

Item 1

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SUMMARY OF
1958 SMALL BUSINESS TAX LEGISLATION
(PUBLIC LAW 85-866, 85TH CONGRESS)

PREPARED BY THE
STAFF OF THE JOINT COMMITTEE ON
INTERNAL REVENUE TAXATION



MARCH 17, 1959

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LETTER OF TRANSMITTAL

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,
Washington, March 17, 1959.

To Members of the Joint Committee on Internal Revenue Taxation:

There is transmitted herewith a summary, as prepared by the staff of the committee, of the 1958 small business tax legislation. It is believed that this summary should be of considerable benefit to persons concerned with small business problems by acquainting them with the action taken by the Congress last year to aid small business.

Very truly yours,

WILBUR D. MILLS,
Chairman, Joint Committee on Internal Revenue Taxation.

LETTER OF SUBMITTAL

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,
Washington, D.C., March 17, 1959.

HON. WILBUR D. MILLS,
Chairman, Joint Committee on Internal Revenue Taxation,
Washington, D.C.

MY DEAR MR. CHAIRMAN: There is submitted herewith a summary, prepared by the staff of the committee, of the 1958 small business tax legislation.

Respectfully submitted.

COLIN F. STAM,
Chief of Staff.

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SUMMARY OF 1958 SMALL BUSINESS TAX LEGISLATION

I. INTRODUCTION

The Technical Amendments Act of 1958 (title I, Public Law 85-866) is designed to correct unintended benefits and hardships and to make technical amendments in the Internal Revenue Code of 1954. It contains certain provisions which are of particular aid to small business. The Small Business Tax Revision Act of 1958 (title II of Public Law 85-866) is designed to aid and encourage small business. This document is a summary of all the substantive provisions of title II, and those substantive provisions of title I which are of particular aid to small business.

Since the enactment of Public Law 85-866 on September 2, 1958, the Treasury Department has issued certain announcements, temporary rules and proposed regulations amplifying these small-business provisions. For the convenience of the reader such announcements, temporary rules and proposed regulations issued on or before March 17, 1959, have been set forth in the appendixes to this document, and appropriate references to them are made in the text.

II. TECHNICAL AMENDMENTS ACT OF 1958

A. Small-business investment companies (sec. 57)

In 1958 Congress passed the Small Business Investment Act of 1958. This law is designed to make equity capital and long-term credit more readily available for small-business concerns. To carry out this purpose, this act provides for the formation of small-business investment companies. These companies are authorized to provide equity capital to small-business concerns through the purchase of convertible debentures. The small-business investment companies are to be private companies with a paid-in capital and surplus of at least \$300,000. Also, the Small Business Administration is authorized to make loans to these companies of up to \$150,000 through the purchase of subordinated debentures.

Section 57 of the Technical Amendments Act of 1958 added to the 1954 Code certain tax provisions (secs. 1242, 1243 and 243 (b)), relating to the tax treatment of these small-business investment companies and their stockholders in order to substantially increase the effectiveness of these small-business investment companies. First, it provides that these investment companies are to be allowed an ordinary loss deduction, rather than a capital loss deduction, on losses realized on the convertible debentures (including stock received pursuant to the conversion privilege) acquired in connection with the supplying of long-term equity-type capital for various small-business concerns. This loss deduction includes losses due to worthlessness, as well as those arising from the sale or exchange of the security. Second, taxpayers invest-

ing in the stock of the small-business investment companies also are to be allowed an ordinary loss deduction, rather than a capital loss deduction, on losses arising from the worthlessness, or from the sale or exchange of such stock. This loss is treated as attributable to a trade or business of the taxpayer for purposes of the net operating loss deduction. Third, these proposed investment companies are to be allowed a deduction for 100 percent of the dividends received from a taxable domestic corporation rather than the 85 percent deduction generally allowed corporate taxpayers.

These new provisions apply with respect to taxable years beginning after September 2, 1958, the date of enactment of the Technical Amendments Act of 1958.

Announcements by the Treasury Department in connection with sections 1242, 1243, and 243(b) are set forth in appendix I.

B. Amounts received as damages for injuries under the antitrust laws (sec. 58)

Before the enactment of the Technical Amendments Act of 1958, an amount received (or accrued) during a year which represented an award or settlement of a civil action brought under section 4 of the Clayton Act for injuries sustained by the taxpayer in his business or property because of anything forbidden in the antitrust laws was included in gross income as a lump sum in the year received (or accrued).

Section 58 of the Technical Amendments Act of 1958 has added a new provision (a new sec. 1306) providing a limitation with respect to the tax imposed on amounts representing damages received as awards or settlements in a civil action brought under section 4 of the Clayton Act for injuries sustained in the taxpayer's business or property because of violations of the antitrust law. In such cases the tax attributable to the award or settlement is not to be greater than the increases in taxes which would have resulted if the award or settlement had been included in the taxpayer's income, on a pro rata basis, over the period in which the taxpayer was injured.

This provision is effective for taxable years ending after September 2, 1958, the date of enactment, but only in the case of amounts received after that date for awards or settlements made after that date.

C. Revocation of election permitting certain proprietorships and partnerships to be taxed as corporations (sec. 63)

Section 1361, enacted in 1954, permits certain proprietorships and partnerships with 50 or less members to elect to be treated for tax purposes as corporations. This privilege is limited to those businesses where capital is a material income-producing factor or where 50 percent or more of the gross income consists of gains, profits, or income derived from trading as a principal or from certain types of brokerage commissions.

Section 1361 provides that an election to come under the corporate treatment must be made, in accordance with regulations prescribed by the Secretary or his delegate, not later than 60 days after the close of any taxable year. However, the Treasury Department was not able to issue regulations under section 1361 before the last day (March 1, 1955) on which this election could be made for 1954. As a result, it issued Treasury Decision 6124 on February 24, 1955, which permitted taxpayers to make a binding election within a 60-day period after the

close of the taxable year. It was provided, however, that this election would not be valid unless perfected by the filing of an amended return on or before the last day of the third month following the month in which the final regulations are published.

To make certain that an election under this section *will not be binding* on the taxpayer before the final regulations under this section are published, a specific *statutory* substitute for Treasury Decision 6124 has been provided. First, it provides that an election to be taxed as a corporation under section 1361, which is filed in accordance with regulations prescribed by the Secretary or his delegate, is to be treated as a valid election. However, it further provides that a valid election may be subsequently revoked at any time after the enactment of the Technical Amendments Act of 1958 (September 2, 1958) and on or before the last day of the third month following the month in which final regulations are published on section 1361. Such a revocation, if made, will be effective for all years to which the election applied. The new provision also provides for keeping the statute of limitations open for an additional period with respect to (i) the assessment of deficiencies attributable to an enterprise which makes an election under section 1361, and (ii) the credit or refund of any overpayments attributable to such an enterprise. The statute of limitations is kept open for the additional period regardless of whether or not the election is revoked pursuant to this new provision.

Temporary rules published by the Treasury Department in connection with section 1361 are set forth in appendix II.

D. Election of certain small-business corporations (sec. 64)

To permit shareholders in small-business corporations, in lieu of payment of the corporate tax, to elect to be taxed directly on the corporation's earnings, a new subchapter (subch. S, secs. 1371-1377) has been added to the code by the Technical Amendments Act of 1958. Where the tax treatment provided by this subchapter is elected, the shareholders include in their own income for tax purposes the current taxable income of the corporation, both the portion which is distributed and that which is not. Neither type of income in this case is eligible for a dividend-received credit or exclusion, since it has been subject to no tax at the corporate level. Generally, the character of an item entering into the computation of taxable income of an electing small-business corporation does not pass through to the shareholder. The taxable income of such a corporation, whether or not distributed, is generally treated as ordinary income to the shareholder, without the retention of any special characteristics it might have had to the corporation. As a result, distributions of current earnings and profits of an electing small-business corporation are generally treated as dividends to the shareholder to the same extent as distributions of current earnings and profits of any nonelecting corporation. For example, where the earnings and profits for a taxable year of an electing small-business corporation exceed its taxable income for that year (as would be the case where percentage depletion exceeds cost depletion, or where tax-exempt interest is received, or where there are other items affecting taxable income but not earnings or profits or affecting earnings and profits but not taxable income), any current distribution of those earnings and profits is treated as a dividend to the shareholder under the usual rules applicable to corporate dis-

tributions. Any future distribution of earnings and profits of an electing small-business corporation accumulated prior to the year of distribution and attributable to such items will also be treated as a dividend to the shareholder under the usual rules applicable to corporate distributions. This may be illustrated as follows: If the earnings and profits for the taxable year of an electing small-business corporation are \$10,000, but its taxable income for that year is only \$8,000 (the \$2,000 difference being due to the excess of percentage depletion over cost depletion, or the receipt of tax-exempt interest, or similar items), a distribution of \$10,000 in the taxable year to its shareholders would result in a dividend of \$10,000 and not merely \$8,000. If only \$8,000 were distributed in the taxable year, and \$2,000 of these earnings and profits were distributed in a subsequent taxable year, the \$2,000 would be treated as a dividend in the later year.

In short, an electing small-business corporation is not generally a "conduit" for its shareholders under the provisions of subchapter S. These provisions do not provide strict partnership tax treatment—where the conduit principle is well established—for all items which in any way affect the computation of taxable income. This rule has been adopted so that this provision can operate in as simple a manner as possible. Long-term capital gains, however, are an exception to this general rule. In the case of these long-term capital gains, the character carries over to the shareholder level.

Where a shareholder has been taxed on corporate earnings which were not at that time distributed, and then the corporation in a subsequent year distributes these earnings to shareholders, no further tax is required from the shareholder at that time, since these earnings have already been taxed to him in a prior year. Once all such earnings have been distributed, if further distributions are then made, and the corporation had earnings and profits (usually those arising before it elected this special tax treatment) then such distributions are to be taxed to the shareholders in the same manner as ordinary dividends from corporations.

Under this provision the net operating losses of the corporation currently also are passed through to the shareholders. Thus, at the corporate level where this special treatment is elected, there is no carryover or carryback of operating losses to or from a year with respect to which this special treatment has been elected. At the individual level these "distributed" corporate losses are to be treated in the same manner as any loss which the individual shareholders might have from a proprietorship, that is, they first offset income of the individual, in that year (whether or not derived from another business) and then any excess of these losses may be carried back and offset against the individual's income in prior years and, if any losses still remain, they may be carried forward and offset against his income in subsequent years.

Where this special treatment has been elected the basis of a shareholder's stock is increased for any of the corporate earnings taxed to him which are not then distributed, although this basis is subsequently reduced if these tax-paid corporate earnings are distributed. The basis of the stock of a shareholder is also reduced for any corporate losses which are passed through to him. The losses that he may take, however, are limited to the basis he has for the stock. Thus, his basis for the stock cannot be reduced below zero.

The right to elect the treatment provided under this new subchapter is limited to what are defined as small business corporations. These corporations must be domestic corporations which are not eligible to file a consolidated return with any other corporation. Also, they must not have more than 10 shareholders, their shareholders must all be individuals (or an estate), no nonresident aliens may be shareholders, and the corporation may not have more than one class of stock. If any of the shares of a corporation are owned by a trust, that corporation cannot qualify as a small-business corporation.

An election may be made to apply the tax treatment provided by this new subchapter only if all of the shareholders consent to this election. For this purpose the shareholders are those of record as of the first day of the taxable year in question, or if the election is made after that time, shareholders of record when the election is made. An election to come under this provision must be made in a 2 months' interval, either in the first month before the beginning of the taxable year for which the election is to be made or in the first month of that year. (A longer period of time, up to 90 days after the date of enactment of the Technical Amendments Act of 1958, is allowed for the first taxable year beginning after December 31, 1957, and on or before September 2, 1958, and ending after the latter date.) Once this provision is elected it is effective not only for the taxable year but also for all subsequent years, although this election may be terminated.

The election to the tax treatment provided by this subchapter can be terminated in any one of several ways. First, the election is terminated if a new person becomes a shareholder of the corporation and he does not consent to the election. Second, the election can be terminated if all of the shareholders consent to its revocation. A revocation, however, is effective only with respect to subsequent years unless it is made in the first month of the taxable year. Third, the election as to the treatment under this new subchapter is to be terminated if the corporation ceases to qualify as a small-business corporation; that is, if the corporation no longer meets the requirements of a small-business corporation, such as having not more than 10 shareholders or having no nonresident alien as a shareholder. Fourth, the election to be taxed under this new subchapter terminates if the corporation derives more than 80 percent of its gross receipts from sources outside the United States and, fifth, the election terminates if more than 20 percent of the corporation's gross receipts are derived from interest, dividends, rents, royalties, or other forms of passive income.

In order to prevent a corporation from electing in and out of the application of the provisions of this new subchapter, a limitation has been added providing that if a corporation has made an election under this subchapter, and if this election has been terminated or revoked, the corporation (or any successor) is not to be eligible to elect this treatment for any taxable year prior to its fifth taxable year which begins after the first taxable year for which the termination or revocation is effective. However, the Secretary or his delegate is given the authority to make exceptions to this limitation.

The provisions of subchapter S are effective with respect to taxable years beginning after December 31, 1957.

Announcements, temporary rules and proposed regulations published by the Treasury Department in connection with subchapter S, as well as a copy of Form 2553 (Election by Small Business Corporation), Form 1120-S (U.S. Small Business Corporation Return of Income) and excerpts from the instructions relating to Form 1120-S, are set forth in appendix III.

III. SMALL BUSINESS TAX REVISION ACT OF 1958

A. Losses on small-business stock (sec. 202)

This section adds a new section 1244 to the code. It provides ordinary loss rather than capital loss treatment on the sale or exchange of small-business stock (or upon its becoming worthless). This treatment is available only in the case of an individual or partnership and only if he or it is the original holder of the stock.

To limit the benefit of this provision to small business, the aggregate of the stock offerings of any corporation which are eligible for this ordinary loss treatment is limited to \$500,000. Moreover, to be eligible for this treatment the total stock offering per corporation plus the equity capital of the corporation may not exceed \$1 million. In addition, the maximum loss which a taxpayer can treat as an ordinary loss under this provision is \$25,000 a year (or \$50,000 in the case of a husband and wife filing a joint return). To limit this tax benefit to shareholders in companies which are largely operating companies, a restriction is imposed that, in general, requires that the corporation, in the 5-year period before the taxpayer incurred the loss on the stock, must have derived more than half of its gross receipts from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. This restriction is not applicable, however, with respect to any corporation if for that 5-year period, its allowable deductions (with certain exceptions) exceed the amount of gross income.

B. Three-year net operating loss carryback (sec. 203)

Under the law before the enactment of the Small Business Tax Revision Act of 1958 a loss could be carried back and offset against income of the 2 years before the loss year and then if any loss still remained it could be carried forward and offset against income in the 5 years following the year of the loss. Section 203 of the Small Business Tax Revision Act of 1958 provides for a 3-year net operating loss carryback instead of only a 2-year carryback as under prior law. This 3-year net operating loss carryback is made available with respect to losses of the calendar year 1958 (or from the portion of a fiscal year falling in 1958) and following years. The 3-year carryback combined with the year of the loss and the 5 succeeding years of the carry-forward provide a 9-year span over which either corporate or unincorporated businesses may average out their losses.

C. Additional first-year depreciation allowance for small business (sec. 204)

Section 204 of the Small Business Tax Revision Act of 1958 added a new section 179 to the code. This section provides that a taxpayer may write off 20 percent of the cost of tangible personal property in the year of acquisition. This treatment is available for newly acquired used property as well as for new assets. With respect to the

remaining cost of the property, depreciation may be taken in the same manner as under existing law.

The aggregate costs of property with respect to which this 20-percent writeoff can be taken in any year is limited to \$10,000 (\$20,000 in the case of a husband and wife filing a joint return). The 20-percent writeoff is made available only in the case of tangible personal property of a character subject to the allowance for depreciation. In addition, this special writeoff is available only in the case of property having a useful life of 6 years or more. Further restrictions limit the property for which the fast writeoff can be taken to that which is acquired from an unrelated person and from corporations which are not members of the same "affiliated group." By "affiliated group" is meant those which would be eligible to file a consolidated return if the affiliation test for this purpose were 50 percent instead of 80 percent. Members of such an "affiliated group" cannot have the 20-percent writeoff with respect to purchases from each other. Also, the \$10,000 maximum limitation is applied to the entire "affiliated group."

This 20-percent writeoff provision is available with respect to taxable years ending after June 30, 1958, but only in the case of property acquired after December 31, 1957.

Announcements and temporary rules published by the Treasury Department in connection with the new section 179 are set forth in appendix IV.

D. Increase of minimum accumulated earnings credit (sec. 205)

In addition to the regular corporate income tax, present law imposes an accumulated earnings tax (formerly called the sec. 102 tax) of 27½ to 38½ percent on improperly accumulated corporate earnings. In computing the income base on which this tax is imposed, there is excluded an amount equal to the earnings and profits of the taxable year which are retained for the reasonable needs of the business. This is known as the accumulated earnings credit. The law in effect prior to the enactment of the Small Business Tax Revision Act of 1958 provided, however, that in any case there was to be a minimum credit of \$60,000 of earnings which could be accumulated before any income was subject to this tax. This was a cumulative credit, however, rather than an annual credit.

The section increases this \$60,000 minimum accumulated earnings credit to \$100,000. By raising this amount to \$100,000, a slightly wider margin of accumulation is provided with respect to which business can be free of worry concerning the accumulated earnings tax. This increase in the minimum credit is not in any way intended as an indication that accumulated earnings in excess of \$100,000 are necessarily subject to this special tax.

This change is made effective with respect to taxable years beginning after December 31, 1957.

E. Installment payments of estate tax attributable to investments in closely held business enterprise (sec. 206)

Section 206 of the Small Business Tax Revision Act of 1958 added a new section 6166 to the code. This provides that where the value of an interest in a closely held business represents a significant portion of the base on which the Federal estate tax is computed, the Federal death tax can then be paid in 10 annual installments rather than in 1

lump-sum payment 15 months after the death of the decedent. To be eligible for this treatment the interest in a closely held business (or the aggregate interests in several businesses, if the interest in each is more than half) must represent 35 percent of the gross estate or 50 percent of the taxable estate of the decedent. Moreover, the tax deferral is available only with respect to the portion of the estate tax attributable to the value represented by the interest in the closely held business (or businesses). The installment payments where estates qualify under this provision are subject to interest at the rate of 4 percent.

The new section defines a closely held business for purposes of this section as including a proprietorship, an interest in a partnership or stock ownership in a corporation of 20 percent or more, or an interest in a partnership or corporation in which there are 10 or fewer partners or shareholders.

Provision is made for the termination of the installment privilege where there is a withdrawal from the business of 50 percent of the value of the business or where 50 percent of the interest in the business included in the gross estate is distributed, sold, or otherwise disposed of.

The new section, in addition to providing for the acceleration of the installment payments in the case of withdrawals and sales or other dispositions, also provides that after the fourth year of the estate, any accumulated income of the estate must be applied against the balance of the unpaid estate tax.

This provision applies to estates of decedents where the date for filing of the Federal estate return is after September 2, 1958, the date of enactment of the act. It also applies in the case of a deficiency assessed after that date if the deficiency is not due to negligence, intentional disregard of rules and regulations or to fraud. This is limited, however, to deficiencies arising in the case of decedents dying after August 16, 1954, where the date for filing their estate tax return (including extensions) expired before September 2, 1958.

Temporary rules issued by the Treasury Department in connection with the new section 6166 are set forth in appendix V.

APPENDIXES

(Except where stated otherwise, the material in the appendixes represents the substantive text of the designated Treasury Department publications)

APPENDIX I

SMALL-BUSINESS INVESTMENT COMPANIES

ANNOUNCEMENTS OF THE TREASURY DEPARTMENT IN CONNECTION WITH NEW SECTIONS 1242, 1243 AND 243(b)

TECHNICAL INFORMATION RELEASE—OCTOBER 2, 1958 (TIR-99)

Certain provisions of the Technical Amendments Act of 1958 (Public Law 85-866) will affect the tax treatment of small-business investment companies organized under the provisions of the Small Business Investment Act of 1958, Internal Revenue Service announced today.

IRS said the primary purpose of these companies will be to make equity capital readily available for small-business concerns through the purchase of debenture bonds which may be converted into stocks of the borrowing concern.

Under the provisions of the new law, IRS said, the tax treatment of small-business investment companies and their stockholders involves three principal features. They are:

1. Small-business investment companies are allowed an ordinary loss deduction, rather than a capital loss deduction, on losses sustained through worthlessness or sale of convertible debentures, or stock, acquired on the lending of long-term equity-type capital to small businesses.

2. Investors in the stock of small-business investment companies are allowed an ordinary loss deduction, rather than a capital loss, on losses from the worthlessness or sale of such stock.

3. Small-business investment companies are allowed a deduction for 100 percent of the dividends received from a taxable domestic corporation instead of the 85 percent deduction generally allowed corporate taxpayers.

IRS said provisions are effective for taxable years beginning after September 2, 1958, the date of enactment of the Technical Amendments Act of 1958.

(IRS-D.C.-42132)

TECHNICAL INFORMATION RELEASE—NOVEMBER 21, 1958 (TIR-110)

In Technical Information Release No. 99, dated October 2, 1958, the Internal Revenue Service explained provisions of the Technical Amendments Act of 1958 which affect the tax treatment of small business investment companies organized under the Small Business Investment Act of 1958.

Inquiry has been made whether a small-business investment company organized under title III of the Small Business Investment Act of 1958 is subject to the personal holding company tax imposed by section 541 of the Internal Revenue Code of 1954 if all of its income consists of interest and dividends on debentures and stock acquired in small business concerns under provisions of that act.

IRS said the corporation will be subject to the personal holding company tax only, if at any time during the last half of the taxable year, more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

(IRS-D.C.-43710)

REVENUE RULING 59-69, I.R.B. 1959-10, 18

Advice has been requested whether a small business investment company operating under the provisions of the Small Business Investment Act of 1958 (72 Stat. 689) is subject to the provisions of sections 541 through 547 of the Internal Revenue Code of 1954, pertaining to personal holding companies, if at least 80 percent of its gross income for the taxable year is personal holding company income as defined in section 543 of the code, such as interest and dividends from debentures and stock acquired from small business concerns under the provisions of the Small Business Investment Act of 1958.

The purpose of the Small Business Investment Act of 1958 is to establish a program to stimulate and supplement the flow of private equity capital and long-term loans to small business concerns. The act provides for the operation of small business investment companies organized to provide such capital through the purchase of debenture bonds convertible into the stock of the borrowing corporation. Thus, much of the income of a small business investment company will consist of interest and dividends.

Section 541 of the code, in general, imposes a personal holding company tax on the undistributed personal holding company income of any corporation 80 percent of the income of which consists of personal holding company income, as defined in section 543 of the code, if at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals. Among the types of income which are defined by section 543 of the code as personal holding company income are dividends and interest.

Three specific provisions dealing with small business investment companies were added to the Internal Revenue Code of 1954 by the Technical Amendments Act of 1958 (72 Stat. 1606). One of two new sections, section 1242, provides, in effect, that investors in the stock of small business investment companies shall be allowed an ordinary loss deduction, rather than a capital loss, on losses from the worthlessness or sale of such stock. A small business investment company is allowed, under the provisions of the second new section, section 1243 of the code, an ordinary loss deduction, rather than a capital loss deduction, on losses sustained through the worthlessness or sale of convertible debenture, or stock converted therefrom, acquired on the lending of equity and long-term capital to small business. The third feature relating to these companies is embodied in amended section 243 of the code, which allows such a company a deduction for 100 percent of the dividends received from a taxable domestic corporation, other than dividends on preferred stock of a public utility company for which deduction under section 244 of the code is allowable, instead of the 85-percent deduction generally allowed corporate taxpayers.

A small business investment company, like all corporations, may be subject to the provisions of section 541 of the code, unless it is specifically excluded from those provisions. Since none of the additions and changes to the code, relating to small business investment companies, made by the Technical Amendments Act of 1958 specifically excluded such companies from the personal holding company tax, they are subject to that tax if they are otherwise within the provisions of sections 541 through 547 of the code.

Accordingly, it is held that a small business investment company is subject to the personal holding company tax under section 541 of the code, if at least 80 percent of its gross income for the taxable year is personal holding company income as defined in section 543 of the code, such as interest and dividends from debentures and stock acquired in small business concerns under the provisions of the Small Business Investment Act of 1958, and if at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

APPENDIX II

REVOCATION OF ELECTION PERMITTING CERTAIN PROPRIETORSHIPS AND PARTNERSHIPS TO BE TAXED AS CORPORATIONS

TEMPORARY RULES OF THE TREASURY DEPARTMENT IN CONNECTION WITH SECTION 1361 (TREASURY DECISION 6332, NOV. 3, 1958)

§ 18.1-2 REVOCATION OF ELECTION PERMITTING CERTAIN PROPRIETORSHIPS AND PARTNERSHIPS TO BE TAXED AS DOMESTIC CORPORATIONS—(a) *In general.*—Section 63 of the Technical Amendments Act of 1958 (72 Stat. 1649), approved September 2, 1958, provides that a statement of election to be taxed as a domestic corporation under section 1361 of the Internal Revenue Code of 1954 shall be treated as a valid election if filed in accordance with regulations prescribed by the Secretary or his delegate. Thus, if a statement of election to be taxed as a corporation has been or is filed in accordance with the provisions of Treasury Decision 6124 (Temporary Rules (26 CFR 1954)) [C. B. 1955-1, 719] such statement of election shall be treated as a valid election, except as provided in paragraph (e) of this section, relating to statements of election withdrawn with the permission of the Internal Revenue Service. Under section 63, however, any such election made on, before, or after September 2, 1958, may be revoked (notwithstanding any provision to the contrary in section 1361) after September 2, 1958, and on or before the last day of the third month following the month in which regulations under section 1361 are published in the Federal Register. If a new election has been made after a change of ownership described in section 1361(f), then such new election, or the original election, or both, may be revoked. Any such revocation shall be effective only if made in accordance with the provisions of paragraph (b) of this section. A revocation under this section may be made notwithstanding that the enterprise has been completely liquidated as contemplated in section 1361(l), or that the enterprise has actually been incorporated.

(b) *Manner of revoking election.*—(1) The election shall be revoked by filing within the time prescribed in subparagraph (2) of this paragraph, (i) a statement that the partners or the proprietor, as the case may be, revoke the election made under section 1361(a) to have the enterprise taxed as a corporation, and (ii) the amended returns required by subparagraph (3) of this paragraph.

(2) The statement of revocation and the amended returns may be filed at any time after September 2, 1958, but must be filed on or before the last day of the third month following the month in which regulations under section 1361 are published in the Federal Register. In the case of a new election made after a change of ownership described in section 1361(f), a separate statement of revocation and the amended returns required by subparagraph (3) of this paragraph must be filed with respect to each election which is being revoked. The statement of revocation must be signed by the proprietor or all of the partners owning an interest in the enterprise at any time during the period with respect to which the particular election under section 1361 would apply but for the revocation. If any individual who is required to sign the statement of revocation is deceased, the statement shall be signed either by his successor in interest or by the executor or administrator of such deceased individual's estate. The statement of revocation must be filed with the district director for the district in which the statement of election was filed. Such statement of revocation must state the name and address under which the corporation income tax returns of the enterprise were filed for the prior taxable years during which the election would apply but for the revocation, and the internal revenue district in which such returns were filed. The statement shall also state the names and addresses of the individuals affected by the revocation, their taxable years involved, and the internal revenue districts in which the income tax returns of such individuals were filed.

(3) Revocation of the election to be taxed as a corporation shall be effective only if the statement of revocation referred to in subparagraph (2) of this paragraph is filed and only if amended income tax returns of the proprietor, or partnership returns on Form 1065 (accompanied by amended income tax returns of the partners), are filed. Such returns shall be filed for each taxable year affected by the revocation and should be filed with the statement of revocation. If an amended income tax return is filed with a district director other than the district director with whom the statement of revocation is filed, a copy of the statement of revocation must be filed with such return. The amended income tax and partnership returns shall be filed as if there had been no election made

under section 1361, and shall reflect any increase or decrease in tax over the tax previously determined (as defined in section 1314 (a)) which results from treating the enterprise as a proprietorship or as a partnership, as the case may be. See paragraph (d) (5) of this section for rules applicable to items of income, deduction, or credit to be taken into account in determining such increase or decrease in tax.

(c) *Effect of revocation.*—(1) A revocation made in accordance with the provisions of this section shall apply to all taxable years to which the particular election would apply but for the revocation.

(2) The increase or decrease in tax shown on amended returns filed in accordance with this section over the tax previously determined (as defined in section 1314(a)) shall not be subject to the additions to tax imposed by sections 6654 and 6654, to the extent that such increase or decrease in tax is attributable to the revocation of the election under section 1361. The provisions of chapter 67, relating to interest, shall be applicable to such increase or decrease in tax. For rules applicable in determining the increase or decrease in tax, see paragraph (d) (5) of this section.

(3) If the election under section 1361 is revoked, any election or option made on the corporation return, Form 1120, filed for the enterprise shall be deemed to have been made by the proprietor, partners or partnership, and such election or option shall be given effect in the making of amended income tax and partnership returns required to be filed by paragraph (b) (3) of this section.

(d) *Tolling of statute of limitations.*—(1) Notwithstanding any law or rule of law which would otherwise prevent an assessment, the statutory period for the assessment and collection of any deficiency attributable to a section 1361 enterprise (but only to the extent of the increase in tax determined in accordance with subparagraph (5) of this paragraph) shall not expire until after the expiration date specified in subparagraph (4) of this paragraph.

(2) If credit or refund of any overpayment attributable to a section 1361 enterprise (but only to the extent of the decrease in tax determined in accordance with subparagraph (5) of this paragraph) is prevented at any time on or before the expiration date specified in subparagraph (4) of this paragraph by the operation of any law or rule of law (other than chapter 74 of the 1954 Code, relating to compromises and closing agreements), credit or refund of such overpayment may nevertheless be allowed or made if claim therefor is filed on or before such expiration date.

(3) A deficiency or overpayment in tax described in subparagraph (1) or (2) of this paragraph may be determined with respect to (i) an enterprise for which an election under section 1361 was made, (ii) the electing proprietor or partners, and (iii) any other taxpayer affected by the election.

(4) The term "expiration date" means that date which is one year after whichever of the following days is the earlier:

(i) The last day of the third month following the month in which regulations under section 1361 of the 1954 Code are published in the Federal Register; or

(ii) If the election is revoked pursuant to paragraph (b) of this section, the day on which an effective revocation is made.

(5) For purposes of this section, the increase or decrease in tax over the tax previously determined (as defined in section 1314(a)) for any taxable year shall be that amount which results from the correct treatment of all items which pertain to the enterprise, and for this purpose items of income, deduction, or credit completely unrelated to the enterprise shall not be taken into account. For example, the failure to claim an allowable deduction for a dependency exemption or the improper taking of such exemption are not adjustments which are attributable to the enterprise. However, due regard shall be given to the effect which an adjustment attributable to the enterprise may have on the computation of gross income, taxable income and other matters under subtitle A of the 1954 Code. Thus, for example, if such an adjustment results in an increase in an individual's adjusted gross income, it may be necessary to recompute the deduction for charitable contributions or medical expenses, since the amount of those deductions is determined or limited by the amount of the taxpayer's adjusted gross income. An adjustment attributable to the enterprise may affect more than one taxpayer and more than one taxable year. For example, if an election by a partnership is revoked pursuant to paragraph (b) of this section, it will be necessary to recompute the income tax liability of all members of the partnership for all taxable years to which the election applied. Similar computations will be necessary for any other taxable year affected, or treated as affected, by a net operating loss deduction (as defined in section 172) or by a capital loss carryover (as defined in section 1212) determined with reference to any taxable year to which an election

applied (or would have applied but for a revocation of such election). On the other hand, if the election is not revoked, it may be necessary to make adjustments to the taxable income of the enterprise, for example, due to failure to report items of income or to claim deductions, or adjustments in items of income or deduction allocable to a proprietor or partner, for example, personal holding company income or dividend distributions. Moreover, items which have been taken into account in filing the corporation return, Form 1120, for the enterprise, which items should have been taken into account in the returns of the proprietor or partners, or vice versa, are to be given proper effect in determining the increase or decrease in tax.

(e) *Exception.*—The provisions of this section do not apply to—

(1) Any statement of election filed in accordance with Treasury Decision 6124 which was withdrawn before September 2, 1958, with the permission of the Internal Revenue Service, and

(2) Any deficiency or overpayment of any taxpayer for any taxable year during which a statement of election described in subparagraph (1) of this paragraph was applicable, attributable to the withdrawal described in such subparagraph (1).

(f) *Elections under section 1361.*—Elections under section 1361 should continue to be made in accordance with the requirements of Treasury Decision 6124 [C.B. 1955-1, 719] with respect to information required in the statement of election and the time, manner, and place of filing such statement. However, those provisions of Treasury Decision 6124 which relate to the perfection of an election under section 1361 are hereby revoked.

Because the election under section 1361 of the 1954 Code may be revoked at any time after September 2, 1958, in accordance with regulations under section 63 of the Technical Amendments Act of 1958 and because of the need for temporary rules under which such a revocation can be made, it is found impracticable to issue this Treasury Decision with notice and public procedure thereon under section 4(a) of the Administrative Procedure Act, approved June 11, 1946, or subject to the effective date limitation of section 4(c) of that Act..

APPENDIX III

ELECTION OF CERTAIN SMALL-BUSINESS CORPORATIONS

ANNOUNCEMENTS, TEMPORARY RULES, PROPOSED REGULATIONS, AND CERTAIN OTHER PUBLICATIONS OF THE TREASURY DEPARTMENT IN CONNECTION WITH SUBCHAPTER S

TECHNICAL INFORMATION RELEASE—SEPTEMBER 26, 1958 (TIR-98)

Regulations under which a small-business corporation may elect to have its shareholders taxed on its income will be published in the Federal Register today (September 26, 1958).

Internal Revenue Service said this election is provided by the Technical Amendments Act of 1958 (Public Law 85-866).

IRS said the election may be made only by a domestic corporation which is not a member of an affiliated group of corporations and only with the consent of all its shareholders.

Further, IRS said, such a corporation cannot make the election if it has more than one class of stock, has more than 10 shareholders, has a shareholder who is other than an individual or estate, or has a shareholder who is a nonresident alien.

IRS said if these conditions are met and the election is made, the corporation's income will be taxed to the shareholders, whether or not distributed. The agency added:

The election may be made only for taxable years of corporations beginning after December 31, 1957, and ending after September 2, 1958. Generally, the election may be made during the first month of a taxable year, or during the preceding month. However, for taxable years beginning before September 3, 1958, and ending after such date, the election must be made before the close of the taxable year, or December 2, 1958, whichever is earlier.

Form 2553 has been prescribed for use by corporations desiring to make the election, IRS said. Consent of the shareholders of the corporation to the election must be attached. The form provides for furnishing (1) the name and address of the corporation, (2) the place and date of incorporation, (3) the first taxable year for which the election is made, (4) the number of shares of stock issued and outstanding, (5) whether the corporation is the outgrowth of any form of predecessor (if so, the name of the predecessor, the type of organization, and the

period during which it was in existence), (6) the principal business activity of the corporation, and (7) the name and address of each shareholder, the number of shares owned by each, and the internal revenue district where each shareholder's individual income tax return is filed.

Copies of form 2553 will be available in the offices of the district directors of internal revenue at an early date. However, IRS emphasized that if an election must be filed before such forms become available, the election may be made by letter setting forth clearly the information described above which is required by the form.

The election and the consents of shareholders are to be filed with the district director with whom the corporation return is filed. For further information corporations or shareholders should consult the office of their district director, IRS said.

(IRS-D.C.-42086)

TECHNICAL INFORMATION RELEASE—OCTOBER 10, 1958 (TIR-104)

The following revenue ruling will appear in the Internal Revenue Bulletin 1958-42, dated October 20, 1958:

[Rev. Rul. 58-516]

"The term 'calendar month' as used in section 18.1-1(b) of the Income Tax Regulations (Treasury Decision 6317, approved September 22, 1958), relating to the election of certain small-business corporations under subchapter S of the Internal Revenue Code of 1954, as added by section 64 of the Technical Amendments Act of 1958, means, in the case of a new corporation whose taxable year begins after the first day of a particular month, for purposes of making the election under section 1372 by such corporation, the period beginning on such first day of the taxable year and ending on the corresponding day of the succeeding month, or in case there is no such corresponding day, the last day of the succeeding month.

(IRS-D.C.-42469)

TECHNICAL INFORMATION RELEASE—NOVEMBER 26, 1958 (TIR-113)

In response to many inquiries concerning the election by corporations under section 1372 of the 1954 Code to have the corporate income taxed directly to the shareholders, the Internal Revenue Service released the following questions and answers:

Question 1. Does section 1372(e)(5), which provides for a termination of the election for any year in which the corporation derives more than 20 percent of its gross receipts from rent, prevent an effective election by a corporation engaged in the operation of a hotel or motel?

Answer. No. The income derived from the operation of a hotel or motel, even though such income includes charges for lodging as well as for personal services, is not considered to be rent as that term is used in section 1372(e)(5).

Question 2. Can a bank or a licensed personal finance company, the income of which consists largely of interest but which is specifically exempted from the personal holding company provisions of the Internal Revenue Code, make an effective election under section 1372?

Answer. No. Under the provisions of section 1372(e)(5) the election is terminated for any year in which any corporation derives more than 20 percent of its gross receipts from interest, and no exemption from the operation of this provision is provided for a bank or a licensed personal finance company.

Question 3. For purposes of section 1371(a) under which a small-business corporation cannot have more than 10 shareholders and section 1372(a) under which all the shareholders must consent to the election, who are considered shareholders, under the following circumstances: (a) Stock which is the community property of a husband and wife under the community-property law of a State; (b) stock held by coowners, tenants by the entirety, tenants in common or joint tenants; and (c) stock owned by two or more minors but held in the name of a guardian or custodian?

Answer. In case (a), both the husband and wife are counted as shareholders, and both must consent to the election. In case (b), each coowner, joint tenant, etc., is counted as a shareholder and each must consent to the election. In case (c), each minor is counted as a shareholder. The consent of the minor shall be given by the minor or by his legal guardian, or, if he has no legal guardian, by his natural guardian.

Question 4. If stock in a corporation is held by a testamentary trust, is the corporation disqualified under section 1371(a)(2)?

Answer. Yes. However, before the stock is transferred to the trust by the executor, the estate (rather than the trust) would be the shareholder and the corporation could make the election. The election would terminate, however, upon the subsequent transfer of the stock to the trust.

Question 5. If stock has been transferred to a minor under the Uniform Gifts to Minors Act or the Gifts of Securities to Minors Act is such stock owned by a trust, thereby disqualifying the corporation from making the election under section 1372?

Answer. No. Even though a form of fiduciary relationship is created by gifts under such acts, the stock is considered to be owned by an individual and not by a trust.

Question 6. Is the requirement of only one class of stock met where a corporation has (a) class A voting common stock and class B nonvoting common stock with dividend rights and liquidation preferences being equal; (b) class A common and class B common with equal dividend rights, equal liquidation preferences, and equal voting rights except that each class has the right to elect half the members of the board of directors; and (c) authorized but unissued preferred stock with only one class of common outstanding?

Answer. In case (a), the corporation is considered as having more than one class of stock and is therefore precluded from making the election under section 1372. In case (b), the corporation is considered to have only one class of stock. In case (c), the corporation is considered as having only one class of stock and therefore may make the election under section 1372, but the election will be terminated in any year in which any of the authorized preferred stock is issued.

For further information on the making of an election, see Treasury Decision 6317, approved September 22, 1958 (Federal Register, dated Sept. 26, 1958, or Internal Revenue Bulletin 1958-41, p. 77, dated Oct. 13, 1958) and Form 2553, Election by Small Business Corporation. (IRS-D.C.-43982)

TECHNICAL INFORMATION RELEASE—DECEMBER 23, 1958 (TIR-122)

On November 26, 1958, the Internal Revenue Service issued Technical Information Release No. 113 containing several questions and answers with respect to the election by corporations under section 1372 of the 1954 Code to have the corporate income taxed directly to the shareholders.

In the answer to question 3 (a) of TIR No. 113 it was stated that, with respect to stock which is the community property of the husband and wife under the community property law of a State, both the husband and wife are counted as shareholders, and both must consent to the election by the corporation. The IRS said today that an election under section 1372, which was timely filed on or before December 1, 1958, and which would be valid but for the fact that a consent was timely filed by only one of the spouses in community property States, would not be treated as invalid solely by virtue of the failure of both spouses to consent, provided a consent is filed by the other spouse on or before February 2, 1959.

The consent may be made by filing a statement signed by the shareholder in which the shareholder consents to the election of the corporation under section 1372 (a). The statement shall set forth the name and address of the corporation and the shareholder, the number of shares owned by the shareholder and his spouse, and the date (or dates) on which such stock was acquired. The statement shall be filed with the district director of internal revenue with whom the election by the corporation was filed. (IRS-D.C.-44671)

TEMPORARY RULES RELATING TO ELECTION OF SMALL BUSINESS CORPORATIONS
(TREASURY DECISION 6317, SEPT. 25, 1958)

Section 18.1-1. ELECTION OF CERTAIN SMALL BUSINESS CORPORATIONS.—
(a) *In general.*—Section 64 of the Technical Amendments Act of 1958 (72 Stat. 1650) amends the Internal Revenue Code of 1954 by adding at the end of chapter 1 a new subchapter S, comprising sections 1371 through 1377, and by adding a new section 6037, relating to information returns. Subchapter S permits a "small business corporation" (as defined in section 1371(a)) to elect under section 1372(a) (with the consent of all its shareholders) not to be subject to the income tax imposed by chapter 1. The election may be made only if the corporation is a domestic corporation; is not a member of an affiliated group of corporations (as

defined in section 1504); and does not have (1) more than one class of stock, (2) more than 10 shareholders, (3) a shareholder (other than an estate) who is not an individual, or (4) a shareholder who is a nonresident alien. An election under section 1372(a) may be made only with respect to a taxable year beginning after December 31, 1957, and ending after September 2, 1958. The election shall be effective for the taxable year of the corporation for which it is made and for all succeeding taxable years unless it is terminated under section 1372(e). The taxable income of an electing small business corporation, to the extent that it exceeds dividends distributed in money out of earnings and profits of the taxable year, is taxed directly to the shareholders to the extent that it would have constituted a dividend if it had been distributed on the last day of the corporation's taxable year.

(b) *Manner of making election.*—(1) *In general.*—The election under section 1372(a) should be made by the corporation by filing Form 2553, containing the information required by such form, and by filing, in the manner provided in subparagraph (3) of this paragraph, a statement of the consent of each shareholder of the corporation. If the Form 2553 is not available, the election may be made by filing a statement containing the information required by Form 2553. Copies of Form 2553 or a description of the information required by such form will be furnished by district directors upon request. The election shall be signed by the person or persons who are authorized to sign the return required under section 6037 and shall be filed with the district director with whom such return is to be filed.

(2) *Time of making election.*—(i) Except as provided in subdivision (ii) of this subparagraph, the election under section 1372(a) and subparagraph (1) of this paragraph shall be filed for any taxable year either (a) during the first calendar month of such taxable year, or (b) during the calendar month preceding such first calendar month.

(ii) For any taxable year of a corporation which begins after December 31, 1957, and before September 3, 1958, and which ends after September 2, 1958, the election under section 1372(a) and subparagraph (1) of this paragraph shall be made on or before December 1, 1958, or on or before the last day of the corporation's taxable year, whichever is earlier. An election for such taxable year may be made, however, only if the corporation has been a small business corporation (as defined in section 1371(a)) on each day after September 2, 1958, and before the day of election.

(3) *Statement of shareholder consent.*—(i) An election under section 1372(a) shall be valid only if all persons who are shareholders of the corporation on the first day of the corporation's taxable year, or on the day of election (whichever is later) consent to such election. Such shareholder consent shall be in the form of a statement signed by the shareholders in which each such shareholder consents to the election of the corporation under section 1372(a). The statement shall set forth the name and address of the corporation and of each shareholder, the number of shares of stock owned by each shareholder, and the date (or dates) on which such stock was acquired. The consents of all shareholders shall be attached to the election of the corporation filed with the district director. If the election is made before the first day of the corporation's taxable year, the consents of persons who become shareholders after the date of election and on or before such first day shall be filed with the district director with whom the election was filed as soon as practicable after such first day. In the case of a consent filed after the date of election, a copy of the consent shall be filed with the return required to be filed under section 6037. In no event will an election under section 1372(a) be valid if the consents are filed after the last day prescribed for making the election.

(c) *New shareholders.*—Section 1372(e)(1) provides that an election under section 1372(a) shall terminate if any person who was not a shareholder on the first day of the first taxable year for which the election is effective, or on the day on which the election is made (whichever is later), becomes a shareholder and does not consent to the election under section 1372(a). Such termination shall be effective for the taxable year of the corporation in which such person becomes a shareholder and for all succeeding taxable years of such corporation. Any such consent by a new shareholder shall be made in a statement filed with the district director with whom the election was filed. Such statement of consent shall be filed within a period of 30 days beginning on the day on which such person becomes a new shareholder. Such statement shall state that such person consents to the election under section 1372(a) and shall contain the name and address of the corporation and of such person, the number of shares of stock owned by such person,

the date on which such shares were acquired, and the name and address of each person from whom such shares were acquired. A copy of the consent of a new shareholder shall be filed with the return required to be filed under section 6037 for the taxable year to which such consent applies.

(d) *Revocation of election.*—Under section 1372(e)(2) an election under section 1372(a) may be revoked by the corporation (with the consent of all its shareholders) for any taxable year of the corporation after the first taxable year for which the election is effective. Such revocation shall be made by the corporation by filing a statement that the corporation revokes the election made under section 1372(a). The statement shall be signed by the person or persons who are authorized to sign the return of the corporation required under section 6037 and shall be filed with the district director with whom the election was filed. In addition, there shall be attached to the statement of revocation a statement of consent, signed by each person who is a shareholder of the corporation on the day on which such statement of revocation is filed, in which each such shareholder consents to the revocation by the corporation of the election under section 1372(a). Such revocation, if made before the close of the first month of the corporation's taxable year, shall be effective for the taxable year in which the revocation is made and for all succeeding taxable years of the corporation. If the revocation is made after the close of the first month of the corporation's taxable year, such revocation shall be effective for the taxable year of the corporation following that in which the revocation is made and for all succeeding taxable years of the corporation.

(e) *Return of electing small business corporation.*—Section 6037 of the 1954 Code requires that every electing small business corporation (as defined in section 1371(b)) shall make a return for each taxable year for which the election is effective. The return shall be filed on such form as shall be prescribed therefor and shall contain the information required by section 6037 and by such form. The return shall be signed by the person or persons who are authorized to sign a return under section 6062 and shall be filed with the district director with whom the income tax return of the corporation would be filed if the corporation were subject to the tax imposed by chapter 1. The return required under section 6037 shall be filed on or before the 15th day of the third month following the close of the taxable year of the corporation.

PROPOSED REGULATIONS OF THE TREASURY DEPARTMENT IN CONNECTION WITH
SMALL BUSINESS CORPORATIONS (MARCH 12, 1959)

DEPARTMENT OF THE TREASURY

Internal Revenue Service

[26 CFR (1954) Part 1]

INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

NOTICE OF PROPOSED RULEMAKING

Notice is hereby given, pursuant to the Administrative Procedure Act, approved June 11, 1946, that the regulations set forth in tentative form below are proposed to be prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury or his delegate. Prior to the final adoption of such regulations, consideration will be given to any comments or suggestions pertaining thereto which are submitted in writing, in duplicate, to the Commissioner of Internal Revenue, Attention: T:P, Washington 25, D.C., within the period of 30 days from the date of publication of this notice in the FEDERAL REGISTER. Any person submitting written comments or suggestions who desires an opportunity to comment orally at a public hearing on these proposed regulations should submit his request, in writing, to the Commissioner within the 30-day period. In such a case, a public hearing will be held, and notice of the time, place, and date will be published in a subsequent issue of the FEDERAL REGISTER. The proposed regulations are to be issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

[SEAL]

DANA LATHAM,
Commissioner of Internal Revenue.

The regulations set forth in paragraph 1 below are hereby prescribed under subchapter S of chapter 1 of the Internal Revenue Code of 1954. The regulations

set forth in paragraph 2 below are hereby prescribed under section 6037 of such Code. Section 1.442-1 of the Income Tax Regulations (26 CFR 1.442-1) is hereby amended as set for in paragraph 3 below. Except as specifically provided otherwise, these regulations are applicable for taxable years beginning after December 31, 1957.

PARAGRAPH 1. The following regulations are hereby prescribed under subchapter S of chapter 1 of the Internal Revenue Code of 1954:

ELECTION OF CERTAIN SMALL BUSINESS CORPORATIONS AS TO TAXABLE STATUS

- Sec.
- 1.1371 Statutory provisions; definitions.
 - 1.1371-1 Definition of small business corporation.
 - 1.1371-2 Definition of electing small business corporation.
 - 1.1372 Statutory provisions; election by small business corporation.
 - 1.1372-1 Election by small business corporation.
 - 1.1372-2 Manner and time for making election and filing shareholders' consent.
 - 1.1372-3 Shareholders' consent.
 - 1.1372-4 Termination of election.
 - 1.1372-5 Election after termination.
 - 1.1373 Statutory provisions; corporation undistributed taxable income taxed to shareholders.
 - 1.1373-1 Corporation undistributed taxable income taxed to shareholders.
 - 1.1374 Statutory provisions; corporation net operating loss allowed to shareholders.
 - 1.1374-1 Net operating losses involving electing small business corporations.
 - 1.1374-2 Application with other provisions.
 - 1.1374-3 Pre-1958 taxable years.
 - 1.1374-4 Examples.
 - 1.1375 Statutory provisions; special rules applicable to distributions of electing small business corporations.
 - 1.1375-1 Special rules applicable to capital gains.
 - 1.1375-2 Dividends received exclusive and credit not allowed.
 - 1.1375-3 Treatment of family groups.
 - 1.1375-4 Distributions of previously taxed income.
 - 1.1376 Statutory provisions; adjustment to basis of stock of, and indebtedness owing, shareholders.
 - 1.1376-1 Adjustment to basis of stock of, and indebtedness to, shareholders.
 - 1.1376-2 Reduction in basis of stock and indebtedness.
 - 1.1377 Statutory provisions; special rules applicable to earnings and profits of electing small business corporations.
 - 1.1377-1 Reduction of earnings and profits for undistributed taxable income.
 - 1.1377-2 Current earnings and profits not reduced by any amount not allowable as a deduction.
 - 1.1377-3 Earnings and profits not affected by net operating loss.

ELECTION OF CERTAIN SMALL BUSINESS CORPORATIONS AS TO TAXABLE STATUS

§ 1.1371 Statutory provisions; definitions.

"SEC. 1371. *Definitions*—(a) *Small business corporation*. For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not a member of an affiliated group (as defined in section 1504) and which does not—

- "(1) Have more than 10 shareholders;
- "(2) Have as a shareholder a person (other than an estate) who is not an individual;
- "(3) Have a nonresident alien as a shareholder; and
- "(4) Have more than one class of stock.

"(b) *Electing small business corporation*. For purposes of this subchapter, the term "electing small business corporation" means, with respect to any taxable year, a small business corporation which has made an election under section 1372(a) which, under section 1372, is in effect for such taxable year."

[Sec. 1371 as added by sec. 64(a), Technical Amendments Act, 1958 (72 Stat. 1650)]

§ 1.1371-1 Definition of small business corporation.

(a) *In general*. For purposes of subchapter S of chapter 1 of the Code, and §§ 1.1371 through 1.1377, the term "small business corporation" means a domestic corporation which is not a member of an affiliated group of corporations (as defined in section 1504) and which does not have—

- (1) More than 10 shareholders,
- (2) As a shareholder a person (other than an estate) who is not an individual,
- (3) A nonresident alien as a shareholder, and
- (4) More than one class of stock.

(b) *Domestic corporation*. The term "domestic corporation," as used in section 1371(a), means a corporation as defined in section 7701(a)(3) created or organized in the United States or under the law of the United States or of any State or Territory. The term does not include an unincorporated business enterprise electing to be taxed as a domestic corporation under section 1361.

(c) *Member of an affiliated group.* A corporation which is a member of an affiliated group of corporations, as defined in section 1504, is not a small business corporation, whether or not such affiliated group has ever filed a consolidated return. However, under section 1504(b)(8) an electing small business corporation is excluded from the definition of "ineligible corporation." Thus, if a corporation which qualifies as a small business corporation under section 1371 makes the election provided in section 1372 and after the date on which the qualifications must be met acquires ownership of 80 percent or more of the voting stock and of each class of non-voting stock of another corporation, it will not be considered a member of an affiliated group and will not cease to be a small business corporation solely by virtue of its subsequent acquisition of the subsidiary corporation.

(d) *Number of shareholders.* A corporation does not qualify as a small business corporation if it has more than 10 shareholders. Ordinarily, the persons who would have to include in gross income dividends distributed with respect to the stock of the corporation are considered to be the shareholders of the corporation. For example, if stock is owned as community property or by tenants in common, joint tenants, or tenants by the entirety, each person having a community interest in such stock and each tenant in common, joint tenant, or tenant by the entirety is generally considered a shareholder. Persons for whom stock in a corporation is held by a nominee, agent, guardian, or custodian will generally be considered shareholders of the corporation. In the case of a voting trust which is not subject to the provisions of subchapter J of chapter 1 of the Code, the beneficial owners (rather than the trust) are considered the shareholders.¹ However, if stock is owned by a trust which is subject to the provisions of subchapter J of chapter 1 of the Code, the trust is considered the shareholder even though the dividends paid to the trust are includible directly in the income of the grantor or some other person under subpart E of such subchapter J, and if stock is owned by a partnership, such partnership and not its partners is considered to be the shareholder.¹

(e) *Shareholders must be individuals or estates.* A corporation in which any shareholder is a corporation, trust, or partnership does not qualify as a small business corporation. The word "trust" as used in this paragraph means all trusts subject to the provisions of subchapter J of chapter 1 of the Code, including subpart E thereof.¹ Thus, even though the grantor is treated as the owner of all or any part of a trust, the corporation in which such trust is a shareholder does not meet the qualifications of a small business corporation.

(f) *No nonresident alien shareholder.* A corporation having a nonresident alien shareholder does not qualify as a small business corporation.

(g) *Classes of stock.* A corporation having more than one class of stock does not qualify as a small business corporation. In determining whether a corporation has more than one class of stock, only stock which is issued and outstanding is considered. Therefore, treasury stock and unissued stock of a different class than that held by the shareholders will not disqualify a corporation under section 1371(a)(4). If the outstanding shares of stock of the corporation (including stock which is improperly designated as a debt obligation) are not identical with respect to the rights and interest which they convey in the control, profits, and assets of the corporation, then the corporation is considered to have more than one class of stock. Thus, a difference as to voting rights, dividend rights, or liquidation preferences of outstanding stock will disqualify a corporation. However, if two or more groups of shares are identical in every respect except that each group has the right to elect members of the board of directors in a number proportionate to the number of shares in each group, they are considered one class of stock.

§ 1.1371-2 Definition of electing small business corporation.

Section 1371(b) defines an electing small business corporation in terms of a particular taxable year. If a small business corporation, as defined in section 1371(a), has made an election under section 1372(a), and such election is in effect for the taxable year in question, then the corporation is an electing small business corporation for such taxable year. A corporation is not an electing small business corporation as to a particular taxable year if it was ineligible to make the election or if a termination under section 1372(e) is effective as to such taxable year.

§ 1.1372 Statutory provisions; election by small business corporation. ..

"SEC. 1372. *Election by small business corporation*—(a) *Eligibility.* Except as provided in subsection (f), any small business corporation may elect, in accordance with the provisions of this section, not to be subject to the taxes imposed by this

¹ See changes made in Notice of Proposed Rule Making issued March 17, 1959, which follows.

chapter. Such election shall be valid only if all persons who are shareholders in such corporation—

“(1) On the first day of the first taxable year for which such election is effective, if such election is made on or before such first day, or

“(2) On the day on which the election is made, if the election is made after such first day,
consent to such election.

“(b) *Effect.* If a small business corporation makes an election under subsection (a), then—

“(1) With respect to the taxable years of the corporation for which such election is in effect, such corporation shall not be subject to the taxes imposed by this chapter and, with respect to such taxable years and all succeeding taxable years, the provisions of section 1377 shall apply to such corporation, and

“(2) With respect to the taxable years of a shareholder of such corporation in which or with which the taxable years of the corporation for which such election is in effect end, the provisions of sections 1373, 1374, and 1375 shall apply to such shareholder, and with respect to such taxable years and all succeeding taxable years, the provisions of section 1376 shall apply to such shareholder.

“(c) *Where and how made*—(1) *In general.* An election under subsection (a) may be made by a small business corporation for any taxable year at any time during the first month of such taxable year, or at any time during the month preceding such first month. Such election shall be made in such manner as the Secretary or his delegate shall prescribe by regulations.

“(2) *Taxable years beginning before date of enactment.* An election may be made under subsection (a) by a small business corporation for its first taxable year which begins after December 31, 1957, and on or before the date of the enactment of this subchapter, and ends after such date at any time—

“(A) Within the 90-day period beginning on the day after the date of the enactment of this subchapter, or

“(B) If its taxable year ends within such 90-day period, before the close of such taxable year.

An election may be made pursuant to this paragraph only if the small business corporation has been a small business corporation (as defined in section 1371(a)) on each day after the date of the enactment of this subchapter and before the day of such election.

“(d) *Years for which effective.* An election under subsection (a) shall be effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, unless it is terminated, with respect to any such taxable year, under subsection (e).

“(e) *Termination*—(1) *New shareholders.* An election under subsection (a) made by a small business corporation shall terminate if any person who was not a shareholder in such corporation—

“(A) On the first day of the first taxable year of the corporation for which the election is effective, if such election is made on or before such first day, or

“(B) On the day on which the election is made, if such election is made after such first day,

becomes a shareholder in such corporation and does not consent to such election within such time as the Secretary or his delegate shall prescribe by regulations. Such termination shall be effective for the taxable year of the corporation in which such person becomes a shareholder in the corporation and for all succeeding taxable years of the corporation.

“(2) *Revocation.* An election under subsection (a) made by a small business corporation may be revoked by it for any taxable year of the corporation after the first taxable year for which the election is effective. An election may be revoked only if all persons who are shareholders in the corporation on the day on which the revocation is made consent to the revocation. A revocation under this paragraph shall be effective—

“(A) For the taxable year in which made, if made before the close of the first month of such taxable year,

“(B) For the taxable year following the taxable year in which made, if made after the close of such first month, and for all succeeding taxable years of the corporation. Such revocation shall be made in such manner as the Secretary or his delegate shall prescribe by regulations.

“(3) *Ceases to be small business corporation.* An election under subsection (a) made by a small business corporation shall terminate if at any time—

“(A) After the first day of the first taxable year of the corporation for which the election is effective, if such election is made on or before such first day, or

“(B) After the day on which the election is made, if such election is made after such first day,

the corporation ceases to be a small business corporation (as defined in section 1371(a)). Such termination shall be effective for the taxable year of the corporation in which the corporation ceases to be a small business corporation and for all succeeding taxable years of the corporation.

“(4) *Foreign income.* An election under subsection (a) made by a small business corporation shall terminate if for any taxable year of the corporation for which the election is in effect, such corporation derives more than 80 percent of its gross receipts from sources outside the United States. Such termination shall be effective for the taxable year of the corporation in which it derives more than 80 percent of its gross receipts from sources outside the United States, and for all succeeding taxable years of the corporation.

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

“(f) *Election after termination.* Is a small business corporation has made an election under subsection (a) and if such election has been terminated or revoked under subsection (e), such corporation (and any successor corporation) shall not be eligible to make an election under subsection (a) for any taxable year prior to its fifth taxable year which begins after the first taxable year for which such termination or revocation is effective, unless the Secretary or his delegate consents to such election.”

[Sec. 1372 as added by sec. 64(a), Technical Amendments Act 1958 (72 Stat. 1650)]

§ 1.1372-1 Election by small business corporation.

(a) *Eligibility.* (1) Under section 1372 an eligible small business corporation may elect not to be subject to the taxes imposed by chapter 1 of the Code. The qualifications of a small business corporation must be met as of the first day of the first taxable year of the corporation for which the election is to be effective and on the date of election, unless the election is made after such first day, in which case the qualification need not exist prior to the date of election. For example, the existence of a corporate shareholder or a nonresident alien as a shareholder prior to the date of election does not preclude qualification. However, if the election is made for a taxable year beginning before September 3, 1958, the qualifications must be met on such date and on each day after such date and before the date of election. The election by a small business corporation is valid only if all the shareholders in the corporation on the first day of the first taxable year for which the election is to be effective, or on the date of election, whichever is later, consent to such election. See § 1.1372-3, relating to shareholders' consents.

(2) A corporation is not eligible to make an election under section 1372(a) if it is in the process of complete or partial liquidation, if it has adopted a plan of such liquidation, or if it contemplates such liquidation or the adoption of a plan of such liquidation in the near future.

(b) *Effect of election.*—(1) *Effect on corporation.* The effect on a small business corporation of a valid election under section 1372 is to exempt such corporation from the taxes imposed by chapter 1 of the Code with respect to taxable years of the corporation for which the election is in effect and to subject the corporation with respect to such taxable years and all its subsequent taxable years to section 1377, relating to special rules for computing the earnings and profits of an electing small business corporation.

(2) *Effect on shareholders.* The effect of a valid election by the corporation is to subject the shareholders to the provisions of section 1373 (providing for the taxation of the corporation's undistributed taxable income to the shareholders), section 1374 (allowing the net operating loss of the electing corporation to the shareholders), section 1375 (relating to special rules applicable to distributions of an electing small business corporation), and section 1376 (relating to adjustment to basis of stock of, and indebtedness owing, shareholders). The provisions

of sections 1373, 1374, and 1375 apply only to a taxable year of the shareholder affected by the election. Section 1376 applies to such taxable year and all succeeding taxable years of the shareholder. A person who ceased to be a shareholder during the first month of the corporation's taxable year in which a valid election is made, but prior to the date of elections, is subject to the provision of sections 1374, 1375, and 1376 even though such person is not an individual or an estate.

(c) *Other chapter 1 rules applicable.* To the extent that other provisions of chapter 1 of the Code are not inconsistent with those under subchapter S thereof and the regulations thereunder, such provisions will apply with respect to both the electing small business corporation and its shareholders in the same manner that they would apply had no election been made. For example:

(1) Taxable income of an electing small business corporation is computed in the same manner that it would have been had no election been made except as otherwise provided in section 1373(d);¹

(2) Section 301, relating to distributions of property, applies to distributions of an electing small business corporation in the same manner that it would apply had no election been made;

(3) Sections 302, 303, 304, and 331 are applicable to distributions by an electing small business corporation that are treated as distributions in exchange for stock;

(4) Section 305 applies to distributions by an electing small business corporation of its own stock;

(5) Section 311 applies to distributions by an electing small business corporation;

(6) Except as provided in section 1377, earnings and profits of an electing small business corporation are computed in the same manner that they would have been computed had no election been made;

(7) Section 316, relating to the definition of a dividend, applies to distributions by an electing small business corporation except as provided in section 1375 (d) (1), relating to distributions of previously taxed income (see paragraphs (d) and (e) of § 1.1373-1 for rules relating to allocation of current earnings and profits to distributions during the taxable year); and

(8) Section 341, relating to collapsible corporations, may apply to gain on the sale or exchange of, or a distribution which is in exchange for, stock in an electing small business corporation.

§ 1.1372-2 Manner and time for making election and filing shareholders' consent.

(a) *Manner of making election.* The election of a small business corporation should be made by the corporation by filing Form 2553, containing the information required by such form, and by filing, in the manner provided in § 1.1372-3, a statement of the consent of each shareholder of the corporation. The election form shall be signed by any person who is authorized to sign the return required under section 6037 and shall be filed with the district director with whom such return is to be filed.

(b) *Time of making election.*—(1) *Taxable years beginning on or after September 3, 1958.* For taxable years beginning on or after September 3, 1958, the election shall be filed either (i) during the first month of such taxable year, or (ii) during the month preceding such first month. In the case of a new corporation whose taxable year begins after the first day of a particular month, the term "month" means the period commencing with the beginning of the first day of the taxable year and ending with the close of the day preceding the numerically corresponding day of the succeeding calendar month or, if there is no such corresponding day, with the close of the last day of such succeeding calendar month.

(2) *Taxable years beginning on or before September 2, 1958.* For taxable years beginning on or before September 2, 1958, but after December 31, 1957, and ending after September 2, 1958, the election shall be made on or before December 1, 1958, or on or before the last day of the corporation's taxable year, whichever is earlier. An election for such taxable year may be made, however, only if the corporation has been a small business corporation on each day after September 2, 1958, and before the date of election.

(3) *Election prior to expiration of period.* An election under section 1372(a) which is made prior to the expiration of the period for making the election is binding and may not be withdrawn even though the time within which the election could have been made has not elapsed.

(c) *Years for which election is effective.* An election under section 1372 may be made only with respect to taxable years beginning after December 31, 1957, and ending after September 2, 1958. An election is effective for the entire taxable year of the corporation for which it is made and for all succeeding taxable years

¹ See changes made in Notice of Proposed Rule Making issued March 17, 1959, which follows.

of the corporation, unless it is terminated with respect to any taxable year. Thus, the election has a continuing effect and need not be renewed annually, although annual returns of information must be filed under section 6037.

§ 1.1372-2 Shareholders' consent.

(a) *In general.* The consent of a shareholder to an election by a small business corporation shall be in the form of a statement signed by the shareholder in which such shareholder consents to the election of the corporation. Such shareholder's consent is binding and may not be withdrawn after a valid election is made by the corporation. The consent of a minor shall be made by the minor or by his legal guardian, or his natural guardian if no legal guardian has been appointed. The consent of an estate shall be made by the executor or administrator thereof. The statement shall set forth the name and address of the corporation and of the shareholder, the number of shares of stock owned by him, and the date (or dates) on which such stock was acquired. The consents of all shareholders may be incorporated in one statement. The consents of all shareholders shall be attached to the election of the corporation. If the election is made before the first day of the corporation's taxable year for which it is effective, the consents of persons who become shareholders after the date of election and are shareholders on such first day shall be filed with the district director with whom the election was filed as soon as practicable after such first day. Where a consent is filed after the date of election, a copy of the consent shall also be filed with the return required to be filed under section 6037. Except as provided by paragraph (b) of this section, an election under section 1372 will not be valid if any of the consents are filed after the first day prescribed for making the election. However, an election timely filed on or before December 1, 1958, and which would be valid but for the fact that a consent was timely filed by only one of the spouses in a community-property State, will not be invalid solely by virtue of the failure of both spouses to consent, provided a consent is filed by the other spouse on or before February 2, 1959.

(b) *New shareholders.* If a person becomes a shareholder of an electing small business corporation after the first day of the taxable year for which the election is effective, or after the day on which the election is made (if such day is later than the first day of the taxable year), the consent of such shareholder shall be made in a statement filed (with the district director with whom the election is filed) within the period of 30 days beginning with the day on which such person becomes a new shareholder. A copy of such consent should be furnished to the corporation by the new shareholder. If the new shareholder is an estate, the 30-day period shall not begin until the executor or administrator has been appointed, but in no event shall such period begin later than 30 days following the close of the corporation's taxable year in which the estate became a shareholder. The statement of consent shall set forth the name and address of the corporation and of such new shareholder, the number of shares of stock owned by such shareholder, the date on which such shares were acquired, and the name and address of each person from whom such shares were acquired. A copy of the consent of such new shareholder shall be filed with the return required to be filed under section 6037 for the taxable year to which such consent applies. For the effect of the failure of a new shareholder to consent, see paragraph (b)(1) of § 1.1372-4.

§ 1.1372-4 Termination of election.

(a) *In general.* An election under section 1372(a) can be terminated in any one of the five ways described in section 1372(e)(1) through (5) and paragraph (b) of this section. For years affected by termination, see paragraph (c) of this section.

(b) *Methods of termination—(1) Failure of new shareholder to consent.* An election under section 1372(a) shall terminate if any person who was not a shareholder on the first day of the first taxable year for which the election is effective, or on the day on which the election is made (if such day is later than the first day of the taxable year), becomes a shareholder and does not consent to the election under section 1372(a) within the time prescribed by paragraph (b) of § 1.1372-3. In the event of a termination caused by the failure of a new shareholder to consent to the election within the required time, the corporation shall notify the district director with whom the election under section 1372(a) was filed.

(2) *Revocation.* An election under section 1372(a) may be revoked by the corporation for any taxable year of the corporation after the first taxable year for which the election is effective. A revocation can be made only with the consent of all the persons who are shareholders at the beginning of the day of revocation. Such revocation shall be made by the corporation by filing a statement that the corporation revokes the election made under section 1372(a), which statement shall indicate the first taxable year of the corporation for which the revocation is

intended to be effective. The statement shall be signed by any person authorized to sign the return of the corporation under section 6037 and shall be filed with the district director with whom the election was filed. In addition, there shall be attached to the statement of revocation a statement of consent, signed by each person who is a shareholder of the corporation at the beginning of the day on which such statement of revocation is filed, in which each such shareholder consents to the revocation by the corporation of the election under section 1372(a). For the time within which a revocation must be made to be effective for a particular taxable year of the corporation, see paragraph (c) of this section.

(3) *Ceases to be small business corporation.* An election under section 1372(a) terminates if at any time after the first day of the first taxable year of the corporation for which the election is effective, or after the day on which the election is made (if such day is later than the first day of the taxable year), the corporation ceases to be a small business corporation as defined in section 1371(a). Thus, the election is terminated if an eleventh person, a nonresident alien, or a trust, partnership, or corporation becomes a shareholder, or if another class of stock is issued by the corporation. In the event of a termination under this subparagraph the corporation shall immediately notify the district director with whom the election under section 1372(a) was filed. Such notification shall set forth the cause of the termination and the date thereof. In addition, if the termination was caused by the transfer of stock to an eleventh shareholder, to a nonresident alien, or to a trust, partnership, or corporation, the notification shall specify the number of shares transferred to such person, the name of such person (or in the case of a trust the names of the trustees and beneficiaries), and the name of the shareholder who transferred such stock to such person. If the termination was caused by the issuance of a second class of stock, the notification shall indicate the number of shares of such new class issued and shall describe the differentiating characteristics of the new class of stock.

(4) *Foreign income.* (i) An election terminates if for any taxable year of the corporation the corporation has gross receipts, more than 80 percent of which are derived from sources outside the United States. For the meaning of the term "gross receipts," see subparagraph (5) (ii) of this paragraph. In determining the source of gross receipts under section 1372(e) (4), the principles of sections 861 through 864, relating to determination of sources of gross income, shall apply.

(ii) The rules of this subparagraph may be illustrated by the following example:

Example. A corporation has gross receipts from the sale of personal property produced (in whole or in part) by the corporation within the United States and sold within a foreign country. An independent factory or production price has not been established as provided in example (1) of paragraph (b) (2) of § 1.863-3. One-half of the gross receipts from the sale of such property shall be apportioned in accordance with the value of the corporation's property within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the corporation's property within the United States, and the denominator of which consists of the value of the taxpayer's property both within the United States and within the foreign country. The remaining one-half of such gross receipts shall be apportioned in accordance with the gross sales of the corporation within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the corporation's gross sales for the taxable year within the United States, and the denominator of which consists of the taxpayer's gross sales for the taxable year both within the United States and within the foreign country.

(5) *Personal holding company income*—(i) *In general.* An election shall terminate if for any taxable year of the corporation the corporation has gross receipts more than 20 percent of which is derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities, as determined in accordance with the rules of this subparagraph.

(ii) *Gross receipts.* (a) The term "gross receipts" as used in section 1372(e) is not synonymous with "gross income". The test under section 1372(e) (4) and (5) shall be made on the basis of total gross receipts, except that, for purposes of section 1372(e) (5), gross receipts from the sales or exchanges of stock or securities shall be taken into account only to the extent of gains therefrom. The term "gross receipts" means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income. Thus, the total amount of receipts is not reduced by returns and allowances, cost, or deduc-

tions. For example, gross receipts will include the total amount received or accrued during the corporation's taxable year from the sale or exchange of any kind of property, from investments, and for services rendered by the corporation. However, gross receipts does not include amounts received in nontaxable sales or exchanges, except to the extent that gain is recognized by the corporation, nor does that term include amounts received as a loan, as a repayment of a loan, as a contribution to capital, or on the issuance by the corporation of its own stock.

(b) The meaning of the term "gross receipts" as used in section 1372(e) (4) and (5) may be further illustrated by the following examples:

Example (1). A corporation on the accrual basis sells property and receives payment partly in money and partly in the form of a note payable at a future time. The amount of the money and the face amount of the note would be considered gross receipts in the taxable year of the sale and would not be reduced by the adjusted basis of the property, the costs of sale, or any other amount.

Example (2). A corporation has a long-term contract as defined in paragraph (a) of § 1.451-3 with respect to which it reports income according to the percentage-of-completion method as described in paragraph (b)(1) of § 1.451-3. The portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year shall be included in gross receipts for such year.

Example (3). A corporation which regularly sells personal property on the installment plan elects to report its taxable income on the installment basis in accordance with section 453. The installment payments actually received in a given taxable year of the corporation shall be included in gross receipts for such year.

(iii) *Royalties.* The term "royalties" as used in section 1372(e)(5) means all royalties, including mineral, oil, and gas royalties (whether or not the aggregate amount of such royalties constitutes 50 percent or more of the gross income of the corporation for the taxable year), and amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property. The provisions of sections 631 (b) and (c) and 1235 have no application in determining whether payments with respect to timber, coal, or patents are royalties for purposes of this subdivision. For the definition of "mineral, oil, or gas royalties" see paragraph (b) (11) (ii) and (iii) of § 1.543-1. For purposes of this subdivision, the gross amount of royalties shall not be reduced by any part of the cost of the rights under which they are received or by any amount allowable as a deduction in computing taxable income.

(iv) *Rents.* The term "rents" as used in section 1372(a)(5)¹ means amounts received for the use of, or right to use, property (whether real or personal) of the corporation, whether or not such amounts constitute 50 percent or more of the gross income of the corporation for the taxable year. The term "rents" does not include payments for the use or occupancy of rooms or other space where significant services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist homes, motor courts, or motels. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such services; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in an office building, etc., are generally "rents" under section 1372(a)(5). Payments for the parking of automobiles ordinarily do not constitute rents. Payments for the warehousing of goods or for the use of personal property do not constitute rents if significant services are rendered in connection with such payments.

(v) *Dividends.* The term "dividends" as used in section 1372(e)(5) includes dividends as defined in section 316, amounts required to be included in gross income under section 551 (relating to foreign personal holding company income taxed to United States shareholders), and consent dividends determined as provided in section 565.

(vi) *Interest.* The term "interest" as used in section 1372(e)(5) means any amounts includible in gross income received for the use of money (including tax-exempt interest).¹

¹ See changes made in Notice of Proposed Rule Making issued March 17, 1959, which follows.

(vii) *Annuities.* The term "annuities" as used in section 1372(e) (5) means the entire amount received as an annuity under an annuity, endowment, or life insurance contract, regardless of whether only part of such amount would be includible in gross income under section 72.

(viii) *Gross receipts from the sale of stock or securities.* For purposes of section 1372(e) (5), gross receipts from the sales or exchanges of stock or securities are taken into account only to the extent of gains therefrom. Thus, the gross receipts from the sale of a particular share of stock will be the excess of the amount realized over the adjusted basis of such share. If the adjusted basis should equal or exceed the amount realized on the sale or exchange of a certain share of stock, bond, etc., there would be no gross receipts resulting from the sale of such security. Losses on sales or exchanges of stock or securities do not offset gains on the sales or exchanges of other stock or securities for purposes of computing gross receipts from such sales or exchanges. Gross receipts from the sale or exchange of stocks and securities include gains received from such sales or exchanges by a corporation even though such corporation is a regular dealer in stocks and securities. For the meaning of the term "stocks or securities" see paragraph (b) (5) (i) of § 1.543-1.

(c) *Years affected by termination.* The termination of an election resulting from the occurrences described in subparagraph (1), (3), (4), or (5) of paragraph (b) of this section is effective for the taxable year of the corporation in which occur the events causing the termination and for all succeeding taxable years of the corporation. Thus, if an electing small business corporation which is on a calendar year ending December 31, 1960, should issue a second class of stock on December 1, 1960, the election under section 1372(a) would terminate as of January 1, 1960, and the termination would remain in effect for all future years unless and until a new election is made by the corporation. Generally, a termination by revocation described in paragraph (b) (2) of this section is effective for the taxable year in which it is made and for all subsequent taxable years if it is made during the first month of that year. However, a termination by revocation cannot be made effective for the first taxable year of the corporation for which the election is made. If the revocation is not made during the first month of a taxable year, it is effective for the taxable year following the year in which it is made, and for all subsequent years.

§ 1.1372-5 Election after termination.

(a) *In general.* If a corporation has made a valid election and such election has been terminated, such corporation (or any successor corporation) is not eligible to make a new election for any taxable year prior to its fifth taxable year which begins after the first taxable year for which such termination is effective, unless consent to such new election is given by the Commissioner. The burden will be on the corporation to establish that under the relevant facts the commissioner should consent to a new election. The fact that more than 50 percent 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 will tend to establish that consent should be granted. In the absence of such fact, consent will ordinarily be denied unless 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.

(b) *Successor corporation.* The term "successor corporation" as used in section 1372(f) means any corporation—

(1) 50 percent or more of the stock of which is owned, directly or indirectly, by the same persons who, at any time during the first taxable year for which such termination was effective, owned 50 percent or more of the stock of the small business corporation with respect to which the election was terminated, and

(2)(i) Which acquires a substantial portion of the assets of such small business corporation, or

(ii) A substantial portion of the assets of which were assets of such small business corporation.

§ 1.1373 Statutory provisions; corporation undistributed taxable income taxed to shareholders.

"SEC. 1373. *Corporation undistributed taxable income taxed to shareholders*—(a) *General rule.* The undistributed taxable income of an electing small business corporation for any taxable year shall be included in the gross income of the shareholders of such corporation in the manner and to the extent set forth in this section.

“(b) *Amount included in gross income.* Each person who is a shareholder of an electing small business corporation on the last day of a taxable year of such corporation shall include in his gross income, for his taxable year in which or with which the taxable year of the corporation ends, the amount he would have received as a dividend, if on such last day there had been distributed pro rata to its shareholders by such corporation an amount equal to the corporation's undistributed taxable income for the corporation's taxable year. For purposes of this chapter, the amount so included shall be treated as an amount distributed as a dividend on the last day of the taxable year of the corporation.

“(c) *Undistributed taxable income defined.* For purposes of this section, the term ‘undistributed taxable income’ means taxable income (computed as provided in subsection (d)) minus the amount of money distributed as dividends during the taxable year, to the extent that any such amount is a distribution out of earnings and profits of the taxable year as specified in section 316(a)(2).

“(d) *Taxable income.* For purposes of this subchapter, the taxable income of an electing small business corporation shall be determined without regard to—

“(1) The deduction allowed by section 172 (relating to net operating loss deduction), and

“(2) The deductions allowed by part VIII of subchapter B (other than the deduction allowed by section 248, relating to organization expenditures).”

[Sec. 1373 as added by sec. 64(a), Technical Amendments Act 1958 (72 Stat. 1652)]

§ 1.1373-1 Corporation undistributed taxable income taxed to shareholders.

(a) *In general*—(1) *Inclusion in gross income.* Each person who is a shareholder of an electing small business corporation on the last day of a taxable year of such corporation shall include in his gross income, for his taxable year in which or with which the taxable year of the corporation ends, the amount he would have received as a dividend if on such last day the corporation distributed pro rata to its shareholders an amount of money equal to its undistributed taxable income for the corporation's taxable year. The amount so included in the gross income of the shareholders is treated, for purposes of chapter 1 of the Code, as if it had been distributed as a dividend on the last day of the corporation's taxable year. See, however, section 1375 for special rules applicable to distributions.

(2) *Shareholders affected by rule of section 1373.* Only those persons who are shareholders of the corporation on the last day of the taxable year of the corporation are required to include in their gross income the amounts specified in section 1373. In determining who are the shareholders of the corporation on the last day of the taxable year for purposes of section 1373, the rules of paragraph (d) of § 1.1371-1 shall apply. If stock is transferred on the last day of the taxable year of the corporation, the transferee (and not the transferor) will be considered the shareholder of such stock for purposes of section 1373. A donee or purchaser of stock in the corporation is not considered a shareholder unless such stock is acquired in a bona fide transaction and the donee or purchaser is the real owner of such stock. The circumstances, not only as of the time of the purported transfer but also during the periods preceding and following it, will be taken into consideration in determining the bona fides of the transfer. Transactions between members of a family will be closely scrutinized.

(b) *Determination of amount included by shareholders.* To determine the amount each shareholder must include in his gross income as provided in paragraph (a) of this section, it is necessary to—

(1) Compute the taxable income of the electing small business corporation for its taxable year in accordance with the provisions of paragraph (c) of this section,

(2) Determine in accordance with paragraph (d) of this section the amount of money distributed as dividends during the taxable year out of earnings and profits of such taxable year,

(3) Subtract the amount determined in subparagraph (2) of this paragraph from the amount computed in subparagraph (1) of this paragraph. The result is the undistributed taxable income for the taxable year,

(4) Determine in accordance with paragraph (e) of this section the amount that would be treated as a dividend to such shareholder if an amount of money equal to such undistributed taxable income were distributed pro rata to the shareholders of the corporation on the last day of the taxable year of the corporation in a distribution which is not in exchange for stock.

(c) *Computation of taxable income.* The taxable income of an electing small business corporation is computed in the same manner as it would be computed if no election had been made, with the following exceptions:

(1) The deduction allowed by section 172 (relating to net operating loss deductions) is disregarded, and

(2) The special corporate deductions allowed by part VIII of subchapter B of chapter 1 of the Code (other than the deduction allowed by section 248, relating to organization expenditures) are disregarded.

(d) *Determination of dividends in money out of earnings and profits of the taxable year.* In applying section 316(a) to distributions by an electing small business corporation, earnings and profits of the taxable year are first allocated to actual distributions of money made during such taxable year which are not in exchange for stock. Therefore, such distributions of money are dividends from earnings and profits of the taxable year to the extent of such earnings and profits even though there may be distributions of property other than money during such taxable year or constructive distributions pursuant to section 1373(b) at the end of such taxable year. If such distributions of money made during the taxable year exceed the earnings and profits of such year, then that proportion of each such distribution which the total of the earnings and profits of the year bears to the total of such distributions made during the year shall be regarded as out of the earnings and profits of that year. For purposes of section 1373(c) a distribution of money does not include a distribution of an obligation of the corporation or a distribution of property other than money in satisfaction of a dividend declared in money. See section 1377(b) for special rule relating to computation of earnings and profits of an electing small business corporation for any taxable year.

(e) *Dividend resulting from constructive distribution of undistributed taxable income.* The amount which would be treated as a dividend if the undistributed taxable income were distributed on the last day of the taxable year is determined in accordance with section 316. In determining the extent to which distributions of an electing small business corporation are out of earnings and profits of the taxable year, the following rules apply:

(1) Earnings and profits of the taxable year are first allocated to the actual distributions of money described in paragraph (d) of this section.

(2) The excess of such earnings and profits over such actual distributions of money is allocated ratably to the constructive distribution of undistributed taxable income and actual distributions of property other than money (taken into account at fair market value for purposes of this allocation) which are not in exchange for stock, and

(3) The remainder of such earnings and profits is available to be allocated to distributions in exchange for stock of the corporation such as distributions under section 302 or 331.

(f) *When distributions are considered made.* An actual distribution by an electing small business corporation will be considered to be made only at the time it is received by the shareholder, and earnings and profits of such corporation shall not be reduced with respect to such distribution before such time.

(g) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). An electing small business corporation has taxable income and current earnings and profits of \$100,000 for its taxable year. During that year it distributes \$80,000 in money among its 10 equal shareholders. The \$8,000 received by each shareholder in that year is included in his gross income (for his taxable year in which it was received) as a dividend from current earnings and profits. The undistributed taxable income of the corporation for the taxable year is \$20,000 (\$100,000 minus \$80,000 dividends in money). Since each shareholder would have received a dividend of \$2,000 if the undistributed taxable income had been distributed pro rata, that amount must be included as a dividend in the gross income of each shareholder for his taxable year in which or with which the taxable year of the corporation ends.

Example (2). Assume the same facts as in example (1) except that the corporation has only \$70,000 of taxable income. The difference between taxable income and current earnings and profits of \$100,000 is attributable to the fact that certain deductions allowable in computing taxable income (such as percentage depletion in excess of cost depletion) do not decrease earnings and profits. The distributions of \$80,000 during the taxable year are still included as dividends in the gross income of the shareholders since they are distributions out of earnings and profits. However, there is no amount to be included under section 1373(b) since the corporation has no undistributed taxable income for the taxable year.

Example (3). An electing small business corporation has taxable income and earnings and profits of \$10,000 for its taxable year. The corporation

has no accumulated earnings and profits as of the beginning of the taxable year. During the taxable year it distributes property other than money with a basis of \$10,000 and a fair market value of \$20,000. The undistributed taxable income of the corporation is \$10,000 since the property distribution does not reduce taxable income for purposes of that computation. However, the current earnings and profits are allocated ratably to the constructive distribution of undistributed taxable income and the distribution of property, taken into account at fair market value; that is, \$3,333 to the constructive distribution and \$6,667 to the distribution of property. Therefore, although undistributed taxable income is \$10,000, only \$3,333 would be treated as a dividend on a distribution of undistributed taxable income, and that is the amount the shareholders include pro rata in gross income pursuant to section 1373(b). The distribution of property is a dividend only to the extent of \$6,667.

Example (4). Assume the facts are the same as in example (3) except that the corporation has accumulated earnings and profits of \$20,000 as of the beginning of the taxable year. The \$20,000 accumulated earnings and profits at the beginning of the taxable year are sufficient to cover that portion of the distribution of property which is not out of current earnings and profits (\$13,333) and that portion of the constructive distribution which is not out of current earnings and profits (\$6,667). Therefore, both distributions will be fully taxable as dividends.

Example (5). An electing small business corporation has taxable income and current earnings and profits of \$100,000 for the taxable year. There are no accumulated earnings and profits as of the beginning of the taxable year. During the taxable year the corporation distributes \$50,000 in a redemption that qualifies under section 302(a). The undistributed taxable income of the corporation is \$100,000. Since the current earnings and profits of \$100,000 are first allocated to the constructive distribution of \$100,000, that amount is includible in the gross income of the persons who were shareholders on the last day of the taxable year.

Example (6). Corporation X of which A and B are each 50-percent shareholders has been an electing small business corporation for several years. Shortly before its taxable year 1962, corporation X adopts a plan of complete liquidation. During 1962 it has \$3,000 of taxable income and earnings and profits. The only distributions made during 1962 are distributions in liquidation. The final distribution is made on October 15, 1962, after which corporation X retains no assets and is no longer in existence for tax purposes. Corporation X has \$3,000 of undistributed taxable income for its taxable year ended October 15, 1962, and A and B must each include \$1,500 for his taxable year in which ends the taxable year of corporation X. Under section 1376(a), A and B both increase the basis of their respective shares in corporation X by \$1,500, and this increase is taken into account in determining gain or loss on the liquidation of corporation X.

§ 1.1374 Statutory provisions; corporation net operating loss allowed to shareholders.

"SEC. 1374. *Corporation net operating loss allowed to shareholders*—(a) *General rule.* A net operating loss of an electing small business corporation for any taxable year shall be allowed as a deduction from gross income of the shareholders of such corporation in the manner and to the extent set forth in this section.

"(b) *Allowance of deduction.* Each person who is a shareholder of an electing small business corporation at any time during a taxable year of the corporation in which it has a net operating loss shall be allowed as a deduction from gross income, for his taxable year in which or with which the taxable year of the corporation ends, an amount equal to his portion of the corporation's net operating loss (as determined under subsection (c)).

"(c) *Determination of shareholder's portion*—(1) *In general.* For purposes of this section, a shareholder's portion of the net operating loss of an electing small business corporation is his pro rata share of the corporation's net operating loss (computed as provided in section 172(c), except that the deductions provided in part VIII (except section 248) of subchapter B shall not be allowed) for his taxable year in which or with which the taxable year of the corporation ends. For purposes of this paragraph, a shareholder's pro rata share of the corporation's net operating loss is the sum of the portions of the corporation's daily net operating loss attributable on a pro rata basis to the shares held by him on each day of the taxable year. For purposes of the preceding sentence, the corporation's daily net operat-

ing loss is the corporation's net operating loss divided by the number of days in the taxable year.

"(2) *Limitation.* A shareholder's portion of the net operating loss of an electing small business corporation for any taxable year shall not exceed the sum of—

"(A) The adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of the shareholder's stock in the electing small business corporation, determined as of the close of the taxable year of the corporation (or, in respect of stock sold or otherwise disposed of during such taxable year, as of the day before the day of such sale or other disposition), and

"(B) The adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of any indebtedness of the corporation to the shareholder, determined as of the close of the taxable year of the corporation (or, if the shareholder is not a shareholder as of the close of such taxable year, as of the close of the last day in such taxable year on which the shareholder was a shareholder in the corporation).

"(d) *Application with other provisions*—(1) *In general.* The deduction allowed by subsection (b) shall, for purposes of this chapter, be considered as a deduction attributable to a trade or business carried on by the shareholder.

"(2) *Adjustment of net operating loss carrybacks and carryovers of shareholders.* For purposes of determining, under section 172, the net operating loss carrybacks to taxable years beginning before January 1, 1958, from a taxable year of the shareholder for which he is allowed a deduction under subsection (b), such deduction shall be disregarded in determining the net operating loss for such taxable year. In the case of a net operating loss for a taxable year in which a shareholder is allowed a deduction under subsection (b), the determination of the portion of such loss which may be carried to subsequent years shall be made without regard to the preceding sentence and in accordance with section 172(b)(2), but the sum of the taxable incomes for taxable years beginning before January 1, 1958, shall be deemed not to exceed the amount of the net operating loss determined with the application of the preceding sentence."

[Sec. 1374 as added by sec. 64(a), Technical Amendments Act 1958 (72 Stat. 1653)]

§ 1.1374-1 Net operating losses involving electing small business corporations.

(a) *Deduction not allowed to corporation.* Under section 1373(d), an electing small business corporation is not allowed a deduction for a net operating loss. Under section 172(h), a net operating loss sustained in taxable years in which a corporation is an electing small business corporation is disregarded in computing the net operating loss deduction of the corporation for taxable years in which it is not an electing small business corporation. In applying section 172(b)(1) and (2) to a net operating loss sustained in a taxable year in which the corporation was not an electing small business corporation, a taxable year in which the corporation was an electing small business corporation is counted as a taxable year to which such net operating loss is carried back or over. However, the taxable income for such year as determined under section 172(b)(2) is treated as if it were zero for purposes of computing the balance of the loss available to the corporation as a carryback or carryover to other taxable years in which the corporation is not an electing small business corporation.

(b) *Deduction allowed to shareholders*—(1) *In general.* Under section 1374(a), the net operating loss of an electing small business corporation is allowed as a deduction from gross income of the shareholders of such corporation. Each person who is a shareholder in such corporation at any time during a taxable year of the corporation in which a net operating loss is sustained by the corporation is entitled to a deduction for his pro rata share of such loss. The net operating loss of an electing small business corporation for any taxable year is computed as provided in section 172(c), except that the deductions provided in part VIII of subchapter B of chapter 1 of the Code (except section 248) are not allowed.

(2) *Year of shareholder in which deduction allowable.* The deduction allowed shareholders by section 1374(b) is a deduction for the taxable year of the shareholder in which or with which the taxable year of the corporation ends. Therefore, if a shareholder dies before the end of the taxable year of the corporation, neither he nor any other person is entitled to a deduction for his pro rata share of the corporation's net operating loss for such taxable year.

(3) *Pro rata share.* A shareholder's pro rata share of the net operating loss of an electing small business corporation is computed as follows:

(i) Divide the corporation's net operating loss by the number of days in the taxable year of the corporation, thus determining the daily net operating loss of the corporation.

(ii) Determine for each day the shareholder's portion of such daily net operating loss by applying to such loss the ratio which the stock owned by the shareholder on that day bears to the total stock outstanding on that day.

(iii) Total the shareholder's daily portions of such daily net operating loss of the corporation for its taxable year.

For purposes of the rule in this subparagraph, shares of stock which are transferred during the year are considered to be held by the transferee (and not the transferor) as of the day of the transfer.

(4) *Limitation on deduction*—(i) *In general.* Under section 1374(c)(2), the amount of the net operating loss of the electing small business corporation for any taxable year which may be deducted by any shareholder under section 1374(c)(1) shall not exceed the sum of:

(a) The adjusted basis of the shareholder's stock in the electing small business corporation, and

(b) The adjusted basis of any indebtedness of the corporation to the shareholder.

(ii) *Time for determining basis of stock and indebtedness.* The adjusted basis of the stock of, or indebtedness to, the shareholder for purposes of subdivision (i) of this subparagraph is determined as of the close of the taxable year of the corporation, except that—

(a) The adjusted basis of stock which is sold or otherwise disposed of during the taxable year of the corporation is determined as of the close of the day of such sale or other disposition, and

(b) If the shareholder is not a shareholder as of the close of the taxable year of the corporation, the adjusted basis of any indebtedness of the corporation to the shareholder is determined as of the close of the last day in such taxable year on which he was a shareholder.

(iii) *Computation of basis of stock and indebtedness.* In computing the adjusted basis of stock and indebtedness for purposes of determining how much of a net operating loss may be deducted by a shareholder, any decrease in basis required by section 1376(b) because of such loss shall be disregarded. However, adjustments to the basis of stock and indebtedness under section 1376 for prior years are to be considered.

§ 1.1374-2 Application with other provisions.

The deduction allowed shareholders by section 1374 shall, for purposes of chapter 1 of the Code, be considered as a deduction attributable to a trade or business carried on by the shareholder. Thus, it is allowable in computing adjusted gross income, and is not subject to the limitations of section 172(d)(4) (relating to nonbusiness deductions) in computing the net operating loss of a shareholder. Also, it is a deduction of the type on which a limitation may be imposed under section 270 (relating to "hobby losses").

§ 1.1374-3 Pre-1958 taxable years.

The deduction allowed by section 1374(b) is disregarded in determining the amount of the shareholder's net operating loss for purposes of determining the net operating loss carrybacks to taxable years beginning prior to January 1, 1958. The deduction is to be given effect, however, in computing the amount of the shareholder's net operating loss for purposes of carrying the same over or back to any year other than a year beginning prior to January 1, 1958. For purposes of determining the amount of the net operating loss which may be carried to such years, the loss shall not be diminished by taxable income for years beginning before January 1, 1958, except to the extent that it was allowed to offset income of those years.

§ 1.1374-4 Examples.

The operation of section 1374 may be illustrated by the following examples:

Example (1). Corporation X, an electing small business corporation, has a net operating loss of \$10,000 for its taxable year ending December 31, 1960. At all times during its taxable year 1960 the corporation had as shareholders the same 10 individuals, each of whom owned one-tenth of the stock on each day of the corporation's taxable year. As a result of the corporation's net operating loss, each of the 10 shareholders has a \$1,000 deduction for his taxable year in which or with which the taxable year of the corporation ends, assuming that such amount does not exceed the limitation of section 1374(c)(2).

Example (2). Assume the same facts as in example (1) except that A, one of the shareholders of the corporation, sells his stock to B on July 2, 1960,

and B holds the stock for the remainder of the year. A and B would each have a \$500 deduction resulting from the corporation's net operating loss, assuming that such amount does not exceed the limitation of section 1374(c)(2). If A's taxable year ends November 30, 1960, the \$500 item will be a deduction in his taxable year ending November 30, 1961. See paragraph (a) of § 1.1376-2 for rule requiring A to reduce basis of his stock in determining gain or loss on the sale to B.

Example (3). B is entitled under section 1374 to a deduction in his taxable year 1958 of \$6,000 as his share of the net operating loss of an electing small business corporation. During 1958 he has a net operating loss, computed without regard to such \$6,000 deduction, of \$20,000. In each of his taxable years 1955, 1956, and 1957, he had taxable income of \$9,000. In each of his taxable years 1959 and 1960 he had taxable income of \$3,000. Under section 1374(d)(2), the net operating loss carryback from 1958 to 1955, 1956, and 1957 does not include the \$6,000 deduction resulting from the loss of the small business corporation, so that there is \$7,000 of taxable income remaining in the year 1957 after the carryback. For purposes of carrying the 1958 net operating loss forward to 1959 and 1960, the \$6,000 amount is included in the net operating loss, and is not reduced by taxable income of years prior to 1958. Therefore, the taxable income for the taxable years 1959 and 1960 is reduced to zero by the carryover.

§ 1.1375 Statutory provisions; special rules applicable to distributions of electing small business corporations.

"SEC. 1375. *Special rules applicable to distributions of electing small business corporations*—(a) *Capital gains*—(1) *Treatment in hands of shareholders.* The amount includible in the gross income of a shareholder as dividends (including amounts treated as dividends under section 1373(b)) from an electing small business corporation during any taxable year of the corporation, to the extent that such amount is a distribution of property out of earnings and profits of the taxable year as specified in section 316(a)(2), shall be treated as a long-term capital gain to the extent of the shareholder's pro rata share of the excess of the corporation's net long-term capital gain over its net short-term capital loss for such taxable year. For purposes of this paragraph, such excess shall be deemed not to exceed the corporation's taxable income computed as provided in section 1373(d) for the taxable year.

"(2) *Determination of shareholder's pro rata share.* A shareholder's pro rata share of such excess for any taxable year shall be an amount which bears the same ratio to such excess as the amount of dividends described in paragraph (1) includible in the shareholder's gross income bears to the entire amount of dividends described in paragraph (1) includible in the gross income of all shareholders.

"(b) *Dividends received credit not allowed.* The amount includible in the gross income of a shareholder as dividends from an electing small business corporation during any taxable year of the corporation (including any amount treated as a dividend under section 1373(b)) shall not be considered a dividend for purposes of section 34, section 37, or section 116 to the extent that such amount is a distribution of property out of earnings and profits of the taxable year as specified in section 316(a)(2). For purposes of this subsection, the earnings and profits of the taxable year shall be deemed not to exceed the corporation's taxable income (computed as provided in section 1373(d)) for the taxable year.

"(c) *Treatment of family groups.* Any dividend received by a shareholder from an electing small business corporation (including any amount treated as a dividend under section 1373(b)) may be apportioned or allocated by the Secretary or his delegate between or among shareholders of such corporation who are members of such shareholder's family (as defined in section 704(e)(3)), if he determines that such apportionment or allocation is necessary in order to reflect the value of services rendered to the corporation by such shareholders.

"(d) *Distributions of undistributed taxable income previously taxed to shareholders*—(1) *Distributions not considered as dividends.* An electing small business corporation may distribute, in accordance with regulations prescribed by the Secretary or his delegate, to any shareholder all or any portion of the shareholder's net share of the corporation's undistributed taxable income for taxable years prior to the taxable year in which such distribution is made. Any such distribution shall, for purposes of this chapter, be considered a distribution which is not a dividend, but the earnings and profits of the corporation shall not be reduced by reason of any such distribution.

"(2) *Shareholder's net share of undistributed taxable income.* For purposes of this subsection, a shareholder's net share of the undistributed taxable income of an electing small business corporation is an amount equal to—

"(A) The sum of the amounts included in the gross income of the shareholder under section 1373(b) for all prior taxable years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year), reduced by

"(B) The sum of—

"(i) The amounts allowable under section 1374(b) as a deduction from gross income of the shareholder for all prior taxable years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year), and

"(ii) All amounts previously distributed during the taxable year and all prior taxable years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year) to the shareholder which under paragraph (1) were considered distributions which were not dividends."

[Sec. 1375 as added by sec. 64(a), Technical Amendments Act 1958 (72 Stat. 1654)]

§ 1.1375-1 Special rules applicable to capital gains.

(a) *In general.* The amount includible by a shareholder in gross income as dividends received from an electing small business corporation during any taxable year of such corporation shall be treated as long-term capital gain to the extent, if any, of such shareholder's pro rata share of the excess of the corporation's net long-term capital gain over its net short-term capital loss for such taxable year. For this purpose such excess shall not exceed the taxable income (as defined in section 1373(d) of the corporation for the taxable year. This capital gain treatment applies both to actual distributions of dividends and to amounts treated as dividends pursuant to section 1373(b); however, it applies only to the extent that a dividend is out of earnings and profits of the current taxable year of the corporation.

(b) *Determination of pro rata share.* To compute a shareholder's pro rata share of capital gain it is necessary to determine—

(1) The excess of the corporation's long-term capital gain over its short-term capital loss for the taxable year;

(2) The corporation's taxable income (as defined in section 1373(d)) for the taxable year;

(3) The amount of dividends from earnings and profits of the current taxable year included in such shareholder's gross income, determined in accordance with paragraphs (d) and (e) of § 1.1373-1; and

(4) The amount of dividends from earnings and profits of the current taxable year included in the gross income of all shareholders of the corporation during such taxable year.

The pro rata share is the amount which bears the same ratio to the lesser of the amounts determined in subparagraphs (1) and (2) of this paragraph as the amount determined in subparagraph (3) of this paragraph bears to the amount determined in subparagraph (4) of this paragraph.

(c) *Allocation of capital gains to various distributions.* If distributions of dividends (including amounts treated as dividends under section 1372(b))¹ out of the earnings and profits of the taxable year of an electing small business corporation are made to a shareholder at different times during the corporation's taxable year, the amount treated as capital gain to the shareholder pursuant to section 1375(a) shall be allocated ratably to the various distributions of such dividends. Thus, if the taxable year of the corporation includes portions of two taxable years of the shareholder, and in both of such years of the shareholder there are distributions treated as dividends out of earnings and profits of the corporation's taxable year, part of the capital gain is allocated to the earlier taxable year of the shareholder and part to the later taxable year.

(d) *Level for determining character of gain.* Ordinarily, for purposes of determining whether gain on the sale or exchange of an asset by an electing small business corporation is capital gain, the character of the asset is determined at the corporate level. However, if an electing small business 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

¹ See changes made in Notice of Proposed Rule Making issued March 17, 1959, which follows.

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. For this purpose, in determining the character of the asset 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.

(c) *Examples.* The application of this section may be illustrated by the following examples:

Example (1). An electing small business corporation which has three equal shareholders has net long-term capital gain in excess of net short-term capital loss of \$9,000 for its taxable year 1959. In that year it has taxable income (as defined in section 1373 (d)) and current earnings and profits in excess of \$9,000, but makes no distributions. Of the undistributed taxable income includible in the gross income of each of the three shareholders pursuant to section 1373 (b) as dividends deemed received, \$3,000 is treated as long-term capital gain.

Example (2). An electing small business corporation which has four equal shareholders has taxable income (as defined in section 1373(d)) and current earnings and profits of \$80,000 for the taxable year. It has an excess of \$100,000 of net long-term capital gain over net short-term capital loss for the taxable year. The corporation distributes \$100,000 in money during the taxable year, \$25,000 to each shareholder, all of which is treated as a dividend since the corporation had a substantial amount of accumulated earnings and profits at the beginning of the taxable year. However, since the amount which will be treated as long-term capital gain in the hands of the shareholders cannot exceed the corporation's taxable income for the taxable year, and is limited to distributions out of earnings and profits of the taxable year, the amount which can be treated as long-term capital gain by each shareholder is \$20,000.

Example (3). An electing small business corporation on the calendar year has two equal shareholders on fiscal years ending June 30. For the taxable year 1959 the corporation has taxable income and current earnings and profits of \$200,000 (including a long-term capital gain of \$80,000). The corporation distributes cash dividends of \$75,000 to each of its shareholders on March 15, 1959, and \$25,000 to each on September 15, 1959. Each shareholder's pro rata share of the corporation's capital gain is \$40,000 ($\frac{1}{2}$ of \$80,000).

of this share of the capital gain, \$30,000 ($\frac{\$75,000}{\$100,000} \times \$40,000$) is includible by each shareholder in his taxable year ending June 30, 1959, and \$10,000 thereof in his taxable year ended June 30, 1960.

§ 1.1375-2 Dividends received exclusion and credit not allowed.

(a) *In general.* Under section 1375 (b), the amounts includible in the gross income of a shareholder as dividends from an electing small business corporation (including amounts treated as dividends under section 1373(b)) are not considered dividends for purposes of section 34 (dividends received credit), section 37 (retirement income credit), and section 116 (partial dividends exclusion) to the extent that such amounts are distributions out of the earnings and profits of the taxable year. For purposes of the preceding sentence, the earnings and profits of the taxable year are deemed not to exceed the corporation's taxable income (as defined in section 1373(d)). For rules as to the allocation of the earnings and profits of the taxable year to distributions made during the year, see paragraphs (d) and (e) of § 1.1373-1.

(b) *Examples.* The following examples illustrate the application of section 1375(b) and paragraph (a) of this section:

Example (1). An electing small business corporation has taxable income (as defined in section 1373(d)) and earnings and profits of \$10,000 for the taxable year and accumulated earnings and profits of \$20,000 at the beginning of the taxable year. During the taxable year the corporation distributes a dividend of \$15,000 in money. Of the amount distributed, \$10,000 is not entitled to the dividends received exclusion under section 116 or the credits under section 34 or 37, since it is paid out of the earnings and profits of the corporation's taxable year. The \$5,000 paid out of accumulated earnings and profits is considered a dividend for purposes of the exclusion and credits.

Example (2). Assume the same facts as in example (1), except that the taxable income for the taxable year is \$9,000 and the corporation also received \$1,000 of tax-exempt interest on certain governmental obligations. Of the \$15,000 distributed, only \$9,000 would not be considered a dividend for purposes of the dividends received exclusion under section 116 or the credits

under section 34 or 37, since, for purposes of section 1375(b), the earnings and profits for the taxable year are deemed not to exceed taxable income (as defined in section 1373(d)).

§ 1.1375-3 Treatment of family groups.

(a) *In general.* Pursuant to section 1375(c) any dividend received by a shareholder from an electing small business corporation (including any amount treated as a dividend under section 1373(b)) may be apportioned or allocated by the district director between or among shareholders of such corporation who are members of such shareholder's family, if he determines that such apportionment or allocation is necessary in order to reflect the value of services rendered to the corporation by such shareholders. In determining the value of services rendered by a shareholder, consideration shall be given to all the facts and circumstances to all the facts and circumstances of the business, including the managerial responsibilities of the shareholder, and the amount that would ordinarily be paid in order to obtain comparable services from a person not having an interest in the corporation. The taxable income of the corporation shall be neither increased nor decreased because of the reallocation of dividends under section 1375(c). The amount reallocated shall be considered a dividend to the shareholder to whom it is reallocated.

(b) *Family defined.* For purposes of section 1375(c), the family of an individual shall include only his spouse, ancestors, and lineal descendants.

(c) *Example.* The provisions of section 1375(c) may be illustrated by the following example:

Example. The stock of an electing small business corporation is owned 50 percent by F and 50 percent by S, a minor son of F. For the taxable year the corporation has \$80,000 of taxable income and earnings and profits. During the year the corporation distributes dividends (including amounts treated as dividends under section 1373(b)) of \$35,000 to F and \$35,000 to S. Compensation of \$10,000 is paid by the corporation to F for services rendered during the year, and no compensation is paid to S, who rendered no services. Based on the relevant facts, a reasonable compensation for the services rendered by F would be \$30,000. In the discretion of the district director, up to \$10,000 of the \$25,000 dividend received by S may, for tax purposes, be allocated to F.¹

(d) *Effect of waiver of dividends resulting in disproportionate distributions among members of family.* If a non-pro rata distribution of dividends is made to members of a family group, the member of such group who receives less than his pro rata share of such distribution will be deemed to have waived his right to dividends to the extent that his distribution is less than his pro rata share, unless he can establish that the distribution was made disproportionately without his consent. In the case of such a waiver, the amount distributed to members of the family group shall be reallocated among all the members of the group in accordance with the number of shares owned by each member.

§ 1.1375-4 Distribution of previously taxed income.

(a) *In general.* Under section 1375(d)(1), a distribution by an electing small business corporation to a shareholder of all or any portion of his net share of previously taxed income is considered a distribution which is not a dividend. Such a distribution reduces the basis of the shareholder's stock in the corporation in accordance with section 301(c)(2), and, if it exceeds such basis, is subject to the provisions of section 301(c)(3). The earnings and profits of the corporations are not reduced by reason of such a distribution. If an election is terminated under section 1372(e), the corporation may not, during the first taxable year to which the termination applies or during any subsequent taxable year, distribute previously taxed income of taxable years prior to the termination as a nondividend distribution pursuant to this section.

(b) *Source of distribution.* Except as provided in paragraph (c) of this section, any actual distribution of money by an electing small business corporation to a shareholder which, but for the operation of this section, would be a dividend out of accumulated earnings and profits shall be considered a distribution of previously taxed income to the extent of the shareholder's net share of previously taxed income immediately before the distribution. Thus, a distribution of property other than money or a distribution in exchange for stock, or a constructive distribution under section 1373 (b), is never a distribution of previously taxed income. Since current earnings and profits are first applied to distributions of money which are not in exchange for stock (see paragraphs (d) and

¹ See changes made in Notice of Proposed Rule Making issued March 17, 1959, which follows.

(e) of § 1.1373-1), a distribution of previously taxed income may occur only if during its taxable year the corporation makes such money distributions in excess of its earnings and profits for such taxable year.

(c) *Election.* An electing small business corporation may, with the consent of all its shareholders, elect to treat distributions as out of accumulated earnings and profits rather than as distributions of previously taxed income. Such election must be filed with the return required under section 6037. Such election applies only with respect to distributions made by the corporation during the taxable year to which such return relates.

(d) *Shareholder's net share of previously taxed income.* A shareholder's net share of previously taxed income as of the time of a distribution is—

(1) The sum of the amounts included in the gross income of the shareholder under section 1373(b) for all of his taxable years ending before the distribution, less

(2) The sum of—

(i) The amounts allowable under section 1374(b) as a deduction from gross income of the shareholder for all of his taxable years ending before the distribution, and

(ii) The amounts previously distributed to the shareholder during his current taxable year and all of his prior taxable years, which, under section 1375 (d) (1), were not considered dividends.

In computing the sum of the amounts included in gross income under section 1373(b), only the amount included on the shareholder's income tax return for a prior taxable year is taken into account, unless the shareholder is not required to file a return for such prior taxable year. The amounts allowable under section 1374(b) as a deduction means all allowable deductions whether or not claimed on the income tax return of the shareholder and whether or not resulting in any tax benefit. If a new election is made subsequent to a termination under section 1372(e) of a prior election, a shareholder's net share of previously taxed income is determined solely by reference to taxable years which are subject to the new election.

(e) *Benefits not transferable.* A shareholder's right to nondividend distributions under this section is personal and cannot in any manner be transferred to another. If a shareholder transfers part but not all of his stock in an electing small business corporation his net share of previously taxed income is not reduced by reason of the transfer and the transferee does not acquire any part of such net share. If a shareholder transfers all of his stock in an electing small business corporation, any right which he may have had to nondividend treatment upon the receipt of distributions lapses entirely unless he again becomes a shareholder in the corporation while it is subject to the same election.

(f) *Record requirement.* A record of the net share of previously taxed income of each shareholder shall be maintained by the electing small business corporation. In addition, each shareholder of such corporation shall keep a record of his own net share of previously taxed income and shall make such record available to the corporation for its information.

(g) *Examples.* The operation of this section may be illustrated by the following examples:

Example (1). (i) Corporation X, of which A (a calendar year taxpayer) is the sole stockholder is an electing small business corporation for its taxable years ended December 31, 1958, 1959, and 1960. For its taxable year 1958 it has a net operating loss of \$10,000. For its taxable year 1959 it has undistributed taxable income of \$50,000. Assuming that A included in his return the undistributed taxable income for 1959 and assuming that the 1958 net operating loss did not exceed the limitation imposed by section 1374(c)(2), A's net share of previously taxed income as of January 1, 1960, is \$40,000.

(ii) Assume the additional fact that for the taxable year 1960 Corporation X has a net operating loss of \$40,000, which is fully allowable to A as a deduction. This net operating loss does not affect A's share of previously taxed income for purposes of determining the nature of distributions during 1960, since such net share is reduced only by the deductions allowable for taxable years of the shareholder ending before the distribution. However, in computing his net share of previously taxed income for years subsequent to 1960, A must take the \$40,000 deduction for 1960 into account.

(iii) If in 1960, at a time when his net share of previously taxed income is \$40,000, A sold his stock in the corporation to B, who was not previously a shareholder. B's net share of previously taxed income as of the date of purchase would be zero. The result would be the same if, for example, B had received the stock by gift or by bequest from A.

Example (2). Corporation Y, an electing small business corporation, is on a fiscal year ending January 31. C, a shareholder in the corporation, is on a calendar year. For its fiscal year ending January 31, 1960, corporation Y has \$50,000 of undistributed taxable income, half of which is included in C's gross income for his taxable year 1960. The amount so included does not increase C's net share of previously taxed income for purposes of distributions at any time during 1960, since his net share of previously taxed income is increased only by amounts included in gross income for his taxable years ending before the distribution.

Example (3). Corporation Z, an electing small business corporation, has two equal shareholders, A and B (both calendar year taxpayers), during its taxable year ended December 31, 1960. No election is made under paragraph (c) of this section. As of the beginning of 1960 the corporation has \$20,000 of accumulated earnings and profits. For the taxable year 1960, corporation Z has current earnings and profits and taxable income of \$8,000. In June 1960, it makes money distributions of \$5,000 to A and \$5,000 to B, and in November 1960, it distributes the same amount in money to each. Immediately before the distribution in June, A's net share of previously taxed income was \$6,000 and B's net share was \$4,000. Current earnings and profits are allocated ratably to each of the four distributions. (See paragraphs (d) and (e) of § 1.1373-1.) Therefore, each distribution to A and B is a dividend from current earnings and profits to the extent of \$2,000. As to the June distribution, the \$3,000 distributed to A and B which is not out of current earnings and profits is a distribution of previously taxed income and therefore not a dividend, since immediately before the distribution the net share of each is in excess of \$3,000. As to the November distribution, the \$3,000 distributed to A which is not out of current earnings and profits is a nondividend distribution since his net share of previously taxed income at that date is \$3,000 (\$6,000 less \$3,000 absorbed by the June distribution); however, the \$3,000 distribution to B is not out of current earnings and profits is a nondividend distribution to the extent of \$1,000 and a dividend from accumulated earnings and profits to the extent of \$2,000, since his net share of previously taxed income at that date is \$1,000 (\$4,000 less \$3,000 absorbed by the June distribution).

Example (4). Corporation N, an electing small business corporation, has current earnings and profits and taxable income of \$30,000 for 1960. As of the beginning of that taxable year it has \$20,000 of accumulated earnings and profits. During the year the corporation distributes \$28,000 in money to its shareholders and makes a distribution of property other than money with a fair market value and basis of \$10,000. Since current earnings and profits are applied first to the distributions of money (see paragraphs (d) and (e) of § 1.1373-1), the entire distribution of \$28,000 is a dividend out of current earnings and profits. In addition, since a distribution of previously taxed income cannot be made in property other than money, the property distribution is a dividend to the full extent of its value, \$10,000, partly from current and partly from accumulated earnings and profits.

§ 1.1376 Statutory provisions; adjustment to basis of stock of, and indebtedness owing, shareholders.

"SEC. 1376. Adjustment to basis of stock of, and indebtedness owing, shareholders—(a) Increase in basis of stock for amounts treated as dividends. The basis of a shareholder's stock in an electing small business corporation shall be increased by the amount required to be included in the gross income of such shareholder under section 1373(b), but only to the extent to which such amount is included in his gross income in his return, increased or decreased by any adjustment of such amount in any redetermination of the shareholder's tax liability.

"(b) Reduction in basis of stock and indebtedness for shareholder's portion of corporation net operating loss—(1) Reduction in basis of stock. The basis of a shareholder's stock in an electing small business corporation shall be reduced (but not below zero) by an amount equal to the amount of his portion of the corporation's net operating loss for any taxable year attributable to such stock (as determined under section 1374(c)).

"(2) Reduction in basis of indebtedness. The basis of any indebtedness of an electing small business corporation to a shareholder of such corporation shall be reduced (but not below zero) by an amount equal to the amount of the shareholder's portion of the corporation's net operating loss for any taxable year (as determined under section 1374(c)), but only to the extent that such amount

exceeds the adjusted basis of the stock of such corporation held by the shareholder."

[Sec. 1376 as added by sec. 64(a), Technical Amendments Act 1958 (72 Stat. 1655)]

§ 1.1376-1 Adjustment to basis of stock of, and indebtedness to, shareholders.

Increase in basis of stock. Under section 1376(a) the basis of a shareholder's stock in an electing small business corporation is increased by the amount required to be included in the gross income of such shareholder under section 1373(b), but only to the extent to which such amount is actually included in his gross income in his income tax return (unless under section 6012(a)(1) the shareholder is not required to file a return), increased or decreased by any adjustment of such amount in any redetermination of the shareholder's tax liability. The effect of this rule is the same as if, on the last day of the corporation's taxable year, such amount had actually been distributed as a dividend and then reinvested by such shareholder. This increase in basis will affect only those shares of stock of the electing small business corporation which the shareholder owned at the end of the corporation's taxable year and is apportioned in equal amounts to each such share. The increase is effective as of such last day, and survives a termination of the corporation's election. See section 1372(b)(2).

§ 1.1376-2 Reduction in basis of stock and indebtedness.

(a) *Reduction in basis of stock*—(1) *In general.* Under section 1376(b)(1), the basis of a shareholder's stock in an electing small business corporation is reduced by an amount equal to his portion of the corporation's net operating loss for any taxable year attributable to such stock. However, the basis of such stock is not to be reduced below zero.

(2) *Amount of reduction in basis of individual shares.* (i) The amount of the reduction in the basis of each share of stock shall be that portion of the shareholder's pro rata share of the corporation's net operating loss which is attributable to each such share under the rule in section 1374(c). In the event that the basis reduction applicable to a share of stock under the rule in the preceding sentence exceeds the basis of such share, the excess shall be applied in reduction of the basis of all other shares of stock owned by the same shareholder in proportion to the basis of such shares remaining after the application of the rule in the preceding sentence.

(ii) The application of this subparagraph may be illustrated by the following example:

Example. A's pro rata share of the corporation's net operating loss for the taxable year is \$100. This amount is attributable, under the rule of section 1374(c), to three shares of stock held by A during the taxable year; one of which was owned by him during the entire year and the other two of which were acquired by him in the middle of the year. The amount of the pro rata share of the loss attributable to each share is as follows:

Share No. 1 (owned for entire year).....	\$50
Share No. 2 (owned for one-half year).....	25
Share No. 3 (owned for one-half year).....	25

The reduction in basis of share No. 1 is \$50, and the reduction in basis of shares No. 2 and No. 3 is \$25 each. Assume that the adjusted basis of the three shares of stock prior to this reduction is as follows:

Share No. 1.....	\$40
Share No. 2.....	45
Share No. 3.....	35

After the reduction in basis by the amount of the loss attributable to each share, the basis of the shares is as follows:

Share No. 1.....	\$0
Share No. 2.....	20
Share No. 3.....	10

The \$10 excess of the basis reduction allocable to share No. 1 over the basis of that share is applied to reduce the basis of shares No. 2 and No. 3 in proportion to their remaining basis. Therefore, \$6.67 of such excess reduces the basis of share No. 2, and \$3.33 of such excess reduces the basis of share No. 3. After this reduction the shares have the following basis:

Share No. 1.....	\$0
Share No. 2.....	13.33
Share No. 3.....	6.67

(3) *Time of reduction.* (i) The reduction in the basis of stock provided under section 1376(b)(1) shall be effective as of the close of the corporation's taxable year in which the net operating loss was incurred as to stock which is held at such time and as of the close of the day before disposition if the stock was disposed of prior to that time.

(ii) The application of this subparagraph may be illustrated by the following example:

Example. Corporation X, an electing small business corporation, is on a calendar year. On June 2, 1960, A, a shareholder in corporation X, sells 50 shares of stock which, without regard to section 1376(b)(1), have a basis of \$10,000. At the end of 1960 it is determined that corporation X has a net operating loss for the year, and \$1,000 of A's pro rata share of such loss is attributable to the 50 shares sold in June. The reduction in basis required by section 1376(b)(1) is effective as of the close of June 1, 1960, the day before the sale, and A's basis for purposes of determining gain or loss on the sale is \$9,000.

(b) *Reduction in basis of indebtedness*—(1) *In general.* Under section 1376(b) (2), the basis of any indebtedness of an electing small business corporation to a shareholder is reduced by an amount equal to the shareholder's portion of the corporation's net operating loss for the taxable year, but only to the extent that such amount exceeds the basis of the shareholder's stock in the corporation. Thus, the amount of the shareholder's portion of the net operating loss is first applied in reduction of the basis of his stock in accordance with the rules of paragraph (a) of this section, and only the remainder, if any, reduces the basis of the indebtedness.

(2) *Indebtedness affected by basis reduction.* The reduction in the basis of indebtedness provided by section 1376 (b) (2) shall apply to the indebtedness to the shareholder as of the close of the corporation's taxable year in which the net operating loss was incurred if the shareholder held stock in the corporation at such time, or, if the shareholder was not a shareholder at such time, then as of the close of the last day on which he was a shareholder.

(3) *Amount of reduction in basis of more than one indebtedness.* If more than one indebtedness is affected by the basis reduction provided by section 1376 (b) (2), the reduction shall be applied to each such indebtedness in proportion to the basis of the various debts.

(4) *Time of reduction.* The reduction in the basis of indebtedness provided by section 1376(b)(2) shall be effective as of the close of the corporation's taxable year in which the net operating loss was incurred if the shareholder held stock in the corporation at that time, or, if the shareholder was not a shareholder at that time, then as of the last day on which he was a shareholder.

§ 1.1377 Statutory provisions; special rules applicable to earnings and profits of electing small business corporation.

"SEC. 1377. *Special rules applicable to earnings and profits of electing small business corporations*—(a) *Reduction for undistributed taxable income.* The accumulated earnings and profits of an electing small business corporation as of the close of its taxable year shall be reduced to the extent that its undistributed taxable income for such year is required to be included in the gross income of the shareholders of such corporation under section 1373(b).

"(b) *Current earnings and profits not reduced by any amount not allowable as deduction.* The earnings and profits of an electing small business corporation for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income (as provided in section 1373(d)) for such taxable year.

"(c) *Earnings and profits not affected by net operating loss.* The earnings and profits and the accumulated earnings and profits of an electing small business corporation shall not be affected by any item of gross income or any deduction taken into account in determining the amount of any net operating loss (computed as provided in section 1374(c)) of such corporation."

[Sec. 1377 as added by sec. 64(a), Technical Amendments Act 1958 (72 Stat. 1656)]

§ 1.377-1 Reduction of earnings and profits for undistributed taxable income.

Section 1377(a) provides that the accumulated earnings and profits of an electing small business corporation as of the close of its taxable year shall be reduced to the extent that its undistributed taxable income for such year is required to be included in the gross income of shareholders under section 1373(b). See section 1375(d) and paragraph (a) of § 1.1375-4 for the correlative rule that distributions of previously taxed income do not reduce earnings and profits.

§ 1.1377-2 Current earnings and profits not reduced by any amount not allowable as a deduction.

(a)(1) The earnings and profits of an electing small business corporation for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for such taxable year.

(2) The application of this paragraph may be illustrated by the following examples:

Example (1). Corporation X has \$300,000 of accumulated earnings and profits as of the beginning of the taxable year. It would have had earnings and profits of \$400,000 for the taxable year (taking into account a net capital loss of \$100,000, which amount was not deductible in determining its taxable income) but because it is an electing small business corporation it has earnings and profits of \$500,000 for the taxable year. If the corporation makes a dividend distribution during the year in the amount of \$500,000, all of such amount will be considered a distribution of current earnings and profits. However, the corporation will have only \$200,000 of accumulated earnings and profits as of the beginning of the following taxable year.

Example (2). Assume the same facts as in example (1), except that the corporation does not have any accumulated earnings and profits as of the beginning of the taxable year. The entire \$500,000 distribution is a distribution of current earnings and profits. As of the beginning of the year following the taxable year in which the \$500,000 distribution was made, the corporation has neither accumulated earnings and profits nor a deficit in accumulated earnings and profits. It would begin such year with its paid-in capital reduced by \$100,000.

(b) Except as otherwise provided in section 1377, the earnings and profits of the taxable year of an electing small business corporation are computed in the same manner as the earnings and profits of corporations generally. Therefore, such earnings and profits can exceed the taxable income of the corporation, as in the case of a corporation which uses percentage depletion in computing its taxable income or which receives tax-exempt interest on certain governmental obligations.

§ 1.1377-3 Earnings and profits not affected by net operating loss.

(a) Under section 1377(c), the current earnings and profits and the accumulated earnings and profits of an electing small business corporation are not affected by any item of gross income or any deduction taken into account in determining the amount of any net operating loss (computed as provided in section 1374(c)(1)) of such corporation.

(b) The application of this section may be illustrated by the following example:

Example. At the beginning of its calendar year 1960 corporation X, an electing small business corporation, has accumulated earnings and profits of \$50,000. During 1960 the corporation has \$5,000 of gross income and deductible expenses of \$15,000, which produce a \$10,000 net operating loss for the taxable year. If corporation X were not an electing small business corporation, its accumulated earnings and profits as of January 1, 1961, would have been \$40,000. However, since corporation X was an electing small business corporation for 1960, its accumulated earnings and profits are not affected by the income and deductions for 1960 because they are taken into account in determining the net operating loss. Accordingly, the accumulated earnings and profits of corporation X as of January 1, 1961, are \$50,000.

PAR. 2. The following regulations are hereby prescribed under section 6037 of the Internal Revenue Code of 1954:

§ 1.6037 Statutory provisions; return of electing small business corporation.

"SEC. 6037. *Return of electing small business corporation.* Every electing small business corporation (as defined in section 1371(a)(2)) shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowable by subtitle A, the names and addresses of all persons owning stock in the corporation at any time during the taxable year, the number of shares of stock owned by each shareholder at all times during the taxable year, the amount of money and other property distributed by the corporation during the taxable year to each shareholder, the date of each such distribution, and such other information, for the purpose of carrying out the provisions of subchapter S of chapter 1, as the Secretary or his delegate may by forms and regulations prescribe.

Any return filed pursuant to this section shall, for purposes of chapter 66 (relating to limitations), be treated as a return filed by the corporation under section 6012."

[Sec. 6037 as added by sec. 64(c), Technical Amendments Act, 1958 (72 Stat. 1656)]

§ 1.6037-1 Return of electing small business corporation.

(a) *In general.* Every small business corporation (as defined in section 1371 (a)) which has made an election under section 1372(a) not to be subject to the tax imposed by chapter 1 of the Code shall file, with respect to each taxable year for which the election is in effect, a return of income on Form 1120-S. The return shall set forth the items of gross income and the deductions allowable in computing taxable income as required by the return form or in the instructions issued with respect thereto. The return shall also set forth the following information concerning the electing small business corporation:

(1) The names and addresses of all persons owning stock in the corporation at any time during the taxable year;

(2) The number of shares of stock owned by each shareholder at all times during the taxable year;

(3) The amount of money and other property distributed by the corporation during the taxable year to each shareholder;

(4) The date of each distribution of money and other property; and

(5) Such other information as is required by the form or by the instructions issued with respect to such form.

(b) *Time and place for filing return.* The return shall be filed on or before the 15th day of the third month following the close of the taxable year with the district director for the internal revenue district in which the corporation's principal place of business or principal office or agency is located. (See section 6072.)

(c) *Other provisions.* The return on Form 1120-S will be treated as a return filed by the corporation under section 6012, relating to persons required to make returns of income, for purposes of the provisions of chapter 66 of the Code, relating to limitations. Thus, for example, the period of limitation on assessment and collection of any corporate tax found to be due upon a subsequent determination that the corporation was not entitled to the benefits of subchapter S of chapter 1 of the Code will run from the date of filing the return under section 6037, or from the date prescribed for filing such return, whichever is the later.

(d) *Penalties.* For criminal penalties for failure to file a return, supply information, or pay tax, and for filing a false or fraudulent return, statement, or other document, see sections 7203, 7206, and 7207.

PAR. 3. Section 1.442-1 of the Income Tax Regulations (26 CFR 1.442-1) is amended by inserting a principal heading for such section, by revising the heading for paragraph (a), by revising paragraphs (b)(1), (c)(1), and (f), and by inserting paragraph (c)(4), so that such headings and paragraphs under § 1.442-1 will read as follows:

§ 1.442-1 Change of annual accounting period.

(a) *Manner of effecting such change.* * * *

(b) *Prior approval of the Commissioner.*—(1) *In general.* In order to secure prior approval of a change of a taxpayer's annual accounting period, the taxpayer must file an application on Form 1128 with the Commissioner of Internal Revenue, Washington 25, D.C., on or before the last day of the month following the close of the short period for which a return is required to effect the change of accounting period. In general, a change of annual accounting period will be approved where the taxpayer establishes a substantial business purpose for making the change. In determining whether a taxpayer has established a substantial business purpose for making the change, consideration will be given to all the facts and circumstances relating to the change, including the tax consequences resulting therefrom. If the effect of the change is to defer a substantial portion of the taxpayer's income, or to shift a substantial portion of deductions, from one year to another so as to reduce substantially the tax liability of the taxpayer, the change will ordinarily not be approved. Further, approval will ordinarily be denied if the effect of the change is to cause a similar deferral or shifting in the case of another taxpayer, such as a partner, beneficiary, shareholder in an electing small business corporation as defined in section 1371(b), etc., so as to reduce substantially such other taxpayer's tax liability. In addition, a change will ordinarily not be approved if the short period resulting from the change is one in which there is a net operating loss or, in the case of an electing small business corporation, if a substantial portion of the income of such corporation for the short period consists of amounts treated as long-term capital gain. Among the nontax factors that will be considered in determining whether a substantial business purpose has been

established is the effect of the change on the taxpayer's annual cycle of business activity. However, even though a substantial business purpose is not established, the Commissioner in appropriate cases may permit a husband and wife to change his or her taxable year in order to secure the benefits of section 2 (relating to tax in the case of joint returns). See paragraph (c) of this section for special rule for newly married couples.

* * * * *

(c) *Special rule for certain corporations.* (1) A corporation (other than a corporation to which subparagraph (4) of this paragraph applies) may change its annual accounting period without the prior approval of the Commissioner if all the conditions in subparagraph (2) of this paragraph are met, and if the corporation files a statement with the district director of internal revenue with whom the returns of the corporation are filed at or before the time (including extensions) for filing the return for the short period required by such change. This statement shall indicate that the corporation is changing its annual accounting period under § 1.442-1(c) and shall contain information indicating that all of the conditions in subparagraph (2) of this paragraph have been met.

* * * * *

(4) A corporation which is an electing small business corporation during the short period required to effect the change of annual accounting period may change its taxable year only if it secures the prior approval of the Commissioner in accordance with paragraph (b)(1) of this section. This subparagraph shall apply only if such short period ends after February 28, 1959.

* * * * *

(f) *Effective date.* The provisions of this section (other than paragraphs (c) (4) and (e) thereof) are effective for any change of annual accounting period where the last day of the short period to effect the change ends on or after March 1, 1957, the date the regulations under section 442 are published in the FEDERAL REGISTER.

[F.R. Doc. 59-2102; Filed, Mar. 11, 1959]

CHANGES IN PROPOSED REGULATIONS OF THE TREASURY DEPARTMENT IN CONNECTION WITH SMALL BUSINESS CORPORATIONS (MARCH 17, 1959)

DEPARTMENT OF THE TREASURY

Internal Revenue Service

[26 CFR (1954) Part 1]

INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

NOTICE OF PROPOSED RULEMAKING

Correction

In F. R. Document 59-2102, appearing in the issue for Thursday, March 12, 1959, at page 1793, make the following changes:

1. Last two sentences of paragraph (d) of § 1.13171-1 should be deleted, and the following two sentences should be substituted therefor: "However, if stock is owned by a trust which is subject to the provisions of subchapter J of chapter 1 of the Code or by a voting trust, the trust is considered the shareholder even though the dividends paid to the trust are includible directly in the income of the grantor or some other person. If stock is owned by a partnership, such partnership and not its partners is considered to be the shareholder."

2. Second sentence of paragraph (e) of § 1.13171-1 should be changed to read: "The word 'trust' as used in this paragraph includes all trusts subject to the provisions of subchapter J of chapter 1 of the Code (including subpart E thereof) and voting trusts."

3. Subparagraph (1) of paragraph (c) of § 1.372-1 should be changed to read:

(1) In general, except as otherwise provided in section 1373(d), taxable income of an electing small business corporation is computed in the same manner that it would have been had no election been made.

4. The reference to section 1372(a)(5) appearing in the first and fifth sentences of subdivision (iv) of § 1.1372-4(b)(5) should be changed to section 1372(e)(5).

5. Subdivision (vi) of § 1.1372-4(b)(5) should be changed by deleting the words "includible in gross income".

6. Parenthetical material appearing in the first sentence of paragraph (c) of § 1.1375-1 should be changed to read: "(including amounts treated as dividends under section 1373(b))".

7. The example appearing under paragraph (c) of § 1.1375-3 should be changed to read as follows:

Example. The stock of an electing small business corporation is owned 50 percent by F and 50 percent by S, a minor son of F. For the taxable year the corporation has \$70,000 of taxable income and earnings and profits. During the year the corporation distributes dividends (including amounts treated as dividends under section 1373(b)) of \$35,000 to F and \$35,000 to S. Compensation of \$10,000 is paid by the corporation to F for services rendered during the year, and no compensation is paid to S, who rendered no services. Based on the relevant facts, a reasonable compensation for the services rendered by F would be \$30,000. In the discretion of the district director, up to \$10,000 of the \$35,000 dividend received by S may, for tax purposes, be allocated to F.

FORM 2553

SEPTEMBER 1958

U. S. TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE**ELECTION BY SMALL BUSINESS CORPORATION**As to taxable status under subchapter S
of the Internal Revenue Code

NOTE: This election under section 1372(a) (with the consent of all your stockholders) to be treated as a "small business corporation" for income tax purposes may be made only if the corporation is a domestic corporation which is not a member of an affiliated group (as

defined in section 1504) and which does not have (1) more than 10 shareholders; (2) a shareholder (other than an estate) who is not an individual; (3) a shareholder who is a nonresident alien; and (4) more than one class of stock.

Name of corporation

Number and street

City or town, postal zone number, county, State

Date submitted

First taxable year for which
election is effective

Place incorporated

Date incorporated

Number of shares issued and
outstandingIs the corporation the out-
growth or continuation of any
form of predecessor?If "Yes", state name of predecessor, type of organization, and the period during which it was in
existence☐ YES ☐ NO

Principal business activity (see instruction F)

Name and address of each shareholder	Number of shares	Internal Revenue District where individual return is filed
1.....		
2.....		
3.....		
4.....		
5.....		
6.....		
7.....		
8.....		
9.....		
10.....		

NOTE: In order for this election to be valid, the consent statement of each stockholder must be submitted with this form. See instruction E.

SIGNATURE AND VERIFICATION

I declare under penalties of perjury that this election is duly authorized, and that the statements made herein are to the best of my knowledge and belief true, correct, and complete statements.

(Date)

(Signature of officer)

(Title)

PURPOSE

The purpose of this election is to permit the taxable income of a "small business corporation", to the extent that it exceeds dividends distributed in money out of earnings and profits of the taxable year, to be taxed directly to the shareholders (rather than to the corporation) to the extent that it would have constituted a dividend if it had been distributed on the last day of the corporation's taxable year.

INSTRUCTIONS

A. Corporations eligible to elect.—The election may be made only if the corporation is a domestic corporation; is not a member of an affiliated group of corporations, as defined in section 1504 of the Code; and does not have (1) more than one class of stock, (2) more than 10 shareholders, (3) a shareholder (other than an estate) who is not an individual, or (4) a shareholder who is a nonresident alien.

B. Valid election.—This election shall be valid only if all persons who are shareholders of the corporation on the first day of the corporation's taxable year or on the day of election, whichever is later, consent to such election. In no event will an election be valid if the consents (see instruction E) are filed after the last day prescribed for filing the election.

C. Taxable year to which election may be made.—The election may be made only with respect to a taxable year beginning after December 31, 1957, and ending after September 2, 1958. It shall be effective for the taxable year for which it is made and for all succeeding taxable years unless it is terminated under section 1372(e).

D. Time of making election.—This form must be completed and filed for any taxable year during (a) the first calendar month of such taxable year, or (b) the calendar month preceding such first calendar month; EXCEPT that for any taxable year which begins after December 31, 1957, and before September 3, 1958, and which ends after September 2, 1958, the form must be filed on or before December 1, 1958, or on or before the last day of the taxable year, whichever is earlier. However, where the time for making the election falls within the exception above, there is a further qualification that the corporation must have been a small business corporation on each day after September 2, 1958, and before the day of election.

E. Shareholders' statement of consent.—The shareholders' consent shall be in the form of a statement signed by the shareholders in which each shareholder consents to the election of the corporation. The statement shall set forth the name and address of the corporation and of each shareholder, the number of shares of stock owned by each shareholder, and the date(s) on which such stock was acquired. The consents of all shareholders at the date of election shall be attached to this form. If the election is made before the first day of the corporation's taxable year, the consents of persons who became shareholders after the date of the election and on or before such first day shall be filed with the district director with whom this election was filed as soon as practicable after such first day but in no event later than the last day prescribed for filing the election.

F. Principal business activity.—In reporting the principal business activity give the one business activity that accounts for the largest percentage of "total receipts". "Total receipts" means gross sales and/or gross receipts, plus all other income. State the broad field of business activity as well as the specific product or service, such as "Mining copper", "Manufacturing cotton broad woven fabric", "Wholesale food", or "Retail apparel".

G. Where to file.—This election is to be filed with the District Director of Internal Revenue for the district in which the corporation's principal place of business or principal office or agency is located.

H. Signature and verification.—This form must be signed either by the president, vice-president, treasurer, assistant treasurer or chief accounting officer, or other corporate officer (such as tax officer) who is authorized to sign.

U. S. GOVERNMENT PRINTING OFFICE: 1958 O - 108545

EXCERPTS FROM INSTRUCTIONS FOR THE 1958 FORM 1120-S—U.S. SMALL BUSINESS CORPORATION RETURN OF INCOME

(References are to the Internal Revenue Code)

A. Corporations required to file Form 1120-S.—Every small business corporation (as defined in section 1371(a)) which has filed a proper and timely election under section 1372(a) not to be subject to the income tax imposed by chapter 1 must file Form 1120-S. See form 2553.

B. Consents of shareholders.—Consents of all shareholders are required to be attached to the election form notifying the District Director of the election. However, where the election was made before the first day of the taxable year, the consents of persons who became shareholders after the date of election and on or before such first day must be filed with the District Director with whom the election was filed as soon as practicable after such first day and in no event later than the last day prescribed for making the election. Copies of such latter consents must be attached to the Form 1120-S at the time the return is filed.

New shareholders (any person who was not a shareholder on the first day of the first taxable year for which the election is effective, or on the day on which the election is made, whichever is later) must consent to the election and such statement of consent must be filed with the District Director with whom the election was filed within a period of 30 days after they become shareholders or the election is automatically terminated. Copies of such consents must also be attached to the return.

C. Termination.—The election by the corporation is automatically terminated (1) by the failure of a new shareholder to consent to such election as explained in B above; (2) where it ceases to be a small business corporation as defined in section 1371(a); (3) where it derives more than 80 percent of its gross receipts from sources outside the U.S.; or (4) where it has gross receipts of which more than 20 percent

is derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from sales or exchanges being taken into account for this purpose only to the extent of gains therefrom). Such termination is effective for the taxable year in which any one of the foregoing occurs and for all succeeding taxable years of the corporation.

The election may be revoked for any taxable year after the first taxable year for which the election is effective. An election to revoke may be made only if all persons who are shareholders on the day on which the revocation is made consent to the revocation. The revocation is effective (1) for the taxable year in which made, if made before the close of the first month of the taxable year, or (2) for the taxable year following the taxable year in which made, if made after the close of the first month; and for all succeeding taxable years. The revocation is to be made in the manner prescribed by regulations.

Where the small business corporation has elected under section 1372(a) and the election has been terminated or revoked, the corporation is not eligible to again elect under 1772(a) for five years unless the Secretary or his delegate consents to such an election.

D. Period to be covered by return.—The return shall be filed for the calendar year 1958 or other taxable year beginning in 1958.

E. Time and place for filing.—The return must be filed on or before the 15th day of the third month following the close of the taxable year with the District Director of Internal Revenue for the district in which the corporation's principal place of business or principal office or agency is located. (Section 6072.)

H. Accounting methods.—Taxable income shall be computed in accordance with the method of accounting regularly used by the taxpayer in maintaining its books and records. In all cases the method adopted should clearly reflect taxable income. The basic methods of accounting are the "cash receipts and disbursements method" and the "accrual method." Section 446 permits the use of these methods or any other method permitted under the Code or any combination of these methods in accordance with regulations. If a taxpayer engages in more than one trade or business, it may, with respect to each trade or business, use a different method of accounting. Each method must, however, clearly reflect the income of the particular trade or business with which it is used, and separate profit and loss statements for each trade or business must be submitted. Except in those cases where the law specifically permits it, a taxpayer may not change the method of accounting upon the basis of which it has reported its income in prior years (for its income as a whole or with respect to any separate trade or business) without first securing consent. For procedure to be followed in securing consent, see your District Director.

L. Net operating loss and other deductions.—The deduction for net operating losses provided by section 172 and the Special Deductions provided in Part VIII (except section 248) of subchapter B, shall not be allowed to an electing small business corporation. (Section 1373 (d).)

SCHEDULE K. SHAREHOLDER'S SHARE OF INCOME.—The schedule of Distribution and Income should show complete information with respect to all the persons who were shareholders of the corporation during any portion of the taxable year. Under the tax treatment provided by Subchapter S, shareholders generally are taxable upon their distributive shares of the current taxable income of the corporation, whether or not actually distributed. Since each shareholder is required to include his share in his individual return, he should be furnished the information applicable to him.

Column 1.—Enter the name and address of each shareholder. Where return of shareholder is filed in an internal revenue district other than that which this return is filed, specify district.

Column 2.—Enter the number of shares of stock owned by each shareholder. If the number of shares owned by a shareholder changed during the year, show separately the number of shares held for each period.

Column 3.—Enter the percentage of time devoted to the business by each shareholder.

Column 4.—Enter salary and other payments to each shareholder for services rendered.

Column 5.—Enter for each shareholder the date and amount of each dividend distribution made in money or property, during the taxable year.

Column 6.—Enter for each shareholder who was a shareholder on the last day of the corporation's taxable year, his portion of the corporation's undistributed taxable income. A shareholder's portion of the undistributed taxable income is the amount which he would have received as a dividend if such income had been

distributed pro rata to the shareholders on the last day of the corporation's taxable year. A dividend distribution of property other than money may cause line 3 to exceed the total of column 6.

In the case of a net operating loss for the taxable year, enter in this column for each shareholder who was a shareholder at any time during the corporation's taxable year his pro rata share of the loss. For treatment of, determination of, and limitation on a shareholder's pro rata share of such loss, see section 1374 and the regulations thereunder.

Column 7.—Enter for each shareholder his pro rata share of the corporation's excess of net long-term capital gain over net short-term capital loss (line 8b, page 1). Each shareholder is entitled to treat as long-term capital gain a portion of the sum of the dividends he received plus his share of the constructive dividends derived from the undistributed taxable income. A shareholder's portion is determined by applying to such excess the same ratio that the amount of his dividends (actual or constructive) which are out of earnings and profits of the current year bears to the total dividends (actual or constructive) includible by all shareholders from the same source. In making the allocation, the excess of net long-term capital gain over short-term capital loss cannot exceed taxable income (line 27, page 1). The amount entered here should be reported on Schedule D of his individual income tax return as a long-term capital gain from an "electing small business corporation".

Column 8.—Enter in this column for each shareholder the amount of money or property includible in the income of the shareholder as dividends from the small business corporation which are entitled to the dividends received exclusion provided by section 116 and the credit provided by section 34. Of the amounts includible in the gross income of a shareholder as dividends from an electing small business corporation, only those which are not considered to be out of the earnings and profits of the taxable year are entitled to the dividends received exclusion and credit. For purposes of this rule the earnings and profits of the taxable year are deemed not to exceed the taxable income for the year. The dividends entitled to the exclusion and credit would include, for example, dividends paid out of accumulated earnings and profits and from interest on tax exempt securities. The amounts shown in this column should be entered by the shareholders in Schedule A of their individual income tax returns, Forms 1040.

Column 9.—Enter in this column for each shareholder the sum of the dividends actually distributed (column 5) and the constructive dividends derived from undistributed taxable income (column 6), less the sum of the amount treated as long-term capital gain (column 7) and the amount of dividends entitled to the dividends received exclusion and credit (column 8). The amounts shown in this column should be entered by the shareholders as ordinary income in Schedule H of their individual income tax returns, Forms 1040.

Column 10.—Enter in this column for each shareholder the date and the amount of each distribution of money and property not out of earnings and profits. For taxable years after the first taxable year to which the election applies, include any distribution of accumulated undistributed taxable income. See section 1375(d).

GENERAL INFORMATION

1. A net operating loss for any taxable year shall be allowed as a deduction from gross income of the shareholders in the manner and to the extent set forth in section 1374.

2. For treatment of family groups, see section 1375(c).

3. For the adjustment to basis of stock of, and indebtedness owing to, shareholders, see section 1376.

4. For special rules applying to earnings and profits, see section 1377.

FORM 1120-S U. S. Treasury Department Internal Revenue Service	U. S. SMALL BUSINESS CORPORATION RETURN OF INCOME FOR CALENDAR YEAR 1958 or other taxable year beginning..... 1958, and ending 195	1958
Date of election as small business corporation	PLEASE TYPE OR PRINT PLAINLY	
Employer's identification number	Name Number and street City or town, postal zone number, State	
GROSS INCOME		
1. Gross receipts..... Less: Returns and allowances..... 2. Less: Cost of goods sold (Schedule A) and/or operations (Schedule B)..... 3. Gross profit..... 4. Dividends..... 5. Interest (Schedule C)..... 6. Rents..... 7. Royalties..... 8. Gains and losses (from separate Schedule D (Form 1120-S)) (a) Net short-term capital gain reduced by any net long-term capital loss..... (b) Net long-term capital gain reduced by any net short-term capital loss..... (c) Net gain (loss) from sale or exchange of property other than capital assets..... 9. Other income (Attach schedule)..... 10. Total income, lines 3 to 9, inclusive.....		
DEDUCTIONS		
11. Compensation of officers..... 12. Salaries and wages (not deducted elsewhere)..... 13. Rents..... 14. Repairs (Do not include cost of improvements or capital expenditure)..... 15. Bad debts (Schedule F)..... 16. Interest..... 17. Taxes (Schedule G)..... 18. Contributions or gifts paid (Schedule H)..... 19. Losses by fire, storm, shipwreck, or other casualty, or theft (Attach schedule)..... 20. Amortization (Attach schedule)..... 21. Depreciation (Schedule I)..... 22. Depletion of mines, oil and gas wells, timber, etc. (Attach schedule)..... 23. Advertising (Attach schedule)..... 24. Amounts contributed under: (a) Pension, annuity, stock bonus, or profit-sharing plans (Attach schedule)..... (b) Other employee benefit plans (Attach schedule)..... 25. Other deductions (Schedule J)..... 26. Total deductions in lines 11 to 25, inclusive..... 27. Taxable income, line 10 less line 26.....		

SIGNATURE AND VERIFICATION (See Instruction F)

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

CORPORATE
 SEAL

.....
 (Date) (Signature of officer) (Title)

I declare under the penalties of perjury that I prepared this return for the taxpayer named herein; and that this return (including any accompanying schedules and statements) is, to the best of my knowledge and belief, a true, correct, and complete return based on all the information relating to the matters required to be reported in this return of which I have any knowledge.

.....
 (Date) (Individual or firm signature) (Address)

Schedule A.—COST OF GOODS SOLD. (See Instruction 2) (Where inventories are an income-determining factor)				Schedule B.—COST OF OPERATIONS (Where inventories are not an income-determining factor)			
1. Inventory at beginning of year..... 2. Merchandise bought for manufacture or sale..... 3. Salaries and wages..... 4. Other costs per books (Attach schedule)..... 5. Total..... 6. Less: Inventory at end of year..... 7. Cost of goods sold (Enter here and on line 2, page 1).....				1. Salaries and wages..... 2. Other costs (to be detailed): (a)..... (b)..... (c)..... (d)..... (e)..... 3. Total (Enter here and on line 2, page 1).....			
Schedule C.—INTEREST (See Instruction 5)							
1. Interest on loans, notes, mortgages, bonds, bank deposits, etc..... 2. Interest on corporation bonds, etc..... 3. Interest on obligations of the United States, etc..... (a) Issued prior to March 1, 1941—(1) United States savings bonds and Treasury bonds owned in excess of the principal amount of \$5,000, and (2) obligations of an instrumentality of the United States..... (b) Issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof..... 4. Total interest—Enter here and on line 5, page 1.....							
Schedule D.—Separate Schedule D (Form 1120-S) should be used in reporting sales or exchanges of property and filed with this return (See Instruction 8)							
Schedule E.—BAD DEBTS. (See Instruction 15)							
1. Taxable year	Amount of Notes and Accounts Receivable Outstanding at—		4. Taxable (or Net) Income Reported	5. Sales on Account	6. Bad Debts of Corporation if No Reserve Is Carried on Books	If Corporation Carries a Reserve	
	2. Beginning of Year	3. End of Year				7. Gross Amount Added to Reserve	8. Amount Charged Against Reserve
1955.....							
1956.....							
1957.....							
1958.....							
NOTE: Securities which are capital assets and which become worthless within the taxable year should be reported in separate Schedule D (Form 1120-S)							
Schedule G.—TAXES. (See Instruction 17)				Schedule H.—CONTRIBUTIONS OR GIFTS PAID (See Instruction 18)			
Explanation			Amount		Name and Address of Organization		Amount
Total (Enter here and on line 17, page 1).....					Contributions carryover (See instructions).....		
					Total contributions (Enter here and on line 18, page 1, subject to 5 percent limitation).....		
Schedule I.—DEPRECIATION. (See Instruction 21)							
1. Kind of Property (if buildings, state material of which constructed). Exclude Land and Other Non-depreciable Property List Assets in Groups by Depreciation Method	2. Date Acquired	3. Cost or Other Basis	4. Depreciation Allowed (or allowable) in Prior Years	5. Method of Computing Depreciation	6. Rate ("") or Life (years)	7. Depreciation This Year	
1. Total.....							
2. Less: Amount of depreciation claimed in Schedules A and B and elsewhere on return.....							
3. Balance—Enter here and on line 21, page 1.....							

Schedule L.—BALANCE SHEETS (See Instructions)

ASSETS	Beginning of Taxable Year		End of Taxable Year	
	Amount	Total	Amount	Total
1. Cash.....				
2. Notes and accounts receivable.....				
(a) Less: Reserve for bad debts.....				
3. Inventories: (a) Other than last-in, first-out.....				
(b) Last-in, first-out.....				
4. Prepaid expenses and supplies.....				
5. Investments in governmental obligations:				
(a) Obligations of a State, Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia.....				
(b) Obligations of the United States and its instrumentalities.....				
6. Mortgage and real estate loans.....				
7. Loans to shareholders.....				
8. Other investments (Attach schedule).....				
9. Buildings and other fixed depreciable assets.....				
(a) Less: Accumulated amortization and depreciation.....				
10. Depletable assets.....				
(a) Less: Accumulated depletion.....				
11. Land (net of any amortization).....				
12. Intangible assets (amortizable only).....				
(a) Less: Accumulated amortization.....				
13. Other assets (Attach schedule).....				
14. Total Assets.....				
LIABILITIES AND CAPITAL				
15. Accounts payable.....				
16. Bonds, notes, and mortgages payable (short-term) to:				
(a) Banks.....				
(b) Small business investment companies.....				
(c) Shareholders.....				
(d) Others.....				
17. Accrued expenses.....				
18. Bonds, notes, and mortgages payable (long-term) to:				
(a) Banks.....				
(b) Small business investment companies.....				
(c) Shareholders.....				
(d) Others.....				
19. Other liabilities (Attach schedule).....				
20. Capital stock.....				
21. Paid-in or capital surplus.....				
22. Surplus reserves (Attach schedule).....				
23. Earned surplus and undivided profits accumulated.....				
24. Shareholders' undistributed taxable income.....		X X X X X X		
25. Total liabilities and capital.....				

Schedule M.—RECONCILIATION OF TAXABLE INCOME

1. Income from books.....	9. Total from line 8.....
Add: Nondeductible items.....	Less: Nontaxable income and allowable deductions not recorded on books.....
2. Contributions in excess of 5% limitation.....	10. Nontaxable interest on:
3. Insurance premiums paid on the life of any officer or employee where the corporation is directly or indirectly a beneficiary.....	(a) Obligations of a State, Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia.....
4. Unallowable interest expense.....	(b) Obligations of the United States issued on or before Sept. 1, 1917; all postal savings bonds.....
5. Excess of capital losses over capital gains.....	11. Other nontaxable income (Attach schedule).....
6. Adjustment for tax purposes not recorded on books (Attach schedule).....	12. Adjustment for tax purposes (Attach schedule).....
7. Other (Attach schedule).....	13. Other (Attach schedule).....
	14. Total.....
8. Total.....	15. Taxable income (Line 9 minus 14).....

APPENDIX IV

ADDITIONAL FIRST-YEAR DEPRECIATION ALLOWANCE FOR
SMALL BUSINESSANNOUNCEMENTS AND TEMPORARY RULES OF THE TREASURY DEPARTMENT IN
CONNECTION WITH NEW SECTION 179

TECHNICAL INFORMATION RELEASE—DECEMBER 3, 1958 (TIR-114)

The Technical Amendments Act of 1958 (Public Law 85-866) provides an additional depreciation allowance on tangible personal property for the first taxable year for which a regular depreciation deduction is allowable, Internal Revenue Service announced today.

This additional allowance, IRS said, is 20 percent of the cost of the property and regular depreciation is allowable on the balance of the cost after deducting the new allowance.

IRS added the additional allowance applies only to tangible personal property purchased after December 31, 1957, for use in a trade or business or for the production of income.

However, the allowance is not applicable to tangible personal property which has a useful life of less than 6 years at the time of acquisition, and does not apply at all to real property, the agency explained.

IRS said the additional depreciation allowance may be obtained by filing an election to have the additional allowance apply. Such election may be made only for taxable years ending after June 30, 1958. The election for any taxable year must be made within the time provided by law for filing the tax return (including any extensions of time) for such year. The election must be made in the manner prescribed by regulations contained in Treasury Decision 6335, published in the Federal Register on November 19, 1958.

These regulations, IRS stated, provide that the election be made in a statement attached to the taxpayer's income tax return for the taxable year to which the election applies. The statement must indicate that the taxpayer has elected to take the additional depreciation allowance and must set forth the following information:

(1) Description of property; (2) date property acquired; (3) estimated useful life at date of acquisition; (4) how and from whom the property was acquired; (5) total cost of each item of property with respect to which election was made; and, (6) portion of cost of property selected.

IRS explained there is a limitation on the new additional depreciation allowance for any one taxable year. The additional allowance applies only to so much of the cost of property for the taxable year as does not exceed \$10,000, or, in the case of a husband and wife filing a joint return, \$20,000.

IRS said the additional depreciation allowance is not available to trusts and that it does not apply with respect to personal property purchased from certain closely related persons nor to property acquired by gift or inheritance.

(IRS-D.C.-44054)

TEMPORARY RULES RELATING TO ADDITIONAL FIRST-YEAR DEPRECIATION ALLOW-
ANCE FOR SMALL BUSINESS (TREASURY DECISION 6335, Nov. 18, 1958)

Section 18.1-3. ADDITIONAL FIRST-YEAR DEPRECIATION ALLOWANCE FOR SMALL BUSINESS.—(a) *In general.*—Section 204 of the Small Business Tax Revision Act of 1958 (72 Stat. 1679) amends the Internal Revenue Code of 1954 by adding a new section 179, relating to additional first-year depreciation allowance for small business. Section 179(a) provides that in the case of "section 179 property" the term "reasonable allowance" as used in section 167(a), relating to the deduction for depreciation, may, at the election of the taxpayer, include an allowance of 20 percent of the cost (subject to certain limitations) of such property for the first taxable year for which a deduction is allowable under section 167(a) with respect to such property. An election under section 179(a) may be made only with respect to a taxable year ending after June 30, 1958. For a definition of what constitutes "section 179 property", see section 179(d). The election under section 179(c) applies only to "section 179 property" to the extent the cost of such property for such taxable year does not exceed \$10,000, or, in the case of a husband and wife filing a joint return under section 6013 for the taxable year,

\$20,000. The taxpayer shall select the cost (or fractional part of the cost) of one or more items of "section 179 property" qualifying for the election in the taxable year in an amount not in excess of the applicable limitation.

(b) *Time and manner of making election.*—The election provided by section 179(c) with respect to "section 179 property" shall be made in a statement attached to the taxpayer's income tax return for the taxable year to which the election applies. The return and statement must be filed not later than the date prescribed by law for filing the return (including any extensions of time) for such taxable year. The statement shall indicate that the taxpayer has elected the provisions of section 179(a), and shall set forth the following information with respect to the property subject to the election:

- (1) Description of property.
- (2) Date property acquired.
- (3) Estimated useful life at date of acquisition.
- (4) How and from whom the property was acquired.
- (5) Total cost of each item of property with respect to which election is made.

- (6) Portion of cost of property selected.

The selection made by the taxpayer with respect to such property shall be adhered to in computing the taxpayer's taxable income for the taxable year for which the selection is made and for all subsequent taxable years.

(c) *Consent to revoke election.*—An election made under section 179 and this section with respect to any property shall be binding with respect to such property for the taxable year for which the election is made, and for all subsequent taxable years, unless consent to revoke the election is obtained from the Commissioner. No application for consent to revoke an election under section 179 will be accepted before the date of publication in the Federal Register of the regulations under section 179. Such regulations, however, will provide a reasonable period of time within which taxpayers will be permitted to apply for such consents in the case of taxable years which end after June 30, 1958, and before the date of publication of regulations under section 179.

(d) *Affiliated group.*—Taxpayers which constitute an affiliated group as defined in section 179(d)(7) shall be treated as one taxpayer for the purpose of the limitation under section 179(b). In the case of an affiliated group the allowance for additional first-year depreciation may, in accordance with an agreement entered into by the members of the group, be taken by any one such member or divided among them in any portion. Any member of such group that is allowed any portion of the deduction under section 179 shall file a statement in accordance with paragraph (b) of this section. Such statement shall include, in addition to the information required under paragraph (b) of this section, the names of the other members of the affiliated group and a description of the manner in which the deduction under section 179 has been divided among them.

(e) *Records.*—Any taxpayer who elects the additional allowance under section 179 with respect to "section 179 property" shall reflect the adjustment to basis required by section 179(b)(8) in the records which he is required to keep under Section 1.167(a)-7 of this chapter.

EXCERPTS FROM INSTRUCTIONS FOR THE 1958 U.S. PARTNERSHIP RETURN FORM 1065

Note: For taxable years ending after June 30, 1958, a partnership engaged in business may elect to write off part of the cost of its tangible depreciable personal property acquired after December 31, 1957, which has a useful life of at least 6 years from the date of acquisition. The allowance is in addition to regular depreciation allowable on the balance of the basis of the asset and is deductible in the first year in which the regular depreciation deduction is allowable with respect to the property.

The amount that may be written off is up to 20 percent of the cost of the property but not to exceed \$2,000 (\$4,000 if married and filing a joint return) for each partner. For example—

The A & B Company, a partnership consisting of A and B, purchased an asset which cost \$100,000. Each partner is married and each is filing a joint return. The profit and loss sharing ratio is 50 percent to each. The total that may be written off is \$8,000 (20 percent of \$100,000 limited to \$4,000 for each partner). If the purchase price of the asset had been \$20,000 and the profit and loss ratio was 90 percent to A and 10 percent to B, the total

amount that the partnership could write off would be 20 percent of \$20,000 or \$4,000 (90 percent of \$4,000 or \$3,600 for A and 10 percent of \$4,000 or \$400 for B).

Attach a schedule showing the computation and distribution of this additional first-year depreciation allowance.

APPENDIX V

INSTALLMENT PAYMENTS OF ESTATE TAX ATTRIBUTABLE TO INVESTMENTS IN CLOSELY HELD BUSINESS ENTERPRISE

TEMPORARY RULES OF THE TREASURY DEPARTMENT IN CONNECTION WITH THE NEW SECTION 6166

SEC. 24.1-1 EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX WHERE ESTATE CONSISTS LARGELY OF INTEREST IN CLOSELY HELD BUSINESS (Treasury Decision 6321, October 8, 1958)

(a) *In general.*—Section 6166 provides that under certain conditions where an interest in a closely held business is included in the gross estate of a decedent who was a citizen or resident of the United States at the time of his death, the executor may elect to pay in installments part or all of the Federal estate tax imposed by section 2001. See section 6166 for the definition of an interest in a closely held business, the limitation placed on the amount which may be paid in installments, the number of installments in which the tax may be paid, and the circumstances under which the privilege of paying the tax in installments will terminate. The election shall be exercised by filing notice of election to pay the tax in installments with the district director.

(b) *Where due date of return is after September 2, 1958.*—If the due date of the return is after September 2, 1958, an election to pay the estate tax in installments will apply both to the tax shown on the return and to any deficiency in tax assessed in connection therewith. The notice of election to pay the tax in installments shall be filed on or before the due date of the return. See Section 20.6075-1 of this chapter (Estate Tax Regulations) for the due date of the return. However, if the due date for filing the return is after September 2, 1958, but before November 3, 1958, the election will be considered as timely made if the notice of election is filed with the district director on or before November 3, 1958.

(c) *Where due date of return is on or before September 2, 1958.*—If the due date of the return is on or before September 2, 1958, an election by the executor to pay estate tax in installments will apply only to a deficiency in tax assessed after September 2, 1958. See Section 20.6075-1 of this chapter (Estate Tax Regulations) for the due date of the return. The notice of election to pay the deficiency in installments shall be filed not later than 60 days after the issuance of notice and demand by the district director for the payment of the deficiency. The election described in this paragraph may be made only if the decedent died after August 16, 1954.

(d) *Form of notice of election.*—The notice of election to pay the estate tax in installments may be in the form of a letter addressed to the district director. The executor shall state in the notice the amount of tax which he elects to pay in installments, and the total number of installments (including in a case described in paragraph (b) of this section the installment due 15 months after the date of the decedent's death, and including in a case described in paragraph (c) of this section those installments the dates for payment of which would have arrived within the meaning of section 6166(i) in which he elects to make the payment of such tax. The properties in the gross estate which constituted the decedent's interest in a closely held business should be listed in the notice, and identified by the schedule and item number at which they appear on the estate tax return. The notice should set forth the facts which formed the basis for the executor's conclusion that the estate qualifies for the payment of the estate tax in installments.

