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STAFF RECOMMENDATIONS FOR SIMPLIFICATION OF TAX RULES RELATING TO SUBCHAPTER S CORPORATIONS

A REPORT

PREPARED BY THE STAFF OF THE

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AND THE

COMMITTEE ON FINANCE

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INTRODUCTION

This pamphlet presents recommendations by the staff of the Joint Committee on Taxation for legislative changes in the tax treatment of subchapter S corporations and their shareholders. These recommendations are the product of a study which began in 1977 to examine the tax treatment of subchapter S corporations (sometimes referred to as electing small business corporations) and their shareholders.

A tentative set of recommendations was published in May 1979, and comments and suggestions were received from the Treasury Department, members of the Tax Section of the American Bar Association, members of the Federal Tax Division of the American Institute of Certified Public Accountants, tax practitioners, and other groups and individuals. The staff recommendations published in this pamphlet reflect many of these comments.

The basic intent of the recommendations is to simplify the tax rules relating to subchapter S corporations by removing a number of tax traps and a few unintended benefits from the subchapter S rules without opening major avenues for tax avoidance.

It is anticipated that, in the near future, these recommendations with any necessary changes resulting from additional comments or suggestions by interested parties (and from problems encountered in drafting a bill encompassing the proposals) will be prepared as a bill for introduction.

The subchapter S study (and the resulting recommendations) are a part of a broad effort by the staff of the Joint Committee on Taxation to recommend changes in the Internal Revenue Code which do not have major policy impact but rather make improvements in the structural workings of the tax system. Other parts of this effort have been reflected in the recently enacted legislation making certain simplifying changes in the procedural provisions of the Code (P.L. 96–167), and the recently introduced bills which would simplify the tax treatment of installment sales (H.R. 6883 and S. 2451). It is anticipated that future projects will examine other portions of the tax law which may be appropriate subjects for simplification.

The first part of the pamphlet is a summary of the recommendations. This is followed by a discussion of the background of subchapter S. The third part of the pamphlet sets forth the recommendations and reasons for the recommendations in detail. Additional recommendations by the Treasury Department are contained in the Appendix.

I. SUMMARY OF RECOMMENDATIONS

In general, these recommendations are 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.

Eligibility

With respect to the initial and continued eligibility for subchapter S treatment, the following recommendations are made:

(1) The number of permitted shareholders would be increased from 15 to 25;

(2) A trust all of which is treated as owned by a person other than the grantor (under sec. 678) [1] would be eligible to hold stock in a subchapter S corporation with the person who is treated as the owner being treated as a shareholder for all purposes (in a manner similar to the rules relating to grantor trusts under present law);

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

(4) The present law rule which results in the termination of an election if the corporation derives more than 80 percent of its gross receipts from sources outside the United States would be repealed;

(5) 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; and

(6) 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.

Elections, revocations and terminations

The recommendations 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 consented to the election. If an election is made at another time, it would be effective for the subsequent taxable year.

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[1] Unless specifically indicated to the contrary, all references to sections in this pamphlet are to sections of the Internal Revenue Code of 1954, as amended.

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 recommendations provide that an election could be revoked by those shareholders holding 66⅔ percent or more 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 recommendations provide that timely filing of a subchapter S return would constitute a timely request and a consent of the shareholders to elect subchapter S for the year to which the return pertains if the election of the corporation was terminated (other than by revocation) in a prior year.

Passthrough of income, etc.

The recommendations also 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 partnerships. Thus, for example, such items as tax-exempt interest, capital losses, foreign income or loss, and foreign income taxes would pass through and retain their character in the hands of shareholders.

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.

Selection of taxable year

Under the recommendations, 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 one of the following: (a) the calendar year, (b) the taxable year of all shareholders owning 5 percent or more of the shares of the corporation's stock, (c) if all the corporation's 5-percent or more shareholders report on the calendar year, a year ending on September 30, October 31, or November 30, or (d) any year 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 the date of enactment 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 the date of enactment continue to do so. For purposes of this transitional rule, transfers of stock through inheritance would not be considered changes in ownership.

Carryforward of loss

Under the recommendations, 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.

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). Thus, the proposal would simplify the distribution rules for newly electing and presently electing corporations without accumulated earnings and profits. Under these rules, all distributions, regardless of when made, would be tax-free to the extent of the shareholder's basis in the stock.

For corporations with accumulated earnings and profits, the amount of the distribution would be applied first against that part of the shareholder's basis attributable to the net amount of "previous income" (taxable income plus nontaxable income less deductible and nondeductible expenses) passed through to the shareholders. Any amount in excess of that part of the shareholder's basis attributable to the passthrough of previous income would be treated as a distribution out of accumulated earnings and profits. Any residual amount would then be applied against the shareholder's remaining basis in his stock; and, finally, the amount of the distribution exceeding basis would be treated as capital gain (subject to the applicability of the collapsible corporation rules). These distribution rules would apply to the transferee of stock in a subchapter S corporation with accumulated earnings and profits. The previous income account would be determined at the corporate level.

Under the recommendations, 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 analogous to those provided for partnerships under section 705 (except that where property distributions are treated as a return of basis, the basis in stock and debt would be reduced by the fair market value of the property). 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 recommendations, gain would be recognized by a subchapter S corporation upon nonliquidating distributions of inventory assets, section 1231 property, or capital assets. (In general, these rules are needed to prevent avoidance or extensive deferral of gain on property which has been disposed of by the corporation).

Under the recommendations, distributions subsequent to the termination of subchapter S election would be treated first as distributions of previous income, to the extent thereof, until the later of one year after the effective date of termination or 120 days following the date of a determination that the corporation's subchapter S election had terminated for a previous year. If the election is revoked, distributions would be eligible for this special treatment only for the one year period following the effective date of the revocation.

Maximum tax and qualified plans

For the purposes of the rules relating to maximum tax and qualified pension, etc., plans, if more than 20 percent of the gross receipts of a subchapter S corporation is passive investment income for a taxable year, the amount of the shareholder's compensation (otherwise treated as reasonable compensation) would be reduced by a fraction, the numerator of which is the corporation's passive investment income and the denominator of which is the corporation's gross receipts. These restrictions would not apply if a corporation would not lose its subchapter S eligibility under present law (sec. 1372(e)(5)(B)—where the passive investment income is less than $3,000 in the first or second taxable year in which a corporation commences the active conduct of a trade or business) or if the corporation would not be a personal holding company by reason of section 542(c).

Statutory fringe benefits

Under the recommendations, certain corporate statutory fringe benefits would not be available to more than 5 percent shareholder-employees of an electing corporation for a taxable year if for that year more than 20 percent of the gross receipts of the corporation constitute passive investment income (unless one of the exceptions in section 542(c) or 1372(e)(5)(B) applies). The corporate statutory fringe benefits to which this rule applies are (1) the $5,000 death benefits exclusion; (2) the exclusion from income for amounts paid from an accident and health plan; (3) the exclusion from income for amounts paid by an employer to an accident and health plan; (4) the exclusion of the cost of up to $50,000 of group-term life insurance; and (5) the exclusion from income of meals and lodging furnished for the convenience of the employer.

II. BACKGROUND

Development of Project

The Joint Committee staff has been reviewing the subchapter S provisions of the Code. During May 1979, the staff circulated certain tentative conclusions as to the changes it would recommend in these provisions. After receiving comments from the Treasury Department, representatives of several professional groups, tax practitioners and others, the staff reviewed and revised its tentative recommendations. The staff very much appreciates the assistance it has received from those persons who met with the staff or submitted comments on the tentative recommendations.

Many comments raised issues which were not discussed in the tentative recommendations. In some instances, the staff made further recommendations to deal with these problems; in other instances, the staff did not make recommendations. (In a number of these latter situations, the staff concluded that although there were some valid arguments for the proposals, these arguments were outweighed by competing considerations—such as complexity and the creation of tax benefits not available under present law.)

The Treasury Department has been consulted several times on these revised recommendations. Many of Treasury's comments have been reflected in the staff's recommendations; however, Treasury does not fully agree with all of the staff's recommendations and has some additional recommendations. In those instances in which Treasury disagrees with the recommendations, Treasury's comments are summarized in the revised recommendations and are set forth in detail in the Appendix.

The revised recommendations are summarized in Part III of this pamphlet. It is anticipated that these recommendations will form the basis for a bill to be introduced within the next few months.

Overview of Subchapter S

Subchapter S was enacted in 1958 to minimize the effect of Federal income taxes on choices of the form of business organization and to permit the incorporation and operation of certain small businesses without the incidence of income taxation at both the corporate and shareholder levels. (S. Rept. No. 1983, 85th Cong., 2d Sess., 87 (1958).)

Because of the passthrough of income and loss to a subchapter S corporation's owner without the imposition of tax on the corporation (except on certain capital gains), subchapter S is often described as a method of taxing corporations as if they were partnerships. In fact, there are a number of significant differences in the tax treatment resulting under the partnership (subchapter K) and subchapter S provisions. For example, the partnership provisions provide a complete passthrough of the tax characteristics of the items of income and deduction incurred by the partnership. With the exception of capital gains, the subchapter S provisions do not provide such a passthrough.

Under the partnership provisions, a distribution that does not exceed a partner's basis in his partnership interest generally is treated as a nontaxable return of capital. In many instances, a similar distribution to a subchapter S shareholder is treated as a taxable distribution. Under the partnership provisions, a loss carryover is allowed to the extent that losses exceed a partner's basis in his partnership interest as of the close of the year. Such is not the case in the comparable subchapter S situation.

These and other differences between the partnership and subchapter S provisions will be cited, to the extent relevant, in explaining the recommendations.

Unfortunately, the approximate 20-year history of subchapter S attests to many traps for those not extremely familiar with its provisions. The traps most often fallen into involve: (1) unintentional violation of the continuing eligibility rules (particularly the restriction on passive investment income), resulting in retroactive terminations of elections; (2) the making of taxable distributions which were intended to be tax-free distributions of previously taxed income; and (3) a shareholder having an insufficient basis to absorb his share of the corporation's loss, resulting in the permanent disallowance of that part of the loss.[1]

The 20-year history of subchapter S also indicates that knowledgeable taxpayers and tax counsel have derived some unintended benefits from the subchapter S provisions. Examples of these benefits include the deferral of income resulting from the selection of a taxable year for the corporation which is different from that of the majority of its shareholders and the use of the retroactive termination provisions of subchapter S to prevent the passthrough of a substantial amount of income to the shareholders.

The staff has reviewed subchapter S from the perspective of simplifying its operation (particularly in the area of distributions), removing both the traps for the unwary and the few unintended tax avoidance benefits, and eliminating (where practical) some of the unwarranted differences in tax consequences under the partnership and subchapter S provisions.

In the interest of brevity, present law is explained only to the extent relevant to the explanation of the recommendations. Thus, it should be assumed that present law would be retained except where a specific recommendation would require change.

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[1] Although the loss may be disallowed permanently as such, in some circumstances at least some of the benefits of the loss may be realized at a later date. Thus, for example, if the shareholder's basis is later increased by at least the amount of the disallowed loss (either through contributions or allocation of undistributed income) and the shareholder's interest in the corporation is thereafter disposed of in a taxable transaction, the amount of gain recognized is reduced (or the amount of loss recognized is increased) by the amount of the disallowed loss. Even in such cases, however, the disallowed loss normally is converted from an ordinary loss into a capital loss (unless sec. 1244 applies) or a reduction in a capital gain. Also, the allowance of these limited benefits from the loss is deferred for a longer period than would be the case in a loss carryover system.

There may be no benefits from the disallowed loss in some circumstances, such as when the stock (and debt) of the corporation acquires a step-up in basis upon the death of the shareholder.

III. DESCRIPTION OF RECOMMENDATIONS

A. Initial and Continued Eligibility for Subchapter S Treatment

1. Permitted number of shareholders (sec. 1371(a)(1))

The number of permitted shareholders would be increased from fifteen to twenty-five.

In 1978, Congress increased the permitted number of shareholders at all times to fifteen. It is believed that the increase to twenty-five shareholders would provide the potential for a greater infusion of capital into small businesses, while, at the same time, maintaining the permitted number of shareholders at a level which is consonant with the policy of restricting the subchapter S provisions to small businesses. The increase also would provide an additional margin of safety in regard to the permitted number being exceeded as a result of stock inheritances. (Recent statistics reflect that approximately 97 percent of all electing corporations have seven or fewer shareholders.) It is recognized that substantial increases in the number of eligible shareholders may well create substantial audit problems unless an entity audit approach is developed. (Under such an approach, in general, an audit of the corporation determines, for all the shareholders, all issues involving the taxation of items on the shareholders' returns which are taken into account by reason of the shareholders' ownership interests in a subchapter S corporation.) Although staff understands that Treasury is developing such an approach in the partnership area, it apparently has not been sufficiently developed so that specific legislative proposals can be introduced at this time.

The Treasury Department believes that any increase in the permitted number of shareholders should be coupled with a change in the audit provisions under which an audit of the corporation would result in determinations of tax consequences which would be binding on all the shareholders. (See the Appendix.)

2. Eligible shareholders (sec. 1371(a)(2) and (e))

A trust all of which is treated as owned by a person other than the grantor under section 678 would be eligible to hold stock in a subchapter S corporation. The person treated as the owner (and not the trust) would be treated as the shareholder for purposes of determining whether the corporation meets the subchapter S eligibility requirements. The trust would continue to be eligible for 60 days after such person's death.

3. One class of stock requirement (sec. 1371(a)(4))

Differences in voting rights in common stock would be permissible. Since voting right differences would not present any accounting problems in allocating income or loss among shareholders, which is the primary rationale for the one class of stock requirement, no reason could be seen for prohibiting the flexibility added by this feature. (As under current law, no special allocations of income, losses, or credit would be allowed.)

Treasury has recommended that a specific type of preferred security be permitted. In general, the permitted preferred securities would be required to bear a fixed or determinable rate of return, and the owners of the preferred securities would be treated as shareholders for all subchapter S purposes. In determining the amount of losses allowed as a deduction to a shareholder, the shareholder's adjusted basis in preferred securities would be included in the limitation on losses. Payment of the return on preferred securities generally would be treated as ordinary income to the owner of the preferred securities and as an ordinary deduction to the corporation. However, such a deduction would be disallowed to the extent it would create a loss. The treatment of these preferred securities as a permitted second class of stock would supersede the existing case law as to when the one class of stock rule has been violated.

The staff recommendations do not endorse this Treasury proposal at this time. However, the staff has reprinted this Treasury proposal in the Appendix because it believes the proposal deserves careful study.[2]

4. Foreign income (sec. 1372(e)(4))

An election would no longer be terminated if the corporation derives more than 80 percent of its gross receipts from sources outside the United States. The legislative history of subchapter S does not indicate the reason for restricting the amount of foreign receipts of a subchapter S corporation, particularly at the level of 80 percent of gross receipts.[3]

Since eligibility for subchapter S status would continue to be restricted to domestic corporations owned by United States taxpayers who would be taxed currently on all the corporation's income (and the character of income would flow through to the shareholders), there appears to be no reason for discouraging (on even a minimal basis) the foreign operations of such a corporation.

5. Passive investment income (sec. 1372(e)(5))

The proposal would eliminate the provision under which an election would be terminated if more than 20 percent of a corporation's gross receipts is passive investment income.

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[2] In considering the Treasury proposal or other proposals relating to a second class of stock, it appears that the following issues, inter alia, should be considered: (1) whether, on balance, the proposal would increase or reduce complexity; (2) whether problems would arise if a corporation with accumulated earnings and profits has insufficient current income to cover actual distributions with respect to preferred securities; (3) whether it is appropriate to make legislative provision for a second class of stock which in some respects is more limited in scope than the cases which hold that a subchapter S corporation can have both common stock and another class of equity without violating the one class of stock rule (see *Portage Plastics Co.* v. *United States*, 486 F. 2d 632 (7th Cir. 1973), and the cases cited therein); and (4) whether the adoption of such a proposal would require adoption of more stringent rules to prevent the assignment of income among family members.

[3] This limitation may have been intended to bear some relationship to the rule which treats dividends as foreign source income if more than 80 percent of the payor corporation's gross income is from foreign sources (sec. 861(a)(2)).

Perhaps the principal reason for the inclusion of this restriction in 1958 was to reduce the incentive to incorporate one's investment activities for the primary purpose of obtaining tax deferral benefits accorded to pension, profit-sharing, and other similar qualified plans. However, this reason appears to have been substantially reduced with the imposition by the Tax Reform Act of 1969 of the H.R. 10-type of limitation on contributions made for an employee holding more than 5 percent of the subchapter S corporation's stock. Because subchapter S income is taxed currently to the shareholders, the allowance of passive investment income does not subvert the purposes of the personal holding company provisions.

Furthermore, the passive investment income limitation has caused a number of inadvertent terminations of elections, as well as a substantial amount of litigation as to what constitutes passive investment income. Controversy exists as to whether the term passive investment income includes interest and rents which are earned in the active conduct of a trade or business (e.g., interest of a small loan company or produced film rents of an active production company). Elimination of this restriction would remove much uncertainty, reduce litigation, and prevent retroactive terminations of subchapter S elections.

The removal of the passive income restriction enhances the potential for abuse of the fair market value distribution rule applicable to subchapter S corporations. Thus, a rule is provided for distributions of certain assets of the corporation. (See section H.8 of this part.)

In the absence of other changes, the removal of the passive investment income restriction presents substantial opportunities to convert investment income into earned income so as to obtain maximum tax treatment and qualified pension, etc., plan benefits with respect to that income. Also, removal of the passive income restriction permits the use of passive income in a subchapter S corporation to support the provision of favorable tax treatment accorded certain corporate fringe benefits. Consequently, rules are provided to deal with these situations. (See sections I and J of this part.)

6. New shareholders (sec. 1372(e)(1))

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

It is believed that there is little or no justification for a new shareholder, who knows or should know he is acquiring stock of a subchapter S corporation, to have the power (described by some as blackmail power) to terminate that corporation's election. More appropriately, his acquisition of that stock should be viewed as a consent to subchapter S treatment.

B. Election, Revocation, and Termination

1. Time of election (sec. 1372(c))

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 stock at any time during the year up to the time the election is made consented to the election. Otherwise, the election would be effective for the next taxable year.

This modification eliminates the allocation of income and loss problem with respect to pre-election stockholders who were either ineligible to hold subchapter S corporation stock or did not consent to the election.

2. *Time of termination of election (sec. 1372(e)(3))*

Events during the taxable year which cause a corporation to fail to meet the definition of a small business corporation would result in a termination of the election as of the day of the event causing the failure. This would change the present law rule which generally causes the termination to be effective retroactively to the first day of the taxable year in which the event occurred. The events causing disqualification would be: (1) the maximum allowable number of shareholders being exceeded during the taxable year; (2) transfer of stock to a corporation, partnership, ineligible trust, or nonresident alien; (3) the creation of a class of stock other than the voting and nonvoting common stock allowed; and (4) the acquisition of a subsidiary (other than certain nonoperating subsidiaries).

The proposed rule would reduce the opportunity occurring under present law for year-end manipulation by which shareholders can intentionally bring about disqualifying events to terminate the election retroactively to the first day of the taxable year. Such retroactive tax planning often occurs where, for instance, a year-end determination is made that an excessive amount of income would pass through to the shareholders for that year unless the subchapter S election is retroactively terminated.

The day of the termination event would be treated as the last day of a short subchapter S taxable year, and the following day would serve as the first day of a short subchapter C taxable year. There would be no requirement (because of its impracticality) that the books of a corporation be closed as of the termination date. Instead, the corporation would be required to allocate the income or loss for the entire year (i.e., both short years) on a daily proration basis. However, the corporation could elect, with the consent of all its shareholders, to report the taxable income or loss on each return (subchapter S and subchapter C) on the basis of income or loss shown on the corporation's permanent records (including work papers) as is the case in determining accumulated earnings and profits. Under this method, items would be attributed to the subchapter S and subchapter C years according to the time they were incurred or realized, as reflected in the corporation's permanent records (including work papers).

The subchapter S and subchapter C short taxable years would be treated as one year for net operating loss purposes. The income allocated to the subchapter C taxable year would be subject to annualization for purposes of applying the corporate rate brackets. The return for the subchapter S year would be due on the same date as that for the return for the subchapter C year.

3. Revocation of election (sec. 1372(e)(2))

An election could be revoked by those shareholders holding 66⅔ percent or more of the corporation's voting stock.

Staff found the present law rule, which requires 100 percent of the shareholders to revoke an election, to be too restrictive. It seems that a minority shareholder should not always be able to prevent a revocation desired by most of the shareholders and that some percentage below 100 would be more reasonable in this regard. On the other hand, one or two majority shareholders holding, for instance, 50 percent of the corporation's stock should not have the unilateral power to revoke the election when minority shareholders want to maintain it. Thus, the 66⅔ percent amount was chosen because, in many instances, it would require agreement on the part of both majority shareholders and some minority shareholders to revoke the election. Moreover, this would be in accord with the corporate law of many states which requires a two-thirds (66⅔%) majority of shareholders to approve significant corporate actions. (For the effective date of revocations, see section B.4., below.)

4. Effective date of revocation (sec. 1372(e)(2))

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. This would correspond to the time period in which a retroactive election may be made. Revocations made after the fifteenth day of the third month of the taxable year would be effective on the date filed with the IRS unless the revocation stated some prospective date, in which case it would be effective on such date. (Prospectively dated revocations filed within the initial 2½-month period also would have prospective effect.)

Thus, revocations filed after the fifteenth day of the third month of the taxable year (as well as prospectively dated revocations filed within the initial 2½-month period) which are not designated as being effective for the first day of the next taxable year also would result in the splitting of the year into short subchapter S and subchapter C taxable years. It seems anomalous for shareholders holding 66⅔ percent of the stock to lack the power to terminate an election during the year, when one shareholder could, for instance, by the transfer of stock to an ineligible trust, terminate the election.

C. Election After Termination (Sec. 1372(f))

The timely filing of a subchapter S return would constitute a timely request and a consent of the shareholders to elect subchapter S for the year to which the return pertains if the subchapter S election of such corporation was terminated (other than by revocation) in a year preceding the year to which the return pertains.

This proposal is aimed at the present law situation in which a corporation and its shareholders are mistakenly under the belief that they are subject to subchapter S treatment, when, in fact, some inadvertent event occurring in a previous year has caused a termination of the subchapter S election for that year and all subsequent years. Of course, if a corporation were unaware of the termination of its election, it would not file a new election request. However, if the termination were subsequently discovered (sometimes, many years after the year for which termination became effective), it would be too late under present law to file a timely request with respect to all intervening years.

Under the proposed rule, if a disqualifying event were, for example, to occur in 1980 with respect to a calendar year corporation, a timely filed subchapter S return in 1982 for the taxable year 1981 would constitute a request and a consent of the shareholders to elect subchapter S for 1981 and all subsequent years. Of course, as under present law, the IRS would have the discretion to deny the request. Also, such a request could not be effective for any period during which the corporation would be ineligible to make a subchapter S election. Thus, for instance, if the termination of an earlier election were due to a transfer to an ineligible shareholder, the request could not be given effect for any taxable year in which the ineligible shareholder continued to be a shareholder.

D. Passthrough of Income, Deductions, and Credits (secs. 1373(a) and 1375(a))

The character and source (U.S. or Foreign) of items of income, deduction, and loss, as well as items of credit, would pass through to shareholders in the same general manner as they pass through partnerships.

This would eliminate much of the disparity in the tax treatment of subchapter S corporations and partnerships. Thus, the passthrough would include such items as:

1. *Tax-exempt interest income.*—This income would pass through to the shareholder as such and would increase the basis of the shareholder in his subchapter S stock. Because of the elimination of the earnings and profits account (see section H of this part), subsequent distributions by the corporation will not result in taxation of the tax-exempt income.

2. *Section 1231 gains and losses.*—These gains and losses would be passed through separately and would be aggregated with the shareholder's other section 1231 gains and losses. Thus, section 1231 gains would no longer be aggregated with capital gains at the corporate level and passed through as capital gains.

3. *Capital losses.*—Capital losses exceeding capital gains would pass through to the shareholders.

4. *Charitable deductions.*—The corporate 5-percent limitation would no longer apply, but, as in partnerships, these deductions would retain their character when passed through to the shareholders, at which level they would be subject to the individual limitations.

5. *Additional first-year depreciation.*—As in partnerships, the limitation would first be applied at the entity level and then, when passed through to the shareholders, would be subject to the individual limitations.

6. *Foreign taxes.*—Foreign taxes paid by the corporation would pass through as such to the shareholders, who would claim such taxes either

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

7. *Investment credit.*—As under present law, the investment credit would continue to pass through to the subchapter S corporation's shareholders. However, unlike present law, there would be automatic shareholder liability upon election of subchapter S for recapture of the investment credit in the event of early dispositions, etc., by the subchapter S corporation of investment credit property purchased prior to the election. Under present law, the failure of the subchapter S shareholders to agree at the time of election to the assumption of investment credit recapture liability results in immediate recapture.

8. *Depletion.*—The present rules governing depletion with regard to partnership mineral interests in minerals other than oil and gas would apply to depletion of non-oil and gas properties of a subchapter S corporation. No recommendation has been made as to the precise mechanism that should be used in applying the 1,000 barrel a day limitation on oil and gas percentage depletion or to prevent the proliferation of the depletion deduction through transfers of proven properties to or by subchapter S corporations. The staff is continuing to study problems relating to oil and gas depletion, and recommendations on these matters may be made either in connection with this project or with a review of the rules relating to application of oil and gas depletion for pass-through entities.

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

E. Allocation of Income and Losses (Sec. 1373(b)) and Special Rules for Losses

1. As is the case under present law for losses, income would be passed through and allocated to shareholders on a per-share, per-day basis. The elimination of the present law rule, under which income is allocated to those holding the subchapter S stock as of the close of the year, will provide consistent treatment between income and losses of a subchapter S corporation and eliminate the potential for assignment of income resulting under this rule.

2. In cases of transfers of subchapter S stock during the taxable year, income, losses, and credits would be allocated in essentially the same manner as that when the election terminates during the year. Thus, the allocation would be made on a per-share, per-day basis unless the corporation, with the consent of its shareholders, elected to allocate according to its permanent records (including work papers).

3. Under current law and under the staff recommendations, if a subchapter S corporation with accumulated earnings and profits has a loss for a taxable year, the loss would be deductible to the shareholders to the extent of their bases, and the bases of shareholders in stock and debt would have to be reduced to zero before such losses would be disallowed. Treasury proposes that when a corporation with accumulated earnings and profits experiences a loss, the loss would exhaust net income passed through to shareholders, accumulated earnings and profits, and the shareholders' remaining bases in stock and debt, in that order. To the extent that the losses are treated as depleting earnings and profits, the losses would not be deductible to the shareholders since the earnings and profits had not previously been taxed to the shareholders. (See the Appendix.)

F. Selection of Taxable Year

The rules proposed below conform to the partnership rules applicable to the selection of a taxable year. They would eliminate the potential under present law of an 11-month deferral of reporting subchapter S income. They also would eliminate the potential bunching of income that results under the present subchapter S distribution (constructive and actual) and year of inclusion rules.

1. Subject to transitional rules, the taxable year of a subchapter S corporation would be required to be one of the following:

a. the calendar year,

b. the taxable year of all shareholders owning 5 percent or more of the shares of the corporation's stock,

c. if all the corporation's 5-percent or more shareholders report on the calendar year, a year ending on September 30, October 31, or November 30, or

d. any year for which it has established a business purpose to the satisfaction of the Secretary.

2. If a corporation makes a new election under subchapter S, its first electing year would end on the following December 31, unless the corporation:

a. establishes a business purpose to the satisfaction of the Secretary for another taxable year,

b. selects the taxable (non-calendar) year of all its 5-percent or more shareholders, or,

c. if all the corporation's 5-percent or more shareholders report on the calendar year, selects any year ending on either September 30, October 31, or November 30.

3. Transitional rules would be provided which would permit the retention of existing taxable years for subchapter S corporations so long as the persons who own 50 percent of the outstanding stock in the corporation on the date of enactment continue to do so. For these purposes, transfers of stock through inheritance would not be considered changes in ownership. Treasury believes that the transitional rule would be more reasonable if a transfer at death were treated as a change of ownership.

4. Treasury also has an additional recommendation under which the taxable year of the corporation would close with respect to a deceased shareholder on the date of his death. (The reasons for this recommendation are set forth in the Appendix.)

G. Loss Carryover (Sec. 1376(c)(2))

A subchapter S shareholder would be entitled to a loss carryover to the extent that the aggregate amount of the bases in his subchapter S stock and loans to the corporation are exceeded by the amount of loss passed through to him for the year involved. The loss carryover may be deducted only by that shareholder if and when the basis in his stock or loans to the corporation is restored.

This proposal is similar to the partnership rule and would eliminate an inequitable rule which has resulted in a trap for the unwary.

Subsequent to the termination of the subchapter S election, loss carryovers would become deductible if the shareholder's basis in his stock or loans to the corporation is restored by the later of the following dates:

1. One year after the effective date of termination, or
2. 120 days following the date of a determination that the corporation's subchapter S election had terminated for a previous year. Essentially, a determination would be defined as a court decision which becomes final, a closing agreement, or an agreement between the corporation and the IRS that the corporation failed to qualify.

In the case of a termination resulting from a revocation of an election, restoration of basis for purposes of deduction of the loss carryover would be required to be made within the one-year period following the effective date of termination.

H. Distributions (Sec. 1375)

1. Amount of distribution

The amount of any distribution would equal the amount of cash distributed plus the fair market value of any property distributed.

The choice of the partnership adjusted basis rule for distributions would have necessitated the adoption of the partnership collapsible rules (see section 751(b)). Staff found these collapsible rules to be unworkable in many instances. Moreover, any unfavorable consequences of the partnership adjusted basis and corresponding collapsible rules could be avoided by simply revoking the subchapter S election and, thereby, obtaining the benefits of the subchapter C fair market value distribution rules.

Consequently, the fair market value rule of present law was retained to avoid both the complexity of the partnership collapsible rules and the tax gamesmanship resulting from what would in effect be a choice between the subchapter S adjusted basis rules and (by revocation of the election) the subchapter C fair market value rules.

2. Application of distribution—Corporation electing under new rules and corporation without accumulated earnings and profits

The amount of the distribution by a corporation without accumulated earnings and profits (cash plus the fair market value of any property distributed) would be 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 his stock, capital gains would result (subject to the applicability of section 341). Earnings and profits would be eliminated with respect to all post-enactment income of any electing corporation. Thus, 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. However, a corporation could have earnings and profits attributable to (1) taxable years for which an election was not in effect, (2) taxable years beginning prior to the date of enactment for which an election was in effect, and (3) a corporate acquisition which results in a carryover of earnings and profits under section 381.

The proposed rule would simplify the distribution rules for newly electing and presently electing corporations without accumulated earnings and profits. Under this rule, all distributions, regardless of when made, will be tax-free to the extent of the shareholder's basis in his stock.

3. Corporations with accumulated earnings and profits

The amount of a distribution by a corporation with accumulated earnings and profits would be applied first against that part of the shareholder's basis attributable to the net amount of previous income (taxable plus nontaxable income less deductible and nondeductible expenses) passed through to the shareholder; any amount in excess of that part of the shareholder's basis attributable to the passthrough of previous income would then be treated as a distribution out of accumulated earnings and profits; any residual amount would then be applied against the shareholder's remaining basis in his stock; and, finally, the amount of the distribution exceeding basis would be treated as capital gain (subject to the applicability of Code section 341).

Under the proposal, even those shareholders of electing corporations with accumulated earnings and profits will be assured of tax-free treatment with respect to distributions, regardless of when made, to the extent net income (taxable and nontaxable income less deductible and nondeductible expenses) has been passed through and reflected in stock basis. It is contemplated that the previous income account will be a corporate level account. This will ensure that distributions to a new shareholder will be treated in the same manner regardless of whether such shareholder purchases shares from the corporation or from another shareholder.

4. Transfer of stock of subchapter S corporation with accumulated earnings and profits

The rules described above would apply to the transferee of stock in a subchapter S corporation having accumulated earnings and profits regardless of the manner in which the transferee acquires the stock.

5. Basis adjustments to stock and debt

Under the proposal, 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. These rules will be analogous to that provided for partnership under Code section 705 (including its adjustments for percentage depletion for non-oil and gas mineral properties). Unlike the partnership rules, however, to the extent property distributions are treated as a return of basis, basis will be reduced by the fair market value of these properties. Moreover, any passthrough of income for a particular year (allocated according to the proportion of stock held in the corporation) would first increase the shareholder's basis in loans to the corporation to the extent the basis was previously reduced by the passthrough of losses.

Treasury recommends that if the basis of debt remains reduced because of losses taken in subchapter S years, gain on the sale, redemption, or other disposition of the debt, which would otherwise be treated as capital gain, would be treated as ordinary income to the extent of the lesser of (i) the amount of reduction reflected in the shareholder's basis for the debt, or (ii) the earnings and profits of the corporation at the time of sale, redemption, or disposition. (See the Appendix.)

6. Distribution of inventory

Gain would be recognized by subchapter S corporations upon nonliquidating distributions of inventory assets (described in Code section 312(b)(2)(A)). The amount of the recognition would equal the excess of the fair market value of the distributed inventory over its adjusted basis.

While earnings and profits are eliminated (except for the carryover of accumulated earnings and profits from previous years of subchapter S corporations), the proposal would retain a rule similar in effect to section 312(b) (which causes dividend treatment to the extent of the excess of the fair market value of distributed inventory over its adjusted basis). Without this recognition, the inventory could be distributed tax free and sold at a stepped-up fair market value basis without gain recognition by the selling shareholder.

7. Distribution of certain property

Gain would be recognized to the subchapter S corporation upon any nonliquidating distribution of section 1231 property or capital assets.

The combination of (1) the elimination of the passive income restriction, (2) the elimination of earnings and profits for subchapter S years, and (3) the retention of the fair market value distribution rule substantially increases the opportunities for a tax-free step-up in basis for assets that are unrelated to the business of the corporation and section 1231 assets. In many instances, these assets could be distributed tax-free (except for recapture in certain instances) and subsequently sold without income recognition to the selling shareholder because of the stepped-up fair market value basis. The basis of the shareholder's interest in the corporation would be correspondingly reduced, and consequently, the gain inherent in the reduced basis would be deferred (and never recognized if the shares were held until death). The staff had tentatively recommended that this recognition rule apply to nonbusiness property (essentially, capital assets). However, the comments from a broad spectrum of the professional tax community indicated that, in addition to the problems that would be encountered in defining "nonbusiness property," substantial opportunities for tax avoidance would remain with respect to any distributions at fair market value of trade of business properties, such as factory buildings and warehouses. Consequently, the final recommendation now covers both capital assets and trade or business properties.

8. Distribution after termination of election

Distributions subsequent to the termination of a subchapter S election would first be treated as distributions of previous income, to the extent thereof, until the later of the following dates:

a. one year after the effective date of termination, or

b. 120 days following the date of a determination that the corporation's subchapter S election had terminated for a previous year. Essentially, a determination would be defined as a court decision which becomes final, a closing agreement, or an agreement between the corporation and the IRS that the corporation failed to qualify.

Distributions following a termination resulting from a revocation of an election would be subject to the previous income treatment described above only for the one-year period following the effective date of the termination.

I. Maximum Tax and Qualified Pension, Etc., Plans

In the absence of other provisions, the elimination of the passive income test under these recommendations would, in some circumstances, make it very advantageous for an individual to incorporate his investments and have the corporation pay the individual a salary for managing the investments. If the salary constitutes reasonable compensation for services rendered, the salary could qualify as earned income for purposes of the maximum tax and could serve as a base for contributions to a qualified plan.

These results are not obtainable through use of a partnership or proprietorship. First, the rules relating to what is reasonable compensation for self-employed individuals require that such compensation be reduced for passive income elements. Second, in computing the contribution base of a sole proprietor or partner, only amounts constituting earned income are taken into account. Finally, the management of investments would not constitute a trade or business so as to justify the characterization of a proprietor's salary as compensation. See *Higgins* v. *Commissioner*, 312 U.S. 212 (1941). No comparable rules are applicable to the compensation of shareholder-employees of corporations (including shareholder-employees of subchapter S corporations).

Under the staff recommendations, although no new restrictions of general applicability would be imposed on the eligibility of compensation of shareholder-employees of subchapter S corporations for maximum tax and pension contribution purposes, restrictions would be imposed where the corporation has passive income in excess of that permitted under existing law for a subchapter S corporation. Thus, in general, if more than 20 percent of the gross receipts of a corporation is passive investment income for a taxable year, the amount of the shareholder's compensation (otherwise treated as reasonable compensation) would be reduced by a fraction, the numerator of which is the corporation's passive investment income and the denominator of which is the corporation's gross receipts. These restrictions would not apply in cases where the passive income is less than $3,000 and it is the first or second taxable year in which the corporation commenced the active conduct of a trade or business. (In such a situation, a subchapter S election is not terminated under present law, sec. 1372(e)(5)(B).) Also, if a corporation would not be a personal holding company by reason of section 542(c), it would not be subject to the passive investment income limitations.

J. Fringe Benefits

The elimination of the passive income limitation also provides an opportunity to use passive investment income to support the provision of favorable tax treatment accorded certain corporate fringe benefits. The changes described below are recommended to prevent the allowance of favorable tax treatment to certain fringe benefits provided to shareholder employees by certain subchapter S corporations with excessive passive investment income.

Certain corporate statutory fringe benefits would not be available to more than 5-percent shareholder-employees of an electing corporation for a taxable year if more than 20 percent of the gross receipts of the corporation for the taxable year constitute passive investment income unless one of the exceptions in section 542(c) or 1372(e)(5)(B) applies.

The corporate statutory fringe benefits which would not be available to shareholder-employees of certain electing corporations are as follows:

1. the $5,000 death benefits exclusion (sec. 101(b)),
2. the exclusion from income for amounts paid from an accident and health plan (secs. 105 (b), (c), and (d)),
3. the exclusion from income for amounts paid by an employer to an accident and health plan (sec. 106),
4. the exclusion of the cost of up to $50,000 of group-term life insurance on an employee's life (sec. 79), and
5. the exclusion from income of meals or lodging furnished for the convenience of the employer (sec. 119).

APPENDIX

Treasury Staff Comments on the Subchapter S Proposal by the Staff of the Joint Committee on Taxation

One class of stock requirement

Section 1371(a)(4) now bars a subchapter S corporation from having more than one class of stock. This statutory requirement has been effectively modified by a series of cases that have allowed a subchapter S corporation to retain its status when certain debt instruments of the corporation were recharacterized as equity. As a result of the judicial reluctance to disqualify subchapter S corporations because of the one class requirement, the status of a subchapter S corporation that issues a second type of instrument is unclear.

Although the Joint Committee Staff has recommended no statutory change in this regard, we think that under the present state of the law a change is necessary. A rational regulatory scheme under section 385 should apply the debt/equity classification throughout the Code, including the status of securities issued by subchapter S corporations. But, as the case law suggests, the loss of subchapter S qualification is often a harsh result when a corporation issues nominal debt that is treated as equity under section 385. It is a result that flows from the current subchapter S requirement of section 1371(a)(4); it should not be a classification problem under section 385. Therefore, the problem should not be solved by overriding the rules of section 385. Rather, the solution is to change the subchapter S qualification requirements directly by amending the statute to allow a second class of stock with delineated characteristics.

A necessary component of introducing a second class of stock into subchapter S is the income tax treatment of the holders of these instruments and the holders of common stock. The cases that have allowed another "equity" participation in subchapter S have not addressed this issue. Therefore, even if there were room under current law to find that certain types of equity do not constitute a "second class of stock," legislation would still be needed to allocate income rationally. Moreover, allowing a second class of stock should not increase the opportunity to shift income among shareholders.

We suggest below possible requirements for a permissible second class of subchapter S stock. Thereafter, we recommend an approach to income allocation. Although our recommended treatment of a second-class shareholder may be analogized to the treatment of a bondholder under subchapter C, the analogy is only that, and is not complete. We have not felt constrained by either subchapter C or section 385 classifications in developing our rule, just as the treatment of common shareholders under subchapter S is unique in the Code.

Section 1371(a)(4) would be changed to allow both common stock and "preferred securities." A preferred security could not be convertible into common stock. It could be cumulative. It must bear a fixed, reasonable rate of return neither dependent upon the discretion of the corporation's board of directors nor measured by a percentage of profits. If payment is contingent upon earnings, it must be payable when earned. The holder of a preferred security must be eligible to be a subchapter S shareholder and must consent to the election. Consenting preferred security holders will be counted in determining the number of shareholders for qualification purposes.

If a security that does not meet the requirements of a preferred security is classified as debt under section 385, it will be treated as debt; if it is classified as preferred stock, it will be treated as an impermissible class of stock and the corporation will lose its subchapter S status. Section 385 will determine whether the security is debt or equity for treatment under subchapter C or subchapter S. Whether the existence of preferred stock leads to disqualification will be determined by the subchapter S statute, and not by section 385.

The income taxation of a preferred security holder would also be governed exclusively by subchapter S. Both the holder and the corporation must be on an accrual basis with respect to the rate of return payable on the securities: our intention is that taxation would not depend upon distributions if the security holder had a right to income in that year. For example, assume that the security entitled the holder to 10% of face value per year, payable only out of profits with cumulative rights; assume also that the corporation had no earnings in year 1 and earnings in year 2. The holder would not be taxed in year 1, but would be taxed in year 2 on the amount payable to him with respect to years 1 and 2, regardless of whether it was actually paid in year 2. However, if a distribution were paid to the preferred holders before it was earned, the holders would be taxed in the year of distribution.

The rate of return will be taxed as ordinary income to the holder, and will be a deduction to the corporation, provided that the deduction does not create a loss. Any allowable deductions will be passed through to the common shareholders under the normal conduit scheme. Excess deductions (those that would create a loss) that are actually paid cannot be carried over to another year; they are deemed to be attributable to capital of the common shareholders. Excess deductions that are not actually paid may be carried over.

The basis of a preferred security that is held by a common shareholder will be added to the shareholder's bases in his stock and debt in determining how much he may deduct of his allocated amount of the corporation's losses.

A return of capital to the preferred holders will reduce their basis and will not be deductible by the corporation.

This approach tries to provide a safe harbor rule for subchapter S qualification purposes without undue complexity. Because the forced accrual tax treatment of a preferred security holder will differ from the treatment of a bondholder or a preferred shareholder, there is a cost for the certainty that the corporation will be treated as a subchapter S corporation. But we have tried to direct that cost at borderline preferred stock cases without interfering with legitimate borrowing by the corporation. For example, if the subchapter S corporation were to borrow from a bank, the loan instrument could not be a preferred security because the bank is not an eligible shareholder, even if the terms of the debt would otherwise qualify it. Nonetheless, since the debt would be treated as debt under section 385, the subchapter S corporation would not lose its qualification. On the other hand, if the corporation borrowed from an individual on such terms that the debt might be stock, the creditor could consent to be taxed as a preferred security holder (assuming that the other qualifications are met) to assure subchapter S treatment to the corporation. If the creditor does not consent, then the corporation would have to decide whether to take the risk that the debt will be classified a stock, a result that would disqualify the corporation.

Likewise, we have tried to make the safe harbor unavailable for situations that are clearly impermissible now. If a subchapter S corporation borrows from a corporation on terms that would classify the debt as equity, the safe harbor rule is inapplicable because the lender is not an eligible shareholder.

Permitted number of shareholders

The Joint Committee Staff has proposed that the number of permitted shareholders in a subchapter S corporation be increased to 25 shareholders.

Because subchapter S corporations will be treated as almost total conduits under the Staff's proposal, adjustments of specific tax items relating to the corporation will generally affect all shareholders. A mechanism should be provided to avoid multiple proceedings on the same tax issue. Therefore, we think that the increase in the number of shareholders should be coupled with a change in the audit provisions governing subchapter S corporations similar to a partnership audit proposal now being developed. Specifically, we believe that an audit of the corporation should result in binding determinations of the tax attributes that flow from the corporation, which the shareholders would be required to follow.

Selection of taxable year

The Staff presents a transitional rule which would allow an existing subchapter S corporation to retain its present taxable year as long as 50 percent of the outstanding stock in the corporation does not change hands after the date of enactment. The Staff would exempt transfers at death from this rule, thereby effectively granting a permanent exemption from the taxable year rules for many corporations. We believe that the transitional rule would be more reasonable if a transfer at death were counted as a change of ownership.

In addition, we believe that the taxable year of the corporation should close with respect to a deceased shareholder on the date of his death, as well as with respect to a shareholder who sells all his shares. Our recommendation departs from the partnership rule under which the partnership year does not close with respect to a partner because of death. The partnership rule now often shifts a deceased partner's partnership income for the year of his death from his final return to his estate's return. As a result, carryover partnership losses that the deceased partner may have had are wasted; current partnership losses cannot be used to offset the decedent's other income; and partnership income is taxed at estate income tax rates, which are less favorable than individual rates. On the other hand, for partners with non-partnership income, the partnership rule allows income to be split between two taxpayers.

By closing the corporation's taxable year with respect to a decedent, all income and deductions from the corporation through the date of death would be reported in the decedent's final return. Income and deductions from the date of death to the end of the corporation's taxable year would be reported by the deceased shareholder's successor in interest. This would minimize the income and deductions from the corporation that would be treated as income or deductions in respect of a decedent.

Losses of corporations with earnings and profits

The Staff has proposed that losses be allowed to subchapter S shareholders to the extent of the bases in their shares and their loans to the corporation. Even when a corporation has accumulated earnings and profits, losses would be deductible to the shareholders to the extent of their bases; bases would have to be depleted completely before the losses would be treated as a nondeductible erosion of accumulated earnings and profits.

Tracing the sources from which a loss is sustained, like tracing distributions, is somewhat arbitrary. Under the Staff's proposal, however, distributions are deemed to be made first from the net amount of income previously passed through to the shareholders and then from accumulated earnings and profits before the shareholders' remaining stock bases are touched. We believe that the same ordering principle, once applied to distributions, is equally pertinent to losses. The underlying assumption in both situations is that original capital is the last layer of funding to be depleted, either by losses or by distributions.

Accordingly, we propose that when a corporation with accumulated earnings and profits experiences a loss, the loss would exhaust net income passed through to shareholders, accumulated earnings and profits, and the shareholders' remaining bases in stock and debt, in that order. To the extent that the losses are treated as depleting earnings and profits, the losses would not be deductible to the shareholders, since the earnings and profits had not previously been taxed to the shareholders.

Redemption of debt

Under the Staff's proposal, losses in excess of the basis of a shareholder's stock will reduce the basis of any loans he has made to the corporation. On the other hand, income allocated to the shareholder is deemed to restore the basis of his debt before that of his stock. However, if the basis of debt remains reduced because of losses taken in subchapter S years, and the corporation later loses its subchapter S status, redemption of the debt will convert ordinary losses into capital gain.

To prevent this conversion, we believe that ordinary income treatment is appropriate for gain on the disposition of debt, the basis of which has been reduced by subchapter S losses. Specifically, we propose that if the basis of debt reflects a reduction by virtue of subchapter S losses, then gain on sale, redemption or other disposition of the debt, which would otherwise be treated as capital gain, would be treated as ordinary income to the extent of the lesser of (i) the amount of reduction reflected in the shareholder's basis for debt, or (ii) the earnings and profits of the corporation at the time of redemption, sale or disposition. The recapture rule would not apply if the disposition of debt resulted in a complete termination of interest in the corporation.

This aspect of debt treatment was part of the Treasury's subchapter S proposal in 1968, and had been approved by the American Bar Association at that time. We see no reason to abandon a proposal that has been carefully considered and accepted.

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