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PRESENT LAW AND PROPOSALS RELATING TO SUBCHAPTER S CORPORATIONS AND HOME OFFICE DEDUCTIONS

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT

ON MAY 26, 1995

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OF THE

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INTRODUCTION

The Subcommittee on Taxation and IRS Oversight of the Senate Committee on Finance has scheduled a public hearing on May 26, 1995, on issues relating to subchapter S corporations and shareholders and the deductibility of home office expenses by individuals. The hearing includes an examination of S. 758 ("S Corporation Reform Act of 1995"), introduced by Senators Hatch, Pryor, Simpson, Breaux, Baucus, Grassley, D'Amato and others on May 4, 1995, and S. 327 ("Home Office Deduction Act of 1995") as introduced by Senators Hatch, Baucus, Grassley and others on February 1, 1995. A similar provision with respect to home office expenses is included in H.R. 1215 ("Tax Fairness and Deficit Reduction Act of 1995"), as passed by the House of Representatives on April 5, 1995. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes present-law and background with respect to subchapter S corporations and home office expenses and the provisions of S. 758 and S. 327, and the home office provisions of H.R. 1215.

Part I of the pamphlet is an overview of present-law subchapter S and the treatment of home office expenses and legislative proposals to change these areas of the tax law. Part II provides background on choice of entity considerations, describes present law and the legislative background of subchapter S, provides data on subchapter S corporations, and describes the provisions of S. 758. Part III is a description of the present-law treatment of home office expenses by individuals, the provisions of S. 327, and the home office provisions of H.R. 1215.

[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Proposals Relating to Subchapter S Corporations and Home Office Deductions* (JCS–16–95), May 24, 1995.

I. OVERVIEW

Subchapter S corporations

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

Subchapter S of the Internal Revenue Code of 1986 ("Code") allows certain qualified corporations to elect to be relieved from corporate-level taxation and to pass the corporate items of taxable income and loss through to the shareholders of the corporation. Thus, a corporation that elects subchapter S status (an "S corporation") and its shareholders generally are treated more like a partnership and its partners than a C corporation and its shareholders for Federal income tax purposes. The election does not inhibit the shareholders' limited liability protection provided by local law. In order to make an election to be treated as an S corporation, a corporation must meet certain requirements primarily regarding its capital structure and the identity of its shareholders. Other entities, primarily limited liability companies, may achieve similar tax treatment and limited liability results without having to meet the requirements of subchapter S of the Code.

Subchapter S was first enacted in 1958 in order to remove tax considerations from choice-of-entity decisions for some taxpayers and provide tax relief for small businesses. Since 1958, subchapter S has been amended several times (most notably in 1982) in order to more closely align the treatment of S corporations and partnerships. Moreover, other changes to the Code (particularly changes to individual and corporate tax rates and the treatment of taxable corporations) have had an effect on the number of subchapter S elections.

Approximately one-half of all corporations filing tax returns are now S corporations. This figure represents the rapid growth of subchapter S elections following the passage of the Tax Reform Act of 1986. While the number of S corporations is substantial, their relative size is not. S corporations tend to engage in non-capital intensive businesses and in 1993 held only 4 percent of all corporate assets. In addition, S corporations reported 16.5 percent of all business receipts and 11.1 percent of corporate net income in 1993. Fewer than one-sixth of all S corporations have more than three shareholders. Still, there are some large S corporations. There are almost 1,000 S corporations with assets in excess of $50,000,000. (See data in Tables 1–3 and Charts 1–5, in Part II.D of this pamphlet.)

S. 758 ("S Corporation Reform Act of 1995"), introduced by Senators Hatch, Pryor, Simpson, Breaux, Baucus, Grassley, D'Amato and others on May 4, 1995, would make several changes to subchapter S. The principal changes would be to: (1) increase the maximum number of shareholders to 50; (2) treat members of a family as one shareholder; (3) allow nonresident aliens and certain tax-exempt organizations to be shareholders; (4) allow discretionary trusts to be shareholders; (5) permit S corporations to issue preferred stock, to issue convertible debt as "safe harbor" debt, and to own subsidiaries; (6) allow S corporations to earn greater amounts of passive income without adverse tax consequences; and (7) make several changes to subchapter S to improve administrability and compliance and provide simplification. The bill generally would be effective for taxable years beginning after December 31, 1995.

Home office expenses

A taxpayer's business use of his or her home may give rise to a deduction for the business portion of expenses related to operating the home, provided that certain criteria are satisfied. However, in *Commissioner v. Soliman*, 113 S. Ct. 701 (1993), the Supreme Court held that an anesthesiologist who used a room in his home to perform administrative and management activities for his business was not entitled to a home office deduction, on the grounds that the "principal place of business" for the taxpayer was not the home office but rather was at the hospitals where the taxpayer performed the "essence of the professional service."

S. 327, introduced by Senator Hatch (and others) on February 1, 1995, would effectively overrule the *Soliman* holding by providing statutorily that a home office qualifies as the "principal place of business" if (1) the office is the location where the taxpayer's essential administrative or management activities are conducted on a regular and systematic (and not incidental) basis by the taxpayer, and (2) the office is necessary because the taxpayer has no other location for the performance of the essential administrative or management activities of the business. S. 327 would be effective for taxable years beginning after 1991. A similar provision with respect to home office expenses was included in H.R. 1215 ("Tax Fairness and Deficit Reduction Act of 1995"), as passed by the House of Representatives on April 5, 1995.

II. TAX TREATMENT OF SUBCHAPTER S CORPORATIONS AND SHAREHOLDERS

A. Background

For Federal income tax purposes, a corporation generally is treated as a separate entity apart from its shareholders. Income earned by a corporation is taxed to it and distributions from a corporation (either as dividends or in liquidation) are included in the shareholders' taxable incomes. The rules governing the relationships of a taxable corporation and its shareholders are generally found in subchapter C of the Internal Revenue Code of 1986 ("Code")[2] and corporations subject to tax are known as "C corporations."

A partnership, on the other hand, generally is not treated as a taxable entity.[3] Instead, income earned by a partnership, whether distributed or not, is taxed to the partners, and distributions from the partnership generally are tax-free. The items of income, gain, loss, deduction or credit of a partnership generally are taken into account by a partner pursuant to the partnership agreement (or in accordance with the partners' interest in the partnership if the agreement does not provide for an allocation) so long as such allocation has substantial economic effect.[4] The rules governing the treatment of a partnership and its partners generally are found in subchapter K of the Code.

The income tax treatment of a business entity does not merely depend on the legal form of its organization. Treasury regulations provide that proper treatment of a business entity depends on whether the enterprise "more nearly" resembles a corporation or partnership. In making this determination, the regulations list six factors and provide that an entity is treated as a corporation if it has more corporate than non-corporate characteristics. The six corporate characteristics are: (1) the existence of associates, (2) an objective to carry on business and divide the profits thereon, (3) continuity of life, (4) centralized management, (5) liability limited to the assets of the entity, and (6) free transferability of interests.[5] Because the first two characteristics listed above (associates and profit motive) are common to both partnerships and corporations, an entity is classified as a partnership if it lacks two of the four remaining corporate characteristics.

In many instances, owners of business enterprises may wish to incorporate for nontax reasons (e.g., to obtain limited liability or easier access to capital markets), but would prefer not to have cor-

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[2] These rules generally govern the tax treatment of corporate formations, distributions, reorganizations, and liquidations.

[3] However, section 7704, as added by the Revenue Act of 1987, provides that certain publicly-traded partnerships are treated as corporations for tax purposes.

[4] Sections 704 (a) and (b). The determination of whether an allocation has substantial economic effect may be difficult. See, e.g., Treasury regulations under section 704(b).

[5] Treas. reg. sec. 301.7701-2(a). The extent to which the Internal Revenue Service (IRS) will continue to use these tests to determine the tax status of an entity is unclear. On April 3, 1995, the IRS announced that it and the Department of the Treasury are considering simplifying the existing classification regulations to allow taxpayers to elect to treat certain domestic unincorporated business organizations as partnerships or as corporations for Federal tax purposes. This "check-the-box" approach would apply to all organizations with two or more associates and an objective to carry on business and divide the profits therefrom, unless the organization's tax status is determined under another Code provision (e.g., sec. 7704 that applies corporate treatment to certain publicly traded partnerships). IRS Notice 95-14, Bulletin No. 1995-14.

porate tax treatment. Noncorporate tax treatment may be preferred because owners may not wish business earnings to be subject to two layers of tax (once when earned and again when distributed), the average or marginal tax rates for the individual shareholders may be lower than that of the corporation,[6] owners may wish to use losses generated by the business to offset income from other sources, and the corporate tax base may include items not applicable to individuals (such as the corporate alternative minimum tax).

Subchapter S of the Code allows certain qualified corporations to elect essentially to be relieved from corporate-level taxation and to pass the corporate items of taxable income and loss through to the shareholders of the corporation. Thus, a corporation that elects subchapter S status (an "S corporation") and its shareholders generally are treated more like a partnership and its partners than a C corporation and its shareholders. In order to make an election to be treated as an S corporation, a corporation must meet certain requirements primarily regarding its capital structure and the identity of its shareholders. These requirements are discussed in detail below.

Until recently, there have been few forms of entity other than S corporations that were treated as partnerships for income tax purposes but had limited liability for the owners under local law. One such vehicle is the limited partnership; through which the liability of certain investors (the limited partners) is limited to the partners' investment in the partnership. Limited partnerships generally are treated as partnerships for income tax purposes because local law generally requires the existence of a general partner whose liability is not limited, and the partnership may lack centralized management, continuity of life, or free transferability of interest.[7] However, a limited partnership may not be an appropriate vehicle for many business enterprises to the extent local law limits the rights of the limited partners.

More recently, however, another form of entity—the limited liability company ("LLC")— has emerged that may provide corporate treatment for local law purposes and partnership treatment for Federal income tax purpose. LLCs are entities organized under State law. Although LLC statutes differ from State to State, common characteristics under most States' laws include limited liability of owners, management vested in owners or managers, lack of free transferability of interests, and often a lack of continuity of

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[6] The top marginal rate applicable to individuals under present law (39.6 percent) is higher than the top marginal rate applicable to corporations (35 percent). However, the graduation of the corporate and individual rate schedules and the division of corporate income among shareholders may mean that the average and marginal tax rates for the individual shareholders under present law may be lower than the rates applicable to corporations. The relative tax rates applicable to corporations and individuals (and the extent to which business earnings are reinvested in the enterprise) are important considerations in determining whether or not subchapter C status is desirable.

[7] See, B. Bittker and J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, Chapter 2 (5th. ed. 1987), para. 2.04: "Limited partnerships, whether subject to the original Uniform Limited Partnership Act or the revised version of the Act, come somewhat closer than general partnerships to association status, but not close enough to cross the line, except in extreme cases."

life.[8] The first LLC statute was enacted in Wyoming in 1977.[9] In 1980, the Department of the Treasury proposed regulations to Code section 7701 that would have treated an LLC as a corporation for income tax purposes. These regulations were withdrawn in 1982 and, in 1988, the Internal Revenue Service ("IRS") ruled that an LLC organized under the Wyoming statute could be treated as a tax partnership.[10] Currently, 48 States have enacted LLC statutes,[11] and the IRS generally has ruled it will treat such entities as tax partnerships.[12] Thus, an LLC generally affords local law and income tax treatment similar to that of an S corporation without having to meet the qualification requirements for such treatment under subchapter S.[13] However, an existing C corporation generally may elect subchapter S without incurring a tax on liquidation,[14] and an S corporation may enter into tax-free reorganizations with other corporations.[15] These features generally are not available with respect to LLCs.

B. Present Law

Eligibility

A "small business corporation" may elect to be an S corporation. A small business corporation is a domestic corporation which is not an ineligible corporation and which does not have (1) more than 35 shareholders, (2) as a shareholder a person (other than an estate or certain trusts) that is not an individual, (3) a nonresident alien as a shareholder, and (4) more than one class of stock. For this purpose, a husband and wife are treated as one shareholder. An ineligible corporation is one that is a member of an affiliated group; a bank, domestic savings and loan association, mutual savings bank, or certain cooperative bank; an insurance company; a section 936 corporation; or a DISC or former DISC. Trusts that are eligible to own S corporation stock include grantor trusts, testamentary trusts and qualified subchapter S trusts ("QSSTs"). A QSST is a trust, the terms of which require that all distributions of the trust may be made to only one beneficiary, who must be a U.S. citizen or resident.[16]

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[8] See, Claridy, "The Limited Liability Company: An S Corporation Alternative or Replacement?" 4 *Journal of S Corporation Taxation*, 202 at 203 (1993).

[9] Wyo. Stat. secs. 17-15-101 through 17-15-136 (1977).

[10] Rev. Rul. 88-76, 1988-1 C.B. 260.

[11] It is reported that Pennsylvania and New Hampshire are considering LLC statutes.

[12] See, Frost and Gartland, "Tax Classification of an LLC Raises a Number of Issues," *Journal of Limited Liability Companies*, 3 (1994) for a discussion of the various IRS rulings. See also, Levine and Paul, "Limited Liability Company Statutes: the New Wave," 4 *Journal of S Corporation Taxation*, 226 (1993) for a discussion of how various LLC statutes differ and how such differences may affect the tax treatment of the entity.

[13] Some commentators have suggested that the use of LLCs is not yet as widespread because of the uncertainty of the extent to which a State will recognize the status of an LLC conducting business in that State but organized under the laws of another State. However, the commentators believe that it is only a matter of time until the States begin recognizing each others' LLCs. See, August, "Editor's Comment: The Limited Liability Company—The 'Super Pass-Through Entity'?" 4 *Journal of S Corporation Taxation*, 199 at 200 (1993). Anecdotal information indicates that interstate recognition of LLCs may have already taken place to a great extent.

[14] But see, section 1363(d) (recapture of certain LIFO inventory benefits upon conversion from C corporation status), section 1374 (corporate-level tax on certain built-in gains if recognized within 10 years of conversion), and section 1375 (corporate-level tax on certain passive investment income to the extent of prior C corporation earnings and profits).

[15] Section 1371(a)(1) (rules of subchapter C applicable to S corporations).

[16] Section 1361. For a description of proposed changes to the present-law eligibility requirements for electing S corporation status, see Part II. E of this pamphlet.

Election, revocation, and termination

In order to be effective, an election to be treated as an S corporation must be made during the first two and a half months of the taxable year; an election made later is effective for the following taxable year. All shareholders must consent to the initial election. The election is effective until terminated; the consent of new shareholders is not required.

An election may be terminated upon revocation by shareholders holding more than one-half of the shares of the corporation. A revocation made during the first two and a half months of the taxable year is effective for that year; a revocation made later is effective for the following taxable year. S corporation status may also be terminated if the corporation ceases to qualify as a small business corporation. In such case, the termination is effective on and after the date of cessation. Finally, an election terminates if an S corporation with subchapter C earnings and profits has passive investment income that exceeds 25 percent of gross receipts for three consecutive taxable years. If S corporation status is terminated, a subsequent election cannot generally be made for five taxable years. The Secretary of the Treasury has the authority to waive certain inadvertent terminations.[17]

Effect of election upon the corporation

In general, an S corporation is not subject to corporate tax. Rather, the taxable income or loss of the corporation is computed in the same manner as in the case of an individual, and the income is passed-through to the shareholders. Special rules apply to C corporations that elect S corporation status. Former C corporations are subject to corporate-level tax on the recapture of LIFO benefits, investment tax credit recapture, certain built-in gains, and certain passive investment income. The rules of subchapter C generally apply to an S corporation and its shareholders. Thus, for example, a sole shareholder may make tax-free contributions of appreciated property to his or her S corporation.[18] However, for purposes of subchapter C, an S corporation in its capacity as a shareholder is treated as an individual.[19]

For purposes of applying certain employee fringe benefit and foreign source income rules, the S corporation is treated as a partnership.[20]

An S corporation must use as its taxable year the calendar year, or any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Secretary of the Treasury.[21]

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[17] Section 1362. For a description of proposed changes to the rules regarding S corporation elections, revocations, and terminations, see Part II. E of this pamphlet.

[18] Section 351 of subchapter C provides for the tax-free treatment of property transferred to corporations controlled by the transferor.

[19] Section 1371(a)(2). For a description of proposed changes to this provision, see Part II. E of this pamphlet.

[20] Sections 1372 and 1373, respectively. For a description of proposed changes to the rules regarding the treatment of fringe benefits, see Part II. E of this pamphlet.

[21] Section 1378. The Tax Reform Act of 1986 and the Revenue Act of 1987 also provided rules regarding the taxable years of partnerships, S corporations, and personal service companies. Such rules allow the use of a fiscal years that result in a deferral period of up to three months,

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Effect of election upon the shareholders

All S corporation items of income, loss, deduction, or credit that could affect the tax liability of an individual generally are passed through to shareholders on a pro-rata basis as of the last day of the S corporation's taxable year.[22] Thus, as in the case of partnerships, entity-level items such as capital gains and losses, components of investment activity, charitable contributions, tax credits, foreign source income, as well as ordinary income or loss from trade or business activities are separately stated and passed through to shareholders. Unlike partnerships, though, special allocations are not provided for shareholders. Pro rata allocations of S corporation items are generally made on a per-day, per-share basis, regardless of when during the year an activity having a tax effect may have actually taken place.[23] The aggregate amount of losses and deductions taken into account by a shareholder for a taxable year cannot exceed that shareholder's adjusted basis of his or her S corporation stock and the adjusted basis of any indebtedness of the S corporation to the shareholder. Any disallowed losses or deductions are carried over indefinitely.[24]

A shareholder increases the adjusted basis in his or her S corporation stock by the items of income of the S corporation; losses, deductions, and nondeductible expenses that pass through to the shareholder decrease such basis.[25] The amount of a distribution from an S corporation that does not have earnings and profits is tax-free to the extent of the shareholder's basis in the stock and reduces such basis; any remainder generally is treated as a capital gain. The amount of a distribution from an S corporation that has earnings and profits[26] is tax-free to the extent of the accumulated adjustments account ("AAA"). The AAA generally is the aggregate amount of undistributed income (less deductions and losses) that has been subject to individual taxation at the shareholder level. The amount of the distribution in excess of the AAA is treated as a dividend to the extent of the corporation's earnings and profits. Any remaining portion of a distribution in excess of the corporation's earnings and profits is treated pursuant to the rules regarding distributions from an S corporation that does not have earnings and profits. Thus, the basis adjustment and AAA rules operate to (1) insure that the items of income and loss that pass through to the shareholder are not duplicated when the shareholder receives a distribution from the S corporation or disposes of his or her stock, and (2) preserve the tax treatment of items that did not pass through to the shareholder.

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so long as the electing entity makes certain required payments or is subject to certain deduction limitations (sec. 441).

[22] Section 1366(a). In addition, special rules apply to gasoline and special fuels tax credit of section 34 and the taxes imposed under sections 1374 and 1375 (sec. 1366(f)).

[23] Section 1377. In the case of any shareholder terminating his or her interest in the corporation, the shareholders may elect to cut-off S corporation's taxable year as of the date of such termination for purposes of applying the per-day, per-share rule. For a description of proposed changes to this rule, see Part II. E of this pamphlet.

[24] Section 1366(d). For a description of proposed changes to the rules regarding losses flowing through from S corporations, see Part II. E of this pamphlet.

[25] Section 1367. In addition, special rules apply to certain depletion deductions.

[26] An S corporation may have earnings and profits if it had previously been a C corporation or if it had been an S corporation prior to 1983. For a description of a proposed elimination of such latter amounts, see Part II. E of this pamphlet.

C. Legislative Background

Early proposals

Subchapter S was first enacted as part of the Technical Amendments Act of 1958. Many commentators, however, have traced the roots of subchapter S to earlier proposals.[27] A system of taxation that resembles present-law subchapter S was described in two Treasury studies of the mid-1940s.[28] The studies suggested that the corporate and individual income tax systems could be integrated by ignoring the legal distinction between corporations and their shareholders, and taxing corporate profits at the individual level, as in the case of partnerships. The studies acknowledge that the use of the partnership method would probably only be administratively feasible for corporations with simple capital structures and with relatively few stockholders.

The President's Budget Message of January 21, 1954[29] proposed that:

> Small businesses should be able to operate under whatever form of organization is desirable for their particular circumstances, without incurring unnecessary tax penalties. To secure this result, I recommend that corporations with a small number of active stockholders be given the option to be taxed as partnerships and that certain partnerships be given the option to be taxed as corporations.

The Internal Revenue Code of 1954 contained a provision that allowed certain partnerships and sole proprietorships to elect to be taxed more like corporations.[30] The Senate amendment to the House bill of the 1954 Act contained a companion provision (but which was not enacted in the 1954 Act) that allowed qualified corporations to elect to be taxed as partnerships.[31] For this purpose, a qualified corporation was a domestic corporation organized after 1954 that had 10 or fewer resident individual shareholders,[32] all of whom were actively engaged in the conduct of the business of the corporation, and that had only one class of stock. The election was available only in the first year of the corporation's existence or in the first year after a more than 20-percent change in ownership. As a result of the election, the corporation was treated as a partnership and a shareholder of the corporation would not be consid-

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[27] See, J. Eustice & J. Kuntz, *Federal Income Taxation of S Corporations*, Chapter 1 (2d. ed. 1985) and Bravenec, "The One-Class-of-Stock Requirement of Subchapter S," 6 *Houston L. Rev.* 215, 238-241 (1968).

[28] See, Div. of Tax Research, U.S. Treas. Dept., "The Postwar Corporate Tax Structure" (1946), contained in 80th Cong. 1st Sess. (pt. 2) 1136 and "Taxation of Small Businesses" (1947), contained in 80th Cong. 1st Sess. (pt. 5) 3739.

[29] 100 Cong. Rec. 567, 571 (1954).

[30] Section 1361 of the Internal Revenue Code of 1954. Section 1361 was repealed in 1966, effective January 1, 1969. The breadth of the use of the election has been questioned. See, S. Surrey, "The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted," 70 *Harv. L. Rev.* 1145, 1149 note (1957) ("(Sec. 1361) apparently received its main impetus and perhaps the only reason for its existence from the situation of a particular Georgia partnership.") and B. Bittker and J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 2.12 (4th d., 1979) ("Its de facto demise through nonuse was probably already a reality by the time Congress formally put it to death in 1966; in effect, it was overlooked by many, unused by most, and mourned by practically none.")

[31] H.R. 8300, 83d Cong., 2d Sess., sec. 1351 (1954).

[32] A domestic partnership could own stock in the corporation so long as all the partners qualified as shareholders.

ered to be an employee for purposes of the rules regarding qualified deferred compensation plans.[33] The election was irrevocable until there was a more than 20-percent change in ownership. If a corporation issued a second class of stock, the election was revoked retroactively. This provision was not included in the House bill and was not adopted in conference.

Subchapter S under the 1958 Act

In 1958, President Eisenhower again proposed providing benefits to small businesses, including a recommendation from the Cabinet Committee on Small Business regarding the integration of the taxation of small corporations and their shareholders.[34] In response, the Senate bill contained provisions that added subchapter S to the Internal Revenue Code of 1954 and eventually became part of the Technical Amendments Act of 1958 ("1958 Act").[35] Legislative history[36] indicates that the enactment of subchapter S had the following goals: (1) to permit businesses to select the form of business organization desired without having to take major tax differences into account;[37] and (2) provide benefits to small businesses.[38] Specifically, the small business benefits described in the legislative history were (1) the taxation of income at potentially lower individual tax rates, (2) the removal of the corporate layer of taxation on such income, and (3) the use of corporate losses by individuals to offset income from other sources.[39]

Subchapter S, as enacted, was different in certain respects from the 1954 Senate provision. As enacted, the election was available to a domestic corporation that was not a member of an affiliated group, had 10 or fewer shareholders, had only shareholders who were resident individuals (or estates), and had one class of stock.

The election was available to existing subchapter C corporations and could be made during the first month of the taxable year for which it was to be effective or the last month of the prior year. In order to be effective, the consent of all (including new) shareholders was required. Termination of the election could result if all shareholders consented to revocation, if the corporation ceased to meet the eligibility tests, if more than 80 percent of the gross receipts of the corporation came from foreign sources, or if more than 20 percent of the gross receipts of the corporation were from passive sources. Terminations generally were effective for the entire taxable year in which the terminating event occurred. Once sub-

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[33] At the time, partners could not participate in partnership qualified deferred compensation plans.

[34] 104 Cong. Rec. 338, 339 (1958).

[35] P.L. 85-866 (1958).

[36] S. Rept. No. 1983, 85th Cong., 2nd Sess. 87 (1958).

[37] Specifically, subchapter S was seen as a complement to section 1361 as added by the 1954 Act that permitted proprietorships and partnerships to be taxed as corporations.

[38] The 1958 Act also added several other benefits targeted toward small businesses, including treating losses on certain small business stock as ordinary rather than capital losses (sec. 1244); extending the carryover period for net operating losses (sec. 172); providing additional first-year depreciation allowances (sec. 179); increasing the minimum accumulated earnings credit (sec. 205, since repealed); and providing for an extension of time for payment of estate tax attributable to investments in closely held enterprises (sec. 6166).

[39] At the time, the top marginal individual tax rate was greater than the top marginal corporate tax rate. However, because individual and corporate tax rates were graduated differently, a shareholder could have a lower marginal tax rate than a corporation. Thus, whether or not Subchapter S provided a benefit depended on the relative rates of the corporation and the shareholder and when corporate earnings were distributed.

chapter S status had been terminated, it could not be re-elected for five taxable years.

In addition, the 1958 Act did not adopt the partnership system of taxation, *per se*, for electing corporations. Rather, the subchapter S election exempted the corporation from corporate tax. Shareholders holding stock on the last day of the year included the undistributed taxable income of the corporation in income as a dividend. Undistributed taxable income was defined as the corporation's taxable income for the year less the cash distributed out of current earnings and profits during the year. In addition, recipient shareholders included actual dividend distributions in income, as under subchapter C. Distributions of previously taxed income were tax-free. Ordering rules provided that cash distributions were deemed to be first from current earnings and profits, then previously taxed income, and then accumulated earnings and profits; special rules applied to property distributions. All or a portion of actual and deemed dividends could be recharacterized as capital gains to the extent the corporation had capital gains. Corporate net operating losses passed through to shareholders on a per-share, per-day basis, but only to the extent of the shareholder's basis in stock and debt. Losses subject to limitation were not carried forward. Shareholders increased the basis in their stock by undistributed net income and reduced basis by net operating losses and tax-free distributions.

Subchapter S Revision Act of 1982

The Subchapter S Revision Act of 1982 ("1982 Act") contained many of the provisions that differentiate present-law subchapter S from the originally enacted 1958 version. The provisions of the 1982 Act were a result of studies of the operation of subchapter S by the Department of the Treasury and the staffs of the Congressional tax committees.[40] The 1982 Act was intended to simplify the operation of subchapter S and eliminate certain unintended adverse "traps" as well as benefits, without disturbing the original 1958 Act goals of minimizing tax considerations in choice-of-entity decisions and providing benefits to small businesses.[41]

In general, as a result of the 1982 Act, the treatment of S corporations and their shareholders more closely resembled that of partnerships and their partners. The major changes of the Act included the increasing in the number of allowable eligible shareholders to 35,[42] allowing the use of nonvoting common stock, creating a "safe harbor" form of corporate debt, streamlining and simplifying the election and termination procedures, providing for the pass through of income and loss on a per-day, per-share basis (regardless of distributions), providing basis adjustment and distribution

[40] See, U.S. Treasury Department, *Technical Explanation of Treasury Tax Proposals: Hearings Before the House Committee on Ways and Means*, 91st Cong., 1st Sess. 5228 (April 22, 1969) and Joint Committee on Taxation, *Staff Recommendations for Simplification of Tax Rules Relating to S Corporations* (JCS-24-80), 96th Cong., 2d Sess., April 30, 1980.

[41] See, *Subchapter S Revision Act of 1982*, Report of the House Committee on Ways and Means on H.R. 6055 (H. Rept. No. 97–826), September 16, 1982 and *Subchapter S Revision Act of 1982*, Report of the Senate Committee on Finance on H.R. 6055 (S. Rept. No. 97–640), September 29, 1982.

[42] The number of eligible shareholders had been increased from 10 to 15 in 1976 and to 25 in 1981. The number "35" corresponded to a private placement exemption in Federal securities law.

rules similar to those applicable to partnerships, allowing losses subject to basis limitations to be carried forward, and requiring the use of certain taxable years.

Changes made to subchapter S since 1982

The Tax Reform Act of 1984 made numerous minor changes to subchapter S, many of which were in the nature of perfecting amendments to the 1982 Act.

The Tax Reform Act of 1986 ("1986 Act") made more significant changes to the treatment and role of S corporations. Most of these changes relate to the overall changes made by the 1986 Act—the broadening of the individual and corporate tax bases, the lowering and inversion of the individual and corporate tax rates, the repeal of the preferential treatment for capital gains, and the repeal of the *General Utilities* doctrine with respect to corporate liquidations. As described in the next section of this pamphlet, the combination of these changes may have given rise to the record number of subchapter S elections following the passage of the 1986 Act.

Before the 1986 Act, there were many reasons why taxation under subchapter C may have been more favorable than taxation under subchapter S. Prior to the 1986 Act, the top marginal individual tax rate (50 percent) was higher than the top marginal corporate tax rate (46 percent). If a corporation was not distributing earnings in the form of dividends, it was preferable to allow business earnings to accumulate and be taxed at corporate, rather than individual, rates.[43] The incentive to operate a business as a C corporation was greatly diminished where business earnings were not accumulating, but were routinely distributed as dividends. In such cases, business earnings were subject to two levels of tax, at a combined top marginal tax rate of 73 percent.[44] However, closely-held corporations, unlike publicly-traded corporations, often are not under pressure to make dividend distributions and thus, generally are able to accumulate earnings in corporate solution.

A corporate strategy that forgoes dividend distributions does not preclude shareholders from realizing the earnings of the corporation. For example, payments may be made in the more tax-favored form of compensation to shareholder-employees, interest to shareholder-creditors, or rents to shareholder-lessors. Although such payments are taxable to the recipient as ordinary income, they are deductible by the corporation, if reasonable in amount. Tax-deductible payments had the effect of reducing the combined top marginal tax rate of 73 percent applicable to dividends to 50 percent (as applied under pre-1986 Act rates). Alternatively, shareholders could have "bailed out" accumulated earnings by selling their shares in the corporation. In such cases, the amount realized by the shareholder on the sale generally is not subject to tax as ordinary income, but rather was offset by the shareholder's basis in his or her stock and treated as a capital gain. Prior to the 1986 Act, the maxi-

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[43] The accumulated earnings tax (sec. 531) is designed to prevent accumulation of earnings beyond the reasonable needs of business. However, this tax may often be avoided with tax planning strategies. The personal holding company tax (sec. 541) is intended to prevent closely held corporations from accumulating passive investment income.

[44] Computed as 46 percent plus ((100 percent less 46 percent) times 50 percent).

mum tax rate on capital gains of individuals was 20 percent.[45] A sale of stock between shareholders is not a taxable event to the corporation.

A shareholder could also "bail out" corporate earnings by liquidating the corporation. Shareholders generally treat the receipt of property in a complete liquidation as a capital gain transaction, taking a fair market value basis in such property.[46] Prior to the 1986 Act, the liquidation of a corporation generally was taxable to the corporation only to the extent of certain items.[47]

The 1986 Act diminished these relative advantages of subchapter C status. After a phase-in period, the 1986 Act lowered the top individual marginal tax rate from 50 percent to 28 percent. Although the highest marginal corporate tax rate was reduced from 46 percent, the resulting phased-in 34 percent rate was above the highest marginal individual rate. Thus, undistributed earnings could generally accumulate at lower rates of tax in an S corporation than in a C corporation. In addition, S corporation status allows the corporation to eventually distribute earnings as dividends on a tax-free basis.

This "rate inversion" is not the only disincentive to C corporation status brought about by the 1986 Act. The preferential rate on capital gains was repealed by the 1986 Act, thus diminishing the ability to "bail out" accumulated corporate earnings at a beneficial tax rate via a stock sale or a liquidation of the corporation.

In addition, the 1986 Act's repeal of the *General Utilities* doctrine required the recognition of full corporate-level gain upon the liquidation of a C corporation. A complementary rule to the *General Utilities* repeal provided for a subchapter C-type tax whenever an S corporation disposed of built-in gain assets inherited from a C corporation within 10 years of the corporation's conversion from C to S status. This rule was designed to insure that taxpayers could not avoid the repeal of the *General Utilities* doctrine by electing S corporation status and soon thereafter liquidating or otherwise disposing of assets of the former C corporation.[48] The repeal of the *General Utilities* doctrine and the complementary S corporation

[45] Alternatively, if a shareholder retains his or her stock until death, the individual-level capital gains tax on accumulated corporate earnings may be completely avoided because the recipient of such stock takes an adjusted basis equal to stock's fair market value, an amount that should reflect the accumulated earnings.

[46] Former Code section 333 allowed, in the case of certain "one-month" corporate liquidations, a qualifying electing shareholder to recognize gain only to the extent of the larger of (1) the shareholder's ratable share of accumulated earnings or (2) the sum of money and stock and securities received in the distribution. Section 333 was repealed by the Tax Reform Act of 1986.

[47] Specifically, the *General Utilities* doctrine provided that the distribution of appreciated property to a shareholder did not give rise to the recognition of taxable income to the corporation even though the shareholder took a fair market value basis in the property received. *General Utilities Operating Co. v. Helvering*, 296 U.S. 200 (1935). Sections 336 and 337 codified this doctrine for the complete liquidation (or deemed liquidation) of a C corporation. The Code and the courts provided exceptions to this nonrecognition rule for certain specific items (such as the deferred gain related to installment obligations and LIFO inventories; the recapture of investment tax credits, accelerated depreciation, intangible drilling costs, etc.; and items covered by the "tax benefit" doctrine). The *General Utilities* doctrine was repealed by the 1986 Act.

[48] Section 1374. Although section 1374 is viewed as a complementary rule to the repeal of the *General Utilities* doctrine, the conversion of a C corporation to S corporation status is treated more favorably than the liquidation of a C corporation into a sole proprietorship or a partnership, despite the economic equivalence of the transactions For a discussion of section 1374, see, letter to Chairman Dan Rostenkowski from Ronald A. Pearlman, Chief of Staff of the Joint Committee on Taxation, recommending several simplification proposals, reprinted in Committee on Ways and Means, *Written Proposals on Tax Simplification* (WMCP 101–27), May 25, 1990, p 24.

rule was generally effective for taxable years beginning after December 31, 1986.[49] Thus, it was possible to make an S corporation election after the date of enactment of the 1986 Act, but before the effective date of the *General Utilities* repeal.

Finally, the 1986 Act contained other provisions that were applicable to C, but not S, corporations. For example, the 1986 Act imposed an alternative minimum tax that provides a new, broadened tax base for C corporations. In addition, C corporations with average gross receipts of more than $5 million were new required to use an accrual method of accounting; certain S corporations could continue to the cash receipts and disbursements method of accounting.

There have been relatively few direct changes to subchapter S since the 1986 Act. The most significant indirect change has been the increases in the top marginal individual tax rates by the Omnibus Budget Reconciliation Act of 1990 (to 31 percent) and the Omnibus Budget Reconciliation Act of 1993 (to 39.6 percent). This latter change again inverted the top corporate and individual rates and has lead to an examination of the feasibility of the subchapter S election by some taxpayers.[50]

D. Data on Subchapter S Corporations

Data from the Internal Revenue Service's *Statistics of Income* ("SOI") suggest that as a result of the 1986 Act, the relative importance of Subchapter S corporations has increased. In the 15 years from 1978 to 1993, the number of S corporation returns filed nearly tripled, with three-quarters of the increase coming after 1986 (Table 1). The increase was most rapid in the years 1987–1990. Since then, the annual growth rate in the number of S corporations returned to rates comparable to those of the early 1980s.

At the same time that the number of S corporation returns have increased, the number of C corporation and partnership returns have decreased. The result of those trends is that S corporations represented 48.4 percent of all corporations in 1993. By contrast, in 1986, S corporations were only 24.1 percent of all corporations. In 1990, the number of S corporations surpassed the number of partnerships for the first time. While there has been a relative shift between partnerships, C corporations, and S corporations, the predominant form of organization throughout the period has remained the sole proprietorship. As Table 1 shows for the period 1978-1992, non-farm sole proprietorships have been just under three-quarters of all businesses.

Along with the increase in the number of S corporations, there has been an increase in the assets, receipts, and net income of S corporations. In 1993, preliminary data show that S corporations reported 16.5 percent of the business receipts and 11.1 percent of the net income of all corporations. In 1986, the comparable figures

[49] Although the ability to realize tax-free gain upon liquidation was generally repealed after 1986, a transition rule was providing for certain closely-held corporations with less than $10 million in value for two additional years. This transition relief was phased-out ratably for firms with equity between $5 million and $10 million.

[50] See, for example, Rohman, Blau, and Lemons, "Should S Elections Be Revoked Because of the New Individual Tax Rates Under RRA'93?," 80 *Journal of Taxation* 14 (1994) and Looney, "Choice of Entity After RRA '93: Back to the Future for S Corporations?" 5 *Journal of S Corporation Taxation* 377 (1994).

were 5.6 percent for business receipts and 3.1 percent for net income. Both figures grew sharply from 1986 to 1987, following only mild fluctuations in the previous decade. The share of total corporate assets held by S corporations has grown less dramatically, doubling from 1.8 percent in 1986 to 4.0 percent in 1993. The growth of S corporations relative to all corporations in terms of number of returns, assets, total receipts and net income is depicted in Chart 1.

Table 1. -- Number of S Corporation Returns Relative to All Business Returns

Year	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
S Corps	478,679	514,907	545,389	541,489	564,219	648,267	701,339	724,749	826,214	1,127,905	1,257,191	1,422,967	1,575,092	1,696,927	1,785,371	1,909,786
C Corps	1,898,100	2,041,887	2,165,149	2,270,931	2,361,714	2,350,804	2,469,404	2,552,470	2,602,301	2,484,228	2,305,598	2,204,896	2,141,558	2,105,200	2,083,652	2,036,828
Partnerships	1,234,157	1,299,593	1,379,654	1,460,502	1,514,212	1,541,539	1,643,581	1,713,603	1,702,952	1,648,035	1,654,245	1,635,164	1,553,529	1,515,345	1,484,752	N/A
Nonfarm sole props	8,908,289	9,343,603	9,730,019	9,584,790	10,105,515	10,703,921	11,262,390	11,928,573	12,393,700	13,091,132	13,679,302	14,297,558	14,782,738	15,180,722	15,495,419	N/A
Total	12,519,225	13,199,990	13,820,211	13,857,712	14,545,660	15,244,531	16,076,714	16,919,395	17,525,167	18,351,300	18,896,336	19,560,585	20,052,917	20,498,194	20,849,194	N/A
% of all businesses																
S Corps	3.8%	3.9%	3.9%	3.9%	3.9%	4.3%	4.4%	4.3%	4.7%	6.1%	6.7%	7.3%	7.9%	8.3%	8.6%	
C Corps	15.2%	15.5%	15.7%	16.4%	16.2%	15.4%	15.4%	15.1%	14.8%	13.5%	12.2%	11.3%	10.7%	10.3%	10.0%	
Partnerships	9.9%	9.8%	10.0%	10.5%	10.4%	10.1%	10.2%	10.1%	9.7%	9.0%	8.8%	8.4%	7.7%	7.4%	7.1%	
Nonfarm sole props	71.2%	70.8%	70.4%	69.2%	69.5%	70.2%	70.1%	70.5%	70.7%	71.3%	72.4%	73.1%	73.7%	74.1%	74.3%	
Annual growth rate in number of returns																
S Corps	11.8%	7.6%	5.9%	-0.7%	4.2%	14.9%	8.2%	3.3%	14.0%	36.5%	11.5%	13.2%	10.7%	7.7%	5.2%	7.0%
C Corps	4.7%	7.6%	6.0%	4.9%	4.0%	-0.5%	5.0%	3.4%	2.0%	-4.5%	-7.2%	-4.4%	-2.9%	-1.7%	-1.0%	-2.2%
Partnerships	7.0%	5.3%	6.2%	5.9%	3.7%	1.8%	6.6%	4.3%	-0.6%	-3.2%	0.4%	-1.2%	-5.0%	-2.5%	-2.0%	
Nonfarm sole props		4.9%	4.1%	-1.5%	5.4%	5.9%	5.2%	5.9%	3.9%	5.6%	4.5%	4.5%	3.4%	2.7%	2.1%	

Source: Internal Revenue Service, Statistics of Income, published and unpublished data

The small share of corporate assets held by S corporations points out that, despite the rapid growth in the number of S corporations following the Tax Reform Act of 1986, S corporations still tend to be small. The data in Table 2 illustrate that over half of S corporations in 1993 had no more than $100,000 in assets. The average assets for all S corporations was $458,039, compared to $5.8 million for all corporations. Still, there are some large S corporations. Just under one thousand S corporations (.05 percent of the total) have assets in excess of $50 million (12.3 percent of the total assets held by S corporations).

The aggregate figures for S corporations conceal some differences according to industry. Charts 2 through 5 illustrate some of the interindustry differences, with S corporations classified according to their principal business activity: agricultural services (including forestry and fishing); mining; construction; manufacturing; transporation, communications, and public utilities; wholesale and retail trade; finance, insurance, and real estate (abbreviated as "FIRE"); and nonagricultural services. While there has been no dramatic change in the distribution of S corporation returns by industry as a result of the 1986 Act, there has been a gradual trend in two of the industries. The percentage of S corporation returns in wholesale and retail trade has declined over the 1980-1993 period, while the percentage of returns in services has increased substantially. The share of total receipts attributable to manufacturing has nearly doubled from 1980-1993; other industry groups show more modest fluctuations. Chart 5 shows that after 1986, the average assets of S corporations increased substantially in all industries except agriculture and services. The largest increase is in manufacturing, where the average S corporation has gone from $638,000 in 1986 to $1.25 million in assets. The increase in average subchapter S corporation assets has slowed in recent years, except in mining. These figures are consistent with the notion that firms electing S corporation status around the time of the 1986 Act had more assets than other S corporations.[51]

One area in which there has been no significant effect from the 1986 Act has been in the number of shareholders for individual S corporations. As shown by the data in Table 3, S corporations continue to be predominately held by three or fewer shareholders. In 1993, half of all S corporations have one shareholder; these firms hold 31 percent of all S corporation assets. Fewer than one-sixth of S corporations have more than three shareholders. Over 90 percent of S corporation assets are in firms with 10 or fewer shareholders.

[51] See, Susan C. Nelson, "S Corporations: The Record of Growth After Tax Reform" 5 *Journal of S Corporation Taxation* 138 (1993).

Table 2. -- 1993 SOI Data on S Corporations

Total Assets	Number of returns	Average assets	Total assets	% of total assets	Average total receipts	Total total receipts	% of total total receipts	Average net income	Total net income	% of total net income
Less than or equal to zero	126,880				151,644	13,078,599,412	0.65%	-8,500	-968,699,440	
$1 to $100,000	1,085,538	28,842	31,308,907,740	3.58%	199,743	195,011,618,249	9.67%	6,262	6,559,108,912	11.88%
$100,000 to $250,000	282,258	160,295	45,244,504,073	5.17%	548,803	137,654,717,649	6.82%	15,720	4,110,930,165	7.44%
$250,000 to $500,000	162,145	353,346	57,293,173,461	6.55%	1,013,580	140,691,070,037	6.98%	19,193	2,777,943,053	5.03%
$500,0000 to $1,000,000	108,386	706,547	76,579,462,570	8.75%	1,682,112	152,979,801,364	7.58%	41,564	3,926,488,313	7.11%
$1,000,000 to $10,000,000	133,083	2,717,804	361,694,369,744	41.35%	6,870,758	814,840,629,549	40.40%	157,250	19,129,741,086	34.63%
$10,000,000 to $50,000,000	10,501	18,578,185	195,081,927,298	22.30%	40,059,731	398,121,856,611	19.74%	1,288,808	12,946,208,567	23.44%
$50,000,000 to $100,000,000	698	67,105,899	46,858,707,171	5.36%	116,513,463	79,659,905,422	3.95%	4,780,470	3,278,460,458	5.94%
$100,000,000 to $250,000,000	237	143,922,667	34,096,575,140	3.90%	237,563,262	55,041,744,822	2.73%	10,116,176	2,334,277,219	4.23%
$250,000,000 to $500,000,000	41	335,410,238	13,885,983,837	1.59%	421,419,441	17,446,764,871	0.86%	19,753,816	817,807,991	1.48%
$500,000,000 and over	18	687,906,640	12,712,514,702	1.45%	675,177,617	12,477,282,369	0.62%	17,337,124	320,390,047	0.58%
Total	1,909,788	458,039	874,756,125,735	100.00%	1,205,878	2,017,003,990,354	100.00%	30,744	55,232,656,370	100.00%

Source: Internal Revenue Service, Statistics of Income, unpublished data

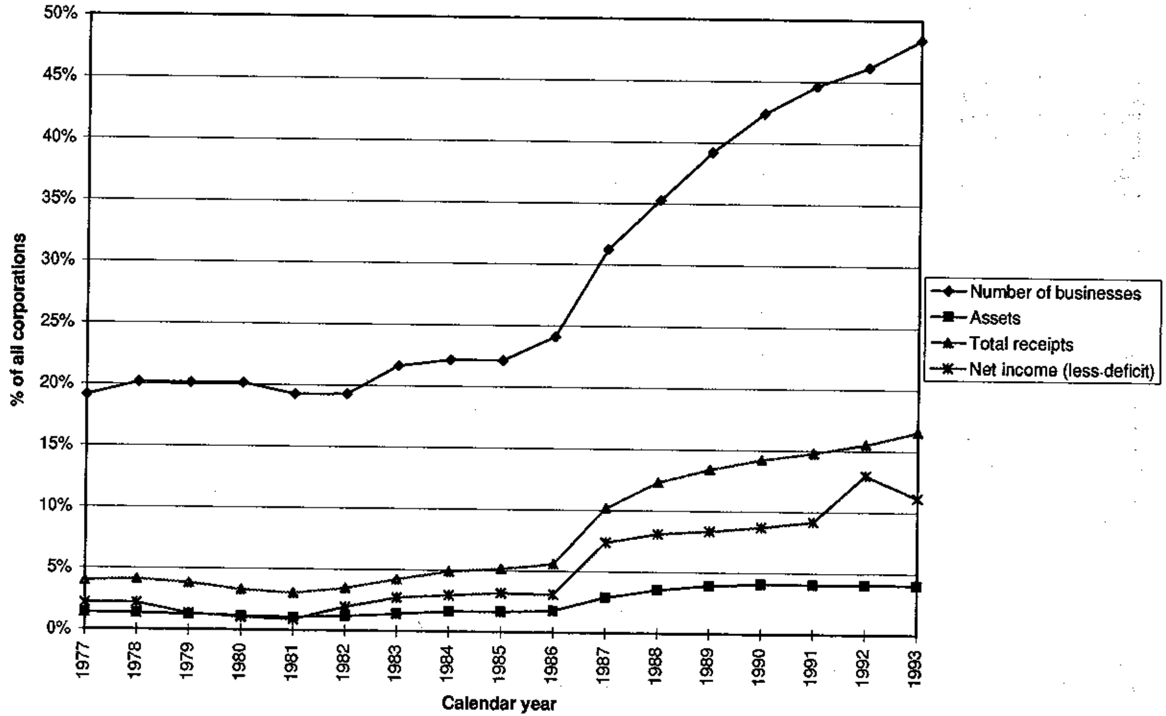
Table 3. -- Returns and Assets of S Corporations by Number of Shareholders, Various Years

	Number of Shareholders								
	1	2	3	4-5	6-10	11-20*	21-30	31+	Total
Returns (in thousands)									
1982	234	186	64	52	23	4	0	0	564
1988	571	412	121	95	36	18	2.7	0.3	1,257
1989	664	460	130	109	41	14	1.9	1.2	1,423
1990	754	503	133	113	45	13	2.1	0.7	1,573
1991	820	539	146	114	45	14	2.3	1.0	1,697
1992	878	565	147	115	49	15	2.8	2.4	1,785
1993	961	594	146	129	51	17	2.7	0.8	1,910
Assets (in $ millions)									
1982	30,164	28,840	17,571	17,063	13,101	3,775	0	0	110,513
1988	176,463	147,246	68,931	82,855	58,424	34,780	10,561	5,273	584,533
1989	209,716	173,291	81,899	96,823	70,993	33,923	13,447	6,758	687,394
1990	231,333	186,348	86,153	100,932	78,483	36,946	15,704	7,119	743,844
1991	245,726	188,627	88,315	105,141	79,737	38,909	15,774	6,255	770,292
1992	255,060	195,386	95,319	107,322	87,254	42,473	17,882	6,702	808,091
1993	273,695	209,935	99,909	117,940	96,724	49,315	19,092	7,589	874,756
% of returns									
1982	41.49%	32.98%	11.35%	9.22%	4.08%	0.71%	0.00%	0.00%	100.00%
1988	45.43%	32.78%	9.63%	7.56%	2.86%	1.43%	0.21%	0.02%	100.00%
1989	46.66%	32.33%	9.14%	7.66%	2.88%	0.98%	0.13%	0.08%	100.00%
1990	47.93%	31.98%	8.46%	7.18%	2.86%	0.83%	0.13%	0.04%	100.00%
1991	48.34%	31.77%	8.63%	6.72%	2.67%	0.82%	0.14%	0.06%	100.00%
1992	49.17%	31.67%	8.22%	6.46%	2.75%	0.85%	0.16%	0.14%	100.00%
1993	50.29%	31.11%	7.65%	6.77%	2.68%	0.91%	0.14%	0.04%	100.00%
% of assets									
1982	27.29%	26.10%	15.90%	15.44%	11.85%	3.42%	0.00%	0.00%	100.00%
1988	30.19%	25.19%	11.79%	14.17%	9.99%	5.95%	1.81%	0.90%	100.00%
1989	30.51%	25.21%	11.91%	14.09%	10.33%	4.94%	1.96%	0.98%	100.00%
1990	31.10%	25.05%	11.58%	13.57%	10.55%	4.97%	2.11%	0.96%	100.00%
1991	31.90%	24.49%	11.47%	13.65%	10.35%	5.05%	2.05%	0.81%	100.00%
1992	31.56%	24.18%	11.80%	13.28%	10.80%	5.26%	2.21%	0.83%	100.00%
1993	31.29%	24.00%	11.42%	13.48%	11.06%	5.64%	2.18%	0.87%	100.00%

* For 1982, this category is 11-25.

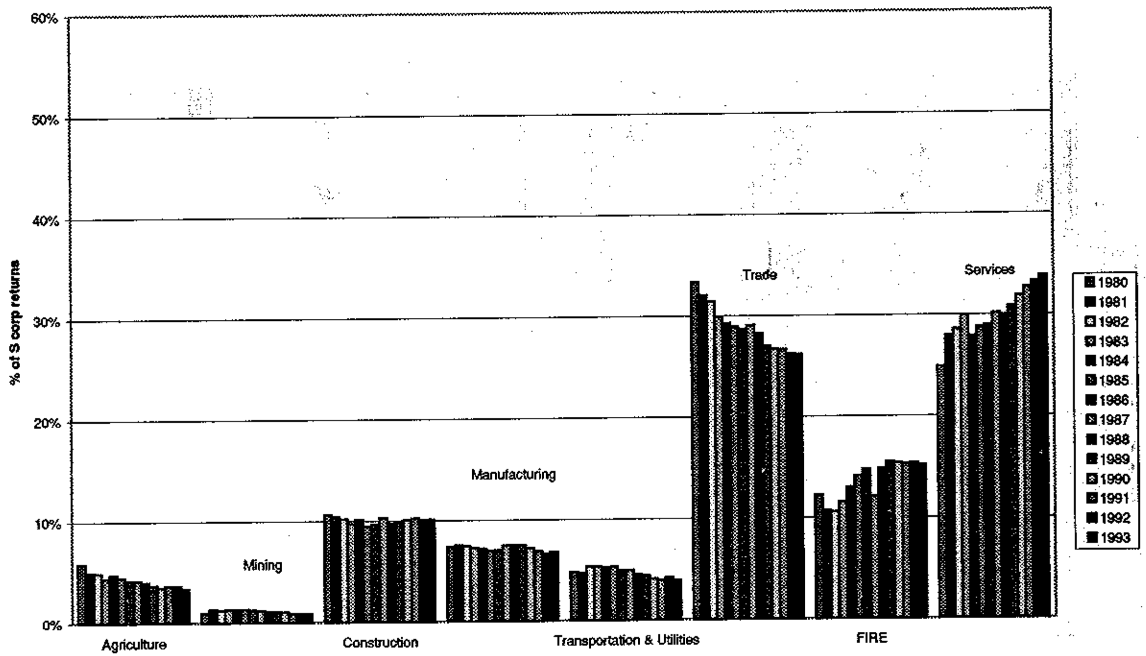
Sources: 1991-1993: Internal Revenue Service, Statistics of Income, unpublished data; 1982 and 1988-1990: Susan C. Nelson, "S Corporations: The Record of Growth After Tax Reform", Journal of S Corporation Taxation

Chart 1. -- S Corporations as Fraction of All Corporations



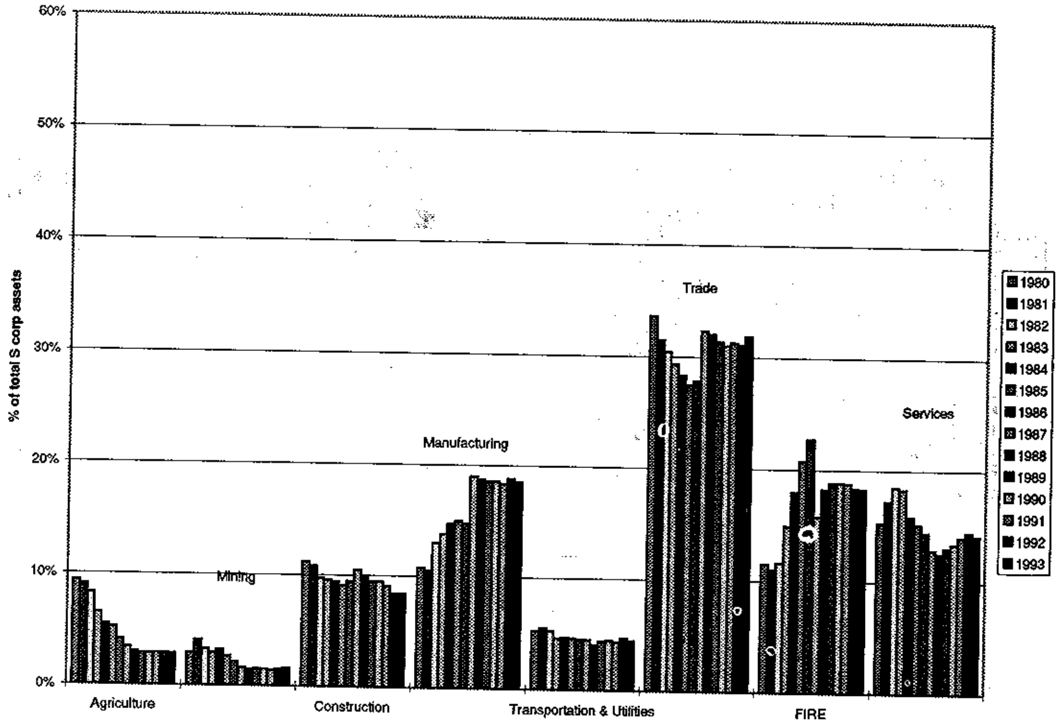
Source: Internal Revenue Service, Statistics of Income, published and unpublished data

Chart 2. -- Distribution of S Corporation Returns by Industry, 1980-1993



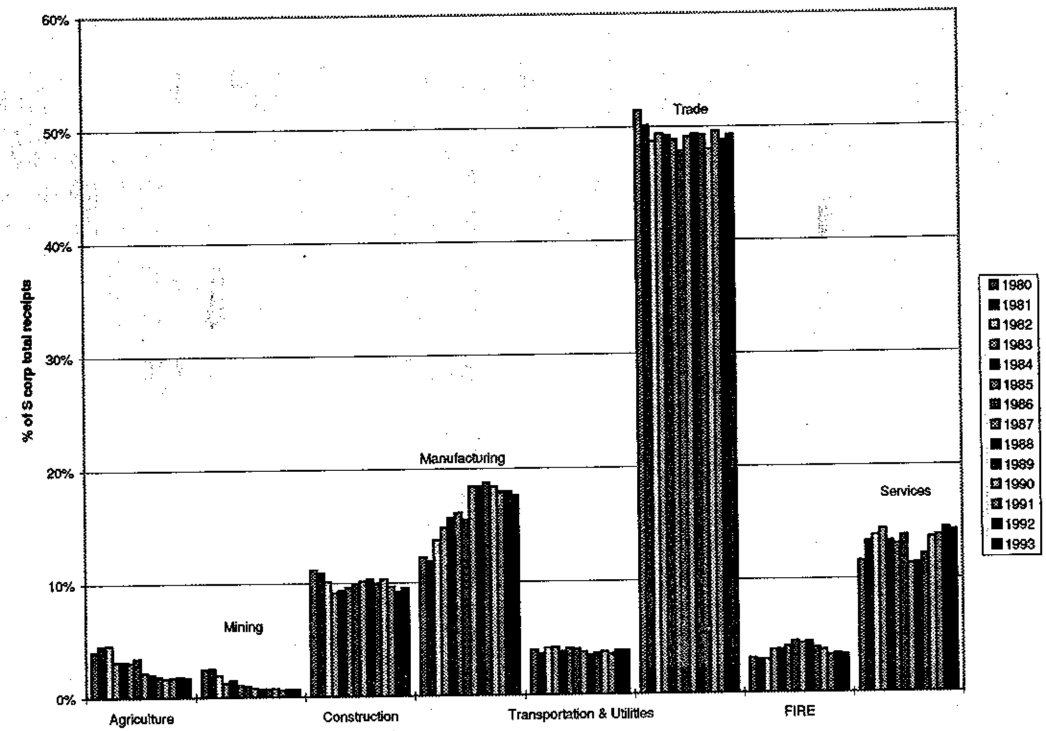
Source: Internal Revenue Service, Statistics of Income, published and unpublished data

Chart 3. -- Distribution of S Corporation Assets by Industry, 1980-1993



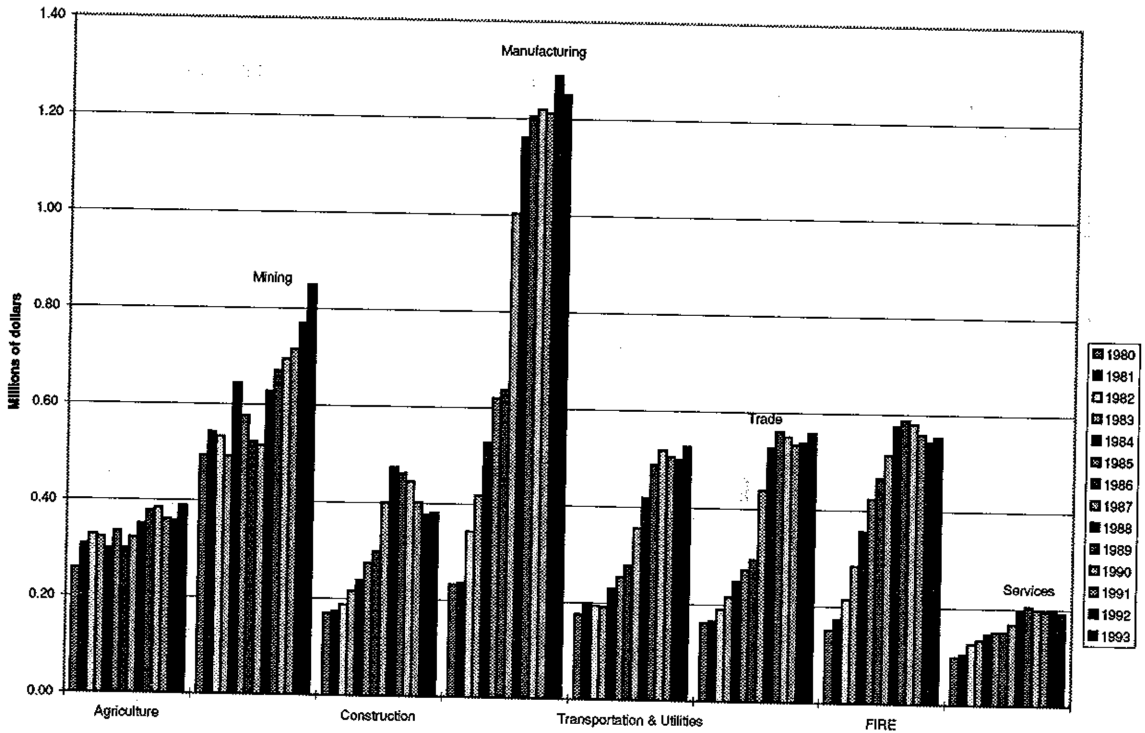
Source: Internal Revenue Service, Statistics of Income, published and unpublished data

Chart 4. -- Distribution of S Corporation Total Receipts by Industry, 1980-1993



Source: Internal Revenue Service, Statistics of Income, published and unpublished data

Chart 5. – S Corporation Average Assets by Industry, 1980-1993



Source: Internal Revenue Service, Statistics of Income, published and unpublished data

E. Explanation of S. 758

S. 758 ("S Corporation Reform Act of 1995") was introduced on May 4, 1995, by Senators Hatch and Pryor (and was co-sponsored by Senators Simpson, Breaux, Lugar, Leahy, Hutchison, Murray, Bond, Kemphorne, Johnston, Ford, Robb, Dorgan, Kerrey, Kyl, Baucus, Craig, Cochran, Cohen, Grassley, D'Amato, Bennett, and Bingaman). Following are descriptions of the provisions of S. 758.

1. Shareholder and corporate eligibility

a. Types and number of eligible shareholders and eligible corporations (secs. 101 and 102 of the bill)

Present Law

The taxable income or loss of an S corporation is taken into account by the corporation's shareholders, rather than by the entity, whether or not such income is distributed. A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 35-shareholders; (2) as a shareholder, a person (other than certain trusts or estates) who is not an individual; (3) a nonresident alien as a shareholder; and (4) more than one class of stock. For purposes of the 35-shareholder limitation, a husband and wife are treated as one shareholder. An "ineligible corporation" means any corporation which is a member of an affiliated group, certain financial institutions, certain insurance companies, a section 936 corporation, or a DISC or former DISC.

Description of Provisions

The bill would make the following changes to the shareholder limitations imposed upon S corporation eligibility.

The maximum number of eligible shareholders would be increased from 35 to 50.

All family members owning stock could elect to be treated as one shareholder. A family would be defined as the lineal descendants of a common ancestor (and their spouses and former spouses). The common ancestor could not be more than six generations removed from the youngest generation of shareholder at the time the S election is made (or the effective date of the provision, if later). The election would be made available to only one family per corporation, must be made with the consent of all shareholders of the corporation and would remain in effect until terminated.

b. Tax-exempt entities allowed to be shareholders (sec. 111 of the bill)

Present Law

A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 35 shareholders; (2) as a shareholder, a person (other than certain trusts or estates) who is not an individual; (3) a nonresident alien as a shareholder; and (4) more than one class of stock. Thus, a tax-exempt entity described in sections 401(a) (relating to qualified retirement plan trusts) and 501(c)(3) (relating to certain charitable organizations) cannot be shareholders in an S corporation.

A tax-exempt entity may be a partner in partnership. If a partnership carries on a trade or business that is an unrelated trade or business with respect to the tax-exempt entity, the tax-exempt partner is required to include its distributive share of income from such trade or business as unrelated business taxable income (sec. 512(c)).

Description of Provision

Tax-exempt organizations described in Code sections 401(a) and 501(c)(3) would be allowed to be shareholders in small business corporations. Items of income or loss of an S corporation would flow-through to the tax-exempt organization for purposes of the unrelated business income tax applicable to such organizations in a manner similar to the treatment of items of income or loss that flow through to tax-exempt organizations that are partners in partnerships under present law.

c. Nonresident aliens allowed to be shareholders (sec. 113 of the bill)

Present Law

A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 35 shareholders; (2) as a shareholder, a person (other than certain trusts or estates) who is not an individual; (3) a nonresident alien as a shareholder; and (4) more than one class of stock.

A nonresident alien individual engaged in a trade or business within the United States is subject to tax on his or her taxable income which is effectively connected with the conduct of a trade or business within the United States (sec. 871). A nonresident alien individual may be a partner in a domestic partnership. A nonresident alien partner is considered to be engaged in a trade or business within the United States if the partnership is so engaged (sec. 875). If a partnership has effectively connected taxable income and any portion of such income is allocable to a foreign partner, the partnership is required to withhold tax with respect to such income on behalf of such partner.

Description of Provision

A nonresident alien would be allowed to be a shareholder in a small business corporation. Any effectively connected U.S. income allocable to the nonresident alien would be subject to a withholding tax in a manner similar to the treatment of such income allocable to nonresident aliens that are partners in U.S. partnerships under present law.

d. Certain trusts eligible to hold stock in S corporations (secs. 114 and 121 of the bill)

Present Law

Under present law, trusts other than grantor trusts, voting trusts, certain testamentary trusts (for a 60-day or two-year period) and "qualified subchapter S trusts" may not be shareholders in a S corporation. A "qualified subchapter S trust" is a trust which is required to have only one current income beneficiary (for life). All the income (as defined for local law purposes) must be currently distributed to that beneficiary. The beneficiary is treated as the owner of the portion of the trust consisting of the stock in the S corporation.

Description of Provision [52]

In general

The provision would allow stock in an S corporation to be held by certain trusts ("electing small business trust"). In order to qualify for this treatment, all beneficiaries of the trust must be an individual, estate, or an organization described in section 401(a) or 501(c)(3). No interest in the trust may be acquired by purchase. For this purpose, "purchase" means any acquisition of property with a cost basis (determined under sec. 1012). Thus, interests in the trust must be acquired by reason of gift, bequest, or similarly.

A trust must elect to be treated as an electing small business trust. An election applies to the taxable year for which made and could be revoked only with the consent of the Secretary of the Treasury or his delegate.

Each potential current beneficiary of the trust would be counted as a shareholder for purposes of the 50-shareholder limitation (or if there were no potential current beneficiaries, the trust would be treated as the shareholder). A potential current income beneficiary means any person, with respect to the applicable period, who is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. Where the trust disposes of all the stock in an S corporation, any person who first became so eligible during the 60 days before the disposition shall not be treated as a potential current beneficiary.

A qualified subchapter S trust with respect to which an election is in effect, and an exempt trust would not be eligible to qualify as an electing small business trust.

Treatment of items relating to S corporation stock

The portion of the trust which consists of stock in one or more S corporations would be treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. The trust would be taxed at the highest individual rate (39.6 percent) on this portion of the trust's income. The taxable income attributable to this portion includes (1) the items of income, loss, or deduction allocated to it as an S corporation share-

[52] A similar provision was included in H.R. 11 ("Revenue Act of 1992"), vetoed by President Bush in 1992, and in H.R. 3419 ("Tax Simplification and Technical Corrections Act of 1993"), as passed by the house of Representatives on May 17, 1994.

holder under the rules of subchapter S, (2) gain or loss from the sale of the S corporation stock, and (3) to the extent provided in regulations, any State or local income taxes and administrative expenses of the trust properly allocable to the S corporation stock. Otherwise allowable capital losses would be allowed only to the extent of capital gains.

In computing the trust's income tax on this portion of the trust, no deduction would be allowed for amounts distributed to beneficiaries, and no deduction or credit would be allowed for any item other than the items described above. This income would not be included in the distributable net income of the trust, and thus would not be included in the beneficiaries' income. No item relating to the S corporation stock could be apportioned to any beneficiary.

On the termination of all or any portion of an electing small business trust; the loss carryovers or excess deductions referred to in section 642(h) would be taken into account by the entire trust, subject to the usual rules on termination of the entire trust.

Treatment of remainder of items held by trust

In determining the tax liability with regard to the remaining portion of the trust, the items taken into account by the subchapter S portion of the trust would be disregarded. Although distributions from the trust would be deductible in computing the taxable income on this portion of the trust, under the usual rules of subchapter J, the trust's distributable net income would not include any income attributable to the S corporation stock.

Holding period for testamentary trusts

The bill would also extend the holding period for all testamentary trusts to two years.

e. Financial institutions as eligible corporations (sec. 112 of the bill)

Present Law

A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which meets certain other requirements. An "ineligible corporation" means any corporation which is a member of an affiliated group, certain financial institutions (i.e., banks, domestic savings and loan associations, mutual savings banks, and certain cooperative banks), certain insurance companies, a section 936 corporation, or a DISC or former DISC.

Description of Provision

A financial institution would be allowed to be an eligible small business corporation unless such institution uses a reserve method of accounting for bad debts as described in section 585 (the experience method generally available to small banks) or section 593 (the percentage of taxable income method generally available to domestic savings and loan associations, mutual savings banks, and certain cooperative banks).

f. Requirement that an S corporation have one class of stock (secs. 201 and 202 of the bill)

Present Law

A small business corporation eligible to be an S corporation may not have more than one class of stock. Certain debt ("straight debt") is not treated as a second class of stock so long as such debt is an unconditional promise to pay on demand or on a specified date a sum certain in money if: (1) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors; (2) there is no convertibility (directly or indirectly) into stock, and (3) the creditor is an individual (other than a nonresident alien), an estate, or certain qualified trusts.

Description of Provisions

The bill would make the following changes to the one class of stock rule applicable to S corporations:

(1) A small business corporation would be permitted to issue certain preferred stock. In general, such stock would be stock that is not convertible and does not participate in corporate growth to any significant extent. Only eligible S corporation shareholders would be allowed to own preferred stock. Payments made on the preferred stock would be treated as interest.

(2) The definition of "straight debt" would be expanded to include debt that is convertible into the stock of the corporation under terms that are substantially the same as the terms that could have been obtained from an unrelated person.

(3) The definition of "straight debt" would be expanded to include debt held by creditors, other than individuals, that are actively and regularly engaged in the business of lending money.

g. S corporation permitted to hold S or C subsidiaries (sec. 221 of the bill)

Present Law

A small business corporation may not be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations). Thus, an S corporation may not own 80 percent or more of the stock of another corporation (whether an S corporation or a C corporation).

In addition, a small business corporation may not have as a shareholder another corporation (whether an S corporation or a C corporation).

Description of Provisions

An S corporation would be allowed to own 80 percent or more of the stock of a C corporation.[53] Dividends received by an S corporation from a C corporation in which the S corporation has an 80 percent or greater ownership stake would not be treated as passive investment income to the extent the dividends are attributable to the

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[53] A similar provision was included in H.R. 11 (the "Revenue Act of 1992"), vetoed by President Bush in 1992, and in H.R. 3419 ("Tax Simplification and Technical Corrections Act of 1993"), as passed by the House of Representatives on May 17, 1994.

earnings and profits of the C corporation derived from the active conduct of a trade or business.

In addition, an S corporation would be allowed to own 100 percent of a qualified S corporation. The qualified S corporation would not be treated as a separate corporation and all the assets, liabilities, and items of income deduction, and credit of the subsidiary would be treated as the assets, liabilities, and items of income, deduction, and credit of the parent S corporation. Thus, transactions between the S corporation parent and subsidiary would not be taken into account and all attributes of the subsidiary (include C corporation earnings and profits, passive investment income, built-in gains, etc.) would be considered to be attributes of the parent. In addition, if a subsidiary ceases to be a qualified S corporation subsidiary (i.e., fails to meet the wholly-owned requirement), the subsidiary will be treated as a new corporation acquiring all of its assets (and assuming all of it liabilities) immediately before such cessation from the parent S corporation in exchange for its stock.[54]

2. Elections and terminations

a. Authority to validate certain invalid elections (sec. 211 of the bill)

Present Law

Under present law, if the Internal Revenue Service (IRS) determines that a corporation's Subchapter S election is inadvertently terminated, the IRS can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and shareholders agree to be treated as if the election had been in effect for that period. Such waivers generally are obtained through the issuance of a private letter ruling. Present law does not grant the IRS the ability to waive the effect of an inadvertent invalid Subchapter S election.

In addition, under present law, a small business corporation must elect to be an S corporation no later than the 15th day of the third month of the taxable year for which the election is effective. The IRS may not validate a late election.

Description of Provision[55]

Under the bill, the authority of the IRS to waive the effect of an inadvertent termination would be extended to allow the Service to waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents (including elections regarding qualified subchapter S trusts), or both. The bill also would allow the IRS to treat a late subchapter S election as timely where the IRS determines that there was reasonable cause for the failure to make a timely election. These portions of the provision would apply to taxable years beginning after December 31, 1982.[56]

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[54] Similar rules apply with respect to wholly owned subsidiaries of real estate investment trusts (REITs) under section 856(i) of present law.

[55] A similar provision was included in H.R. 11 ("Revenue Act of 1992"), vetoed by President Bush in 1992, and in H.R. 3419 ("Tax Simplification and Technical Corrections Act of 1993"), as passed by the House of Representatives on May 17, 1994.

[56] This is the effective date of the present-law provision regarding inadvertent terminations.

Further, the provision would direct the IRS to adopt an automatic waiver procedure with respect to terminations in the cases that the Secretary of the Treasury deems appropriate.

b. Allow interim closing of the books on termination of shareholder interest with consent of corporation and affected shareholders (sec. 212 of the bill)

Present Law

In general, each item of S corporation income, deduction and loss is allocated to shareholders on a per-share, per-day basis. However, if any shareholder terminates his or her interest in an S corporation during a taxable year, the S corporation, with the consent of all its shareholders, may elect to allocate S corporation items by closing its books as of the date of such termination rather than apply the per-share, per-day rule.

Description of Provision

The bill would provide that, under regulations to be prescribed by the Secretary of the Treasury, the election to close the books of the S corporation upon the termination of a shareholder's interest would be made by, and apply to, all affected shareholders rather than by all shareholders. For this purpose, "affected shareholders" would mean any shareholder whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the year. If a shareholder transferred shares to the corporation, "affected shareholders" would include all persons who were shareholders during the year.

c. Expand the post-termination period and amend subchapter S audit procedures (sec. 213 of the bill)

Present Law

Distributions made by a former S corporation during its post-termination period are treated in the same manner as if the distributions were made by an S corporation (i.e., treated by shareholders as nontaxable distributions to the extent of the accumulated adjustment account). Distributions made after the post-termination period are generally treated as made by a C corporation (i.e., treated by shareholders as taxable dividends to the extent of earnings and profits).

The "post-termination period" is the period beginning on the day after the last day of the last taxable year of the S corporation and ending on the later of: (1) a date that is one year later, or (2) the due date for filing the return for the last taxable year and the 120-day period beginning on the date of a determination that the corporation's S corporation election had terminated for a previous taxable year.

In addition, the audit procedures adopted by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") with respect to partnerships also apply to S corporations. Thus, the tax treatment of items is determined at the corporate, rather than individual level.

Description of Provision

The present-law definition of post-termination period would be expanded to include the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the S corporation's election and that adjusts a subchapter S item of income, loss or deduction of the S corporation during the S period. In addition, the definition of "determination" would be expanded to include a final disposition of the Secretary of the Treasury of a claim for refund and, under regulations, certain agreements between the Secretary and any person, relating to the tax liability of the person.

In addition, the bill would repeal the TEFRA audit provisions applicable to S corporations and would provide other rules to require consistency between the returns of the S corporation and its shareholders.[57]

d. Termination of election and additions to tax due to passive investment income (sec. 214 of the bill)

Present Law

An S corporation is subject to corporate-level tax, at the highest marginal corporate tax rate, on its net passive income if the corporation has (1) subchapter C earnings and profits[58] at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

In addition, an S corporation election is terminated whenever the corporation has subchapter C earnings and profits at the close of three consecutive taxable years and has gross receipts for each of such years more than 25 percent of which are passive investment income.

For these purposes, "passive investment income" generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). "Passive investment income" generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, or gain or loss from any section 1256 contract (or related property) of an options or commodity dealer.[59] "Net passive income" is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of the income.

Description of Provision

The bill would increase the passive investment income threshold from 25 percent of gross income to 50 percent of gross income for purposes of levying the corporate-level tax on such income. In addition, "passive investment income" generally would not include gain from the sale of capital assets.

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[57] A similar provision was included in H.R. 11 ("Revenue Act of 1992"), vetoed by President Bush in 1992, and in H.R. 3419 ("Tax Simplification and Technical Corrections Act of 1993"), as passed by the House of Representatives on May 17, 1994.

[58] An S corporation generally will have subchapter C corporation earnings and profits if it had been a C corporation prior to electing to be an S corporation.

[59] See, Treas. reg. sec. 1.1362(c)(5).

The provision also would eliminate the rule that terminates an S corporation election whenever the corporation has excessive passive income for three consecutive years. Rather, for a taxable years beginning after 1995, if an S corporation has excessive passive investment income (as re-defined under the bill) for more than three consecutive taxable years, the rate of corporate-level tax applicable to such income is increased by 10 percentage points for each such succeeding taxable year (capped at a 50-percentage point increase after the seventh consecutive year). For example, if an S corporation has excessive passive investment income for five consecutive years, the corporate-level rates of tax applicable to such income would be 35 percent (the top marginal corporate tax rate) in each of the first three years, 45 percent in the fourth year, and 55 percent in the fifth year.

3. Other provisions

a. Treatment of distributions by S corporations during loss year (sec. 222 of the bill)

Present Law

Under present law, the amount of loss an S corporation shareholder may take into account for a taxable year cannot exceed the sum of the shareholder's adjusted basis in his or her stock of the corporation and the adjusted basis in any indebtedness of the corporation to the shareholder. Any excess loss is carried forward.

Any distribution to a shareholder by an S corporation generally is tax-free to the shareholder to the extent of the shareholder's adjusted basis of his or her stock. The shareholder's adjusted basis is reduced by the tax-free amount of the distribution. Any distribution in excess of the shareholder's adjusted basis is treated as gain from the sale or exchange of the stock.

Under present law, income (whether or not taxable) and expenses (whether or not deductible) serve, respectively, to increase and decrease an S corporation shareholder's basis in the stock of the corporation. These rules appear to require that the adjustments to basis for items of both income and loss for any taxable year apply before the adjustment for distributions applies.[60]

These rules limiting losses and allowing tax-free distributions up to the amount of the shareholder's adjusted basis are similar in certain respects to the rules governing the treatment of losses and cash distributions by partnerships. Under the partnership rules (unlike the S corporation rules), for any taxable year, a partner's basis is first increased by items of income, then decreased by distributions, and finally is decreased by losses for that year.[61]

In addition, if the S corporation has accumulated earnings and profits,[62] any distribution in excess of the amount in an "accumulated adjustments account" will be treated as a dividend (to the extent of the accumulated earnings and profits). A dividend distribution does not reduce the adjusted basis of the shareholder's stock.

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[60] See section 1366(d)(1)(A); H. Rep. 97-826, p. 17; S. Rep. 97-640, p. 18; Treas. reg. sec. 1.1367-1(e).

[61] Treas. reg. sec. 1.704-1(d)(2); Rev. Rul. 66-94, 1966-1 C.B. 166.

[62] An S corporation may have earnings and profits from years prior to its subchapter S election or from pre-1983 subchapter S years.

The "accumulated adjustments account" generally is the amount of the accumulated undistributed post-1982 gross income less deductions.

Description of Provision[63]

The bill would provide that the adjustments for distributions made by an S corporation during a taxable year are taken into account before applying the loss limitation for the year. Thus, distributions during a year would reduce the adjusted basis for purposes of determining the allowable loss for the year, but the loss for a year would not reduce the adjusted basis for purposes of determining the tax status of the distributions made during that year.

The bill also would provide that in determining the amount in the accumulated adjustment account for purposes of determining the tax treatment of distributions made during a taxable year by an S corporation having accumulated earnings and profits, net negative adjustments (i.e., the excess of losses and deductions over income) for that taxable year are disregarded.

The following examples illustrate the application of these provisions:

Example 1.—X is the sole shareholder of corporation A, a calendar year S corporation with no accumulated earnings and profits. X's adjusted basis in the stock of A on January 1, 1996, is $1,000 and X holds no debt of A. During 1996, A makes a distribution to X of $600, recognizes a capital gain of $200 and sustains an operating loss of $900. Under the bill, X's adjusted basis in the A stock is increased to $1,200 ($1,000 plus $200 capital gain recognized) pursuant to section 1368(d) to determine the effect of the distribution. X's adjusted basis is then reduced by the amount of the distribution to $600 ($1,200 less $600) to determine the application of the loss limitation of section 1366(d)(1). X is allowed to take into account $600 of A's operating loss, which reduces X's adjusted basis to zero. The remaining $300 loss is carried forward pursuant to section 1366(d)(2).

Example 2.—The facts are the same as in Example 1, except that on January 1, 1996, A has accumulated earnings and profits of $500 and an accumulated adjustments account of $200. Under the bill, because there is a net negative adjustment for the year, no adjustment is made to the accumulated adjustments account before determining the effect of the distribution under section 1368(c).

As to A, $200 of the $600 distribution is a distribution of A's accumulated adjustments account, reducing the accumulated adjustments account to zero. The remaining $400 of the distribution is a distribution of accumulated earnings and profits ("E&P") and reduces A's E&P to $100. A's accumulated adjustments account is then increased by $200 to reflect the recognized capital gain and reduced by $900 to reflect the operating loss, leaving a negative balance in the accumulated adjustment account on January 1, 1997, of $700 (zero plus $200 less $900).

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[63] A similar provision was included in H.R. 11 ("Revenue Act of 1992"), vetoed by President Bush in 1992, and in H.R. 3419 ("Tax Simplification and Technical Corrections Act of 1993"), as passed by the House of Representatives on May 17, 1994.

As to X, $200 of the distribution is applied against X's adjusted basis of $1,200 ($1,000 plus $200 capital gain recognized), reducing X's adjusted basis to $1,000. The remaining $400 of the distribution is taxable as a dividend and does not reduce X's adjusted basis. Because X's adjusted basis is $1,000, the loss limitation does not apply to X, who may deduct the entire $900 operating loss. X's adjusted basis is then decreased to reflect the $900 operating loss. Accordingly, X's adjusted basis on January 1, 1997, is $100 ($1,000 plus $200 less $200 less $900).

b. Permit consent dividends to by-pass the accumulated adjustments account (sec. 223 of the bill)

Present Law

The accumulated adjustments account ("AAA") of an S corporation generally is the amount of undistributed earnings of the S corporation that have been subject to shareholder-level tax. If an S corporation with both AAA and C corporation earnings and profits makes a distribution to shareholders, the amount of the distribution is deemed to first reduce the AAA. An S corporation may, with the consent of all its affected shareholders, elect to have all distributions made during a taxable year by-pass the AAA. Treasury regulation 1.1368-1(f)(3) allows the election to apply to deemed dividends.

Description of Provision

The Treasury regulation allowing the election to by-pass the AAA to apply to deemed dividends would be codified. Any such distribution to an organization described in section 511(a)(2) would be treated as unrelated business taxable income to such organization.

c. Treatment of S corporations as shareholders in C corporations (sec. 224 of the bill)

Present Law

Present law contains several provisions relating to the treatment of S corporations as corporations generally for purposes of the Internal Revenue Code.

First, under present law, the taxable income of an S corporation is computed in the same manner as in the case of an individual (sec. 1363(b)). Under this rule, the provisions of the Code governing the computation of taxable income which are applicable only to corporations, such as the dividends received deduction, do not apply to S corporations.

Second, except as otherwise provided by the Internal Revenue Code and except to the extent inconsistent with subchapter S, subchapter C (i.e., the rules relating to corporate distributions and adjustments) applies to an S corporation and its shareholders (sec. 1371(a)(1)). Under this second rule, provisions such as the corporate reorganization provisions apply to S corporations. Thus, a C corporation may merge into an S corporation tax-free.

Further, an S corporation in its capacity as a shareholder of another corporation is treated as an individual for purposes of subchapter C (sec. 1371(a)(2)). The IRS has taken the position that this rule prevents the tax-free liquidation of a C corporation into an S corporation because a C corporation cannot liquidate tax-free when owned by an individual shareholder.[64] Thus, a C corporation may elect S corporation status tax-free or may merge into an S corporation tax-free, but may not liquidate into an S corporation tax-free.[65] Also, the Service's reasoning would prevent an S corporation from making an election under section 338 where a C corporation was acquired by an S corporation.

Description of Provision[66]

The bill would repeal the rule that treats an S corporation in its capacity as a shareholder of another corporation as an individual. Thus, the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules, including the provisions of sections 332 and 337 allowing the tax-free liquidation of a corporation into its parent corporation. Following a tax-free liquidation, the built-in gains of the liquidating corporation may later be subject to tax under section 1374 upon a subsequent disposition. An S corporation also will be eligible to make a section 338 election (assuming all the requirements are otherwise met), resulting in immediate recognition of all the acquired C corporation's gains and losses (and the resulting imposition of a tax).

The repeal of this rule would not change the general rule governing the computation of income of an S corporation. For example, it would not allow an S corporation, or its shareholders, to claim a dividends received deduction with respect to dividends received by the S corporation, or to treat any item of income or deduction in a manner inconsistent with the treatment accorded to individual taxpayers.

d. Elimination of pre-1983 earnings and profits of S corporations (sec. 225 of the bill)

Present Law

Under present law, the accumulated earnings and profits of a corporation are not increased for any year in which an election to be treated as an S corporation is in effect. However, under the subchapter S rules in effect before revision in 1982, a corporation electing subchapter S for a taxable year increased its accumulated earnings and profits if its earnings and profits for the year exceeded both its taxable income for the year and its distributions out of that year's earnings and profits. As a result of this rule, a shareholder may later be required to include in his or her income the accumulated earnings and profits when it is distributed by the corporation. The 1982 revision to subchapter S repealed this rule for earnings attributable to taxable years beginning after 1982 but did not do so for previously accumulated S corporation earnings and profits.

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[64] See PLR 8818049, (Feb. 10, 1988). However, see PLR 9245004, (July 28, 1992) for a contrary ruling.

[65] Tax is imposed with respect to LIFO inventory held by a C corporation becoming an S corporation.

[66] A similar provision was included in H.R. 11 ("Revenue Act of 1992"), vetoed by President Bush in 1992, and in H.R. 3419 ("Tax Simplification and Technical Corrections Act of 1993"), as passed by the House of Representatives on May 17, 1994.

Description of Provision[67]

The bill would provide that if a corporation is an S corporation for its first taxable year beginning after December 31, 1995, the accumulated earnings and profits of the corporation as of the beginning of that year would reduced by the accumulated earnings and profits (if any) accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S. Thus, such a corporation's accumulated earnings and profits would be solely attributable to taxable years for which an S election was not in effect. This rule is generally consistent with the change adopted in 1982 limiting the S shareholder's taxable income attributable to S corporation earnings to his or her share of the taxable income of the S corporation.

e. Treatment of charitable contributions of certain property (sec. 226 of the bill)

Present Law

Taxpayers generally are allowed to deduct the fair market value of property contributed to a charitable organization. In the case of business property contributed to a charity and used in the tax-exempt function of the charity, donors must reduce the amount of the deduction by the amount of gain that would not have been long-term capital gain had the property been sold by the donor (sec. 170(e)(1)(A)).[68] However, the amount of the reduction is capped in the case of a corporation (other than an S corporation) that contributes (1) certain inventory used by the donee solely for the care of the ill, needy, or infants (sec. 170(e)(3)(B)) or (2) certain scientific property used for research (sec. 170(e)(4)). In such cases, the amount of the reduction is limited to the sum of (1) one-half of the amount of gain that would not have been long-term capital gain had the property been sold and (2) the amount (if any) by which the charitable contribution (determined by taking into account the amount described in (1)) exceeds twice the basis of the property.

If an S corporation contributes appreciated property to a charity, the shareholders of the corporation must reduce their basis in their S corporation stock by the amount of the contribution that flows through to them.

Description of Provision

The bill would provide that S corporations would be treated the same as C corporations with respect to charitable contributions of (1) certain inventory used by the donee solely for the care of the ill, needy, or infants and (2) certain scientific property used for research.

The bill also would allow an increase in the basis of S corporation stock for the excess of the deduction for charitable contribution over the basis of the property contributed by the corporation.

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[67] A similar provision was included in H.R. 11 ("Revenue Act of 1992"), vetoed by President Bush in 1992 and in H.R. 3419 ("Tax Simplification and Technical Corrections Act of 1993"), as passed by the House of Representatives on May 17, 1994.

[68] Greater reductions in the charitable deduction are required if the property is not used in the charity's tax-exempt function (sec. 170(e)(1)(B)).

f. Treatment of certain fringe benefits (secs. 227 and 301 of the bill)

Present Law

For fringe benefit purposes, an individual that owns two percent or more of the stock of the S corporation at any time during the year is treated the same as a partner in a partnership.

Self-employed individuals may deduct up to 25 percent (30 percent in taxable years beginning after 1994) of the amount paid during the year for medical insurance that covers the individual and his or her spouse and dependents. For this purposes, an individual that owns two percent or more of the stock of the S corporation at any time during the year is treated as a self-employed individual.

A qualified deferred compensation plan of an S corporation is prohibited from making loans to shareholder-employees that own more than five percent of the S corporation stock. Should this prohibition be violated, the plan may be subject to an excise tax and the plan may lose its status as a qualified plan.

Description of Proposal

For fringe benefit purposes, an S corporation would be treated as a C corporation rather than as a partnership. However, two-percent shareholders would be treated as self-employed individuals for purposes of the deduction for medical insurance (i.e., their deductions for medical insurance would be limited to 30 percent of their cost).

In addition, the restriction on loans from qualified plans would be repealed.

g. Treatment of losses on liquidation of S corporation (sec. 302(a) of the bill)

Present Law

If an S corporation is liquidated, gain or loss on the property distributed in liquidation is measured at the corporate level (by comparing the fair market value of the property to its adjusted basis in the hands of the corporation) and flowed through to the shareholders. The character of such gain or loss is also determined at the corporate level and may be flowed through to shareholders as ordinary gain or loss. The gain increases the shareholders' adjusted bases in their stock. The shareholders then have individual-level gain or loss with respect to the property received (measured by comparing the fair market value of the property to the shareholders' adjusted bases in their stock). Such gain or loss generally is capital gain or loss. Thus, a shareholder of an S corporation may have ordinary gain and a capital loss upon the liquidation of an S corporation.

Description of Provision

Loss recognized by a shareholder in complete liquidation of an S corporation would be treated as ordinary loss to the extent the shareholder's adjusted basis in the S corporation stock is attributable to ordinary income that was recognized as a result of the liquidation.

h. Treatment of certain losses carried over under the at-risk rules (sec. 302(b) of the bill)

Present Law

Under section 1366, the amount of loss an S corporation shareholder may take into account cannot exceed the sum of the shareholder's adjusted basis in his or her stock of the corporation and the unadjusted basis in any indebtedness of the corporation to the shareholder. Any disallowed loss is carried forward to the next taxable year. Any loss that is disallowed for the last taxable year of the S corporation may be carried forward to the post-termination period. The "post-termination period" is the period beginning on the day after the last day of the last taxable year of the S corporation and ending on the later of (1) a date that is one year later, or (2) the due date for filing the return for the last taxable year and the 120-day period beginning on the date of a determination that the corporation's S corporation election had terminated for a previous taxable year.

In addition, under section 465, a shareholder of an S corporation may not deduct losses that are flowed through from the corporation to the extent the shareholder is not "at risk" with respect to the loss. Any loss not deductible in one taxable year because of the at-risk rules is carried forward to the next taxable year.

Description of Provision

Losses of an S corporation that are suspended under the at-risk rules of section 465 would be carried forward to the S corporation's post-termination period.

i. Effective date and transition rule for elections after termination (sec. 401 of the bill)

Present Law

A small business corporation that terminates its subchapter S election (whether by revocation or otherwise) may not make another election to be an S corporation for five taxable years unless the Secretary of the Treasury consents to such election.

Description of Provision

Except as otherwise provided, the provisions of the bill would be effective for taxable years beginning after December 31, 1995.

In addition, for purposes of the 5-year rule, any termination of subchapter S status in effect immediately before the date of enactment of the bill would not be taken into account. Thus, any small business corporation that had terminated its S corporation election within the 5-year period before the date of enactment may re-elect subchapter S status upon enactment of the bill without the consent of the Secretary of the Treasury.[69]

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[69] A similar provision was included in the Subchapter S Revision Act of 1982.

III. TAX TREATMENT OF HOME OFFICE EXPENSES

A. Present Law

A taxpayer's business use of his or her home may give rise to a deduction for the business portion of expenses related to operating the home (e.g., a portion of rent or depreciation and repairs). Code section 280A(c)(1) provides, however, that business deductions generally are allowed only with respect to a portion of a home that is used exclusively and regularly in one of the following ways: (1) as the principal place of business for a trade or business; (2) as a place of business used to meet with patients, clients, or customers in the normal course of the taxpayer's trade or business; or (3) in connection with the taxpayer's trade or business, if the portion so used constitutes a separate structure not attached to the dwelling unit. In the case of an employee, the Code further requires that the business use of the home must be for the convenience of the employer (sec. 280A(c)(1)).[70] These rules apply to houses, apartments, condominiums, mobile homes, boats, and other similar property used as the taxpayer's home (sec. 280A(f)(1)). Under Internal Revenue Service (IRS) rulings, the deductibility of expenses incurred for local transportation between a taxpayer's home and a work location sometimes depends on whether the taxpayer's home office qualifies under section 280A(c)(1) as a principal place of business (see Rev. Rul. 94-47, 1994-29 I.R.B. 6).

Prior to 1976, expenses attributable to the business use of a residence were deductible whenever they were "appropriate and helpful" to the taxpayer's business. In 1976, Congress adopted section 280A, in order to provide a narrower scope for the home office deduction, but did not define the term "principal place of business." In *Commissioner v. Soliman*, 113 S.Ct. 701 (1993), the Supreme Court reversed lower court rulings and upheld an IRS interpretation of section 280A that disallowed a home office deduction for a self-employed anesthesiologist who practiced at several hospitals but was not provided office space at the hospitals. Although the anesthesiologist used a room in his home exclusively to perform administrative and management activities for his profession (i.e., he spent two or three hours a day in his home office on bookkeeping, correspondence, reading medical journals, and communicating with surgeons, patients, and insurance companies), the Supreme Court upheld the IRS position that the "principal place of business" for the taxpayer was not the home office, because the taxpayer performed the "essence of the professional service" at the hospitals.[71] Because the taxpayer did not meet with patients at his home office and the room was not a separate structure, a deduction was not available under the second or third exception under section 280A(c)(1) (described above).

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[70] If an employer provides access to suitable space on the employer's premises for the conduct by an employee of particular duties, then, if the employee opts to conduct such duties at home as a matter of personal preference, the employee's use of the home office is not "for the convenience of the employer." See, e.g., *W. Michael Mathes*, (1990) T.C. Memo 1990-483.

[71] In response to the Supreme Court's decision in *Soliman*, the IRS revised its *Publication 587, Business Use of Your Home*, to more closely follow the comparative analysis used in *Soliman* by focusing on the following two primary factors in determining whether a home office is a taxpayer's principal place of business: (1) the relative importance of the activities performed at each business location; and (2) the amount of time spent at each location.

Section 280A(c)(2) contains a special rule that allows a home office deduction for business expenses related to a space within a home that is used on a regular (even if not exclusive) basis as a storage unit for the inventory of the taxpayer's trade or business of selling products at retail or wholesale, but only if the home is the sole fixed location of such trade or business.

Home office deductions may not be claimed if they create (or increase) a net loss from a business activity, although such deductions may be carried over to subsequent taxable years (sec. 280A(c)(5)).

B. Explanation of S. 327 and Provision in H.R. 1215

S. 327

S. 327 ("Home Office Deduction Act of 1995") was introduced on February 1, 1995 by Senator Hatch (and was co-sponsored by Senators Baucus, Exon, Lieberman, Grassley, Johnston, and Kerry). S. 327 would amend present-law section 280A to specifically provide that a home office qualifies as the "principal place of business" if (1) the office is the location where the taxpayer's essential administrative or management activities are conducted on a regular and systematic (and not incidental) basis by the taxpayer, and (2) the office is necessary because the taxpayer has no other location for the performance of the essential administrative or management activities of the business. As under present law, deductions would be allowed for a home office meeting the above two-part test only if the office is exclusively used on a regular basis as a place of business by the taxpayer, and in the case of an employee, only if such exclusive use is for the convenience of the employer.

In addition, S. 327 would clarify that the special rule contained in present-law section 280A(c)(2) permits deductions for expenses related to a storage unit in a taxpayer's home regularly used for inventory or product samples (or both) of the taxpayer's trade or business of selling products at retail or wholesale, provided that the home is the sole fixed location of such trade or business.

Effective date.—S. 327 would be effective for taxable years beginning after 1991.

H.R. 1215

On April 5, 1995, the House of Representatives passed H.R. 1215, which includes a provision that is similar to S. 327. H.R. 1215, however, provides for a slightly different two-part test than does S. 327. Under H.R. 1215, a home office qualifies as the "principal place of business" if (1) the office is used by the taxpayer to conduct administrative or management activities of a trade or business and (2) there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business. H.R. 1215 also includes the same provision contained in S. 327 that clarifies the tax treatment for expenses related to home storage of certain product samples.

Effective date.—The home office deduction provision of H.R. 1215 would be effective for taxable years beginning after 1995.

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