corporation on the cash method of accounting for purposes of deducting those expenses and interest owed to a cash-basis shareholder who owns at least two percent of the stock in the corporation. Thus, the timing of the corporation's deductions (which are taken into account on the shareholder's returns) and the shareholder's income would match. Also, no deductions would be lost if payment is made after the 2½-month period expires.

G. Tax Administration Provisions

Present Law

Under present law, a taxpayer's individual tax liability is determined in proceedings between the Internal Revenue Service and the individual whose tax liability is in dispute. Thus, any issues involving the income or deductions of a subchapter S corporation are determined separately in administrative or judicial proceedings involving the individual shareholder whose tax liability is affected. Statutes of limitations apply at the individual level, based on the returns filed by the individual. The filing by the corporation of its return does not affect the statute of limitations applicable to the shareholders.

Explanation of Provision (sec. 1375)

Under the bill, the tax treatment of items of subchapter S income, loss, deductions, and credits generally would be determined at the corporate level. Shareholders would be given notice of any administrative or judicial proceeding at which such items would be determined. Further, each shareholder would be given the opportunity to participate in these proceedings. Shareholders would be required to file returns consistent with the corporate return or notify the Internal Revenue Service of the inconsistency.

(Similar provisions were made applicable to partnerships by the Tax Equity and Fiscal Responsibility Act of 1982.)

H. Effective Date and Transitional Rules (sec. 1379)

The bill would apply to taxable years beginning after December 31, 1982. Existing subchapter S corporations would be treated under the new rules for the first taxable year beginning after that date. Tax-free distributions of undistributed taxable income from the last pre-enactment year could be made. Also, previously taxed income could be distributed during the first post-enactment year and the 2½-month period after the close of that year. Carryforwards, such as capital loss carryforwards and charitable contribution carryovers from the corporation's last pre-enactment year, would be treated as sustained in the first post-enactment year.

IV. OTHER CONGRESSIONAL ACTION

H.R. 6055, which is identical to S. 2350, was introduced on April 1, 1982, in the House of Representatives by Chairman Rostenkowski and Mr. Conable.

That bill was reported, with amendments, by the Subcommittee on Select Revenue Measures to the Committee on Ways and Means on July 15, 1982. The following amendments were made by the subcommittee.

Passive income test

The passive income test (which the bill retains for corporations with accumulated earnings and profits) would be modified, under the subcommittee amendments, by excepting interest on deferred payment sales of inventory; etc., and income from the conduct of a lending or finance business (as defined in sec. 542(c)(6)), from the definition of passive investment income. Also, only the net gain from the sale or exchange of capital assets (other than stock or securities) would be treated as the gross receipts from the disposition of those assets.

Second class of stock

The bill as amended by the subcommittee would provide that a corporation's subchapter S election would not be terminated because the corporation has outstanding any straight-debt instrument which is held by a person who is eligible to hold subchapter S stock.

Straight-debt would generally mean a written unconditional promise to pay on demand or on a specified date a sum certain in money, so long as the interest rate is fixed and the instrument is not convertible into stock. The determination of whether an instrument which does not meet these safe-harbor requirements is a second class of stock would be made under generally applicable tax principles regarding classification. The Treasury could prescribe regulations to coordinate the treatment of any safe-harbor instrument which otherwise is treated as equity with other provisions of the Code.

Foreign income test

The foreign income test would be repealed by the subcommittee amendments.

"Grandfather" provisions

Foreign or DISC subsidiary rule

A corporation with a foreign subsidiary or a DISC subsidiary which on June 23, 1982, was a subchapter S corporation could remain a subchapter S corporation so long as its election does not terminate, and the majority of its stock is not transferred after 1982.

Previously taxed income

Present-law rules allowing previously taxed income to be distributed tax-free would continue indefinitely under the subcommittee amendments, for income earned under the current subchapter S provisions.

Casualty insurance company

The amendments to subchapter S otherwise made by the bill would not apply under the subcommittee amendments, to a casualty insurance company described in section 831(a) if either—

(a) the corporation was a subchapter S casualty insurance company on July 12, 1982;

(b) the corporation was formed prior to April 1, 1982, and proposed, through a written private offering first circulated to investors prior to that date, to elect to be taxed as a subchapter S corporation and to be operated on an established insurance exchange; or

(c) the corporation is approved for membership on an established insurance exchange pursuant to a written agreement entered into before December 31, 1982, and the corporation is engaged in the casualty insurance business before the end of 1984.

The grandfather rule for these casualty insurance companies would continue until either the subchapter S election is terminated, or more than one-half the stock ceases (other than by reason of death) to be held by persons holding the stock on December 31, 1984.

Miscellaneous technical provisions

The subcommittee amendments would modify the bill to provide that a shareholder's portion of the corporation's income or loss for the taxable year in which the shareholder dies would be included on the shareholder's final tax return.

Also, the subcommittee amendments would clarify the provision allowing a shareholder to take into account his or her share of the corporation's loss in the year the corporation's stock becomes worthless.

V. REVENUE EFFECT

The revenue effects of this bill with respect to both amounts and timing cannot be estimated with precision. However, the net effect of the bill probably would be a revenue loss of less than $10 million annually during the next several years.

The provisions affecting eligibility for subchapter S treatment are expected to reduce budget receipts by less than $5 million annually.

The provisions affecting election, revocation, and termination of subchapter S status are expected to have a negligible revenue effect.

The provisions dealing with treatment of income, deductions, and credits are expected to reduce budget receipts by a negligible amount.

The provisions dealing with treatment of corporate distributions are expected to reduce budget receipts by a negligible amount.

The provision affecting taxable year of corporations is expected to increase budget receipts by a small amount.

All other provisions are not expected to have any significant impact on budget receipts.