

SUMMARY OF H.R. 6055

THE SUBCHAPTER S REVISION ACT OF 1982

In general, H.R. 6055, the Subchapter S Revision Act of 1982, is intended to simplify the tax rules relating to eligibility for subchapter S status and the operation of subchapter S corporations. This would be accomplished by removing eligibility restrictions that appear unnecessary and by revising the rules relating to income, distributions, etc., that tend to create traps for the unwary. The following is a summary of the principal provisions of the bill.

A. Eligibility

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

- (1) the number of permitted shareholders would be increased from 25 to 35;
- (2) Differences in voting rights in common stock would not violate the one class of stock requirement;
- (3) The present law rules under which an election is terminated if more than 20 percent of a corporation's gross receipts is passive investment income would be eliminated as a test of eligibility for corporations which do not have accumulated earnings and profits at the close of the taxable year.

(4) A person becoming a shareholder of a subchapter S corporation after the initial election would not have the power to terminate the election by affirmatively refusing to consent to the election. The new shareholder would be bound by the initial election unless the election is revoked by the stockholders.

B. Elections, revocations and terminations

The bill would provide that an election made during the period ending on the fifteenth day of the third month of the taxable year could be effective for the entire taxable year if all persons who held the stock of the corporation during that year were individuals, estates, and qualified trusts, and all persons holding the stock at any time during the year up to the time the election is made consent to the election. If an election is made at another time, it would be effective for the subsequent taxable year.

An event occurring during the taxable year which causes a corporation to fail to meet the definition of a subchapter S corporation would terminate the election as of the day of the event causing the failure (rather than as of the first day of the taxable year in which the event occurred as under present law). The bill would provide that an election could be revoked by those shareholders holding a majority of the corporation's voting stock (as contrasted with the current rule which requires all shareholders to consent to a revocation). The present law rule allowing a revocation

filed during the first month of the taxable year to be effective for that entire taxable year would be modified so that such a retroactive revocation may be filed up to and including the fifteenth day of the third month of the taxable year.

To minimize the effect of inadvertent terminations, the bill would provide that the Secretary of the Treasury may waive the terminating event so that the corporation may continue to be a subchapter S corporation notwithstanding that event.

C. Passthrough of income, etc.

The bill would provide that the character of items of income, deduction, loss, and credit would pass through to the shareholders in the same general manner as they pass through from partnerships. Thus, for example, such items as tax-exempt interest, capital gains and losses, percentage depletion, foreign income or loss, and foreign income taxes would pass through and retain their character in the hands of shareholders.

D. Allocation of income

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

E. Selection of taxable year

Under the bill, rules generally similar to those applicable to partnerships would apply to a subchapter S corporation's selection of a taxable year. Subject to transitional rules, the taxable year of a corporation making a new subchapter S election after the date of enactment would be required to be either the calendar year,

or any other accounting period for which it establishes a business purpose to the satisfaction of the Treasury Department. These rules also would apply to corporations currently operating under subchapter S. However, a corporation with a subchapter S election in effect on December 31, 1982, could continue its current taxable year so long as the persons who own 50 percent or more of the outstanding stock in the corporation on that date continue to do so. For purposes of this transitional rule, transfers of stock through inheritance would not be considered changes in ownership.

F. Carryforward of loss

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

G. Distributions

The rules relating to distributions from subchapter S corporations would be extensively revised. Under the new rules, a corporation would not have earnings and profits attributable to any taxable year beginning after the date of enactment if a subchapter S election is in effect for that year. In general, the amount of any distribution would equal the amount of cash distributed plus the fair market value of any property distributed.

For corporations with no earnings and profits, the amount of the distribution is applied first against the shareholder's basis in his stock. To the extent the amount of the distribution exceeds the amount of the basis in the stock, capital gains would result (subject to the applicability of the collapsible corporation rules).

For corporations with accumulated earnings and profits, the amount of the distribution would be applied first against the shareholder's portion of the net amount of accumulated subchapter S taxable income less deductible expenses (an "accumulated adjustment account") which had been passed through to the holder of the stock. Any amount in excess of the accumulated subchapter S income would be treated under the usual corporate rules as a distribution out of accumulated earnings and profits to the extent thereof. These distribution rules would apply to the transferee of stock in a subchapter S corporation with accumulated earnings and profits. The amount of subchapter S income would be determined at the corporate level.

Under the bill, both taxable and nontaxable income and deductible and nondeductible expenses would serve to increase and decrease the basis of a subchapter S shareholder in his stock and loans to the corporation. These rules are generally analogous to those provided for partnerships under section 705. Also, unlike present law, basis would be restored to debt obligations as well as stock. Restoration of basis would be made first to debt (to the extent of prior reductions) and then to stock. Under the bill, gain would be recognized by a subchapter S corporation upon nonliquidating distributions of appreciated property.

H. Qualified plans and fringe benefits

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

I. Treatment of transactions between corporation and related parties

Under the bill, amounts accruing to any cash-basis shareholder owning 2 percent or more of the corporation's stock would be deductible only when paid.

J. Administration

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

K. Effective date

The bill would be effective for taxable years beginning after December 31, 1982, except that existing subchapter S pension plans would not need to be conformed to the new rules before 1985.